Seminar Paper No. 540

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ABSTRACT

This paper summarises an official report to the Swedish government (and general public). The economic crisis in Sweden is explained by both system failures and specific policy mistakes. The system failures include distorted incentives and markets, and inappropriate and outdated institutions. The deep recession and extraordinary rise in unemployment started as a collision between inflationary wage development and attempts to pursue a hard-currency policy. The resulting loss of international competitiveness in the tradable sector was accompanied by increased real interest rates, collapsing real estate prices and a related financial crisis.

Following the floating of the Swedish krona in November 1992, the main problem became a domestic demand collapse, which has been accentuated by a spectacular rise in the household saving rate. The report emphasizes that good policy advice is not enough; it is also necessary to analyse and reform the institutions which continually produce undesired outcomes with respect not only to macroeconomic stability but also economic efficiency and growth. The proposed institutional reforms are designed to restore a highly competitive market system and to facilitate a responsible fiscal stabilisation programme. This would also enhance the medium-run credibility for government policies and provide scope for a more expansionary policy in the short run.

* The authors were members of a commission appointed by the Swedish government on December 10, 1992, and chaired by Assar Lindbeck. Their 200 page report was published on March 9, 1993, *Nya villkor för ekonomi och politik*, Ekonomikommisionens förslag, SOU 1993:16, Allmänna Förlaget, Stockholm. The main report was accompanied by two volumes (27 papers) of background material and complements to the report, written by various experts. The main report will be published in English by MIT Press, 1994.

1. Introduction

Sweden is currently suffering from its most severe economic crisis since the 1930s. Because the crisis consists of a complex mixture of acute and chronic problems, short-run measures alone are doomed to failure. This report argues that the problems in Sweden are largely due to distorted markets, aging institutions and ossified decision-making mechanisms, which have not been conducive to favourable long-run economic outcomes. Institutions and mechanisms that might have been adequate thirty or forty years ago are less adequate today. Past political decisions are responsible for many of the economic problems today. However, it is not enough to recommend that politicians make "better" economic policy decisions. What is required is to change incentives for politicians by redesigning political institutions and mechanisms. This view of the economic crisis in Sweden calls for a combination of economic and political analysis; this combination is perhaps the most characteristic feature of the report.

Sweden's chronic (long-term) problems are revealed in disappointingly low efficiency in both the private and the public sectors. The pronounced slowdown in the rate of productivity growth dates back to around 1970. While labour productivity (GDP per employed) grew by about 4 percent per year during the period 1950-1970, the corresponding figure for the years after 1970 is as low as 1.1 percent. The productivity growth slowdown, of course, is not unique but it is more pronounced in Sweden than in the OECD area as a whole: between 1970 and 1991 GDP per employed in Sweden has lagged by about 0.6 percent the OECD average, output in the manufacturing sector has been more than one percent slower per year than in the OECD area, and labour productivity

(value added per employee) in that sector about 0.3 percent slower. Available studies suggest that total factor productivity in manufacturing has grown more slowly than in any other OECD country for which statistics are available. It is not surprising that per capita, PPP-adjusted GDP in Sweden had moved from 8 percent above the OECD average in 1970 to 6 percent below in 1991. Sweden has dropped from third to fourteenth place on the ranking list among OECD countries in terms of per capita GNP.

Sweden's acute (short-term) problems are evidenced most clearly by the deep recession, the financial crisis and the huge public-sector deficit.

(i) The current recession is deeper than in most other countries in the OECD area, if measured by the change in output: GDP has fallen three years in a row, 1991-1993, by 6 percent altogether, while manufacturing output has fallen by about 17 percent, amounting to a larger decline in the latter sector than during the depression of the 1930s. The relatively unfavourable development in Sweden is illustrated by the fact that GDP actually continued to grow, though rather slowly, in the OECD area as a whole during the 1990-1993 period, and that manufacturing output hardly fell at all. The unemployment rate has reached a record level since World War II: as of May 1993 it stood at about 8 percent of the labour force for openly unemployed, while another 5 percent is unable to get a regular job and is instead engaged in various labour market programmes; hence "total" unemployment is around 13 percent.

(ii) Financial markets are in disarray. Several major banks have received government guarantees or outright injections of public funds to bolster their capital; additional rescue operations may be inevitable. To restore their balance sheets banks currently rely on unprecedented

margins between lending and borrowing rates which further aggravate the recession.

(iii) The consolidated public-sector deficit has increased to about 13 percent of GDP, higher than in any other country in the OECD except Greece. The widening of the deficit is well beyond what could be explained by the cyclical downturn or by unusually high interest rates. With unchanged policies the deficit would drive the debt-to-GDP ratio from about 15 percent today to about 70 percent by the end of the decade, without any stabilisation in sight, even if the cyclical situation of the economy were to improve drastically.

The main factors behind the abrupt and severe deterioration of the Swedish economy since about 1990 are not difficult to identify. The acute crisis started as a "cost crisis" in the tradable sector -- a result of nominal wages rising about 2 percent faster per year than in other OECD countries during the 1980s, while labour productivity increased somewhat more slowly. This has resulted in a collision between domestic inflation and the fixed exchange rate. Output and employment in the tradable sector also suffered from the international business slowdown around 1990, which hit particularly hard high-cost countries. In 1991 exports fell by about 1 percent of GDP and private investment by about 4 percent of GDP in 1991, a further fall of investment by about 1 percent of GDP being expected for both 1992 and 1993.

In addition, the enormous real estate price and building boom in the second half of the 1980s was to a large extent the result of an abrupt deregulation of financial markets. In retrospect, credit institutions were not able to deal properly with their new freedom to engage in risky activities -- possibly because they had operated in a strictly regulated system for fifty years. Similarly, households had

learned for years that it was beneficial to borrow and consume, in a world where after-tax real interest rates were often negative. Following the deregulation, household saving plunged (to -4 percent of household disposable income). The household spending spree and the real estate boom were reversed in the early 1990s, when the economy went into a deep recession, and when real after-tax interest rates reached exceptionally high levels, as inflation fell from about 8 to 2 percent and tax rates on interest income (and payments) were lowered to 30 percent. Moreover, just as the real estate market started to collapse, taxes on real estate were raised drastically, which accentuated the decline in real estate prices. As in several other countries, the collapse of the real estate market was the main cause of the crisis for financial institutions.

The fall in household wealth, the increased uncertainty about jobs and incomes associated with reduced asset prices, as well as doubts about the viability of promised social security benefits, boosted household saving to +8 percent in 1992. This swing corresponds to a fall in aggregate demand by about 7 percent of GDP. As a result all components of private spending contracted without the public sector picking up the slack. The cost crisis in the tradable sector was thus followed by a general collapse of aggregate demand for domestic output.

On November 19, 1992 the central bank of Sweden (the Riksbank) had to give up the krona's parity with the ECU. This parity had been unilaterally declared in May 1991, right before Sweden applied for membership into the European Community. By May 1993 the krona had depreciated by about 20 percent against the ECU. A major realignment of the Swedish price level obviously made sense in the light of lost competitiveness. But the dramatic events on the currency market during September, with overnight interest rates at 500%, also made Swedish

politicians and the public at large acutely aware of the crisis. During the spirited defense of the krona in September, the government and the political opposition reached a remarkable agreement to reduce the public-sector deficit by 30-40 billion kronor (2-3 percent of GDP), which contributed to the further fall in household consumption in 1993. The depreciation brought the cost crisis to an end but left the legacy of a "dual" economy: a highly competitive export sector alongside declining domestic aggregate demand.

Against the background of these long-term and short-term experiences, the Report focuses on three major challenges:

- (1) to reduce cyclical instability which had become dramatically evident in the past few years, and more urgently, to come out of the deep recession and avoid high long-term unemployment;
- (2) to achieve a more efficient use of resources in both the private and the public sectors; and
- (3) to improve the long-term growth performance of the Swedish economy.

We emphasise a number of major deficiencies in the Swedish economic and political system: the predominant influence of special interest groups, myopia in policy-making and a fuzzy division of responsibility, within government as well as between public-sector institutions and private organisations. We therefore add to our three substantive chapters on economic policy -- under the headings of Stability, Efficiency and Growth -- a chapter entitled Democracy and Institutional Reform, in which we assemble a number of ideas for reforming institutions and decision-making processes in both the economic and the political system.

