

ASSESSMENT AND RECOMMENDATIONS

The economy is gradually picking up pace...

The Swedish economy has now started to recover from the relatively brief but sharp slowdown in 2001 in which growth decelerated to 1¼ per cent. The main factors behind the weakening were the slowdown of global demand in general and for telecommunication goods and services in particular, together with waning consumer confidence, prompted by the unwinding of the stock market bubble. These elements aside, macroeconomic conditions generally remained buoyant, thanks to sizeable gains in household disposable income, low interest rates, moderately increasing house prices and a weak exchange rate. Combined with the turnaround in consumer sentiment and world trade around the beginning of the year, these factors have elicited a pick-up in consumption and exports, while investment remained subdued early this year. Sweden is entering the incipient upturn in a generally healthy condition, albeit with underlying inflation well above the target rate of 2 per cent, and with robust surpluses on the government and current accounts, although private saving is relatively low.

... and enters the upturn with relatively little spare capacity

Despite the 2001 slowdown, capacity utilisation is fairly high in some non-manufacturing sectors, and the labour market remains quite tight. However, the slowdown was absorbed mainly by weaker productivity growth, which suggests that employment gains may be modest in the early phase of the upturn. At 4 per cent, unemployment is currently below the OECD's estimate of its structural level and wage inflation has picked up somewhat to above 4 per cent per year. The profit share continues to decline and is now lower than at its previous trough in 1990, suggesting that more vigorous productivity growth or lower wage inflation will be needed in order to sustainably align the increases in the business sector's costs and revenues.

The outlook requires a tighter policy stance...

Output is projected to rise by around 2 per cent this year, while in 2003 growth could accelerate to 3¼ per cent, assuming broadly unchanged fiscal policy for that year. The implied return to growth rates above the estimated potential rate of 2¼ to 2½ per cent would eliminate the current small output gap by around the middle of next year. As productivity levels are restored, employment is expected to gradually pick up as from the second half of this year, while unemployment is projected to remain almost unchanged. Wage increases are expected to remain relatively high, at around 4½ per cent, and inflation is likely to remain above the 2 per cent target over the projection period, even though the Riksbank is assumed to raise interest rates gradually, to 5¼ per cent by the middle of next year. The risks to the outlook are balanced. Upside risks to activity could result from a less marked increase in the household saving rate or an extension of the expansionary fiscal stance to 2003. Downside risks to activity could materialise if the current weakness in external demand for telecommunications equipment persists. Furthermore, considerable uncertainty surrounds the assessment of the duration of the dis-investment cycle, which may last longer than assumed.

... given persistent upward pressure on inflation

The acceleration of inflation to beyond the Riksbank's tolerance band around the 2 per cent target put the inflation-targeting monetary policy regime to the test, and the Riksbank raised interest rates by $\frac{1}{4}$ percentage point in March and by the same amount again in April. Unlike other central banks, the Riksbank maintained the repo rate virtually unchanged throughout the downturn and has appropriately embarked on a tightening course earlier. As a result, Sweden has entered the current recovery with higher short-term interest rates than in the euro area and the United States, in contrast with the situation in early 2001 when such differentials were negative. Nevertheless, given the current inflation rates and the prospect of growth returning to above potential rates, interest rates will need to rise further. On current information and the OECD's projections, something like a 1 percentage point hike over the next year would be required, but if fiscal easing continued in 2003 a sharper rise would be necessary to keep inflation within the target range.

The possibility of joining the euro is being actively considered

Debate on the option of Sweden adopting the euro has flourished of late, as sentiment has become more favourable and the government has signalled a possible referendum in 2003. The focus of the debate has been on comparing the role and effectiveness of stabilisation policy inside and outside the Economic and Monetary Union (EMU). As a full member, it would clearly be more difficult to counter asymmetric shocks through active stabilisation policy in the absence of an independent monetary policy. On the other hand, the greater effective exchange rate stability that would result from joining the EMU would significantly reduce one potential source of such shocks. Moreover, adhering strictly to the present objective of maintaining a general government surplus of 2 per cent of GDP over the cycle would seem to provide considerable room for a fiscal policy response should that be deemed warranted.

Fiscal policy is highly expansionary due to tax cuts...

Further fiscal stimulus amounting to around $1\frac{3}{4}$ per cent of GDP has been provided in 2002, according to official estimates. A significant part of the fiscal easing that has occurred over the last three years has been in the form of reduced income tax rates, but tax concessions implemented this year also include measures with no supply-side benefits, such as reduced property taxation, lower VAT on books and magazines, and reinstatement of deductibility of union membership fees. A political decision to implement in 2003 the fourth and final step of the tax-cut programme initiated in 2000 has not yet been taken. Such a move would be warranted for its beneficial structural effects and could be undertaken without unduly jeopardising public finances as even now the structural surplus is estimated to be around $2\frac{1}{2}$ per cent of GDP, but the current high inflation rates suggest that adding further fuel to the current macroeconomic expansion would be rather unhelpful. Any eventual tax cuts should be accompanied by offsetting savings on the expenditure side.

