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Reinventing the Swedish Model

Ludwig Erhard Lecture

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Introduction

Professor Tietmeyer, Ladies and Gentlemen,
Let me first thank You for inviting me to Berlin to deliver the Ludwig Erhard Lecture. It is a great honour.

The theme of my lecture is to argue that the European social model needs to be reinvented. There are strong arguments for the need of a social model that improves citizens' freedom of choice and facilitates social cohesion in our societies.

Ludwig Erhard understood this. More than 50 years ago, he created the concept of *Soziale Marktwirtschaft* - the social market economy, and he implemented his idea successfully. His policies form an important basis for the European model we have today.

But there are also strong arguments for the need to reinvent the current European social model. A comparison to the United States is striking. Growth in the EU has been lower, productivity weaker, unemployment higher and hours worked lower.

In the last decade (1995 – 2006), GDP growth has been about 0.8 percentage points higher in the United States than in the EU15 and productivity growth 0.7 percentage points higher according to the OECD. The unemployment

rate has remained much higher in the EU at 15.7 per cent in 2007 compared to 4.6 per cent in the United States.

But we must not restrict ourselves to comparisons with the United States. Globalisation brings the world closer together, integrating our economies more and more. The recent financial turmoil is not the only example of this. Globalisation presents us with great opportunities to find new markets. At the same time, consumers benefit from increased competition through reduced prices and a greater selection of products and services. If we are to become more competitive and stay more competitive however, we must be able to adapt.

Another challenge we are all facing is the ageing of our populations. A wise man – older than I – has said: “I cannot see why everyone is so worried about me getting older – the alternative is surely worse”. And of course it is marvelous that people are living longer and staying healthier later in life. But we must not forget that this will lead to higher costs for elderly care and increased pressure on pension systems. In order to be able to finance this, we need more resources and these are created by more people working more hours. We have to increase competence and skills in the labour force and we must adapt to continued internationalisation by affirming competition, within the EU and globally.

The experience from the Nordic countries and Sweden in particular lends support to the argument that social cohesion and growth can coexist. Ludwig Erhard was one of the early proponents of this view. A policy mix with a strong emphasis on participation in the labour market and a flexible labour market combined with investment in good education and provision of high quality welfare services can be efficient.

In this lecture I will outline how welfare reforms in Sweden are being implemented to restore the work ethics in the Swedish model. Our reform strategy is built on the need to make work pay, especially for groups that have a weaker position in the labour market.

I will also suggest some general conclusions for Europe. I will try to do this with particular reference to Germany. Let me, however, stress that my expertise is the Swedish welfare state and that my comments on Europe in general and Germany in particular should be seen as an observer’s reflections rather than well developed policy advice.

1. The Swedish model is a misunderstood success

First, I want to point out that the Swedish welfare model has been successful in combating poverty and reducing economic inequality.¹

Poverty is low in Sweden and the risk of poverty is the lowest in the EU - less than 10 per cent. The average risk of poverty in the EU is 15 per cent.

Income is more evenly distributed in Sweden than in any other country in the EU.

Long-term unemployment is an important cause of poverty and exclusion. A short period of unemployment – between jobs or directly after finishing studies – may understandably be difficult for the individual affected. It will probably not however, lead to any permanent problems in the labour market.

People that are long-term unemployed on the other hand, risk becoming disengaged from the labour market, political life and society in general. This is an enormous waste of human skill, knowledge and competence and diminishes individuals' and families' possibilities to exercise control over their own lives and to fulfil their dreams. A society that wants to be cohesive cannot afford to have large groups of people permanently outside the labour market. The Swedish model has also been successful in this respect. Sweden has the lowest long-term unemployment figures in the Union – 15 per cent in 2006 compared with the EU average of 45 per cent.

