

SNS Economic Policy Group Report 1998



Entrepreneurship in the Welfare State

SUMMARY AND CONCLUSIONS

*Ulf Jakobsson (ed.) • Lars Bergman
Pontus Braunerhjelm • Stefan Fölster • Magnus Henrekson*

SNS Förlag

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Ulf Jakobsson (ed.)
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Preface

The SNS Economic Policy Group (SNS Konjunktur-råd) was established in the early 1970's by SNS – the Swedish Center for Business and Policy Studies – in response to a widespread demand for regular independent assessments of Sweden's economic situation and non-partisan evaluations of Swedish economic policy. The Group's composition varies from year to year, but it always consists of four to five economists of high academic standing. Their reports are meant to be brief, well founded in modern economic research but non-technical in style. They are aimed at a wide readership of politicians, civil servants, business leaders, journalists, academics and economics students.

Over the years more than thirty Swedish – and seven foreign – economists (mainly professors of economics) have served on the SNS Economic Policy Group. The reports have made a difference for Swedish economic policy. Their analysis has often formed the basis for domestic policy discussion and many specific policy proposals have (normally with a lag) been turned into actual policy. For this reason, the reports have aroused interest also outside Sweden. In recent years, summaries of the reports have been translated into English.

Chairman of the 1998 Economic Policy Group is

Professor *Ulf Jakobsson*, Director of IUI – the Research Institute of Industrial Economics. The other members are Professor *Lars Bergman*, Stockholm School of Economics, *Pontus Braunerhjelm*, Ph.D., and Associate Professors *Stefan Fölster* and *Magnus Henrekson*, all of IUI. *Stefan Sandström*, Fil.Lic., SNS, has coordinated the work of the group and *Åsa Ahlin*, B.Sc., SNS, has assisted with figures and tables. *Alan Harkess*, M.A. M. Soc. Sc., has assisted with the English translation.

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The SNS Economic Policy Group stands collectively behind the analysis and conclusions of the report. SNS as an organization does not take a stand on policy issues.

Stockholm in January 1998

Hans Tson Söderström
President of SNS

The Entrepreneur in the welfare state

The political debate in Sweden is nowadays often retrospective in character. The golden era of the Swedish model appears as a sunken Atlantis, which has now to be either rediscovered or recreated. At the same time, global and technological changes take Sweden further and further away from the conditions that applied during the first decades of the post-war world. This retrospective view tends occasionally to gain the upper hand in policy making, leading it in a direction that runs counter to the changes that the country must, in one way or another, come to accept. During the successful years of the 1950s and 60s, Swedish economic policy was characterised by a strategy that was largely in harmony with the prevailing economic trends of the period. The rediscovery of a growth strategy that sought to attune itself to changed global conditions rather than to fruitlessly oppose them would be a worthy successor to the policies of that era.

Here we will deal with a number of these changes in Sweden's global environment and we will be particularly concerned with the role of the business enterprise as an agent of change. During the golden era of the Swedish model, the major Swedish industrial companies

played a crucial role in the country's economic strategy. These enterprises were almost thought of as national natural resources. It was then up to the politicians to distribute the economic returns of these national assets. The economic success of these business enterprises helped to create a policy climate in which companies would be apparently able to grow irrespective of incentives and private capital formation. During this era, it also seemed natural that small companies were predestined to play an increasingly marginal role in economic development. The wage earner funds represented the culmination of this type of policy.

The major Swedish business corporations are still the most dynamic element in the Swedish economy. However, they have become increasingly less dependent on the Swedish economy. Accordingly, policies related to incentives and the entrepreneurial climate will have to take account of the need for a much more broadly based structure of business enterprise in Sweden. We will now examine the changes that have given rise to the new role that now confronts business enterprise in the Swedish economy.

Globalisation, EU and the internationalisation of business enterprise. Globalisation is hardly a new phenomenon. The period between 1850 and 1914 was characterised by widespread internationalisation (see O' Rourke, Taylor and Williamson, 1996). In certain respects, current globalisation may be seen as a continuation of the process of globalisation that was interrupted by the First World War. In terms of the real economy, it is the large business corporations that represent the avant

garde of internationalisation. It is inevitable that globalisation will have a particularly marked impact in Sweden since large multinational business corporations are more predominant here than in any of the other Western economies.

In Europe, the internationalisation of business is now entering a new and more expansive phase. European Monetary Union, EMU, will most likely accelerate the process of integration and structural reorganisation. As a result, the European structure of business will increasingly tend to resemble that of the United States. In Europe, within ten years, the number of companies in certain industries could be reduced from around ten to just two or three. In other areas, large diversified corporations may be split up into smaller units which may subsequently merge with other companies in the same industry. This process of industrial restructuring will give rise to substantial productivity gains. At the same time, these mergers and the resultant concentration of operations into certain core areas will give rise to substantial plant closures and relocation of company operations. The overall effects of structural change on companies will be largely determined by the extent to which business conditions in different areas prove to be favourable. A number of major company mergers in Europe during 1997 indicate that the process of structural reorganisation in Europe is already underway. Although Sweden will remain outside EMU, Swedish corporations will not remain outside the process of structural change. All of the major Swedish corporations are in their own sectors an integral part of the European market structure and consequently of any process of structural reorga-

nisation. The question that invariably confronts these companies is whether to actively participate in the process of restructuring or to passively become a victim of change.