... and discretionary spending increases, which add strain on the expenditure ceiling

The expansionary stance of fiscal policy has increasingly spread to public spending as the central government has taken a number of discretionary measures, including increasing grants to local governments for education and care. Introducing a cap on user charges in elderly and childcare will boost public expenditure by a further $\frac{1}{4}$ percentage point of GDP in 2002. Another factor is that income taxes dominate local government revenue and their

cyclical nature tends to spill over to spending behaviour. This pro-cyclical effect needs to be addressed: one approach might involve smoothing the tax base over the cycle; another could be counter-cyclical adjustment of the block grants to lower levels of government. In any case, the most immediate challenge for fiscal policy is to safeguard the central government's expenditure ceiling, which is under increasing strain as the budget margins have disappeared. The government has adopted measures such as tax expenditures, not only *ex post* to cover up for negative surprises, but also to make room for new discretionary spending that would otherwise not be possible under the ceiling.

Spending decisions need to be better embedded in a comprehensive framework

In the medium term, the expenditure ceiling needs to be fully integrated into the new accruals-based budget framework as well as to be made more robust by re-establishing reasonable minimum safety margins. Stricter budget constraints could be imposed on operating expenses and non-entitlement transfers for the three-year projection horizon, as the expenditure is fully within the government's control and adjustments can be made rapidly if necessary. Entitlement expenditures may require a more complex approach, above all to avoid the situation where savings in these transfers due to cyclical developments are absorbed by other programmes. As well as keeping within the overall expenditure total, trade-offs and priorities amongst expenditure categories also need to be more explicitly addressed, while the net benefits associated with spending programmes should be systematically assessed against the alternative of lowering taxes instead.

Accountability for public programmes needs strengthening

Efforts are needed to ensure that taxpayers' money is spent more efficiently. Central government activities are generally carried out by state agencies under rather weak governance arrangements. Although these institutions fit logically within a long-established structure for the organisation of government affairs, recent trends in public sector management towards greater operational freedom have actually weakened effective control. More rigorous accountability for outcomes is required, in particular by linking employment contracts for agency heads to delivery of results and by developing more specific performance criteria. Both would require more effective monitoring and control systems.

Education outcomes need to be achieved more efficiently

Although many reforms to public services have been made since the budgetary crisis in the early 1990s, further reforms are needed both to improve the remaining weak spots and to continue pursuing performance enhancement and greater efficiency across the board. One area meriting attention is the education system, which delivers above average outcomes but at a high cost. Consideration could usefully be given in particular to the following:

- Identifying ways of reducing the number of years taken to obtain basic qualifications, *inter alia* by raising classroom productivity and increasing the number of classroom hours per year. Devoting additional time to core subjects, especially mathematics and science might also help to improve standards and meet the government's stated goals in these areas.
- Instituting more systematic testing and evaluation of school performance so that parents and taxpayers can objectively

compare different schools as well as monitor performance of the system as a whole through time.

- Obtaining substantial gains in resource use by shortening the somewhat circuitous route to and through tertiary studies. This could be done by tailoring the entry process to course requirements, as well as requiring students to meet some of the costs in tuition fees and further limiting the duration of financial assistance to encourage students to choose courses carefully and complete their studies within a reasonable period.

Funding in the health sector needs to be weighed against other priorities

Significant productivity gains have been made in health care, in part because of greater use of internal and external markets. Comprehensive evaluation of this experience would help to identify the scope for additional use of private sector alternatives in this sector. Nevertheless, there are some public perceptions that waiting periods for health care are too long and that the sector is under-funded, although it is difficult to find concrete and reliable evidence of this. At the same time, the increasing proportion of elderly in coming years will put resources under pressure. In any case, additional public funding allocated to this sector will need to be weighed against the costs and benefits of meeting other public priorities instead, especially given the well-established tendency towards ever-increasing demand for health services when the patient bears virtually none of the costs. Increasing the well-designed yet currently modest user charges for health care might be an alternative way of closing a perceived gap between supply and demand, but more analytical work would be needed to fully assess the consequences.

Costs as well as benefits of social choices should be clearly spelt out and erosion of labour supply avoided

Another area where costs and benefits should be considered carefully is in support to families. As a matter of social choice, Sweden has one of the more generous arrangements for paid parental leave in the OECD and provides benefits which are designed to even out the impact of children on household costs. This is an example of public policy where value judgements are important, but it is incumbent on decision makers to inform the public as to the economic consequences of the policies followed and in particular the cost of raising the associated tax revenue. It is not clear that this has been done in the recent decision to extend parental leave. Paid parental leave can promote labour market attachment and gender equity up to a point, but prolonged leave, as well as having fiscal consequences, can lead to skills loss and lower labour supply. Policies should be focussed on further expanding the labour supply in the medium term, since this will be a critical element in permitting Sweden to maintain the highest possible living standards in the face of rising dependency ratios. The proposed individual learning accounts are another example of a policy that would take people away from their work, in this case for what may be uncertain economic returns on the additional investment in their human capital.

