FONDATION ROBERT SCHUMAN
POLICY PAPER

European issues
n°258
13th November 2012

Budgetary Balance and Competitiveness: the Swedish Example

Sébastien Richard

Abstract :

Sweden is deemed by its observers as a leader in the EU in terms of the way it manages its public finances. With a public debt below 40% of the national wealth and balanced public accounts, its budgetary governance method appears to be a path to follow for many countries in the Economic and Monetary Union. Unlike its partners, Sweden succeeded at the beginning of the 1990's in learning from the failure of its economic and social model – the famous Sweden model – to adjust to the new world order; which led to its reform, notably by anticipating the principles adopted in the European Union via the Treaty on Stability, Coordination and Governance.

THE "OLD" SWEDISH MODEL

For a long time the "Swedish model" was seen as the third way between capitalism and collectivisation, to the point that it was considered as a solution to the economic problems that a certain number of western or southern European countries were facing. The construction of the "Swedish Model" dates back to the 1930's. As of 1932 the kingdom was governed by the Social Democratic Party (PSD), which stayed in power until 1976. At that time it used the LO (*Landsorganisationen*) union for support to define a heterodox economic policy that targeted full employment, supported in part by an overdeveloped Welfare State. This was to serve as a shield from the market. In fact until the 1980's the Swedish Model was typified by five things:

• *Co-production by social partners of the labour law*. Since the Salstjobäden Agreement (1938), negotiated and collective agreements have substituted the law, notably in order to maintain the competitiveness of an economy that faced the competition of its neighbours. The minimum wage does not have any legal basis in Sweden – it is the result of a collective agreement. Incidentally union and employer representatives work together within "organised groups of interest" that are responsible for the management of the public institutions involved in the world of work;

• *An economic policy that finds part of its inspiration in Keynesian principles*. This is notably typified by the use of public spending in times of recession and the hoarding of budgetary surpluses in times of expansion. Businesses are also encouraged to act in the same way thanks to the introduction of investment funds in which they place some of their profits and which are released on the decision of the Central Bank. The protectionism of the 1930's was replaced after 1945 by the practice of competitive devaluation;

• *An important role given to union work in the functioning of the labour market itself*. The unions establish a so-called "wage solidarity policy" which means that one type of work is paid in the same manner, whatever the financial situation of the employing company might be (the Rehn-Meidner model). The reduction of the range of salaries enables both a limitation of price increases and also a guarantee of cost-competitiveness and price-competitiveness of companies' products [1]. Combined with targeted public measures (an active employment policy) in support of regions or sectors that have high labour requirements (financial aid for mobility, training), this policy has helped to restructure the post-war economy and to boost growth;

• *A developed social insurance system* (illness, parental leave, unemployment, retirement pensions) linking compensation to work revenues since 1959 and designed to cover all categories of the population;

• *An extensive civil* service that takes on board maternal aid, education, healthcare and aid to the elderly. The impact of the introduction of this system was threefold: there was an increase in taxes in the 1960's, which went as far as representing over half of the national wealth, women entered the labour market and there was a rise in the number of jobs in the civil service (35% of jobs at the beginning of the 1990's).

Economic growth and the concomitant growth of living standards occurred at the same time thanks to the neutrality of the country during the Second World War. Taking advantage of its industrial potential that was intact at the end of the war and abundant natural resources (wood, iron-ore) Sweden participated to the full in rebuilding the continent.

THE MODEL UNDER CHALLENGE

This specialisation reached capacity however during the oil crisis and the rise in energy prices in the 1970's. The slowing in industrial investments which began in the middle of that decade also weakened the kingdom; the reduction in exports led to the emergence of external deficits. The adjustment variable, comprising the value of the Swedish crown, was used to the full, with repeated devaluations leading to a significant decrease in buying power. At the same time there was a change in terms of the active employment policies, which until then had been guided by a commitment to business competitiveness. They were then oriented towards compensating industrial job destruction and focused on the creation of collectively funded jobs in the civil service. The number of civil servants tripled between 1960 and 1990.

The centralisation of wage negotiations suffered because of this economic development. Whilst to date the development of income had been planned nationally and notably took on board the situation of exporting countries, the shift to the service sector and increasing criticism on the part of the employers' union of the "Swedish model", led in 1990 to the end of the centralised system and the introduction of sector negotiations.

The public sector was gradually liberalised in the same way as the railway company was in 1988 as it was split in two, one part responsible for infrastructures and the other for traffic. Competition was introduced two years later in the sector thereby anticipating the regulation introduced by the EU, of which Sweden was still not a member.