In the event of a merger, the strategic functions of a company and the location of its head office inevitably become principal subjects of discussion. Hence these issues are likely to become major areas of concern for Swedish companies in the years ahead. From the standpoint of current developments, the strategic functions and head offices of Swedish companies may tend to leave Sweden. However, this process also presents an opportunity. If Sweden was able to provide a better environment than other countries for the conduct of these strategic functions, there might instead be a movement into Sweden of head offices and strategic decision-making by companies.

Growing importance of human capital. The growth in the relative demand for skilled labour in industrialised countries provides a clear indication of the growing importance of human capital. This would appear to be principally attributable to the role of technological change in stimulating the demand for skilled labour (See, for example, Berman, Bound and Griliches, 1994 and Berman, Bound and Machin, 1997). Competition from low wage countries has also exerted a somewhat more limited effect on the growth in the relative demand for skilled labour in industrialised countries. In the United States and the United Kingdom, this has resulted in increasing wage differentials between skilled and unskilled labour whereas on the continent and in Sweden, it has led to rising unemployment. The

Swedish government is largely seeking to counter this growth of unemployment by means of an educational programme aimed at the long term unemployed. However, it is questionable whether this type of “educational” programme will allow Sweden to become a more competitive high wage economy. Another important related question concerns the economic returns to this increased investment in human capital. Where will they materialise? The conversion of human capital into new business ideas and improved productivity will require enterprise. So far this conversion has been principally confined to the large Swedish companies.

The growing importance of new firms and entrepreneurship. Despite the growing importance of a strong position in international markets for well established companies, the creation of new companies and entrepreneurship have become of major economic significance for the advanced industrial economies. This development is attributable to a number of factors. Firstly, technological change no longer seems to create the same economies of scale in production. In many cases, small scale production and factors such as customer proximity may actually make small units superior in competitive terms. Secondly, the major new business opportunities that have arisen as a result of innovations in technology and markets may be often best exploited within the framework of a new company. Thirdly, the process of deregulation which took place in the industrialised economies a decade ago may have undermined existing monopolies and created new opportunities for entrepreneurs and small businesses.

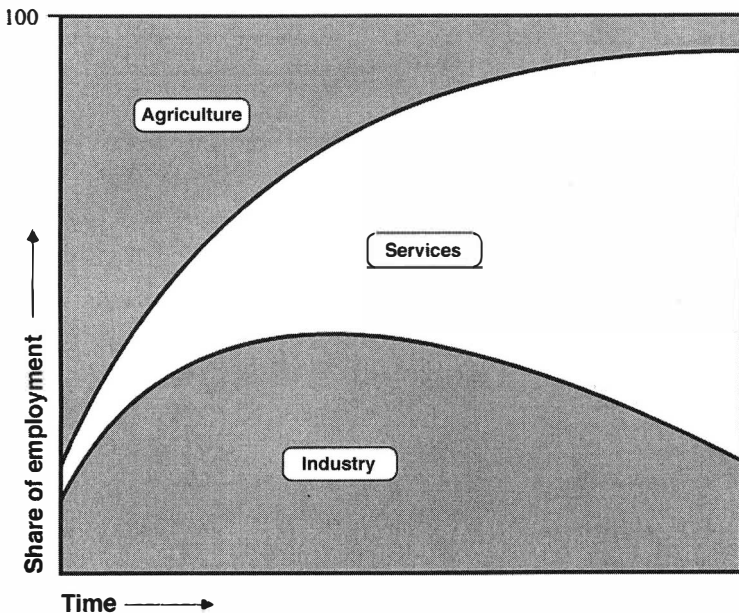
Nowadays the market position of many large com-

panies is no longer based on scale economies in production. Instead competitive advantage may be dependent on unique assets that have been created by means of major investments in marketing or research. Although a protective attitude is often adopted in relation to these assets, it has nevertheless become increasingly common to allow small local companies to take on the responsibility of providing various services, e.g., outsourcing in production. Accordingly, a growing international market concentration may frequently be accompanied by an increase in the scope for entrepreneurship and the creation of new companies. This development provides a major challenge to a country like Sweden whose economic policy has been heavily directed towards large companies. We shall return to this question below.

The potential growth of employment is to be found in the private sector. The tendency for the private sector to grow is not new and applies to all developed industrial countries. This is illustrated in Figure 1. An important aspect of this development is that increases in productivity are generally higher in industrial than in service sectors. In real terms, the growth of industrial production and services in industrial countries has been of roughly the same magnitude over the last two decades (see IMF, 1997). As regards Sweden, the increase in the service sector's share of employment is mainly attributable to the growth in the provision of public services. A continuation along these lines is however impossible due to the difficulties of financing the public sector. In future a successful employment policy will have to be based on the growth of service employ-

ment in the private sector. As will be discussed below, any major expansion of household personal services will require substantial changes in the Swedish tax burden. The heavily centralised Swedish wage bargaining system also curtails the expansion of service employment in the private sector. Although standardised solutions may possibly work well for companies in traditional industries, they are far less likely to be successful in a service sector where there are wide differences between employees in relation to work duties and qualifications. Hours of work and forms of contract may also require a degree of flexibility that is difficult to accommodate within the present negotiating system (see Ramaswamy, 1994).