Even though much of the analysis is an exercise in positive economics, the report is also a normative document based on value judgements. These value judgements are largely founded on the following

three principles: (i) clear division of responsibilities among agents, (ii) pluralism, and (iii) active citizenship.

No less than 113 individual proposals are listed in the Appendix. We regard our proposals as a coherent whole, though some proposals are clearly more important than others -- those that emphasise the interdependence of long-run efficiency and growth and short-run policies. Some proposals are also more urgent than others -- stabilising the public sector debt, solving the bank crisis, lowering interest rates and preventing the emergence of high long-term unemployment. The current presentation, written for a non-Swedish audience, focuses on the issues that we regard as of general interest. The next four sections survey the main points and proposals in the report. A short concluding section completes the paper.

2. Stability

2.1 The Swedish Model: successes and early warning signals

The favourable impression of Sweden's macroeconomic performance during most of the post-war period was well justified for a long time. Unemployment was among the lowest observed, the rate of economic growth was close to the OECD average, while inflation was only slightly above the OECD average. Indeed, in the 1950s and 1960s, Swedish prices and wages were on a trend fully consistent with the stable exchange rate that prevailed throughout the Bretton Woods period. Figure 1b shows that, during the 1960s, nominal hourly wages increased by 8-9 percent a year, but since output per hour worked rose by an impressive 5 percent in the tradable sector, unit labour costs in Swedish industry rose by no more than 4 percent. This rate was then perfectly compatible with the inflation target implied by the fixed exchange rate as seen in Figure 1a.

(FIGURES 1(a) and (b) near here.)

Swedish labour-market performance in this period of very low unemployment was often analysed within the framework of the so-called Scandinavian model of inflation (see, for example, Edgren, et al., 1970). The central message was that domestic wages should not increase faster than the sum of the rise in world market prices and labour productivity in the tradable sector. Fiscal policy was assigned the role of correcting domestic demand so as to prevent both severe overheating and significant underutilisation of resources. But during the boom of the early 1970s and, particularly, during the aftermath of the first oil price shock, both of these mechanisms weakened while productivity growth slowed. Figure 1b reveals that hourly wages continue to grow at the rate of the 1960s even though productivity gains had slowed down very significantly. As a result, labour costs far exceeded the inflation target. Further increases in payroll taxes added to labour costs and to Sweden's competitive problems.

2.2 The crises

A first severe cost crisis erupted in the mid-1970s and was corrected by three devaluations in 1976-77, amounting to a total of 19 percent.

Although the exchange rate policy later became less ambitious -- the krona was pegged to a trade-weighted index of 16 currencies between 1977 and 1981 -- another massive currency adjustment of 26 percent in total was undertaken in two steps during 1981-82. The gap between increases in wages and productivity persisted, however, and the gap between wage increases in Sweden and other countries widened, partly because the unemployment rate continued to be very low while it increased abroad.

Figure 1(a) Labour costs and the inflation target

Note: The inflation target is an average of CPI-inflation in other countries, with weights corresponding to the definition of the exchange rate parity.

Sources: Swedish Statistical Office and the Riksbank.

Figure 1(b) Wage costs and productivity growth

Sources: Swedish Statistical Office and the Riksbank.

The devaluations following this second cost crisis were not used to advantage. Productivity growth did not increase above the previously modest rates. From 1985 onwards, annual wage increases remained at the same high rate of 8-9 percent as in the 1960s. As a consequence, unit labour costs increased, on average, 2-3 percent faster than the inflation target embodied in the fixed parity. The gap widened further as the Swedish economy went into an overheated boom towards the end of the 1980s, spurred, in particular, by the drop in the household saving rate and by fiscal policies that were not sufficiently restrictive. By 1989, the number of registered unemployed barely exceeded the number of vacancies. Although costs and prices decelerated more strongly than abroad after 1990, it was too late to prevent a third cost crisis. In retrospect, it is not surprising that the Swedish authorities eventually had to give in to the speculative pressures in the currency market during the autumn of 1992.

A recurrent feature of Sweden's performance over the past two decades is accordingly an inability to reconcile a domestic inflation trend, and in particular wage formation, with the ambition of maintaining a stable exchange rate against the currencies of some or all important trading partners. So-called centralised bargaining, which should more appropriately be called "multi-level bargaining", has not been able to prevent a considerably faster rate of nominal wage increases in Sweden than in other countries. One way of resolving the dilemma would have been to accommodate the higher domestic inflation rate through some kind of adjustable peg arrangement (or through floating); this option was in fact suggested in a report on the Swedish economy by a group of economists from the Brookings Institution in 1987 (Bosworth and Rivlin, 1987), but at the time it was regarded in Sweden as too defeatist.

It has often been asserted, both in Sweden and among foreign observers, that it was Sweden's "active" labour market policy which kept unemployment low in the 1970s and 1980s. It is our understanding, however, that the recurrent devaluations and the rapid increase in public-sector employment -- from 20 percent of the labour force in 1970 to 35 percent in 1985 -- did most of the trick. We may say that Sweden postponed adjustment of domestic price and wage formation by recurrent devaluations and rapid expansion of public-sector employment. Active labour market policy à la Sweden is useful for promoting labour mobility in high-employment situations, and hence for keeping down the natural rate of unemployment; during deep recessions it cannot do more than replace open unemployment with different types of labour market programmes, like public works programmes and public sector financed retraining.

Another apparent consequence of the policies pursued was that the large multinational enterprises based in Sweden have shifted an ever-increasing share of their operations abroad. One reason is certainly the relatively low rates of return in Sweden; another is to avoid a scarcity of skilled labour. The companies may also have tried to protect themselves against the cycles in the real exchange rate of the krona.

In our view, the only durable solution to excessive inflation lies in institutional reform. The task of stabilising prices has been made harder by the absence of a nominal anchor in the form of a fixed exchange rate. The Commission does not, however, recommend any early attempt at repegging the krona unilaterally to the ECU, the DM or any other conceivable standards -- considering the Swedish record in terms of devaluations and inflation. There is no easy shortcut to creating confidence in the currency, least of all at a time when the credibility

of the EMS has weakened and the timetable for moving towards the European Monetary Union (EMU) has become more uncertain. We recommend instead that Sweden focus on domestic economic reforms to recreate confidence in the krona. When implemented, these reforms will make Sweden's eventual participation in the EMU and in a single European currency -- to which we take a cautiously positive attitude -- look entirely feasible.

Strengthening the framework for economic policy-making and deciding upon a medium-term stabilisation programme for the public-sector debt means that short-run expansionary policies will not be interpreted so easily as the starting point for a new round of inflationary policies. Institutional reform and responsible medium-term fiscal policy may therefore create more scope for expansion in the short term. Hence we start by outlining a long- and medium-term strategy and turn next to short-term measures which could help to alleviate the slump, while being consistent with the long- and medium-term strategy proposal.

2.3 A long- and medium-term strategy

The most urgent reforms (proposals 1-7 in the Appendix) are in our view the following: the Parliament (Riksdag) should make a firm and early commitment to stabilise the ratio of public debt to GDP over a 4-5 year horizon. Non-inflationary wage settlements would be facilitated by reducing unemployment allowances and compensation levels in labour market programmes. Wage bargaining should take place at only one level (sectoral or, for large corporations, firm level) as the present system of multi-level bargaining probably tends to result in larger wage increases as compared to single-level bargaining.

2.3.1 Central Bank independence. We support the proposal¹ to give the Riksbank more independence in aiming for a low inflation rate as an overriding objective of monetary policy. On the basis of the newly emerging consensus on the desirability of low inflation with a floating exchange rate, the Riksbank ought to be made more accountable to the Riksdag. One way would be for the relevant parliamentary committee to organise hearings with the governor of the Riksbank.

2.3.2 Public debt stabilization. The level at which the public debt ratio should be stabilised is essentially a question of intergenerational equity. The speed at which stabilisation should be achieved is to some extent arbitrary. Experience in other European countries and the debate in the European Community on how best to bring debt dynamics under control have demonstrated that it is hard to come up with unambiguous criteria. Having looked at feasible programmes for expenditure cuts and keeping in mind the need to avoid undermining the substantial tax reform undertaken in 1991, we present several specific alternatives for reducing the deficit. Under rather optimistic assumptions with respect to the evolution of output and employment,² they are designed to result in a levelling-off of the debt-to-income ratio at just above 40 percent from 1997-98. Starting from the very unfavourable recent trend in public finances our proposals require a

¹ Riksbanksutredningen (Central Bank Report), 1993.