The deregulation of the financial system between 1978 and 1986 also comprised a break from the Swedish model. Banking regulation was then one of the tightest in Western Europe and notably aimed to bring the benefits of financial investments to the public sector and housing, with the authorities setting the interest rates. In a bid to simplify the sector, deregulation led to the perverse development of a speculative bubble linked to a sharp rise in credit offers. The resulting overheating and inflation forced households and businesses to limit their investments and purchases, notably in the real estate sector and this led the country into recession, just like Ireland and Spain at present. The unemployment rate, which affected 2% of the working population in 1990, rose six-fold in four years.

Real estate speculation also led to an increase in the so-called 'bad' debts amongst the banks' assets, encouraging the financial establishments to raise their provisions. In response to the difficulties experienced by the weakest banks the State had to introduce a rescue plan in 1992 that involved the nationalisation of some establishments. It also created a hive-off structure designed to purchase bad debts back from the banks. This vast plan was financed by public money and led to an increase in public debt. The Swedish crown was devalued by 20% at the same time.

The slippage in public accounts led the kingdom to a final revision of its economic and financial strategy. The public deficit totalled 11.9% of the GDP in 1993 and the debt was nearly 80%. Public spending represented 71% of the GDP. Although the liberalisation of the banking sector was the cause of the 1991-1992 crisis it did not bring into question the goal of liberalising other sectors of the Swedish economy and of reshaping the Welfare State.

1. Cost-competitiveness is linked to production costs, whether this means labour costs or capital. A product or an economy will be all the more competitive in the face of their competitors if costs are low. Price-competitiveness comprises price reductions to enable more sales.

A NEW MODEL: ANTICIPATING THE CRISIS

The introduction in 1996 of a "framework model" which changed the conditions in which the Swedish parliament adopted the state budget was symbolic of the change in ideology. Indeed it led to a return of budgetary balance. A budgetary surplus was achieved in 1998. It was not just a result of a return of growth but of a significant reduction in spending together with an increase in mandatory levies, notably social contributions. The work undertaken to consolidate the budget between 1992 and 1995 rose to 7.5% of the GDP, with the increase in revenues comprising 43% of this sum whilst cuts in spending represented 57% of this plan. Over the period 1994-1999, the budgetary effort rose to 14% of the national wealth.

The base of the Swedish model was widely affected by the reduction in spending as seen in the reduction of retirement pensions, family allowance, unemployment benefit (the rate of replacement dropped from 90 to 80%) or in the reimbursement of medical fees (introduction of an unpaid day, reduction of replacement from 90 to 75% for leave under one year and 70% for longer leave periods). The pension system (defined benefit) was replaced in 1998 by a defined contribution system. The latter which is largely invested gives the right to arrears which change according to the age a person takes retirement, with the minimum age of retirement set at 61. The length of leave was limited in order to increase business competitiveness whilst employers' social contributions were reduced. Labour costs to business were reduced by 2%. Hence social spending estimated at 27% of the GDP in 1994 only represented 19% six years later.

A true strategy in support of the cost-competitiveness of domestically manufactured goods came in support of this action for non-price-competitiveness [2]. This was based on a massive investment in research and development (R&D), with spending in this area reaching 3.4% of the GDP. Financing by the private sector represents more than half of this investment (2% of the GDP). Sweden has now risen well beyond the goals set by the EU in this area, since the EU2020 Strategy set a goal of 3% of the GDP granted to R&D in every country by the end of the decade. The European Commission believes that Sweden is one of the main players in innovation in the EU along with Germany, Denmark and Finland.

This rate of investment can be explained in part by the importance of academic research in the country and the link created between universities and businesses. The reform of higher education introduced in 1993 led to this development. The government defines the goals and priorities, and training programmes are adapted by each university in response to government guidelines. The "New World, New University" bill adopted in 2004 led to an assessment of each of them, a vital condition for the granting of government funding. A share of this money is notably affected to the research councils of these universities that are responsible for linking up with business. Nearly all of the major industrial groups, 71% of businesses and 37% of SMEs involved in research, have formalised their work programmes with universities.

The quality of vocational training in Sweden has also enabled the development of leading edge businesses. This training is given in universities and is funded by public monies. At least 15% of study time is spent in work. In-service training was reformed in 1995. The national programme now aims to improve and update the training of those who are already qualified, on the basis of sessions spread over 40 to 120 weeks. Lessons are organised by businesses and town councils, private organisations and higher education establishments. The State can grant subsidies to businesses which meet national vocational training programme goals. In-service training is not just reserved for those with a job, since 90% of the jobless follow training during the time they spend out of work, and 70% of those who receive training find a job immediately.