Figure 1 Changes in the employment structure in industrial countries – principal trends



Source: IMF (1997).

We have sought to identify certain principal trends which must act as a point of departure for any Swedish strategy that attempts to deal with growth and employment. If Sweden finds that she is unable to adjust to these trends, the present period of macroeconomic stability is likely to be relatively brief.

Large companies and specialisation in the Swedish economy

In few other countries have the major companies become so predominant as in Sweden. At the same time as they have played a vital role for Swedish economic development, they have also exerted a major influence on the Swedish model. In many different contexts, they have acted as an important negotiating party for government and unions. They also seemed to be able to provide a solution to the incentive problems in a socio-economic model with collectivist aims. Capital formation would take place internally within companies and would not contribute to the accumulation of private wealth. In the first decade after the Second World War, the large industrial companies in Sweden helped to establish the idea of autonomy in the conduct of economic policy.

As a result of the changed economic conditions of the 1970s, the role of the major Swedish industrial companies became radically altered. Compared to the late 1960s when they could have been seen as Swedish corporations involved in international trade, they have now become, in many cases, multinational groups whose head office for historical reason happens to be in

Sweden. Accordingly, Sweden became one of the countries that was most affected by the process of internationalisation.

At the same time as internationalisation became more widespread, the growing importance of human capital has led to changes in the nature of business operations in Sweden during recent decades. Research and development has become of increasing importance to the major actors in the corporate sector. As a result, Sweden would seem to be taking on the role of a dual economy where the major industrial companies tend to become more dynamic and innovative than the smaller and more domestically oriented companies.

In the long run, the location of strategic corporate functions within Sweden cannot be taken for granted. However, as long as these functions do remain in Sweden, it would be opportune to develop a growth-oriented economic policy that took the existence of these functions as a point of departure. This would require a policy that was heavily committed to the improvement of educational standards and the creation of conditions that would encourage highly skilled people to live and work in Sweden.

There are some factors that would allow Sweden to expand its knowledge-based production. For example, no other country invests as much in R&D in relation to GDP as Sweden. Moreover, Sweden is unusually well off in terms of numbers of major companies. These companies which are accustomed to operating in markets characterised by intense international competition have also extensive links to smaller more domestically oriented companies. Therefore one might expect that the experience and knowledge of Sweden's

international companies would have been disseminated to the smaller and medium-sized companies which would in turn shift the structure of Swedish industrial production into more advanced sectors.

Notwithstanding the above, in an international perspective, the actual changes that have taken place in the structure of Swedish industry have been relatively marginal. In 1994, over half of industrial employment still belonged to the category of low technology production. If we add intermediate technology, the employment share rises to as high as 85 per cent. Sweden's share of high technology exports is also substantially lower than the OECD average. Against this background, an analysis may be carried out of the factors that appear to restrict the growth of high technology output. Attention can be focused on some particular circumstances that would seem to be especially important in the Swedish case. Firstly, a relatively small number of companies whose production is largely located outside Sweden are responsible for most of the R&D investments in high technology products. Moreover, throughout large parts of Swedish industry, innovative capacity would appear to be limited due for instance to shortages of skilled labour.

The importance of the educational system and the human capital formation for the growth of employment and real incomes is large. This applies particularly to those who have a relatively low level of education. Our analysis leads us to recommend a combination of measures that would both increase the supply of graduates and encourage the growth of service employment in the private sector for part time and relatively less skilled workers. However, public monopolies, the taxation

system and wage rigidities place substantial obstacles in the way of growth in the private service sector.

The supply of university graduates depends on the quality of the educational system and the incentives available to the individual to choose a higher education that will provide him(her) with the relevant skills for a productive working life. As regards the Swedish educational system, there is some evidence to suggest that developments may be going in the wrong direction. In particular, the recent reform of the upper secondary school would appear to have brought about a deterioration of both the academic and occupationally-oriented programmes. At the same time, the available incentives to acquire a higher education are relatively weak. This is mainly attributable to a wage system that operates against higher incomes for graduates, a tax system that produces high marginal rates of tax and a system of financing studies that in practice subsidises university courses that lead to low salaries and/or high risks of unemployment.

The transformation of Sweden into a knowledge-based society requires an expansion of both undergraduate and graduate education in the fields of science, technology and economics. In addition, a priority should also be given to the provision of occupational skills at the upper secondary level. At the same time, the development of high standards in the humanities, fine arts and music is an integral part of an attractive living environment.

Virtuous circles for enterprise

In international terms, Sweden has had a low proportion of self-employed. This may have had significant effects on total employment. A more detailed analysis of the time profile of increases in employment would appear to indicate that the maximum effect on employment of an increase in self-employment is not reached until after two to four years. This would seem to be a reasonable finding in view of the time required for a newly started company to expand production, achieve productivity gains and recruit new personnel.