² More specifically these assumptions are that GDP will fall by 1.5 percent in 1993, rise by 1.5 percent in 1994 and by 3 percent in each of the years 1995-97. In our "optimistic" scenario, we assume a gradual decline in the "total" unemployment rate from a peak of 13 percent in 1993-94 towards 5 percent by the end of 1997. We also make specific assumptions about interest rates and inflation rates. The analysis is partial, ignoring the feed back of the budgetary measures into macroeconomic outcomes. The "pessimistic" scenario may, however, be interpreted as an informal way of considering such feedback.

deficit reduction programme of 60-70 billion kronor (4-5 percent of GNP) beyond the initial effort of 30-40 billion kronor suggested in the September 1992 crisis packages and embodied in the 1993 budget proposal. A less optimistic macroeconomic scenario would require even more stringent budget policies. For instance, if "total" unemployment rate gets stuck at a "European" level of 10 percent and the annual growth rate of output turns out to be one percentage point lower than assumed in the calculation above, additional efforts to reduce the deficit -- by another 30 billion kronor -- would be required in order to stabilise the debt-to-income ratio around 50 percent by the end of the decade. This scenario takes into account the possibility that a restrictive fiscal programme may reduce aggregate demand and output (even though the programme would facilitate lower interest rates).

Figure 2 describes the possible adjustment paths. The two upper curves denote the debt stabilisation strategies under the "optimistic" and "less optimistic" macroeconomic scenario, respectively. (Detailed proposals for short-term stabilisation policy are points 8-19 in the Appendix.)

(FIGURE 2 near here)

A particularly difficult problem, also faced by several other European countries, is how to stabilise the debt-to-GDP ratio some years ahead without driving the economy deeper into a genuine slump in the short-run. To avoid a further collapse we suggest a "back-loaded" fiscal consolidation, i.e., only a modest initial effort in 1994, with the full thrust of the deficit reduction during the period 1995-97. This strategy faces serious limitations and difficulties, particularly in terms of credibility with parliamentary elections coming up in 1994.

Figure 2 Alternative debt-to-GDP scenarios

Source: Authors' calculations.

The effort required to consolidate the public-sector finances is very substantial, but it is comparable with what has been achieved in other European countries over similar periods of about four years, e.g. Denmark 1982-86, Belgium 1981-85 and Ireland 1985-89. These countries, however, had the good fortune to adjust in periods when international economic trends turned out to be more favourable than most current projections for the near future. On the other hand, since debt has not yet accumulated at anything like the levels in Denmark, Belgium and Ireland, Sweden is in a better position to stabilise the debt-to-GDP ratio at a reasonable level.

2.3.3 Interest rates and the banking sector. Early and very concrete action on the budgetary side as well as institutional reforms of the kind discussed above, would make it easier for the Riksbank to continue its policy of reducing short-term interest rates, while observing the impact on the exchange rate and on long-term interest rates. We have no marked preference for either of the two strategies -- the Swedish (or German) strategy of gradual interest rate reductions or the UK strategy of lowering short-term rates aggressively. However, a sudden shift of strategy is not advisable since it could persuade financial markets that the central bank had been forced to abandon its longer-term struggle to aim for low inflation and result in a further depreciation of the krona. A further depreciation would create even better prospects for the tradable sector, which would accentuate the current tendencies towards a "dual economy" and further depress the real income of households, and hence demand, in the ailing domestic market. Yet lower short-term interest rates remain a high priority, not least because they would soften the impact of the banking crisis on the

economy. Thus, it is important that the central bank continues the strategy of gradually lower short-term interest rates.

However, the main interest-rate problem, i.e. high bank lending rates, is related to the crisis in the banking system. The banks seem likely to maintain quite good earnings (before credit losses) in the period 1991-94, even taking non-payment of interest by a large group of borrowers into account. But the decline in property values and other assets, and the need to write off credits, have created severe recorded profit losses and pushed some banks below the minimum capital requirement of 8 percent of risk-weighted assets. Without the injection of about 40 billion kronor in 1992 (to the state owned bank and a small bank that the government was forced to take over), the total capital base of the banking system would have fallen from 117 billion kronor by the end of 1991 to about 70 billion by the end of 1992. One immediate consequence is that the banks are reconstructing their capital through high interest rate margins. Such a policy will appear feasible to individual banks because of the fairly cartelised nature of the Swedish banking industry, but it imposes a severe burden on small- and medium-size firms that depend heavily on bank credit.

A first method to facilitate lower lending rates is to extend government guarantees for particular types of assets. This is a powerful method as an asset guaranteed by the government is safe. This method may not require any immediate payments to the banks; the government pays up only to the extent that capital losses are realised. But banks may still want to bolster their capital through high lending rates, making the guarantees redundant. An alternative method is to force under-capitalized banks to issue new shares. If the existing shareholders or other private investors were unwilling to subscribe, the government would have to

absorb most of the issue, becoming *de facto* the owner of the bank. The government -- in practice the "Bank Rescue Fund" established in 1992 -- should then proceed to split up the bank into a solvent and a non-performing part; the former could be sold off, thereby recovering part of the government's original outlay.

The second method is preferable largely because it is compatible with a more competitive and less defensive banking environment. It also avoids one pitfall of the guarantee method by not providing a safety net for existing shareholders. The shortcoming may be a higher level of publicly injected funds at the outset, though the relative costs may subsequently be reversed. This method should be applied with a minimum of delay in order to avoid the situation which has developed in Norway, where the government appears to be stuck with bank ownership for a long time. Such a situation would risk losing large international Swedish enterprises as clients to foreign banks, hence undermining the longer-run viability of Swedish-owned banks.

Recent experience in financial markets also raises the issue of whether the regulatory set-up in financial markets should be modified in order to prevent similar "accidents" in the future. One possibility is permanent government guarantees for so-called "narrow banks" that allocate all their earning assets to government securities. The idea is to limit government guarantees to the payment system, rather than to the entire credit system. Hopefully, agents in the market have now learned the importance of risk management. New rules, and additional resources for the state agency for financial regulation may also be advisable.

2.3.4 New unemployment policies. The massive public-sector deficit severely constrains the kind of shorter-term stabilisation policy

which could otherwise be recommended to soften the sharpest downturn in economic activity since the 1930s. This is the most troubling aspect of the acute crisis. The single most urgent risk to be confronted is that of internal demand going into a tailspin, with even higher unemployment, as happened in Finland in 1992. If economic trends were to worsen significantly in the course of 1993, a temporary cut in VAT rates and a temporary general investment tax credit could become the only remaining options, despite the widening of the deficit which these steps would imply.

During the 1970s and 1980s, long-term unemployment rose in a majority of West European countries. Sweden has recently experienced a rise in the total unemployment rate to European levels, but large-scale long-term unemployment has not yet emerged. Preventing it is a prime task, while at the same time respecting the constraint of stabilising the public-sector debt-to-income ratio in the medium term. The key concept that we propose is to reorient the huge budgetary expenditures related to unemployment (approximately 90 billion kronor) towards less expensive activities and to lower the compensation level, all with a view to increasing the leverage on employment creation. High school and adult education should be expanded and new inexpensive forms of public works, particularly repair and maintenance of public buildings, should be accelerated. In relation to previous income in employment, benefit levels in existing costly programmes should be reduced to, say, 80 percent for public works programmes, 75 percent for education and retraining and 70 percent for unemployment benefits. While increasing the employment effects of government expenditures, these steps would also weaken any upward pressure on wages and improve the incentives for the unemployed to

seek regular jobs. The latter effect would become important when domestic demand recovers.

Public-sector infrastructure investment could be made more labour-intensive by introducing two or even three shifts. An absolute condition for any acceleration of such investment is, however, that projects with the highest yield according to existing social benefit-cost evaluations are implemented first. In times of low activity, there is always a risk that well-organised local or sectoral interests will manage to circumvent proper and thorough appraisal of public-sector investment projects.

