



## Economic Survey of Sweden, 2008

**How can higher living standards be attained?**

**How deep will the economic downturn be?**

**What targets should guide fiscal policy?**

**Could tax reform boost growth?**

**Could education reforms improve youth employment outcomes?**

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### Summary

Thanks to strong economic institutions and fundamentals, Sweden is well prepared to cope with fall-out from the global financial crisis. The cycle has turned and, clearly, the key near-term challenge is to steer through the slowdown without jeopardising longer-run macroeconomic stability.

With sound structural reforms, material living standards have risen strongly in Sweden over the past 10 to 15 years. Market opening has boosted productivity growth, and recent reforms have curbed labour market exclusion and benefit dependency. The relative decline of previous decades is gradually being reversed. This *Survey* focuses on how to further promote economic growth while preserving social cohesion and examines the following policy challenges:

**Keeping fiscal policy on a sustainable track and continuing tax reforms to promote growth.** The ample fiscal surplus and relatively low public debt allow for some policy easing, but the fiscal framework should be strengthened by linking targets more clearly to long-term considerations. Sweden used to have the highest tax-to-GDP ratio in the OECD but has started to move down the list. The challenge now is to continue with tax cuts, focusing on the worst impediments to growth resulting from corporate and personal income taxation – with due regard to equity concerns.

**Improving education and employment outcomes for youth.** Despite a high overall employment-to-population ratio, youth unemployment is widespread. One reason is that with a high wage floor and stringent employment protection rules, strong skills are required to get a regular job. The quality of compulsory school can be improved, especially regarding

*This Policy Brief presents the assessment and recommendations of the 2008 OECD Economic Survey of Sweden. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.*

mathematics and science. Upper secondary education could make youth more “job ready”, notably *via* more work-place contact. Students should complete higher education and enter the labour market earlier. Universities could benefit from more freedom to develop, possibly based on tuition charging. But in the end, disproportionate youth unemployment can probably only be overcome if also addressing the core labour market rigidities.

**Taking privatisation further.** Starting with a large portfolio of government-owned enterprises, it was easy to identify a list of first candidates for sale. Going forward, privatisation will have to be taken further in those numerous areas where societal objectives are better served by open but regulated markets rather than by public ownership. ■

### How can higher living standards be attained?

With an active, forward-looking approach to economic reform, Sweden has enjoyed considerable international attention in recent years. Around 1970, Swedish GDP per capita was less than 10% below that of the United States, but following the deep crisis in the early 1990s the gap had widened to nearly 25%. Sweden has since started to catch up as market-oriented reforms boosted productivity growth and, most recently, reforms to promote the attractiveness of work have reduced the share of adults living on income benefits. This Survey focuses on how Sweden can continue to catch up via better policies to promote economic growth. Pursuing a growth-oriented reform agenda can help with social cohesion: a growing tax base would ease pressures on public finances and measures in education and labour markets could promote more equal employment outcomes and equality of opportunity.

Specifically, the following key challenges are reviewed in this Survey:

- *Long-term fiscal sustainability and a growth-oriented tax system.* A sound fiscal position has been achieved through consistent consolidation efforts since the crisis of the early 1990s. Now it must be sustained: the fiscal framework should be strengthened with targets more clearly derived from long-term considerations. Building on the recent tax cuts, further reforms could boost growth. In this process, exemptions serving special interests must be avoided.
- *Education policies and employment outcomes for youth.* Despite a high overall employment-to-population ratio, youth continue to face problems on the Swedish labour market. Both the education system and labour market institutions need attention.
- *Privatisation and competition.* Reducing the scope of public ownership, which currently reaches into a wide range of business sectors, will benefit the Swedish economy. Going forward, it will be important to combine privatisation with reforms to ensure effective competition which should enhance welfare. ■