In this light, the limited degree of self-employment in Sweden would appear to be an obstacle to economic growth. However, it should be noted that self-employment is also highly unevenly distributed within Sweden. The differences between countries and regions within Sweden are too large to be solely explained in terms of external factors. Instead, reference is frequently made to “entrepreneurial culture” in order to explain the mechanisms that appear to give rise to virtuous circles in certain regions and to vicious circles in others. If a region has a large number of entrepreneurs, they may be able to create favourable conditions for newly started companies by means of their access to capital and skills as well as the influence that they exert on policy. This type of self-reinforcing mechanism helps to create a virtuous circle for entrepreneurship. In those regions that are subject to a vicious circle, there are fewer self-employed which makes it more difficult to create a political understanding for a policy that seeks to support business enterprise. Moreover, fewer people are available to provide capital and skills. Far too many

Swedish regions would seem to have landed in this type of vicious circle.

An international comparison would appear to indicate that there is a correlation between countries that have a high proportion of self-employed and low levels of taxation and high levels of household savings. Conversely, countries such as Sweden that have high taxes and a relatively low level of household savings also tend to have a low proportion of self-employed. An analysis of data from Swedish counties would appear to support this hypothesis. In counties where there was a relatively large number of self-employed persons, local taxes were below average. The latter is seen as an indication that policy is generally supportive of business.

Against the background of these results, it is hardly surprising to note that the United Kingdom and New Zealand, countries that had undergone major economic policy reforms, also experienced a rapid rise in the proportion of self-employed during the 1980s. At the same time, in contrast to the negative trend of employment seen in most other developed countries, total employment has increased in the United Kingdom and New Zealand.

What then are the conditions that must prevail in order to establish a virtuous circle for entrepreneurship? There are a number of areas that are crucial for a virtuous circle: taxation policy, savings and the supply of risk capital, labour legislation and the role of the public sector as a provider of services.

During most of the post-war period, the tax system has been biased against new companies and companies that have a low capital intensity. Tax benefits have

been available to companies that finance their investments by means of borrowing rather than by raising equity capital. It has also been advantageous from a tax standpoint to have institutional rather than private owners.

Current tax legislation is more neutral than prior to the 1990–1991 tax reform although individual ownership and equity finance still continue to be less favourably treated by the tax system. Moreover, tax legislation often places Swedish owners at a disadvantage compared to foreign owners.

Private savings is of decisive importance for the supply of equity capital and the opportunities for business expansion as well as the creation of new enterprises. The taxation of savings in Sweden is still in aggregate terms relatively high. Historically Swedish households have saved a relatively low proportion of their incomes. As a result, many good business ideas have gone begging due to the lack of private savings. Small, recently established, less capital intensive companies also encounter greater difficulties with prevailing employment protection legislation. In recent decades, this legislation has tended in practice to favour sectors that have had difficulties in expanding employment. New research indicates that gross flows in the labour market are very large. It has been estimated that the net addition of one new job requires a gross flow of ten new jobs. New research also indicates that the need for flexibility is especially great among the rapidly growing companies. Such flexibility would enable the company to recruit new employees in response to growing demand and reduce operations when demand falls short of expectations. The absence of this type of rapid

response as a result of employment protection legislation will tend to undermine the expansive forces in the economy.

The public sector has traditionally monopolised the provision of many services in the rapidly expanding areas of education, health care and social services. Many of these areas are suited to private provision, particularly on a small scale. Here the public sector could act as a guarantor of quality of outcome by ensuring that the standards of service are properly evaluated. The introduction of competition by means of competitive tendering and systems of consumer choice would open up a major area of the Swedish economy to creative entrepreneurship.

An expansion of knowledge-based, frequently export-oriented production would also generate opportunities for increased production and employment in the domestic market. The experience of other countries indicate that there is a great potential for expansion in the private service sector. This would have beneficial effects on both employment, welfare and growth.

The total volume of work currently carried out in Sweden is double the amount that is carried out in the marketplace. Hence it is incorrect to talk about a shortage of work and the need to introduce job-sharing. The widespread support for shorter working hours is explicable in terms of both the highly uneven distribution of market work between individuals and the failure to extend private sector provision into the area of household services. A major requirement for satisfactory economic growth in the coming decades will be the creation of institutional conditions that will allow the expansion of household-related private services. In

the United States, the recent growth of employment has been very rapid, particularly in the private service sector. Compared to the United States and the OECD average, this sector is relatively small in Sweden. A principal reason for the slow growth of the private service sector in Sweden is the high level of taxation on the use of labour. The professional producer of a service is frequently confronted with the superior competition from a potential customer who instead chooses to provide the service by means of his own unpaid labour.

From a static point of view, numerous potentially efficient exchanges will not take place. It is perhaps of even greater importance to emphasise that in a dynamic perspective, the economy will lose both innovative capacity and product development in the private sector.

A reduction in the taxation of labour would have several beneficial effects. Firstly, it would stimulate the growth of a specialised, highly productive service sector. Secondly, it would reduce the need to increase wage differentials in order to increase employment. Thirdly, the increased opportunity for employee specialisation would improve the business climate for the production of high technology goods. Finally, a lower level of taxation on labour would reduce the risk of poverty traps for low income earners.

A sustainable welfare society

Private sector employment plays a central role in financing welfare state expenditure. Most tax revenue is

derived in one way or another from the taxation of labour services. On the expenditure side, the major items relate to individuals who in one way or other are dependent on income from the public sector either in the form of remuneration for employment services or as transfer payments. The average level of these incomes is determined in relation to the wage level prevailing in the private sector. Hence, increased productivity in the private sector will not provide any long term easing of the tax burden. The most important relationship instead becomes that between the number of individuals whose incomes are financed out of taxation and the number of individuals employed in the market sector. This helps to explain why the European situation with jobless growth has created a crisis in the welfare state.