Improving the efficiency of employment policy is not a task solely for public-sector expenditures. Some part of the excess of private saving over investment -- presently about 12 percent of GDP -- could perhaps also be attracted into labour-intensive physical investment. Repair and maintenance of buildings is an obvious example; such activity could be stimulated by outright subsidies or tax allowances. It is less expensive for the government to pay the private sector, for instance, 50,000 kronor to create a job, than if the government itself employs somebody for, say, 150,000 kronor.

To reduce the deficit in the social security system, and to distribute the burdens of high unemployment more fairly between those with and those without regular jobs, social security contributions for firms and employees, actuarially calculated, should be raised. The contributions should also in some measure reflect differences in unemployment risk. In addition, we propose that rules for temporary employment be liberalised to facilitate the creation of additional jobs. Restrictions on temporary employment tend to stabilise employment over normal cyclical swings in activity, but they operate as a brake on the creation of new jobs when starting from a deep slump.

It may be surprising to outside observers that a country which has just experienced an improvement in competitiveness of about 20 percent cannot be confident that a strong swing in net exports from its tradable sectors will pull the economy out of recession. There can be no confidence that this will happen, because these sectors are simply not large enough; they account for only about 20 percent of GDP. The remaining 80 percent, consisting of the sheltered private and public-sectors, is unlikely to be sufficiently stimulated, partly as a consequence of the abrupt increase in the household saving rate. A number of other, more structural, measures are required to change this outlook and they are taken up under the headings of Efficiency and Growth below. These measures, in turn, require implementation of institutional reforms, including changes in decision-making processes in the political system, which are discussed under the heading of Democracy and Institutional Reforms.

3. Efficiency

Sweden's long-run efficiency problems are the result, in part, of political interferences which have distorted markets and, in part, of a failure to provide adequate institutions for a well-functioning market economy. As a consequence resources are used inefficiently. A number of steps could improve the situation: (i) promote a more stable and competitive environment for private firms, (ii) encourage diversity and cost consciousness in the production of public services, and (iii) reform the social security system by bringing it closer to insurance principles.

3.1 A more competitive environment

Evidence that competitive pressures are comparatively weak in private goods markets may be found in the surprising extent to which the Swedish

price level, has, over long periods, exceeded the OECD (and EC) average. For example, Swedish prices for consumer goods in 1990, according to PPP comparisons, were typically 30-40 percent above those in the EC. Only some of that divergence has been eliminated by the recent depreciation and by cuts in indirect labour costs. Weak competition is due to a mixture of public regulation and private cartelisation of markets, where the former often reinforces the latter.

Prime examples of how regulations stifle competition and breed inefficiency are the food and beverage industry and the housing and building sectors, which have been thoroughly regulated since the 1930s and 1940s, respectively. These and other sectors should be deregulated to facilitate the entry of new firms. This requires a critical reexamination of existing barriers to free trade and to entry in the form of licensing requirements, permits to set up enterprises and local government entry restrictions in some sectors, notably retail trade. In this area, however, advice on better economic policy is not enough. It is also necessary to consider institutional reforms which will reduce the influence of special interests on policy outcomes. Our proposals on competition and regulatory policy are summarised under points 20-27 in the Appendix.

Two pending changes will encourage more efficient use of resources in the private sector. One is the adoption of a new anti-trust legislation which could be a powerful vehicle for deregulation, but must be monitored to prevent special interests from capturing the broad discretionary powers of the regulatory authority. To that effect, the regulatory authority must announce how it intends to apply the new legislation -- in analogy to the official "Merger Guidelines" in the

United States. It is also important to monitor that small and medium-sized firms are not discriminated against by the new legislation.

The second pending change is Sweden's participation in the European Economic Area (EEA) which is expected to become a reality in the course of 1993. The EEA will dismantle administrative impediments to trade and to the entry of firms, which will challenge the present market segmentation. We recommend that all steps required to meet Sweden's obligations under the agreement, including legislation on public procurements, be advanced to the earliest possible date, regardless of possible delay in the EEA. The EEA agreement does not cover agricultural products. However, if Sweden becomes a member of the European Community (EC) later in the 1990s, the Common Agricultural Policy will apply after a transition period. Sweden is currently in a historically unique position: domestic agricultural support programmes have been reduced and depreciation of the krona has made some products competitive at world market prices. This is an example where premature application of an expected future regime would not be desirable. Efforts from special interest groups to reintroduce export subsidies -- in the name of EC harmonisation -- into the agricultural sector and the food industry should be resisted.

3.2 Labour market efficiency

Improving long-run efficiency of the labour market is desirable, in addition to checking the rise in unemployment. Centralised wage bargaining has strongly distorted relative wage rates. A shift to decentralised wage setting, ideally at the level of individual firms, would probably help to bring about a relative wage structure that is more conducive to economic efficiency. With an increasingly heterogeneous

labour force, and increased decentralisation within firms, "efficiency wage" aspects, paying above potential market-clearing wages to secure work effort, will gradually become more important. Such wage rates can only be set within individual firms since this is where the required information is available.

Detailed regulation of the Swedish labour market has evolved in response to a number of laudable motives: to improve the job security and health of employees, to give a dismissed worker time to search for new employment, to increase the influence of employees in their workplace, and to facilitate paid leaves of absence from work for continuing education or personal reasons, mainly maternity (and paternity) leave. Nevertheless, regulations of this type have costs. They tend to favour those who hold regular jobs ("insiders") relative to those who do not ("outsiders"), and they weaken the capacity of firms to adjust to changing economic circumstances. It must be admitted that there is little clear empirical evidence regarding the consequences of such labour market regulations. Yet there is little doubt among firm managers and many economists about their general implications. Our proposals are summarised in points 28-32 in the Appendix.

Protection of insiders through "last-in-first-out" rules for dismissal and priority to former employees in rehiring, sometimes defended on grounds of "fairness", can also be defended on grounds of efficiency. Workers who invest in firm-specific human capital bear considerable risk and the human capital of older workers is often less transferable among firms than that of younger workers. Thus, without such rules, younger workers may be less eager to seek employment in risky industries. However, these favourable effects have to be weighed against the sometimes severe difficulties of small firms; retaining key workers

and young and enthusiastic employees may be crucial for the survival of a firm that is forced to shed labour.

We are also critical of the ease and low cost with which employees and their organisations are permitted to escalate labour disputes, e.g. through striking in sympathy with other employees. In general, legislation and courts in Sweden have adopted a very lenient attitude towards broken contracts in the labour market, notably so-called wildcat strikes; it is not obvious why legal sanctions in this area have to be so much less severe than other types of contract breaches.

3.3 Taxation

Large transfer payments, extensive public-sector provision of "social" services and, as a consequence, a high level of taxation, are, of course, all characteristic features of an advanced welfare state like Sweden. A major tax reform in 1991 was, in our view, successful in unifying the income tax system, lowering marginal income tax rates substantially (to 50 percent in the top bracket) and broadening the tax base. This was one rare example of a common long-run interest prevailing over special and short-run interests. The tax reform was about as far-reaching as it could be, given the very high level of public expenditures. The reform fell short of providing adequate revenues, partly because the economy turned downward around the time of its implementation. Yet deficit reduction is not a valid reason for pushing the personal income tax back up.

Labour taxes -- the "tax wedge" -- remain very distortionary: for an individual with a 50 percent marginal income tax rate, the effective marginal tax wedge is still around 70 percent when the incidence of VAT, (the tax element of) employer contributions and other taxes are included. At this point, a reversal of the 1991 tax reform would also have a

detrimental effect on the confidence of citizens in the ability of the political system to keep its promises, maintain stable rules and ensure a reasonable return on education, extra work effort or savings.

A few specific tax proposals are developed in points 38-43 in the Appendix. We advocate indexing capital taxation and eliminating double taxation of corporate profits by abolishing taxes on dividends. The corporate tax rate could in this case remain at its present rather favourable level of 30 percent rather than be reduced further to 25 percent.

3.4 Public goods and services

From an efficiency point of view it is clearly desirable that principles of competition and freedom of choice be extended beyond the private sector to the provision of public-sector services. Government consumption currently accounts for 28 percent of GDP. The bulk of this huge output takes the form of social services (child care, schools, health care and old age care, social work) supplied by local governments through local monopolies and financed by general taxation. Our basic premise is that all production in the government sector which is not directly an exercise of public authority (and does not consist of technical monopolies) should be subjected to as much competition as possible. Otherwise, costs are likely to remain high and output quality unlikely to improve much. For example, the Swedish school system has the highest costs per pupil in the OECD area, while tests of basic skills show rather mediocre levels of achievement; the costs in municipal day care centres are also very high (about US\$ 13,000 per child per year). Moreover, heavy subsidisation may lead to overconsumption in some cases, to excess demand and queues in

others, while standardisation of services fails to match the diversified preferences of users or consumers.