The success of the Swedish model in reducing poverty and enhancing equality is well known. There is a perception that Sweden, not least in the last decade, has been able to combine a high degree of social cohesion and a very efficient economy. While the Euro area has experienced weak growth and high unemployment, Sweden has been an example of how efficiency and equality can be combined.

The central thesis of this lecture is that this is true, but that the reasons behind this success are widely misunderstood. I will also argue that there is a strong need to reinvent the Swedish model to combat social exclusion. I will therefore present our reform strategy, which is based on our ambition to restore the cornerstones of the Swedish model.

¹ EU Commission (2008) Efficiency and Effectiveness of Social Spending, Achievements and Challenges.

2. The Swedish model worked

2.1 Equal distribution before the emergence of the welfare state

Sweden has managed to combine high growth with an equal distribution of prosperity. This is true of development not only in recent decades, but also over a much longer time.

High economic growth...

From 1870 to 1970 Sweden was one of the most successful economies in the world. Sweden developed from being one of the poorest countries in Europe to become in 1970 the fourth richest nation in the world, after the United States, Luxemburg and Switzerland.

The foundations for several of the institutional requirements for good growth and high employment were laid before there was any talk of a specific Scandinavian model.

The modern economic growth literature stresses the importance of having good institutions in the form of free enterprise, a well-functioning legal system, well-defined property rights, public authorities that are free of corruption, and free trade. In this context, it is appropriate to again acknowledge the views and policies of Ludwig Erhard.

These basic conditions had largely been met in Sweden by the mid-1800s. Sweden, like other Scandinavian countries, is among those countries considered to have the best legal systems for promoting growth.²

Already in the 19th century Sweden had carried out reforms towards trade liberalisation by lowering customs duties. This positive attitude towards free trade has persisted and there has been a broad consensus in Parliament on this issue. The Swedish economy was partly built on our comparative advantages, such as forest and ore, and as a country dependent on exports, you must affirm international trade. In a long term perspective, a small economy like Sweden's has clearly benefited from international trade and competition, which has strengthened our industry and improved our ability to adapt.

² Gwartney, J., Lawson, R. & Gartzke, F., (2005), *Economic Freedom of the World 2005 Annual Report*. Fraser Institute.

Liberalisations opening up markets began early. For example, guilds were abandoned in the 1800s and a general liberty to pursue any trade was introduced in 1864.

The same right to inherit property for women and men was introduced early, promoting economic participation by women.³

There is also a long tradition of well-functioning institutions including the legal system. Private property rights were respected, which created certainty. The first patent law was adopted in 1834 and was very important in the development of the Swedish economy, promoting innovation and industrial development in the late 1800s.

One cornerstone in the successful Swedish model was a well functioning market economy based on the rule of law. Even today Sweden is a relatively unregulated economy and the competition in different product markets is high.

... and equal distribution

Between 1870 and 1970 Sweden became not only a rich country, but also a country with an even income distribution and little poverty. In the first half of the 20th century, the absolute maximum income fell and poverty decreased. This resulted in a compressed income structure, and the emergence of a large middle class.

The research to explain the development of the equal income distribution in Sweden is rather limited, although it is clear that it is a long-standing phenomenon. Some possible explanations put forward are early trade unions and collective wage agreements and the education system with compulsory school introduced in 1842. Land reforms in the agricultural sector together with the rise of saving banks made it possible for farmers to work and save and thereby to leave poverty. Also the abandonment of guilds and the same right to inherit property for women were reforms that increased equality.⁴

In the mid-1950s, the tax burden in Sweden was on a level with other OECD countries, but by 1970 it was the highest in the industrialised world.⁵

³ Bergh, A. [2007]; *Den kapitalistiska välfärdsstaten*.

⁴ Bergh, A [2008], "Hur blev Sverige rikt och jämlikt?" in *Ekonomisk debatt* nr.5 2008.

⁵ The National Tax Board, (1999), *Vår omvärld 2010*. (The World Around Us 2010). RSV, Stockholm.