In Sweden the fall in private sector employment together with the rise in unemployment has intensified the problem of financing welfare state expenditure. At the same time as the financial base has been weakened as a result of the decline in private sector employment, an increasing number of persons have become dependent on the public sector for their livelihood. This is partly due to the growth of unemployment and partly to demographic factors. Fewer and fewer finance the incomes of a growing number of people in the public sector. This leads to higher taxes at the same time as public expenditure is spread increasingly thinly. In turn this brings about a growing sense of political unease.

A continued weakening of the trend of employment would over a period of years substantially weaken the budgetary position of the welfare state. On the other hand, if the trend was broken, the rapid rise in employ-

ment in the private sector would greatly ease the financial burden in the public sector.

However, there may well be an element of *Catch 22* in this successful scenario for the maintenance of the present structure of the welfare state. It is presumably the case that major changes would be required in economic policy in order to break the present trend of private employment. The experience of over a decade of high European unemployment would tend to suggest that this type of trend change does not come about on its own. A reform of economic policy may well be required, which in many cases would lead to intervention in the present structure of the welfare state, not least in relation to the level of taxation. But it is fully possible that these policy reforms could be introduced without giving up distributional policy objectives.

We have emphasised that the conditions confronting business enterprise in Sweden have been a principal obstacle to growth and employment. This is particularly true for the self-employed and for the service sector where high levels of personal income tax may have tended to dampen innovation.

A high level of tax, like other types of intervention in the business sector may be justified on the grounds of welfare gains to the community as a whole. However it is possible that these welfare gains may be achieved at lower levels of taxation than currently prevail. International comparisons indicate that certain other countries have been able to achieve the same income distribution as in Sweden but at substantially lower levels of taxation.

A reduction in taxation in Sweden would require a systemic change. The possibility of securing tax reduc-

tions by means of further attempts at improving the efficiency of the system would appear to be practically impossible. In recent years, we have seen a steady stream of small changes that have tinkered with the system in order to improve the efficiency of the public sector. In many cases, these changes have had the character of two steps forward, one step backward. Moreover, they have frequently tended to lower the quality of service in the public sector.

Here we wish to focus on two basic aspects of the social insurance system which illustrate the possibility of introducing changes to the system that would allow a reduction in taxation through an improvement in efficiency.

The first aspect concerns the changes that have occurred in the distribution of income for a given individual over his (her) lifetime compared to the situation that prevailed when the social insurance system was set up. Today incomes vary to a much greater extent over a life cycle since individuals increasingly invest in an education, establish careers and change their life styles. As a result, the distribution of lifetime income is more evenly distributed than the distribution of income for any given year. As incomes vary to a greater extent over a life cycle, there is a correspondingly greater need to redistribute incomes between different periods of an individual life cycle. If this redistribution takes the form of taxes and allowances, as is the case with the present system, there will be a tendency for the increased demand for life cycle redistribution to lead to a higher burden of taxation and increasing marginal rates of tax. Here there would appear to be scope for a reform of the social insurance system that

would provide individuals with a greater opportunity to redistribute incomes between different periods of their lives at the same time as taxes and benefits could be used to an increasing extent to redistribute lifetime income between different individuals.

The other opportunity to improve the efficiency of the social insurance system concerns the use of funding procedures. The substantial research literature in the field would appear to support the argument that funding would lead to lower levels of taxation and higher savings and investment. A number of countries have introduced schemes that increase the degree of funding in their social insurance system.

A policy for the twenty-first century

The need for the Swedish economy to adjust to the changes in technology and international markets that were discussed above creates pressure for change across the whole range of economic and industrial policy. In this analysis, we will focus on the following areas:

An improvement in the level of education. In order to maintain or preferably to improve its standard of living in terms of real income at the same time as employment increases, the performance of Swedish industry and Swedish exports will have to be among the best in the world. This will in turn place demands on the country's system of higher education which will also have to be among the best in the world. Policy in this area may be considered to have two main strands.

Firstly, it must be profitable for the individual to acquire a higher education and make use of it in Sweden. The latter will naturally take on increasing importance as a result of growing internationalisation not least in graduate labour markets. It will also be important that graduates from other countries perceive Sweden as a country in which it will be profitable to work. The growing importance of international networks and the increasing internationalisation of multinational companies make it essential for Sweden to create areas of activity that will allow graduates from different countries to work together.

The government may facilitate this process by means of its system of income taxation. However, in contrast to the international trend towards lower marginal tax rates that became widespread during the 1980s and continued into the 1990s, Swedish marginal tax rates are rising again. This runs counter to the need to create positive incentives for higher education. It also makes it harder for companies to establish multinational workplaces for graduates in Sweden.

Companies through their wage policies also have a major responsibility in this area. It would appear that the combined effect of union demands for a wage policy based on solidarity between different groups of wage earners together with the monopsonistic situation of companies in the labour market has contributed to a low rate of return on higher education in Sweden. It would appear to be in the interest of both parties in the labour market to change this pattern. The government could exert an influence in this area by introducing legislation that would break up the formation of cartels in the labour market.