### How deep will the economic downturn be?

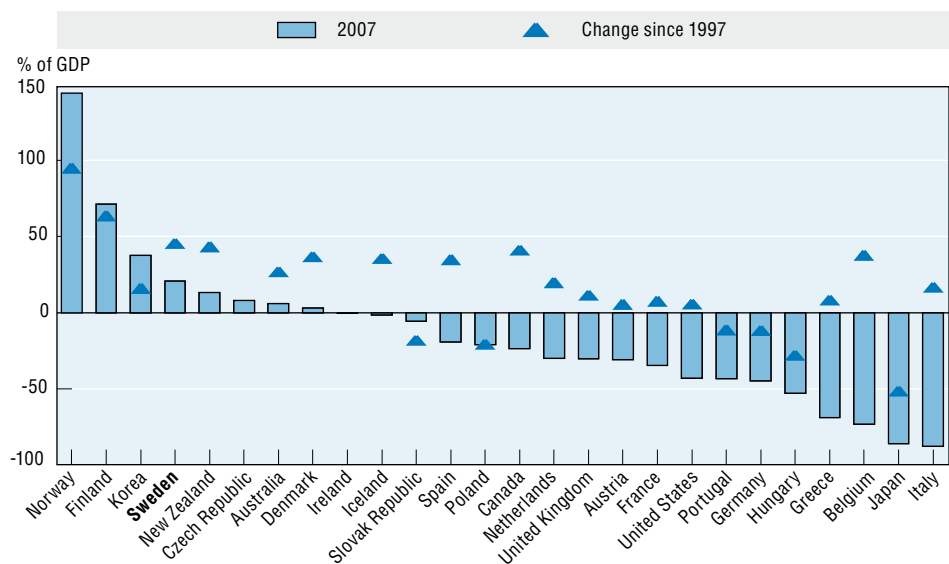
The key near-term economic challenge will be to cope with the fall-out from the financial crisis. Growth has stalled since the start of 2008 due to weak consumption and exports, with consumers facing higher interest rates and food and energy prices, slowing house prices and a weakening labour market. Export growth is likely to remain subdued, given the slowdown in key trading partners. Businesses are likely to cut back investment. As a result of weaker demand, considerable margins of slack are set to emerge. Ultimately, the slowdown could be even stronger if large write-downs of Swedish banks' Baltic assets were to undermine balance sheets, restricting credit in Sweden.

**How should macroeconomic policies respond?**

On the fiscal side, strong automatic stabilisers will provide a substantial cyclical cushion. In addition, the government has announced a number of measures to be included in the 2009 Budget, implying a reduction of the cyclically-adjusted surplus by almost 1% of GDP next year. This has to be seen in the context of the large surpluses recorded in recent years, with government net lending reaching 3½ per cent of GDP in 2007 – far above the targeted 1%. The cyclically-adjusted budget balance is set to remain above 1% of GDP in 2009, even after the planned loosening. Accordingly, the longer-term soundness of public finances would not be undermined. However, suggestions for further discretionary measures should be weighed against the fact that fiscal balances often worsen more during downturns than anticipated using standard cyclical-adjustment techniques.

Over the summer, inflation reached levels last seen in the early 1990s, at over 4%, driven by high fuel and energy prices. In addition, mortgage interest costs for owner-occupied dwellings increased rapidly since mid-2006, directly pushing up CPI inflation. At the same time, inflation expectations rose, including at longer horizons, leading the Riksbank to hike the repo rate to 4¾ per cent by September. With the intensification of the financial crisis, the outlook for growth has weakened and inflation risks have diminished, leading a number of OECD central banks, including the Riksbank, to cut interest rates in early October. The repo rate was cut again to 3¾ per cent in late October, but even further easing may be warranted in the coming quarters. ■

**Figure 1.**  
**GOVERNMENT NET FINANCIAL ASSETS**  
 Sweden's fiscal position has improved more than most OECD countries



Note: General government net financial assets are financial assets less liabilities (usually debt). It is the negative of net financial liabilities or net debt.

Source: OECD, Analytical database.

### What targets should guide fiscal policy?

Sweden's strong fiscal performance has been achieved via a policy framework that has helped contain spending and reduce debt, involving net lending targets, expenditure ceilings and balanced-budget requirements for local governments. The general government net financial position has improved from net debt of over 25% of GDP in the mid-1990s to net assets of 20% of GDP by 2007. Moreover, thanks to the pension reform of the late 1990s, Sweden is better prepared for ageing than most OECD countries.

To ensure that sound public finances are sustained over the longer term, the surplus target should be refined and set on the basis of foreseeable long-term fiscal developments as well as the need to retain scope for fiscal action in the event of serious cyclical downturns. Ensuring sustainability should be emphasised as the central goal, meaning that policies can remain unchanged without the need for higher taxes and without leading to rising debt that could ultimately push up interest rates and cause macroeconomic as well as financial market instability. Sustainable public finances are also a precondition for an equitable distribution of resources between generations. A careful analysis of the government's balance sheet, detailed long-run projections of spending, plus fiscal sustainability and intergenerational equity assessments should be used to underpin the fiscal targets. The targets could be set based on assumptions and methodologies audited by the Fiscal Policy Council. The government has begun work on a review of the fiscal framework in order to strengthen it and safeguard the sustainability of the public finances.