Sickness and disability schemes need to refocus on getting people back to work

Increasing the proportion of people in the workforce requires above all addressing the extent to which the sickness and disability schemes are still being used as an early retirement option. Generous benefits and weak controls on access, despite successive efforts to tighten up, have provided a strong incentive for some people to seek state support on medical grounds that are difficult to verify. The schemes need to be restructured to ensure that those

who genuinely need assistance and are unable to support themselves continue to enjoy a decent standard of living, while those who are primarily taking advantage of the system are correctly identified and required to support themselves by returning to work. In practice, this will require a multi-pronged strategy along the following lines:

- Requiring employers to take greater financial responsibility for sickness over a longer period.
- Limiting the duration of sickness benefits, while also establishing more effective rehabilitation measures.
- Tightening eligibility for disability compensation, setting clear national criteria governing the transition from sickness to disability and granting disability entitlement for a fixed, but renewable, period.
- Scaling back the relative attractiveness of a disability pension compared with work, which arises from housing allowances, special tax treatment and the payment of national pension contributions on behalf of recipients as well as the direct income replacement.

Tax reforms should concentrate on reducing high marginal effective tax rates in order to boost work incentives

The discouraging effects of high effective marginal tax rates are becoming more manifest, and recorded average hours worked in Sweden now appear to be falling again, although it is less clear that less work is actually being undertaken. Instead, formal activity is sometimes less attractive financially than “do-it-yourself” or contracting services within the “black economy” in order to escape the tax net. The government’s tax reform programme has already significantly reduced average and marginal tax rates for many, if not all, households. Looking beyond the completion of the current four-year programme, priorities for tax reform should concentrate on further reducing the highest marginal effective tax rates on labour, and it should be possible to design a revenue-neutral package of measures to achieve this. It could include:

- converting the present basic allowance into a tax credit, or an initial zero rate bracket;
- eliminating the second step of the state income tax and either reducing the rate for remaining state tax payers or raising the threshold further so that fewer people pay the tax;
- reducing the particularly negative impact of the income-tested element of housing supplements;
- raising the average effective VAT rate by applying the standard rate to a wider range of goods and services. Regrettably, the government’s decision to lower the VAT rate on books and periodicals goes in the opposite direction;

- shifting more of the tax burden from earned income to real property, which is currently taxed well below the OECD average and where there are clear economic grounds for a higher share of the taxation burden.

Housing policy needs reform, most urgently by liberalising rent regulation

The housing sector presents a number of challenges to policy makers. Rent setting remains *de facto* highly regulated, discouraging private investors, and municipal housing companies have largely stopped constructing new dwellings. At the same time, a remarkable dichotomy prevails, whereby some regions have high vacancy rates and increasing rates of demolition, while there is rapidly increasing housing demand in high-growth regions, notably around the three big metropolitan areas. It is disturbing that surging house prices in the latter regions have not prompted any significant increase in construction activity, which generates two concerns. *First*, upward pressure on house prices is likely to persist as long as the supply response does not match the increase in demand. In the worst case, this might lead to an asset-price bubble, which could subsequently be painful to unwind. *Second*, the low construction rates are likely to restrain activity, reduce labour mobility and unnecessarily lock in disparities in unemployment rates across regions. There are a number of options for reform that could counter these risks.

- As a first step, a liberalisation of the rent regulation is urgently needed. In any case, the equity-based arguments normally adduced in support of rent regulation appear weak. The allocation of cheap rental accommodation in attractive areas tends to resemble a lottery; the benefits are not particularly concentrated on low-income groups; and the objectives are compromised by spreading subletting and black-market activities.
- Efforts to reduce the rate of cost increases in the construction sector should also be pursued, including initiatives to bolster competition and facilitate greater mobility among construction workers.
- Finally, the apparent lack of suitable sites for development should be addressed. Weaknesses in the planning process should be identified and dealt with. Instituting local property taxes might be one way to strengthen the currently relatively weak incentives on local administrations to supply suitable land sites.

Summing up

Sweden's economic performance has remained robust despite the slowdown last year and its prospects are bright. Macroeconomic policies may need to adjust as the economy picks up, while structural reforms are needed to assure better medium-term growth prospects. However, the momentum of structural reform has slackened and further progress is needed across a wide range of policy areas to maintain growth in living standards and to meet the costs of a generous social welfare system and coming demographic challenges. In particular, there are various aspects of the labour market where problems need to be addressed. In the short term, the tight labour market and inflation persistently above the Riksbank's target will require further monetary

tightening. To achieve an appropriate level of aggregate demand, fiscal stimulus should be avoided next year and planned income tax cuts should be offset by other measures. Central government expenditures need to be scaled back to provide credible margins within the ceilings. The framework for budgeting could be made more robust and expenditure priorities made more explicit, with the benefits systematically compared with the alternative of reducing taxes. Rigorous evaluation of performance in each area of public service would also help to promote efficiency and identify low-return programmes. More effort could be devoted to reducing unhelpful disincentives to work, most notably in the sickness and disability schemes and in the high marginal effective tax rates on labour. Room could be created to reduce income taxes further by raising the effective VAT rate and increasing real estate taxes. Liberalising the housing sector so that a better balance between supply and demand can be achieved would also be beneficial. Overall, the economy is performing well, but the medium-term outlook would be enhanced markedly by taking further structural measures.