The second strand of a positive educational policy would be to raise the quality of Swedish education. Once again there are signs that developments are going in the wrong direction. Firstly, educational policy seems to suggest that there is an apparent conflict between a broadly based education and high quality, specialised education. As a result, financial support to the established universities is being cut in order to develop regional universities. This will make it harder for the best parts of Swedish higher education to maintain their leading positions. Secondly, it is becoming increasingly evident that the Swedish upper secondary school is on the verge of a crisis which stems from the political decision that all upper secondary students should study the same theoretical foundation courses. There are obvious difficulties in carrying out systematic evaluations of such a recent reform. However, the costs of failure may take on huge proportions. Consequently, it would be wise to heed the warning signals such as the clear evidence that knowledge of mathematics in the upper secondary school is on the point of declining drastically.

The success of a programme of expansion of higher education is dependent on the quality of both comprehensive and upper secondary school education. The latter is in turn dependent on the performance of individual teachers. It is therefore a serious problem that the teaching profession is so poorly paid in Sweden. A country that wishes to expand its knowledge-based industries ought to ensure that the teaching profession is considered to be an attractive occupation that provides good salaries for highly qualified work.

Improved conditions for entrepreneurship. We have drawn attention to the increased significance of entrepreneurship and the creation of new companies for economic development. This is most evident in their impact on innovation and the growth of employment in the economy.

The long run importance of enterprise for the growth of employment hardly needs to be developed further. All companies were at one time small. Many of the major Swedish companies were started up around the turn of the century. This early phase of development was often based on the commercial exploitation of an invention. The success of many of the large Swedish companies has in more recent decades tended to over-emphasise a static view of these companies in the sense that they are seen as an inexhaustible national natural resource whose very existence demonstrated that there was no need for new companies. Since economic policy has for a long time treated small business unfavourably, it is hardly surprising that so few companies in Sweden have been committed to growth and development. This is not to say that growth in small businesses is unimportant for economic development. The low growth propensity among Swedish small companies should be seen as a powerful warning sign. They are an indication that new company formation and entrepreneurship in Sweden will not be able to play the role that is required in the current major transformation of the economy. This underlines the need for policy to be reframed in order that it may play a more supportive role for the company sector.

It is for numerous reasons important that policy should not be viewed in terms of special favours for

small companies. What is required instead is a general policy that benefits all types of business enterprise and entrepreneurship.

There is a very close relationship between private enterprise and private asset formation. Hence the creation of favourable conditions for private asset formation is an essential element of a favourable business climate. The reduction or the abolition of wealth taxation might for example be considered as a measure that works in that direction. Similarly the importance of private property as a part of asset formation would indicate that more favourable property taxation would also contribute to a more favourable business climate. These measures in support of private wealth creation are essentially a long term project. In order to increase the opportunity for private individuals to acquire capital in the short run, it might be possible to allow private individuals to invest part of their supplementary pension savings in a business project in exchange for a corresponding reduction of pension rights.

Following the reintroduction of double taxation of company profits, a number of special rules have been made in order to provide tax relief for smaller companies. This is completely contrary to the spirit of the 1990–91 tax reform. The inherent difficulty for the company in trying to foresee the consequences of such special arrangements combined with their arbitrary, ad hoc nature will undermine the very credibility of such measures. Hence they cannot be taken into consideration in relation to the company's long term planning and investment strategy. In our view, these type of special tax arrangements should be abolished together with double taxation of company profits.

An important area in relation to the creation of new companies is to be found on the fringes of the public sector. The existence of municipal companies and the somewhat diffuse boundaries of public enterprise create substantial uncertainty regarding the ground rules for companies in this area. Hence an important element in any programme that seeks to improve the conditions in which companies operate would be the creation of reliable ground rules and the abolition as far as possible of municipal enterprises.

Reform of the welfare state. We have sought here to analyse the Swedish economy from the perspective of the company and the producer. In this context we have argued in favour of measures that would reform the welfare state. A major improvement of economic incentives, for example, can hardly be undertaken without a reduction in taxation. The need for an expansion of the private service sector is perhaps the clearest example of the need for reform of the welfare state since it is the high tax wedges that prevent expansion in this area.

The need for reform of the welfare state can also be seen from an analysis of the difficulties of financing welfare expenditure. An unreformed welfare state will continue to require increases in the burden of taxation at the same time as current tax levels are seen to give rise to substantial losses of welfare. Furthermore, the process of internationalisation of economies will in the long run force high tax countries like Sweden to lower taxation in order to protect their tax base. The fact that over 4 million people are dependent on the public sector for their livelihood at the same time as only 2.5 mil-

lion people are engaged in the private sector provides a clear indication of the need for reform of the welfare state.

At the same time the figures point to the difficulties of implementing far reaching reforms. It is difficult to imagine that a government would be able to mobilise political support for a massive reduction of welfare state expenditure other than in a major crisis. In our view, there is an obvious risk that that is where Sweden will end up if it doesn't begin to introduce a far reaching reform of the welfare state.

Our conclusion is that the welfare state will have to be reformed but that it must be implemented in a fashion that takes account of the duties for which the welfare state is responsible today.