All this happened before the growth of the 'welfare state'. Even at the end of the 1950s, public expenditure as a percentage of GDP was lower in the Scandinavian countries than in most other European countries and also lower than in the United States.

2.2 Roots of the egalitarian Swedish model

International research has uncovered some key factors explaining equality in society. Many of these factors can also explain the development of Swedish income distribution before 1970.

The Swedish model rests on four cornerstones:

- investment in education,
- compressed wages based on productivity compression,
- high labour participation, and
- strong and responsible trade unions.

These pillars of equality are in my mind less distortive to the functioning of the market and less distortive to the labour market than many of the alternatives. Reducing inequality through taxes and transfer payments is more likely to decrease work incentives and to lead to high rates of social exclusion.

Investment in education

Obligatory elementary school was introduced in the first half of the 19th century. A uniform nine year compulsory school was gradually introduced, and completed in the early 1970's.

The uniform compulsory school has increased the number of students entering secondary school and led to a more even distribution of human capital. The reform has also had important positive effects for individuals from families who until then generally had low levels of education. Labour market earnings rose for the entire group, but an additional effect was that a larger share of individuals from this group also studied beyond the compulsory level. The reform increased intergenerational mobility, hence dismantling long-standing educational structures.⁶

⁶ Meghir, Costas och Mårten Palme (2005) "Educational reform, ability and family background.

Compressed wages based on productivity compression

The education system contributed to the fact that differences in the distribution of education and knowledge between groups and regions were less in Sweden than in many other countries.⁷ The supply of well-educated persons increased, as did the lowest level of education in the labour force. This led to a more even distribution of human capital and productivity. The increased supply of well-educated labour is also a factor explaining the decrease in income distribution. Another important factor is the Swedish contract model for wages – with collective agreements based on a contract model for both wages and other working conditions - combined with a relatively high degree of centralisation.

The contract model for wages also meant that wages were decided independently of the individual company's actual ability to pay, leading to the closing down of less productive activities and companies. Together with an active labour market policy – taking care of and protecting the worker and not the work itself – this facilitated structural change.

Social security systems promoted high labour participation

In labour market policy and social insurance, particularly in the 1950s and 1960s, there was an emphasis on the work-first principle, which meant that access to benefit systems assumed, for the most part, that one first had had a job of reasonably long duration and that the individual was actively seeking work in order to continue receiving benefits. The level of benefits was also considerably lower than compensation from gainful employment.

So, in short, the main principles were a social insurance system providing security in the event of change but at the same time strong emphasis on the importance of getting a job.

Publicly financed welfare services were available to all, but designed to support high labour force participation and high productivity growth. This created economic incentives to work and was an important factor explaining high employment.

Strong and responsible trade unions

It is also likely that the stable relations between the social partners with the Swedish contract model for wages and other working conditions, at least in

⁷ Lindbeck, A. [1997]; *The Swedish Experiment*.

the 1950s and 1960s, helped keep unemployment lower and create a good business climate.

The labour market and labour market legislation were characterised by an implicit understanding between the social partners and ensured a reasonable balance between employees' legitimate demands for job security and employers' need to be able to adjust their labour force and the organisation of production in response to changes in competitive conditions. Trade unions have also generally considered structural changes as something that cannot or should not be hindered.

The Swedish egalitarian model promoted equality

Investments in education, the wage structure, the social insurance systems and strong and responsible trade unions - all this contributed to high employment and high economic growth as well as increased equality leading to prosperity for a large part of the population.

3. Increased problems, but countervailing forces made the model work

3.1 Macroeconomic instability and subdued productivity growth

I have now described developments from the middle of the 19th to the middle of the 20th century. In 1970 Sweden was fourth in the OECD ranking of member countries by GDP per capita, but fell to seventh place in 1990 and thirteenth in 2001. The economic downturn that followed the two oil crises in the 1970s had a negative impact on Sweden. But these shocks also affected other industrial countries and it is difficult to argue that Sweden would be so particularly vulnerable to the international business cycle that the oil crisis could be a major reason for this collapse.