Increased competition for services produced by the public sector does not mean that privatisation is the general solution, although privatisation would certainly help in some sectors. In most areas it is neither necessary nor feasible to go that far. One approach is to reallocate a considerable part of central and local governments subsidies, which are now transferred to the suppliers of services. Instead these subsidies could be given directly to the individual users of these services in the form of vouchers, which could be used for a specific purpose in different public or private institutions. When this solution is not practicable, or if it is considered too radical, greater cost consciousness and quality awareness could be promoted by continuing the present experiment of delegating budgetary responsibility to the individual school, hospital or old-age home, while linking government subsidies to indicators of performance. This would help create a more competitive climate among different suppliers of services without creating significant risk of social segregation.

Above all, more experimentation at the local government level is required to find better ways of reconciling individual needs and preferences with the traditional aims of the welfare state by making high quality social services available to all. The central government should not, as it has increasingly done in Sweden, regulate the activities of local governments in detail. It should, however, institute an efficient system of audit and evaluation of such activities by creating a municipal counterpart to the National Audit Board which currently monitors central government activities. The tax ceiling on local governments should be abandoned to widen the scope for differentiation and experimentation. In

parallel, making referendum mandatory for tax changes (at least tax increases) by local governments would improve democratic influence. (see points 57 to 64 in the Appendix).

3.5 Social security

There is no doubt that the social security system and other welfare-state arrangements have been successful in enhancing the income safety of the Swedish population. A number of serious problems have accumulated, however, as the benefits have become ever more comprehensive and generous. When considering remedies for these problems we start from two basic premises: (i) the social-security (or social insurance) system should not overburden the economy through distorted incentives or large deficits, and (ii) the system should be more robust to frequent interventions by policy-makers for stabilisation or redistribution purposes.

The first premise implies a considerable element of co-insurance, for example by limiting benefits to 70-80 percent of previously earned income. If the aim is to move towards a society where individual citizens assume a higher degree of responsibility for their own fortunes, mandatory social insurance coverage should not be so high that voluntary group insurance or individual insurance becomes superfluous for the majority. Cuts in benefit levels constitute an important step in this direction.

A reformed future mandatory system may offer either just a basic protection which gives an equal lump sum to all insured, or, in addition, a component which depends on previously earned income. In the latter case, the income-dependent component should comply with actuarial principles in order to limit tax wedges. If significant scope is left for

voluntarily funded insurance, total savings are likely to rise substantially. This would be useful in a long-run perspective to offset the large deficits in the present systems. The type of system we envisage is illustrated in Figure 3.

(FIGURE 3 NEAR HERE)

The second premise -- robustness to political interventions -- is best met by removing the social insurance system from the regular central government budget process. A revised system could be based on a number of public funds with no privileged access to government financial facilities -- or it could be opened up to competition among private insurance companies, leaving the choice among the latter to the individual citizen. In accordance with our general principle that a much clearer division of responsibilities between the government and labour market organisations is desirable, we warn strongly against current reform proposals, which amount to substituting the present state monopolies in the social insurance system, by corporatist monopolies, controlled by employers and trade unions.

Ideally, benefits levels should be similar under the separate types of insurance coverage available to the individual (e.g. against accidents at work, own illness and children's illness, requiring the parent's absence from work). The basic principle of reform should be similar to the guideline of the 1991 tax reform: uniformity of rates, so as to avoid incentives to arbitrage between different insurance systems. Our proposals are summarised in points 44-56 in The Appendix.

4. Growth

Improving the growth performance is important not only for the long run, but also to handle short-term macroeconomic problems. Sweden has failed

Figure 3. Three elements in a future social insurance system

to adjust to slow growth even after a lengthy learning period. Institutions and mechanisms have continued to be based on the rapid growth of earlier periods, resulting in increasing imbalances in the social insurance system, the government budget, and in persistent inflation. While all these features must be brought in line with recent reality, it would obviously be preferable if some of the gap could also be closed by "improving reality", i.e., by achieving a faster rate of growth.

Economic growth can be encouraged by stimulating investment in physical capital and human capital and by facilitating research and development as well as the diffusion of technological innovations. The general economic environment of firms and households is the most important prerequisite for successful performance in these respects. It requires adequate economic incentives, well-functioning markets, and broad freedom among firms and individuals to take initiatives, including free entry, in a strongly competitive environment. Vital private entrepreneurship also requires private risk-capital, and hence private saving. Capitalism cannot function without capitalists.

4.1 Physical capital accumulation

The fact that Swedish firms have been very successful in expanding their operations abroad supports the notion that explanations for the weak growth of output and productivity in Sweden are related to the economic environment in Sweden, rather than to the competence of management in multinational Swedish firms.

To induce accumulation of physical capital in the private sector, profitability in Sweden has to be at least as high as in other countries. In the past 20 years, this condition has only been met in exceptional

periods. As regards the accumulation of physical capital in the form of public infrastructure, a considerable increase has occurred in recent years from the low level of the 1980s. There does not appear to be a strong case for raising the level of infrastructure investment further, except that some acceleration of projects may be justified by the current situation in the labour market, especially in the construction sector. Sweden is well endowed with the traditional infrastructure required for transportation, municipal services and communications. However, new types of infrastructure, particularly in the area of information technology, will have to be developed over the coming decade (points 70-72 in the Appendix). The main impediments to growth, therefore, appear to involve the other two "sources of growth", namely, human capital and technological development and diffusion.

4.2 Human capital accumulation

More investment in human capital is particularly desirable and will require stronger incentives for education, including job-related training. It will be necessary to accept widening wage and salary differentials to reflect differences in skill, and a somewhat steeper profile of lifetime remuneration linked to the efficiency of the individual employee. The calculations presented in some of the supplementary reports indicate that the emphasis on egalitarian principles over the past two decades has had negative consequences for investment in human capital. In addition, these principles have focused too much on annual, instead of lifetime, earnings. The premium on continuing education and training has dropped to an internationally very low level. (Manual workers hardly receive any relative wage increase at all after age 21.)

Moreover, the basic school system has become lax, with inadequate attention to basic skills in the natural sciences, foreign languages and mathematics. International studies suggest that hours at school and hours of homework are important determinants of student achievement, while the pupil-teacher ratio seems to be less important (within the margins that have been studied). School and homework hours per year are relatively modest in Sweden and could easily be expanded given the current favourable pupil/teacher ratio. The dramatic increase in the density of teachers during the 1960-1990 period does not seem to have led to any measurable effect on performance. (The number of teachers in the schools per child has approximately doubled since 1960.) More efforts should be directed towards better integration between vocational training and the enterprise sector, by e.g. reinstating some elements of the apprentice system (see points 73-82 in the Appendix).

4.3 Research and development

Sweden has a reasonably good system for financing and organising basic research at the universities, but often industry has not followed up this effort. The largest scope for intervention lies in areas that fall between the academic interests of universities and the more applied activities of individual enterprises, particularly when it comes to generic technologies of potential use in many production sectors. Our proposals are found in points 83-86 in The Appendix.

Deficiencies in the development of human capital and technology may be even more severe than suggested by the weak figures of productivity growth. An indication of this is that Sweden tends to encounter cost crises at lower and lower levels of relative unit labour costs. One interpretation is that Sweden has been lagging in product quality over

the last decades. This means that unchanged market shares require falling relative prices of Swedish output. In other words, unchanged profitability of Swedish firms would require falling unit labour costs over time to compensate for lagging product quality -- an area where Sweden was a leader in the 1950s and 1960s. The most likely explanation is deficient accumulation of human capital and technology.