An important point of departure for a systematic reform is that approximately three quarters of current welfare expenditure is concerned with the redistribution of income over an individual's life cycle. Given rising educational standards and an increasingly heterogeneous pattern of individual and household economic arrangements over the life cycle, it ought to be possible to leave this type of income redistribution to individuals themselves. As a result, the egalitarian objectives of the state would become primarily concerned with the redistribution of lifetime incomes between individuals. This may take many different forms. In a series of articles, Stefan Fölster has for instance proposed the introduction of a citizen's account (See Fölster, 1994 and 1998).

A natural part of this reform process would be to extend that part of the pension system that is based on a privately owned, privately managed premium reserve.

This reform would give rise to three positive effects. Firstly, the higher returns would lower the cost of financing the pension system for the economically active generation. Secondly, the individual element in the system will lower the tax wedge. Thirdly, this reform may be seen as part of a process of increasing private wealth which as we have argued above will have a positive effect on the business climate.

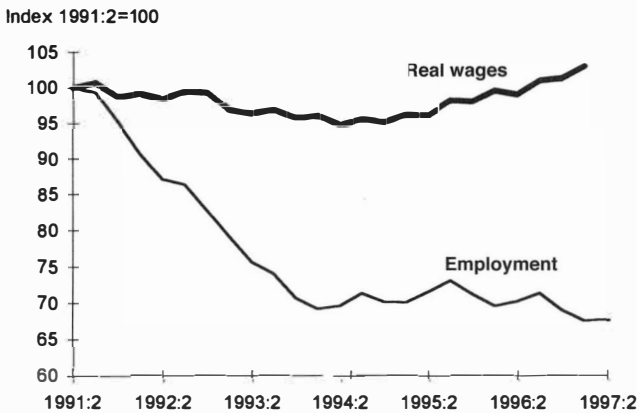
Labour market reform. The high level of unemployment is the single greatest problem confronting the Swedish economy. It has become increasingly apparent that wage formation in Sweden does not function in a way that is compatible with increases in employment. Solving the unemployment problem by means of real wage adjustments will therefore be difficult. This is illustrated in Figures 2 and 3. Employment has fallen substantially at the same time as unemployment has increased. Instead of protecting employment levels by a downward adjustment of real wages, the latter have tended to rise. This is particularly notable in the construction sector where employment has fallen by as much as a quarter since 1990 and real wages have risen, although by a smaller amount than in the rest of the economy. This emphasises the need to reform the Swedish labour market. From a more general perspective, several recent annual reports from the SNS Economic Policy Group have argued the case for reform of the labour market. The same subject was discussed at length in the report from the Economics Commission (SOU 1993:16). In the Swedish Government Commission on the EMU report (SOU 1996:158), the unreformed labour market was seen as a decisive

Figure 2 Employment and real wages in the Swedish economy, 2nd quarter 1991 – 2nd quarter 1997; average hourly wage for workers in the private sector, index 2nd quarter 1991=100



Source: Statistics Sweden

Figure 3 Employment and real wages in the Swedish construction industry, 2nd quarter 1991 – 2nd quarter 1997; average hourly wage for workers in the private sector, index 2nd quarter 1991=100



Source: Statistics Sweden

barrier to early entry into EMU.

Three recent international reports have also carried out detailed analyses of the Swedish labour market. Several chapters of the NBER report (Freeman, Topel and Swedenborg, 1997) gave great prominence to the need for labour market reforms in Sweden. The same subject was also dealt with by the IMF in its *World Economic Outlook* presented last May (IMF, 1997). The point of departure for the IMF analysis was the growing importance of the private service sector in Sweden. The OECD has also devoted considerable attention to an analysis of the Swedish labour market in its most recent report on Sweden (OECD, 1996). The report also contains in its so-called *OECD Jobs Strategy* which has been adjusted to take account of Swedish conditions, detailed proposals for reform of the Swedish labour market. The following are some of its main recommendations (OECD, 1996, p.116):

- *Increase wage and labour cost flexibility.* Among its recommendations, the OECD proposes a reduction of taxes on labour and an acceptance by the unions and employers of increased wage differentials. In order to increase the degree of wage sensitivity to conditions on the labour market, the OECD also proposes a more direct, transparent link between unemployment insurance premiums and wage movements at the industry level. The OECD also recommends a re-examination of the rules related to secondary actions undertaken by trade unions.
- *Reform unemployment and related benefit systems.* The OECD proposes a reduction of unemployment and sickness benefit levels. In addition, an effective time

limit should be placed on the length of the eligibility period for unemployment benefits.

- *Increased working time flexibility and reform employment security provisions.* Here we only wish to emphasise the importance of implementing reforms along the lines proposed by the OECD. Internationalisation and the deregulated capital markets create an overwhelming pressure for change in all European labour markets. If various rigidities continue to affect the operation of the labour market, there is a great risk that the pressure for change will lead to a higher level of unemployment in the next recession. This is the risk inherent in the labour market policy currently being followed by the Swedish government where the strategy is to lower the rate of open unemployment by reductions in the supply of labour. This is achieved by means of early retirement and an increase in the number of persons covered by public manpower programmes. The government's support of an agreement on shorter working hours is also a step in this direction. Although these measures will be able to lower the rate of open unemployment in the short run, they will at the same time make it more difficult for the labour market to operate efficiently and thereby tend to increase unemployment in the longer run.