Dealing with long-run fiscal pressures will require a multi-faceted approach. Current policies rely on pre-funding and increased labour supply to boost tax revenues and reduce spending on income benefits. A measure of pre-funding is appropriate, particularly in the income pension system where surpluses reflect an excess of contributors over beneficiaries – a situation that will reverse in the not-too-distant future. But other approaches will also be needed, in particular to meet demands for higher service standards, for which pre-funding would not be appropriate. Moderating spending growth should therefore be a consistent policy focus, including measures to raise efficiency via user choice and contestability. Also, some of today's publicly-funded services could be paid for privately. ■

### Could tax reform boost growth?

In recent years, Sweden has implemented ambitious tax cuts aimed at boosting growth: it used to have the highest tax-to-GDP ratio in the OECD, but it is now starting to edge down the list. This process should continue, in parallel with spending restraint. The recent OECD *Tax and Growth* study found corporate income taxes to be the most distortive, followed by personal income taxes and then consumption taxes, with housing taxes being the least inimical to growth. Against this background, the envisaged reduction in the corporate tax rate from 28% to 26.3% in 2009 is sensible.

Continued gradual reductions of corporate income taxes and the recent abolition of wealth taxes improve Sweden's attractiveness in the context of growing capital mobility. By contrast, lower employer contributions for small and medium-sized companies, as sometimes discussed, risk impeding their growth and would distort competition.

Further reforms are needed as regards personal income taxation. The total marginal tax wedge (contributions, income and consumption taxes combined) still rises to 70%, beginning not much above average full-time earnings and affecting a third of the full-time employed. Such a high marginal tax wedge is probably part of the reason why average working hours are short, and it is not conducive to entrepreneurship, human capital formation or retaining and attracting highly-skilled staff from abroad. It is therefore encouraging that raising the income threshold for the state income tax, as proposed in the previous *Survey*, is now being considered. Based on detailed models, it has been estimated that the ensuing dynamic effects in terms of labour supply would be larger than from expanding the in-work tax credit. The case for reducing the state income tax would be even more compelling if the effects on human capital formation and international mobility were taken into account.

As these effects are likely to become more important, it is essential to find pragmatic ways to continue to reduce the state income tax. It brings in revenue of just 1.3% of GDP; even large reductions would be relatively cheap when dynamic effects enlarging the tax base are factored in. Such cuts are often contested as the state income tax is one of the few remaining elements creating progression in the Swedish tax system. However, equity is better served by policies to promote learning outcomes for children of all backgrounds and to widen labour market inclusion than by retaining very high marginal taxes for high-income earners or the wealth tax which was recently abolished. Moreover, there would still be ample redistribution in the form of publicly-funded services like child care available to all and relatively generous social security. A socially acceptable – and efficient – approach could be to further move up the threshold from where the state income tax is paid. At some point, consideration should also be given to reinstating Sweden's well-functioning housing tax of 0.7% of each owner-occupied home's market value, which was replaced by a capped municipal fee in 2007. This would boost redistribution in a growth-friendly way.

### ***What progress on rental housing?***

Given the absence of market-determined rents, rental housing is allocated through queuing, extensive search processes and, in some instances, black market trading. As a consequence, some households may have to wait up to ten years for their preferred accommodation or have to buy property

when they would prefer to rent. It is therefore welcome that recent reform proposals go in the direction recommended in the previous OECD Survey. Letting rents rise where there are queues addresses the most important problem of Swedish rent regulation, namely that rents are not allowed to adjust in response to supply and demand. Yet, the system remains administratively complex. The gradual approach of capping rent increases to 5% annually probably helps broaden support for the reform, even though more rapid adjustment would be desirable to bring efficiency gains forward. Measures to spur competition in the construction sector and ease land planning processes are also required.