5. Democracy and institutional reform

It is hazardous to hypothesize about the effects of institutional changes on political decision-making and economic performance. Nevertheless this difficult issue cannot be overlooked. While Sweden faced tougher economic challenges in the 1970s, political reforms probably weakened the capacity to tackle them. Parliamentary mandates were shortened to three years, an exceptionally short period by international comparison and conducive to short-termism in political decision-making. The bicameral system was abandoned and the size of the Riksdag increased out of proportion with the size of the population. Parliamentarians increasingly saw themselves as representing short-run, regional, sectoral or socio-economic interests, whereas the prime role of the Riksdag should be to serve as custodian of the long-run general interest. This process of sectorisation has found expression in the growing power of the specialised committees in the Riksdag and in the focus on narrow private-member bills. The position of key bodies -- notably the Finance Committee -- has weakened in an excessively protracted budgetary process. Comparative studies suggest, furthermore, that the Swedish budget process is as weak as that of generic deficit countries like Greece and Italy.

These factors partly explain the drift in public expenditures and the incapacity to take timely action to trim the budget deficit. Consequently, our proposals include lengthening parliamentary mandates to four, or preferably five, years, reducing the size of the Riksdag and reforming the committee structure to minimise the risk of attachment to special interest groups; for example, the Agricultural and the Housing Committees should be merged with others into a general committee for industrial issues.

A shift in influence from the cabinet towards the Riksdag is, to some extent, caused by increasing fragmentation in the party system and by the absence of stable parliamentary majorities. Still, several steps could be taken to minimise the risks of indecision in the political process: a constructive vote of no confidence may be introduced, so that a cabinet would remain in office as long as a new government cannot be formed; this could be combined with a rule such as Article 49:3 in the French Constitution, according to which a proposal of the government is accepted as long as Parliament does not pass a vote of no confidence.

A provision to prevent the Riksdag from splitting up government proposals could also be a constructive step. This would enable the government to ask for a vote on an entire package of measures or proposals, leaving the Riksdag with a choice of accepting or rejecting the whole package. Such a reform would be particularly appropriate in the budgetary process. One of our main proposals is that parliament takes a decision on the total level of spending before deciding on individual budget items. The situation now is, in fact, the opposite.

In other respects, the role of the Riksdag could be clarified and strengthened, notably by extending its authority and resources to monitor and audit the government. As proposed above, as part of giving the

central bank greater autonomy in policy implementation, under an explicit and legislated mandate of pursuing a policy of low and stable inflation, the Riksbank should be made more accountable to the Riksdag.

Reforms of the operations of the cabinet itself also seem to be called for. Individual ministries have formed excessive attachments to special interests -- as have the corresponding parliamentary committees - - while the coordinating authority of the Prime Minister's Office and the Ministry of Finance is insufficient. These departments should formulate restrictions on total government spending at an initial stage in the budget process. Once the cabinet has approved these overall norms, the process can go on to detailed discussions about the expenditures of each ministry.

Sweden (with Finland) is unique in international comparisons in having gone a long way towards separating the cabinet ministries from the administrative system. Ministries are lean bodies which have delegated administration and regulation to independent boards and agencies. This is a good basis for the reforms we envisage, but more should be done to strengthen the analytical and monitoring functions in the ministries and, in particular, to reinforce their capacity to formulate overall guidelines and determine the scope for expenditures. Each department should have a non-political top civil servant beside the political Under Secretary (Deputy Minister). Our model is close to that observed in Norway (the proposals with respect to the central government are listed in points 92-105 in the Appendix).

With regard to local government, we argue that Sweden is not large enough to maintain three layers of representative government (four if Sweden joins the EC). Moreover, no production sector should be entrusted with power of taxation. One consequence of this should be abolishing of

the county councils, now responsible mainly for the health care system (hospitals) which is financed by a specific county-council tax. Municipal governments - and even the individual institutions in their orbit - should be given more autonomy, notably by not regulating their activities in detail, and by dismantling the central government's authority to impose a ceiling on municipal tax rates. As already mentioned, a mandatory referendum should be introduced as a prerequisite for municipal tax changes.

A popular view is that Sweden is a society of active citizenship where the views of interest groups are constructively represented in the decision-making process, leading to efficient consensual expression of the public interest. Today, however, members of organisations are not very active. Moreover, the division of responsibilities between the government authorities and organised special interests is blurred. It is striking that in Sweden a distinction is rarely made between state, in the sense of the government, and society, which comprises in addition private organisations and households. In practice, state and society are regarded as almost synonymous because non-governmental organisations are so closely interwoven with the political process.

We envisage a more explicitly pluralist society where the vagueness in the assignment of responsibilities is eliminated and the political system, in particular the Riksdag, is left squarely with the responsibility of preserving the public interest. Organisations should not, according to this view, be involved in decision-making in the public sector, or in the administration of justice. By consequence, organisations should not be represented on the boards of public-sector agencies. In particular, the Labour Court, the Rents and Tenancies Court of Appeal and the Market Court should be abolished, and their judicial

functions taken over by courts comprised of legal experts only. Non-governmental organisations should, to a greater extent than today, carry the full costs of their activities, limiting subsidisation from the taxpayer (see points 109-13 in The Appendix).

6. Concluding remarks

Our recommendations may appear over-ambitious and unlikely to be acceptable in their entirety. They will obviously meet with strong resistance from many special interest groups, as well as from parts of the political system. Our justification for being so comprehensive and radical is that the current deep economic crisis has vividly revealed that the task is not simply to correct a few specific mistakes or omissions of economic policy. The crisis has roots which go back several decades and bring into question much of the existing institutional framework.

Some deficiencies in Sweden may clearly be classified as "policy mistakes", while others may more appropriately be called "system failures", even though the borderline between these two concepts is hazy. The most obvious system failures in the economic sphere are perhaps the high level of public spending, the over-generous social-security system, the wide marginal-tax wedges, the low level of private, including household, saving, the detailed regulations and cartelisation in various markets, the lax anti-cartel legislation and the inflation-prone system of wage formation. The weakness in the political system -- the short election periods, the organisation of subcommittees in parliament, the lax budget process, the influence of special-interest groups over the political process, etc. -- may also be classified as system failures.

It is important to realise that these "system failures" are relatively new features of Swedish society. They were not pronounced during the successful period of economic growth, from about 1870 to 1970, when Sweden was perhaps the fastest growing economy in the world (the main "rivals" being Japan and Canada). Before the mid-1960s, public-sector spending was not particularly high in Sweden, neither were tax rates, regulations in product and labour markets were not yet particularly extensive, and private saving was not particularly low.

The most obvious examples of policy mistakes in recent years are perhaps the abrupt deregulation of financial markets in the mid-1980s; the unfortunate timing of the tax reform, relative to both financial deregulation and the business cycle; and the insufficiently restrictive fiscal policy during the second half of the 1980s. It is also obvious that it would have been better if the cuts in public sector spending during the early 1990s slump had instead been made in the overheated 1980s. The abrupt increase in unemployment 1991-1992 was largely a consequence of the discontinuation of the previous policy of accommodating domestic cost increases with devaluations and increased public-sector employment.

Despite the apparent comprehensiveness of our proposed agenda, we are aware of serious omissions in our analysis; the extreme brevity of our assignment (three months of work) simply did not permit us to face up to them. We draw attention to two regrettable omissions: environmental issues, which have barely been addressed, and the likely impact of Sweden's participation in the European Community, possibly extended to an economic and monetary union in the course of a few years. We have only made passing -- and mostly positive -- references to the compatibility of our proposals with Swedish integration into the rest of Europe. We did

not have the time or the resources to discuss our proposals systematically in this perspective; hence we do not attempt any evaluation of the net benefits of Swedish membership in the EC. Moreover, the Swedish decision on whether to join the EC will ultimately depend on wider political issues than those we have considered.

It should, finally, be noted that there is some light at the end of the Swedish tunnel. The 1991 tax reform considerably reduced marginal tax rates and removed a number of distorting asymmetries of the Swedish tax system; inflation has been reduced drastically; co-insurance is being introduced into the social-insurance system; and credit markets have been deregulated -- though the timing and speed of several of these changes created serious transition problems. There is also a fair chance that efficiency in both the private and the public production sector will be improved because of deregulation and increased competition, and that the education system in the future will emphasise basic knowledge more than before. Perhaps there is also a chance of politicians and the general public accepting higher return than before on investment in both physical and human capital. All this means that it is likely that Sweden will return to a faster rate of productivity growth in the near future.

Much remains to be done: a credible programme for gradual stabilisation of public sector debt, success in the attempts to prevent high persistent long-term unemployment, a shift to a less inflationary system of wage formation, and also reforms of political institutions to make them more conducive to a responsible long-term outlook. However, to the extent that it is possible to learn from previous mistakes, Sweden should have a bright future.