Current economic developments

The Swedish economy is at present experiencing a period of cyclical recovery. Accordingly, employment will tend to increase and unemployment can be expected to decline slightly. This growth in the Swedish econo-

my is also to an important extent reinforced by an increase in macroeconomic stability. The budget deficit has been more or less eliminated whereas four years ago, it comprised 13 per cent of GDP. There has also been a remarkable improvement in the rate of inflation. At the beginning of the 1990s, Sweden was still subject to double digit inflation. By way of contrast, the rate of inflation over the last year has actually been below the 2 per cent target rate of the Riksbank.

This increased stability has paved the way for a cyclical recovery. The achievement of a balanced budget allows a relaxation of the highly restrictive fiscal policy that has dominated the economy during the past three years. In addition, the increased confidence in the inflation target of the Riksbank has allowed Swedish interest rates to fall which has provided a further stimulus to the economy.

Until recently, the international conditions for a period of stable economic expansion appeared excellent. In the United States, the economic growth of recent years is likely to continue. At the same time, the continental European economies would appear to be at the beginning of a period of recovery, largely for the same reasons as discussed above in relation to the Swedish economy. Most of the continental European economies have undergone a period of fiscal austerity in order to meet the Maastricht convergence criteria in 1997. Fiscal policy will be relaxed in 1998 at the same time as monetary policy continues to be relatively expansionary. The strengthening of the dollar against the continental European currencies also strengthens the prospect of export expansion in Europe. However, recent developments in Asia will tend to dampen export

growth. Several of the economies in South East Asia find themselves in an acute economic and financial crisis. The same applies to Japan. Accordingly, economic growth in these countries may be expected to be very weak or perhaps negative for at least a couple of years.

The prevailing view is that the impact of these developments in South East Asia on the United States and Europe will be relatively modest, without being negligible. This view is based on the relative size of the trade flows to and from Asia. The real effects are communicated along two channels. Firstly, Asian demand for imports will decline as a result of the deterioration in their domestic economies. This may have a relatively marked effect on Swedish exporters since East and South East Asia has been among the fastest growing markets in recent years. Secondly, the rapid depreciation in exchange rates in South East Asian countries will substantially improve their competitiveness. Accordingly, we can expect a major export offensive from these countries which will lead to lower market shares among their American and European competitors. Although the overall effects of the crisis in South East Asia may be limited, the impact on specific sectors may be quite marked. This will tend to increase the demands for restructuring and flexibility in the European economies to which the launching of EMU will make a major contribution.

In this context, it is important to emphasise that it is always difficult to estimate the effects of major international disturbances. The first oil price shock in 1973 illustrates these difficulties. Most analysts considered that the effects on economic growth would be relatively limited since oil imports comprised only 2–3 per cent of

the GDP of OECD countries. The OECD secretariat, for example, estimated that it would reduce OECD growth rates by 0.5 per cent. However, the outcome was quite different. In conjunction with other problems affecting the OECD economies, the first oil price shock triggered off the deepest recession in the entire post war period. Instead of the forecasted 4 per cent increase in GDP for 1974 which the OECD secretariat had made in December 1973, GDP actually fell 1974. In 1975, GDP in the OECD fell by as much as 2 per cent.

All in all, the expansionary forces in the international economy may be expected to decline over the immediate period ahead. At the same time, there are a number of major obstacles, particularly in the labour market, to a continued period of economic expansion in Sweden. At an early phase of the recent upswing in economic activity, skilled labour shortages were already evident, despite the high level of unemployment.

Nevertheless, in spite of the discussion above, 1998 will probably be characterised by relatively strong economic growth. There is a marked tendency in Sweden to view periods of economic expansion as a normal condition which may be expected to continue for a long time ahead, at the same time as crises are considered to be unfortunate occurrences that will not be repeated. Hence, the economic expansion conceals the overwhelming need to bring about the changes in economic policy for which we have argued in this report. The need for these changes will become increasingly evident when the economy moves into recession. The economic policy measures that are undertaken in that type of situation are invariably motivated by the feeling of panic when a fire needs to be quickly put out.

Hence, the present relative stability of the Swedish economy would be a most opportune moment to get to grips with its underlying structural problems.

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Global changes and new technologies are in the process of changing the foundations on which society is based.

How does the process of globalisation affect business enterprise and economic policy? Human capital is becoming increasingly important, but why is the diffusion of knowledge from high tech multinationals to smaller companies that serve the domestic market proving to be so difficult? What is the role of the educational system in improving the competence of the labour force? And can knowledge be converted into business ideas and improved productivity? New companies and entrepreneurship are becoming increasingly important, but how do we create a virtuous circle for entrepreneurship and what ground rules are required to support entrepreneurship. The private service sector would appear to be the sector with the greatest potential for increasing employment in the future, but how are we going to replace do-it-yourself with market services? And how will it be possible to combine lower taxes and higher welfare?

The central task of economic policy is to find a strategy for economic growth that is able to meet the challenge of global change. An outline strategy is presented in this report.

SNS Economic Policy Group Report 1998

The Economic Policy Group is composed of a group of economists who jointly present their views on the economic situation and economic policy. The following are members of this year's council: Professor *Lars Bergman*, Stockholm School of Economics, *Pontus Braunerhjelm*, Ph.D, Associate Professor *Stefan Fölster*, Associate Professor *Magnus Henrekson*, Professor *Ulf Jakobsson* (ed.) all of Research Institute of Industrial Economics.

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