### ***What progress on labour market exclusion and benefit dependency?***

The share of working-age adults living from income benefits has fallen considerably in recent years. After hovering around 20-21% in 1997-2005, it fell to 18% in 2007. This is partly thanks to cyclical buoyancy. But, as analysed in the previous Survey, recent benefit reforms and other measures addressing labour-market exclusion should have lasting positive effects in the form of higher participation and lower structural unemployment. Much of the improvement reflects falling sickness absence. For a number of years, sickness absence was by far the highest among OECD countries, with 25 working days lost per full-time equivalent employee in 2004. Since then, administration has been tightened and both sickness absence rates and the inflow into disability benefits have fallen by about a third. Even so, sickness absence and the stock of disability benefit recipients remain among the highest internationally. Further reforms, beyond the July 2008 requirements to be ready to change job-function and ultimately workplace, might therefore be needed. ■

### **Could education reforms improve youth employment outcomes?**

By international standards, educational attainment in Sweden is high. Over 90% of the younger cohorts have completed upper secondary education, a share among the highest in the OECD and above the other Nordic countries. However, youth unemployment is widespread, even if it has declined from 22.8% of the labour force in 2005 to 19.2% in 2007 on the back of buoyant economic growth. In Denmark, Iceland, the Netherlands and Norway, where social preferences are similar, youth unemployment is just a third of the Swedish rate. Unemployment is particularly high among youth with poor schooling and among immigrant youth. This indicates problems both in the education system and in the labour market. An education system that helps children and youth from all backgrounds realise their full potential is vital for continued prosperity and for reducing labour market exclusion among youth and the low skilled – notably in the context of relatively generous income benefits and a narrow wage distribution.

### ***Could compulsory school ensure a stronger start for all?***

Learning outcomes in compulsory education are not as good as they used to be. At age 15, student proficiency measured by PISA is above the OECD average for reading but not for mathematics and science. Moreover, 15-year olds' interest in learning about science, time spent on science-related activities outside school and interest in working with science later in life are well below the OECD average, raising questions about how children's natural curiosity and interest in science can be nurtured. The continued development of tests to better monitor progress during school would help. So would the proposed system for accreditation of teachers, with more weight given to their specific competences when allocating tasks among staff. Once the accreditation scheme is well established, greater wage flexibility could reward the best teachers.

### ***Should upper secondary school prepare students better for the labour-market?***

Upper secondary vocational education needs to better prepare students for work. The introduction of apprenticeships is a promising route, emphasising more hands-on practical learning and perhaps giving immigrant and second-generation youth a better understanding of relations in a Swedish workplace. However, apprenticeships must avoid being so specific that students miss the more general skills they might need to reorient professionally later in life. Independent private upper secondary schools have expanded remarkably fast, with the share of students enrolled rising from 3% to 17% in just ten years. The competition they generate is welcome, not least because it shows where the public system could improve. Lack of scale, for example, may hold back vocational programmes from developing well in public secondary schools. Given the deficiencies of vocational programmes, it could be of interest to analyse the consequences of moving responsibility of upper secondary education from the municipalities to the State. Such an analysis could also look at other levels of schooling. To support choice, there should be more transparency for potential students about the labour market prospects associated with alternative options, for instance by publishing data for employment outcomes of recent school leavers.

### ***What challenges face higher education?***

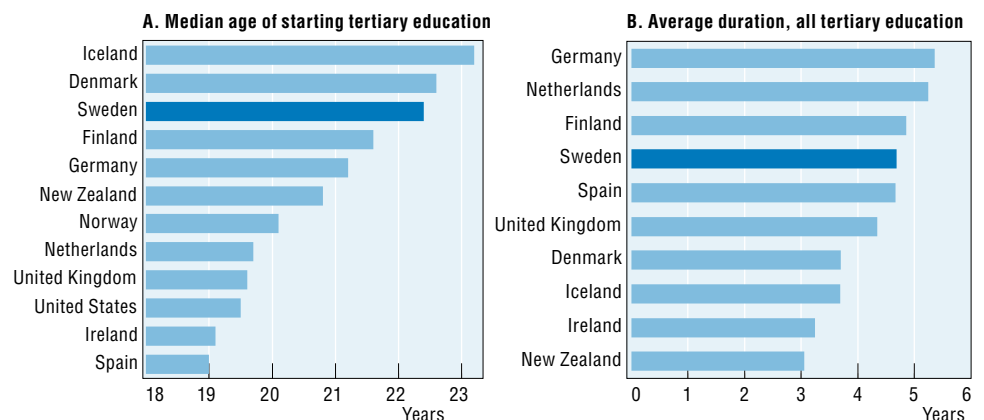
Swedish higher education has a number of strengths. However, a particular weakness of the Swedish system is that students complete higher education late. In order to speed up labour market entry, financial support for students' living costs could be altered with loans replacing grants when studies get prolonged, or with explicit rewards for early entry and completion on time. Quality could be enhanced by basing