Figure 1 GDP per capita, indices and ranking

		1970		1990		2001		2007
1	Switzerland	178	Luxembourg	181	Luxembourg	210	Luxembourg	252
2	Luxembourg	154	Switzerland	146	Norway	145	Norway	168
3	United States	139	United States	137	United States	138	United States	141
4	Sweden	128	Iceland	127	Switzerland	125	Ireland	134
5	Australia	125	Austria	116	Netherlands	120	Switzerland	127
6	Canada	122	Canada	116	Ireland	119	Canada	119
7	Denmark	118	Sweden	115	Iceland	118	Netherlands	119
8	New Zealand	116	Japan	112	Denmark	115	Iceland	118
9	Netherlands	114	Belgium	111	Austria	114	Austria	116
10	Belgium	107	Denmark	110	Canada	114	Sweden	115
11	Austria	106	Germany	110	Belgium	111	Australia	112
12	Germany	106	Norway	107	Australia	110	Denmark	112
13	Iceland	104	Finland	105	Sweden	109	Belgium	108
14	France	100	Italy	105	Italy	106	Finland	107
15	UK	99	Netherlands	105	UK	106	UK	106
16	Italy	95	France	103	Germany	105	Japan	104
17	Finland	93	Australia	102	Finland	104	Germany	103
18	Japan	93	UK	96	France	104	France	101
19	Norway	91	New Zealand	85	Japan	102	Spain	97
20	Greece	82	Spain	79	Spain	88	Italy	93
21	Spain	75	Ireland	77	New Zealand	85	Greece	89
22	Ireland	64	Greece	75	Greece	78	New Zealand	84
23	Portugal	52	Portugal	64	Portugal	69	Korea	77
24	Mexico	44	Korea	49	Korea	68	Portugal	68
25	Turkey	26	Mexico	38	Mexico	36	Mexico	40
26	Korea	22	Turkey	25	Turkey	24	Turkey	39

Source: OECD

3.2 Increased social exclusion

In my view the problems associated with low growth and increasing macroeconomic imbalances in the 1970s and 1980s, as well as the employment problems that were exposed in the wake of the crisis in the early 1990s, were to a considerable extent a result of abandoning some fundamentals in the Swedish model.

Five factors in the economic policy stand out as particularly significant:

- the tax and benefit systems created incentive problems and lock-in effects,
- budget deficits and high inflation undermined macroeconomic stability,
- there was an uncertain investment environment in the wake of macroeconomic imbalances,
- competition policy was weak, and
- there was ignorance of the importance of entrepreneurship and of the capacity for innovation in the business sector.

The public debate in Sweden often points to the expansion of the public sector and the welfare systems as an important explanation for the weak growth after 1970.

Even though I personally believe that this is an important factor, the empirical support for a connection between the size of the public sector and economic growth is not clear-cut.⁸ One explanation for the lack of such a connection is that a large public sector can indeed create inefficiencies through tax wedges and marginal effects that make it less worthwhile to work, but at the same time the public sector's expenditure side can contribute to growth and increase the labour supply.

In Sweden's case, the primary villain was not that part of the increased public expenditures that went to expanding childcare and improving education and health care, but the incentive problems that followed on the heels of increased expenditure on transfers in the form of benefits in the event of sickness, early retirement and unemployment and the high taxes, especially on labour, that were required to finance these transfers.

As a result, the total tax wedges on labour increased sharply. This, in turn, led to a much higher marginal excess burden. Above all else, the high taxes on labour contributed to a reduction in the average number of hours worked, particularly in the period stretching from the early 1970s to the mid-1980s.

In the 1970s and 1980s, the employment rate was still high and open unemployment low in an international perspective. Many thought this was justification for the view that a high tax on labour had no negative consequences for the labour market.