The lack of regulation governing investment funds has also led to the development of leading edge sectors. Swedish fund managers have privileged businesses in the medical and biotechnology sectors: 28.1% of their investments between 2007 and 2011.

Hence the return to budgetary balance has not been

2. Non-price competitiveness is based on the constant improvement of the quality of products. Price increases are compensated for by greater attraction amongst consumers for a better quality product.

achieved to the detriment of the country's economic performance since it has gone hand in hand with a true strategy in support of the competitiveness of Swedish businesses. With the benefits of the achieved productivity, the latter have been able to continue investments taking over the financing of the Welfare State, whose perimeter has now been reduced. GDP growth, +2.7% per year on average between 1996 and 2011 is the most tangible proof of this.

At the same time the privatisation of public companies has continued, enabling an opening of air transport up to competition (1st July 1992) likewise the postal services (1st January 1993) and telecommunications (1st July 1993) and the electricity market (1st January 1996). Again Sweden had already anticipated the deregulation requested by the European Commission. It became a Member of the European Union in 1995 [3].

According to the new budgetary framework the government now has to respect two multi-annual rules: the ceiling of the three-yearly spending and the surplus goal over one economic cycle. According to this goal the government has to make a surplus of 1% of the GDP in the same cycle. The definition of the economic cycle is not defined: the government reassesses the development of public finances yearly over seven financial years, without taking on board any possible one-off spending or revenues which are limited in time. The budget has been re-organised into 27 "spending sectors". The budgetary procedure involves defining the global limits of spending before distributing appropriations. In 2000, four years after the adoption of this new measure the budgetary surplus totalled 5% of the GDP.

Since 2000 local councils (21 regions and 290 communes) have been governed by a balancing rule. If they fall into deficit they must correct this and return to balance within two financial years.

This measure proved effective when Sweden suffered the consequences of the economic crisis in 2008. The surpluses made previously enabled Stockholm to master the excesses of public spending and to implement a pro-active budgetary policy. In surplus in 2008 (+ 2.5% of the GDP), the government registered a public deficit of 2.2% of the GDP the following year. It is due to lie at around 1.1% of the GDP this year, after a return to balance in 2011. The government intends however to go further and strengthen spending ceilings and ensure the budgetary surplus goal.

The new budgetary framework introduced by the Swedish government anticipated the Treaty on Stability, Coordination and Governance (TSCG). The goal pursued by the kingdom's authorities, budgetary surplus, goes even further than the golden rule introduced by the Community's Budgetary Pact, which authorises a structural deficit of 0.5% of the GDP.

The country also established an independent authority, the Finanspolitika radet, whose eight members are appointed by the government for a three year period. Six economists and two politicians sit on this body at present. It is responsible for assessing whether the government is achieving its budgetary goals. Several goals are studied: long term sustainability, the budgetary surplus target, the State ceiling spending and the coherence of the budgetary policy with the country's economic trajectory. It also looks into the compatibility of the Swedish economic structure and long term healthy growth principles, which will not lead to a speculative bubble and high levels of employment. Again Sweden anticipated the measures introduced by the TSCG. Indeed the Budgetary Pact anticipates that the application of the golden rule will be supervised by a national independent authority.

A reform like this has been significant for the development of the Swedish public debt. Estimated at 38% of the GDP this year it is due to drop to 35% in 2013. Servicing the debt now only represents 3% of the State's budgetary spending. Ranked with a triple A by the ratings agencies Sweden borrows at rates lower than Germany.

BREAK OR CONTINUATION?

As part of the new Swedish model the State still has to aim to counter inflation and promote the opening of

3. This wave of privatisation continues today as witnessed in the opening of pharmacies on 1st July 2009 or MOT's on cars on 1st July 2010 up to competition.

its economy to the outside world. Integration into the EU or the abolition in 1993 of the measure that capped the share of capital held by foreign investors in Swedish businesses notably helped towards this. The share of exports in the GDP rose from 28% to 50%, with the country's main trade partners also all sharing high growth potential: Brazil, Russia, India, China, South Africa and Turkey.