APPENDIX. THE PROPOSALS OF THE COMMISSION

A1. STABILISATION

A1.1 Long-term stabilisation policy

1. Let the Swedish krona float while awaiting possible adaptation to a currency union in Europe. A return to a fixed exchange rate is not advisable for the time being.
2. Assign a long-term price-stabilisation goal to the Bank of Sweden. Make the Bank more independent, but at the same time more accountable to the Parliament.
3. Stabilise the public-sector debt in relation to GNP. The debt (mainly nominal debt in domestic currency) should be transformed into indexed bonds and bonds in foreign currency. To make this programme credible, important institutional changes are called for (see pts. 92 through 105 below).
4. Fiscal policy should be used for coarse tuning (rather than fine tuning) in situations with severe deviations from normal capacity utilisation.
5. Liberalise labour market legislation and reduce unemployment benefits so as to create a more flexible labour market that can handle structural and regional change, as well as respond swiftly to economic recovery.
6. The Government should abstain from incomes-policy initiatives, and decentralise wage negotiations in the public sector.

7. To increase the probability of low inflation, we advise the parties in the labour market to limit wage negotiations to one level (sectoral or firm level), even if other working conditions may be negotiated at a higher level.

A1.2 Short-term stabilisation policy

8. Increase the scope for successful monetary and fiscal policy in the short run, by trying to raise the credibility of government policies in the long run. This calls for institutional changes concerning the status of the Bank of Sweden and the budget process.

9. Decide now on a concrete programme to stabilise the public-sector debt within five years, using a combination of expenditure cuts and revenue increases. Start with limited measures only, in 1994, and proceed with more substantial measures in 1995 through 1997, possibly also in 1998. Depending on the development of key macroeconomic variables, the gap to be closed is between 60 and 100 billion Swedish kronor (US\$ 8-13 billion) in addition to decisions already taken (up to January 1993); this will stabilise the debt at 40-50 percent of GNP. EC membership would call for additional expenditure cuts or tax increases.

10. The Bank of Sweden should continue its policy of stepwise reductions in short-term interest rates, as long as nothing dramatic happens to the exchange rate or long-term interest rates.

11. Given that the high borrowing rates in the commercial banks currently pose a greater problem than money market rates, the financial crisis has

to be solved *swiftly* and in such a way as to stimulate the credit supply and force down interest differentials. Issues of new shares is the best way to accomplish this in private banks.

12. If the Government temporarily becomes the principal owner of a private bank, the good and the bad portions of the bank should promptly be separated, and the good portion should be sold back to the market as soon as possible (within a year). The previous owners have to accept the fact that their shares will lose most of their value in the process.

13. In order to increase competition and force borrowing rates down, try to attract new agents (domestic and foreign banks) to the market.

14. When liberalising labour market legislation (point 5), moderate the law regulating temporary employment in firms, at least for the time being, in order to facilitate increased employment when the economy starts to recover.

15. Increase the leverage of the unemployment measures of the Labour Market Board by reducing compensation levels and shifting to less costly programmes (education, inexpensive and labour-intensive public work programmes, etc.), in order to bring down open unemployment at lower cost.

16. Firms and employees should bear a larger part of the costs of unemployment through increased employers' and employees' fees to the Unemployment Benefit Fund.

17. Allow temporary tax deductions for labour-intensive investments, such as repairs, maintenance, rebuilding, etc. in the private sector. Intensify such activities in the public sector as well (renovate schools, etc.).

18. Speed up the process of infrastructure investments by working in double or triple shifts, in order to increase labour intensity and reduce capital costs.

19. If private consumption or investment should fall drastically as compared to prevailing forecasts, we suggest a temporary reduction in the VAT or a temporary increase in the investment tax credit.

A2. EFFICIENCY

A2.1 Competition policy

20. Abolish remaining, officially sanctioned, obstacles to competition in commerce and industry, including entry barriers.

21. Implement those aspects of the EEA agreement which are aimed at enhancing competition, ahead of the established time schedule.

22. Do not accommodate prematurely to those aspects of EC policy which inhibit competition, for instance by re-introducing export subsidies to the agricultural sector and the food industry.

23. Deregulate the housing and construction markets by dismantling rent controls and sections of the building code.

24. Codify, in the form of public guidelines, the new anti-trust legislation, in order to increase predictability and to avoid "capture" from special interests.

25. Adapt the pace of deregulation to the business cycle, but take the necessary decisions immediately.

26. Increase the authority and competence of the Competition Board, allowing it to have jurisdiction over the entire economy, including the public sector.

27. Make regulations subject to reconsideration in Parliament at regular intervals; on such occasions, the costs of the regulations to consumers and taxpayers should be clearly exposed.

A2.2 The labour market

28. Liberalise or abolish the present rules governing the dismissal and re-employment of labour. If the rules are modified rather than abolished, each firm could be given a certain quota within which the rules do not apply.

29. Firms should be responsible for a substantial share of the costs of early retirement pensions, in order to reduce the temptation to place the burden of shedding labour on the taxpayers.

30. Abolish the trade unions' right to veto contracts by tender.

31. Abolish the right to blockade enterprises with unorganised labour that are not involved in a conflict, unless the employees request such a measure.

32. Breaches of contract in the labour market should result in sanctions, as severe as elsewhere.

A2.3 The financial market

33. Major changes in the regulatory framework of the credit and capital markets should be carried out with greater caution than during the 1980s.

34. Divide the General Pension Fund into independent units, in order to improve the functioning of the bond market.

35. Consider guaranteeing the payment system without guaranteeing bank credit. A possible method is to introduce so-called *narrow banks*, whose deposits are guaranteed, and whose assets are placed solely in government bonds; they would still be fully equipped to handle all types of accounts, including checking accounts.

36. Stimulate increased diversity in financial markets, not only by selling (parts of) the banks taken over by the Government to new, Swedish or foreign, owners (point 12), but also by avoiding situations where private shareholders are treated less favourably than institutional owners.

37. Create more leeway for private income insurance to broaden the stock market.

A2.4 Taxation

38. Adhere to the principles of the 1991 tax reform; do not increase marginal tax rates; avoid introducing new asymmetries into the tax system.

39. Index capital taxation, so that real tax rates become independent of the inflation rate.

40. Eliminate double taxation of corporate profits by repealing the tax on dividends to shareholders. Compensate for the loss of tax revenues by not reducing the corporate tax rate from 30 to 25 percent.

41. By using tax reform to make shareholding as advantageous for individuals as for institutions (point 36), current discrimination in the supply of equity capital to small enterprises could be curtailed.

42. Taxes should be made as visible as possible; they should also be called taxes and not fees; the gross wage, including payroll taxes, should be reported along with the wage payment.

43. Intensify measures against economic crime, so that more of the taxes decided upon by the Parliament are actually paid.

A2.5. Social insurances

44. Separate the social insurance system from the government budget, possibly also from the public sector, but only after the system has been reformed.

45. We recommend a compulsory basic social-insurance system that combines a fixed amount, equal for all, and an income-dependent amount. The proportions between these two components may vary among the types of social security.

46. The income-dependent component of the social-insurance system should be made actuarial, at least in the health insurance and the pension systems. As regards unemployment insurance, a solution where employers, employees and the Government share the costs *equally* seems reasonable.

47. Differentiate insurance fees for injuries in the workplace to reflect the frequency of injuries.

48. Set the ceiling on mandatory insurance payments and fees low enough, such that large groups of citizens find it desirable to acquire voluntary income protection. This can be expected to give rise to a substantial increase in private saving.

49. Legislate a ceiling on the sum of mandatory and voluntary insurance, in order to preclude subsidisation of "over-insurance" and abuse.

50. Equalise, as far as possible, the benefit levels in all social security systems between which individuals are likely to move.

51. Ensure that insurance suppliers do not cause others, for instance taxpayers, to incur substantial costs, by ridding themselves of costly policyholders.

52. Merge the insurance against illness and workplace injuries into a *single* system, with the financial burden shared between households and firms.

53. Do not transform the present publicly administered system into a system managed by the parties in the labour market, i.e., into a corporative system.

54. In funded systems, the assets of the policyholders should be kept separate from both the public sector and the finances of firms. A government inspection agency should also be set up.