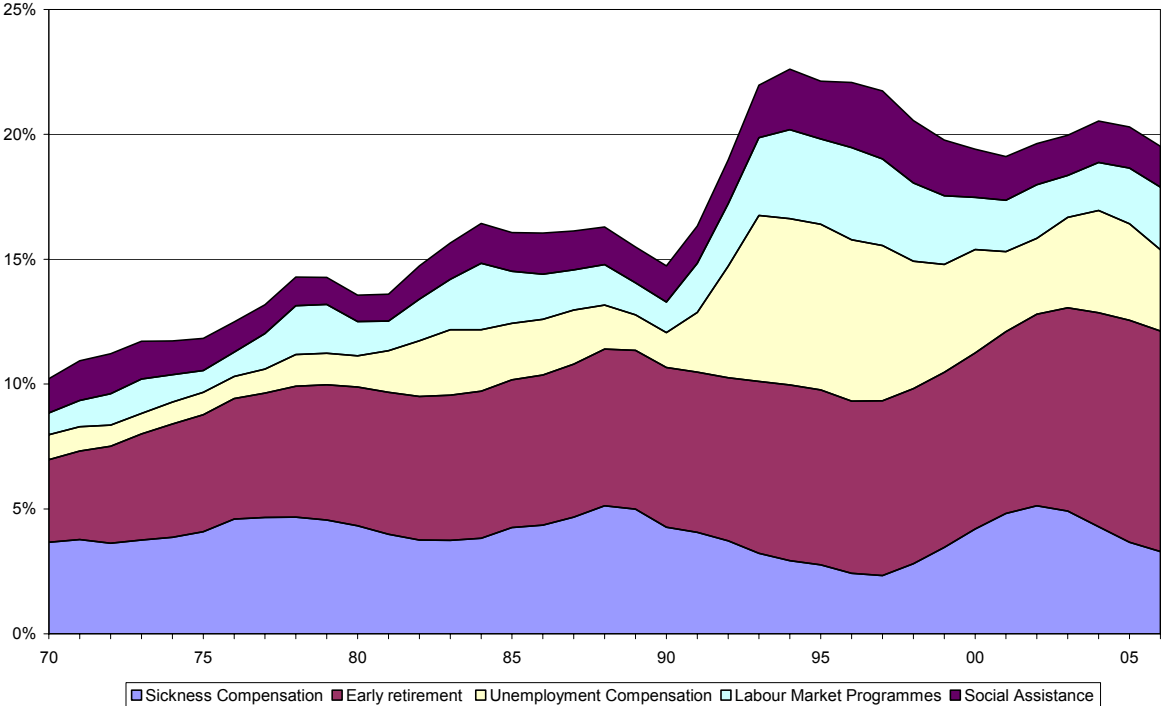
Open unemployment, however, was not – and still is not – a good indicator of actual unemployment or the degree of social exclusion. In spite of the relatively low open unemployment, the percentage of working-age people (age group 20 to 64) supported by various social benefits and subsidies during the 1970s and 1980s increased from just over 10 per cent of the population in 1970 to over 15 per cent at the end of the 1980s, with a further rise to about 20 per cent in the 2000s.⁹

⁸ Ahn & Hemmings (2000), *ibid.*

⁹ These percentages are calculated as whole year equivalents.

Even though open unemployment was low in an international perspective, total exclusion was more extensive and at approximately the same level as in other countries.

Figure 2 Percentage of the population (aged 20-64) dependent on various benefit systems 1970-2006, whole year equivalents



Sources: Statistics Sweden, Swedish Social Insurance Agency and Socialförsäkringsutredningen (Committee on Social Security).

Several factors contributed to the increased dependence on social benefits and subsidies. A gradual increase in benefit levels, particularly activity and sickness compensation and an expansion of the criteria for access to benefits led to overutilisation and moral hazard problems.