the allocation of funding for core research and higher education on more transparent criteria and by giving universities more freedom to develop their own strengths. Relying solely on tax-financing of higher education might be a hindrance in this context. One approach would be to move gradually towards a system where students pay for tuition, while extending government loans available for students in order to finance tuition costs. This is done in a growing number of OECD countries to meet both efficiency and equity objectives, *inter alia* in the light of growing high-skilled mobility. In Sweden, legislation to introduce fees for non-EU students is currently being considered. Reducing the state income tax, as recommended above, would boost the returns to higher education, which are rather low by international standards.

**Are labour market institutions too rigid?**

Shortcomings in the education system cannot alone account for high youth unemployment: Denmark and Norway have PISA scores similar to Sweden’s, but much better youth labour market outcomes. Education reform is needed, but the rigidities in the labour market must also be addressed. High minimum wages and a compressed wage structure make the entrance on the labour market difficult for youth, especially for immigrants and those with incomplete education. Labour demand has been stimulated by a general reduction of the employer contribution for individuals younger than 26. The rebate makes it easier for youth to enter the labour market, but the deadweight costs are presumably large, and its positive effect on youth employment might be offset by demands for higher wages. Active labour market policies are being improved with the Job Guarantee for youth, shifting the focus onto enhancing job-search coaching in the early phase of youth unemployment spells, and reducing the statutory replacement rate after 20 weeks, compared with 40 weeks

**Figure 2.**  
**STUDENTS START**  
**AND COMPLETE TERTIARY**  
**EDUCATION LATE**  
**2006**



Source: OECD, *Education at a Glance 2008*.

for others. Still, benefits are effectively more generous for youth than for prime-age adults as, for example, the ceiling on unemployment benefits is less frequently binding for youth. Dualism in employment protection is of particular concern. The recent extension of the maximum duration of temporary contracts may allow employers to better “try out” young job applicants. However, there is a risk of youth being locked into temporary contracts rather than regular employment. One approach would be to clear the pathways to regular employment by easing the definition of a fair dismissal and lengthening the trial period for regular contracts. The complexity of these issues would call for a review of the broader implications, including with respect to collective wage bargaining. ■

### **Privatisation: what next?**

An important recent achievement has been the progress made in privatising government-owned enterprises. This is warranted, given that the Swedish State’s portfolio of state-owned enterprises is estimated to be worth the equivalent of around one-quarter of the market capitalisation of the Stockholm stock exchange. The scope of the public enterprise sector is among the broadest in the OECD. State ownership of businesses may hold back innovation and entrepreneurship and deter potential entrants. Privatisation should therefore continue – although financial market turmoil may require some transactions to be postponed so as to secure the right price for asset sales. Following on from the current programme (with a bank, a mortgage lender and the incumbent telecom operator yet to be sold under existing parliamentary approval), priority should be given to selling other companies that already operate under market conditions (such as the incumbent airline, other transport companies and forestry companies). Monopoly power should be reduced in some cases, for example in railways and retail, with appropriate regulatory changes to protect consumer welfare. In the case of firms entrusted with special societal interest, there may be other forms of policy intervention that might achieve the same goals without the government needing to own enterprises. As a general rule, asset sale proceeds should not be used to finance new spending or reductions in revenue that would have adverse long-term fiscal implications; rather, they should serve to reduce government debt. ■

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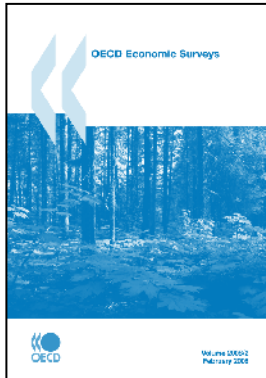
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**Economic Outlook No. 84**, December 2008.

More information about this publication can be found on the OECD's website at [www.oecd.org/eco/Economic\\_Outlook](http://www.oecd.org/eco/Economic_Outlook).

**Economic Policy Reforms: Going for Growth**, 2008 edition.

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