55. In reforming the social-insurance system, it should be kept in mind that old-age and early-retirement pensions imply long-term contracts that cannot be changed suddenly.

56. Transform those components of the social-insurance system that do not provide proper risk insurance (such as childbirth and child care benefits) into a pure benefit system, and retain them in the government budget.

A2.6 The public sector

57. The state should not interfere with production of services at the municipal level more than is absolutely necessary.

58. Social rights, as defined by the central government, to be provided by the municipalities, should be confined to generally recognised, basic needs.

59. Reform the national system for redistribution of income among municipalities in order to increase the incentives for each municipality to enlarge its own tax base.

60. Reforms of public-sector activities should be based on small-scale experiments at the local level.

61. All provision of public services, aside from the exercise of government authority, should eventually be subjected to competition; complaints about restrictions on competition should be made to the Competition Board. Barriers to entry should be removed, and the playing field be levelled.

62. Require an efficient system for auditing and evaluating local government activities, and create a counterpart to the National Audit Bureau for the municipalities. Require that the accounting practices of the municipalities be uniform and expedient, so as to scrutinise costs and evaluate achievements in relation to stated objectives.

63. Natural monopolies should not be privatised without first having examined the possibilities of regulating them (this holds in particular for infrastructure).

64. Consider the introduction of a mandatory referendum in connection with tax increases in municipalities.

A2.7 Balance in public-sector finances

65. The public-sector debt should be stabilised primarily through expenditure cuts.

66. Public expenditure cuts should not be distributed evenly, but based on explicit priorities.

67. Under favourable conditions (with respect to the growth rate and unemployment), keeping public-sector consumption fixed in real terms, and raising revenues by 20 billion kronor (fees to the Unemployment Benefit Fund and more efficient tax collection), are sufficient to stabilise the public debt by 1998, given expenditure reductions already decided upon. If, instead, public-sector consumption should expand in proportion to GDP, transfers have to be cut by 40 billion kronor beyond what has already been decided upon. If revenues are not increased, both public (sector) consumption and transfers have to be cut. If GNP growth turns out to be one percentage point weaker per year than assumed in these calculations, and the unemployment rate five percentage points higher, another 30 billion kronor in expenditure cuts or tax increases will be necessary.

68. If such expenditure cuts are not accomplished, the public debt cannot be stabilised before the turn of the century without substantial tax increases.

69. Any proposal for increased expenditure should be matched by cuts in other areas.

A3. GROWTH

A3.1 Infrastructure

70. The situation in the labour market justifies speeding up infrastructure investments. Over a longer time period, however, there are no compelling reasons to raise the investment level above what has already been decided. The Commission has found no indications of serious deficiencies in the traditional infrastructure (roads, railroads, harbours, etc.).

71. It is important to ensure that *new types of infrastructure* are developed, particularly in the area of information technology.

72. By creating better incentives for the decision process concerning infrastructure investments, these can be made more sensitive to the results from cost-benefit analyses.

A3.2 Investment in education

73. Wage differentials provide an important incentive for productive investments in human capital.

74. Skilled manual workers should be better rewarded in the wage-setting process.

75. There are good socioeconomic reasons for subsidising education. The educational system should be designed in such a way that subsidies are not capitalised by those who manage to receive their education in fields where admission is restricted.

76. Raise the requirements in core school subjects such as Swedish, foreign languages and mathematics -- i.e., abilities that are important regardless of the field a student chooses for specialisation in the future.

77. Reduce costs in the educational system by reverting to previously lower teacher-student ratios.

78. Increase the number of school days and hours per year, so that traditional core subjects (such as mathematics, languages and natural sciences) can be expanded without encroaching upon the humanities, aesthetics or physical education. Increase the amount of required homework.

79. If more resources are required in order for the educational system to carry out its programmes, they may be taken from other types of subsidies to children, such as the daycare system or child allowances; such a reform would then amount to a redistribution over time of the total support to children.

80. Increase the competence of teachers by continuous retraining. Use a steeper wage profile as an incentive.

81. Weight school marks for different subjects when students are selected for higher education.

82. Reintroduce the traditional system of "workshop schools" into private enterprises, for instance in the form of apprentice systems with a combination of theoretical education in school and practical training in the workplace.

A3.3 Technological development and diffusion

83. Government support to R&D activities should be general, not selective.

84. The main responsibility of the government in regard to technical development and competence should continue to be education and research.

85. In order to reduce the risk that generic technologies are undersupplied with resources, the government should support technological development in such areas.

86. To the extent that research institutes are created for R&D purposes, they should have a small permanent staff supplemented by temporarily contracted researchers.

A3.4 General economic environment of firms

87. The government can stimulate economic growth in much the same way as it should stimulate the efficiency of the economy: by improving the general economic, social and political environment of firms and

households, rather than interfering with the conditions and decisions of particular sectors or enterprises.

88. Due to the vast uncertainty regarding the importance of different factors for economic growth, the government should try to influence a broad spectrum of factors that are likely to have favourable effects.

A3.5 Bequest

89. In order to ascertain whether one generation passes on a burden to future generations, we suggest that a system of generational accounting be developed; it should to the greatest possible extent comprise *all* assets and debts transferred between generations.

90. To protect the natural environment from damaging effects of firms' and households' activities, we recommend -- in line with mainstream economics -- that the government use taxes and subsidies rather than regulations. An important example is environmental charges.

91. We recommend the development of "green national accounting" in the government budget proposal, supplementing (but not replacing) traditional national accounting.

A4. DEMOCRACY

A4.1 Central government

92. Amend the constitution in the direction of more consistent parliamentarianism. Reinforce the position of the cabinet. Introduce a so-called constructive vote of no confidence whereby the Government remains in office as long as a new government cannot be formed.

93. Strengthen the position of the Prime Minister's Office and the Ministry of Finance. Reduce the total number of ministries.

94. Intensify the management function of the ministries. Each ministry should have a civil servant as top administrator, alongside of a politically appointed under-secretary.

95. Alter the focus in Parliament from detailed issues to major policy guidelines.

96. Strengthen the Parliament's resources for scrutinising and auditing the cabinet.

97. Reduce the number of standing committees, and strengthen the position of the Finance Committee.

98. Neutralise the influence of interest groups in public-sector decision-making by sharpening the rules on conflict of interest. Assign broader areas of responsibility to the standing committees of Parliament.

99. Extend the election period to four, or preferably five, years.

100. Reduce the number of seats in Parliament by one half.

101. Strengthen the budget process in Government Offices. The Government should stipulate budget norms early in the process, specifying both total expenditures and the expenditures of each ministry.

102. As regards the budget process in Parliament, a superior and coordinating role should be assigned to the Finance Committee. The Parliament should begin with a binding vote on total government expenditures, *before* separate areas are considered. Proposals by Members of Parliament leading to increased expenditures have to be financed by cuts elsewhere.

103. The budget document should be made comprehensive and transparent. All government expenditures should in principle be decided upon during the budget process. Concealed expenditures (e.g. so-called tax expenditures) should be made visible.

104. As the direct, regulatory activities of the central administrative agencies are curtailed, their responsibility for auditing and evaluation should be strengthened and intensified.

105. The price stabilisation objective of the Bank of Sweden, and its independence in relation to the Government and Parliament (point 2), should be determined through legislation, as should its accountability to Parliament.

A4.2 Local government

106. Since specific sectors of the economy should not be given the right of taxation, the county councils (responsible mainly for the health care system) should be abolished.

107. The right of taxation of the State church should, for the same general reason, be revoked.

108. The freeze on local government tax rates should eventually be phased out, as it is not compatible with the concept of local government autonomy; however, we suggest a mandatory local referendum as a prerequisite for tax increases (point 64).

A4.3 Non-governmental organisations

109. Interest groups should not be involved in decision-making in the public sector, or in the administration of justice. As a consequence, organisations should not have representatives on the boards of decision-making public-sector agencies.

110. The Labour Court, the Rents and Tenancies Court of Appeal and the Market Court should be abolished, and their legal functions taken over by courts composed of legal expertise only.

111. Non-governmental organisations should, to a greater extent than today, bear the costs of their own activities, thereby limiting the contributions from taxpayers.

112. The principle of public access to official records should be preserved, particularly in negotiations regarding EC membership.

113. Reinforce the autonomy and competence of the mass media, e.g. by raising the standards of journalist education.

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