Furthermore the Welfare State is still a reality although it relies on public services that have been liberalised to a great extent. Its functioning justifies in part a relatively high rate of mandatory levies since it rises beyond 46% of the GDP. This figure does however lead to two observations. The first involves a six point decrease since1990. The second involves the adaptation of business taxes to the competitiveness goal. Mandatory levies do not weigh much on businesses – the business tax is set at 26.3% whilst their social contributions represent around 31% of their revenues – and target household revenues more directly, with the marginal rate reaches 57% on salaries over 5,300 € gross monthly. A reduction in the business tax has even been anticipated, down to 24% and then to 20%.

This new model, which is less regulated, the result of a series of reforms, highlights the pragmatic side of Swedish economic thought, which above all tries to promote solutions that are best adapted for the continuation of the country's economic development. The country's development in the 1970's, and then at the start of the 1990's helped to forge a political consensus in Sweden over the need to reform the model and to adapt it. The Liberals, who were in office between 1976 to 1982, and then from 1991 to 1994, were the first to see the need to modernise the Welfare State which was endangering Sweden's future. Carl Bildt's government implemented the 111 proposals to reform that were included in a report ordered by an independent committee led by economist Assar Linbeck, which was published in March 1993. The austerity cure that the government imposed on the country at the beginning of the 1990's was approved by the electorate one year later. And it was not relinquished when there was a change of government either. Convinced by the idea that the model had to change, the Social Democrats undertook a relatively identical austerity policy, without going back on anything, which was in fact deemed impossible. Since 2006 the Swedes have preferred to hand the reins of government and reform over to Fredrik Reinfeldt's centre-right who was re-elected in 2010. The constant quest for budgetary balance is then the focus of a real consensus between the government parties. The new budgetary framework and the reform of retirement pensions were achieved after a political agreement was achieved rallying nearly 4/5ths of the Swedish MPs.

The refusal to join the euro zone, confirmed by referendum in 2003 and then in 2007, cannot *a posteriori* be analysed as one of the keys to the Swedish recovery. Sweden indeed gave up making competitive devaluations at the beginning of the 1990's, since the crown had been integrated into the European monetary system. The targeted inflation policy undertaken by the Central Bank of Sweden, itself private, recalls the measures adopted by the European Central Bank in this direction. The Central Bank of Sweden complies with the interests rates set by the European Central Bank.

The adoption of the single currency would even boost the country's good economic health. A study published in 2009 [4] stresses that membership of the Economic and Monetary Union would have a positive impact since Sweden might notably be able to influence the activities of the European Central Bank. Indeed it would be represented on the Governing Council. Its financial sector, which is quite open and exposed abroad, would also benefit from the advantages linked to the single currency.

CONCLUSION

Whilst in the 1930's until the mid-1970's it corresponded to a precise economic structure and proved to be unexportable, the reformed Swedish model might now inspire the budgetary policies of its European partners, since a certain number of reforms had already been anticipated, in some cases 20 years ahead of time. The Swedish crisis at the beginning of the 1990's

4. J. James Read and Ulrich Volz, Too much to lose, or more to gain? Why Sweden should join the Eurozone, Economics series working papers 442, Oxford University, 2009.

– the bursting of the real estate bubble, the collapse of the banking system, soaring public debt and a lack of competitiveness – are not unlike the crisis experienced by a certain number of Member States today.

However the new Swedish model does face real challenges – which are social in the main. They pertain to education – since levels are declining according to the OECD – or the kingdom's political integration since it has been facing high rates of immigration over the past few years. The growth enjoyed by the country does not seem to have settled the issue of unemployment, which affects 7.5% of the working population. Whilst it was estimated at 4% of the working population before the crisis of the 1990's, the structural [5] unemployment rate is said to total 6.5%. Unemployment mainly affects young people 22.8%, i.e. a rate that is close to the European average. Youth unemployment and the concomitant issue of education will be the issues at stake in any further modifications made to the Swedish model, if the local Welfare State does not succeed in finding a solution to this problem.

5. The stuctural unemployment rate measures the level of inadequation between the offer and supply of work; given the technological development of an economy, a share of the working population is no longer adequately trained to respond to employment requirements. Structural unemployment measures this unemployable share of the working population.

Sébastien Richard

Lecturer in Economy and Public Policy at the University Paris X-Nanterre

You can read all of our publications on our site:
www.robert-schuman.eu

Publishing Director: Pascale JOANNIN

THE FONDATION ROBERT SCHUMAN, created in 1991 and acknowledged by State decree in 1992, is the main French research centre on Europe. It develops research on the European Union and its policies and promotes the content of these in France , Europe and abroad. It encourages, enriches and stimulates European debate thanks to its research, publications and the organisation of conferences. The Foundation is presided over by Mr. Jean-Dominique Giuliani.