3.3 Countervailing forces made the economy work

Even if there were apparent problems before the crisis in the early 1990s, the Swedish economy functioned fairly well. Much better than the tax and benefit systems would imply!

This was not, however, an illustration of the bumble bee that flies against the laws of nature, but the result of countervailing forces that were reinforced when taxes and benefits were increased, namely:

- childcare was expanded,
- family taxation was abandoned,
- means tested benefits were avoided, and
- welfare services were the basic instrument for redistribution.

Economic research provides good support for the contribution to increasing labour force participation, particularly among women, made by access to childcare and care for the elderly, a well-functioning basic education, and the individual taxation of spouses.¹⁰

A recent report from OECD indicates that the gap in weekly hours worked by women between Europe and the United States could be closed if European countries were to align their marginal taxes on second earners with those in the United States.¹¹

Childcare was developed and expanded during the 1970s and family taxation was abandoned

A first step towards the universal preschool was taken in 1973 when Parliament decided that municipalities must provide childcare, free of charge, for all six-year-olds.

Since then changes have been made in the regulations and there has been a large expansion of childcare. In 1975 only 17 per cent of children were registered in childcare. Ten years later the figure was 52 per cent.¹²

Family taxation was abolished in 1972. This reduced the marginal tax for the second earner, often women. The empirical evidence has shown that female labour supply is more elastic than the male labour supply. In most cases, the second earner in a family was, and still is, the woman. With joint taxation, the marginal tax rates of married women will therefore be higher than for single women. The introduction of separate taxation decreases the marginal tax rate for married women.

¹⁰ Jaumotte, F., (2003), "Female Labour Force Participation: Past Trends and Main Determinants in OECD Countries", Economics Department Working Papers No. 376, OECD, Paris.

¹¹ OECD [2008]; "Economic policy reforms; Going for Growth".

¹² Skolverket, Rapport 248, Beskrivande data 2004 Förskoleverksamhet, skolbarnsomsorg, skola och vuxenutbildning och SOU 2001:52.

The lower tax rate in combination with the more elastic female labour supply, implies an increase in the female labour supply.¹³ The empirical evidence also implies that the average taxation of households has an income effect on the participation of the second earner. A low household average tax rate thereby leads to lower participation by the second earner.

The family taxation reform in Sweden contributed to increased labour force participation among women. The employment rate rose from 67.7 per cent in 1976 to 81 per cent in 1990, contributing to increased growth.

Means tested benefits were avoided and welfare services free regardless of income

An important part of the Swedish social security system, such as unemployment and sickness insurance, is and has been related to income. The systems have given incentives to work, promoting employment.

Many welfare services have been available free of charge, or very low-priced, and accessible regardless of income. Consequently, they have only had a small influence on the individual's marginal effects. They have, however, had an indirect effect due to the taxes needed to finance them.

Welfare systems counter some of the negative effects of other welfare systems

All in all this meant that the implicit tax level was much lower, relative to other countries, than actual tax rates. It also had a dramatic impact on women's labour force participation. So one can argue that the Swedish model was able to counter some of the negative impact from the welfare state expansion in the late 70s.

4. The reform agenda of the current government

4.1 Problems in the labour market remained after reforms in the 1990s

In the early 1990s, Sweden had three very serious economic problems to solve: to balance public finances and reduce indebtedness, to reach a new, higher growth path and to restore full employment.

The economic crisis strengthened the conclusions reached by many observers, and politicians too, in the latter part of the 1980s, namely that the

¹³ Jaumotte, F., (2003), "Female Labour Force Participation: Past Trends and Main Determinants in OECD Countries", Economics Department Working Papers No. 376, OECD, Paris.

serious situation in which the Swedish economy then found itself was not of a temporary nature, but required a fundamental change in economic policy.

The embryos for an economic policy reform programme that had their beginnings in the 1980s grew and several reform programmes were initiated in the early 1990s. They included structural policies as well as a framework for stabilisation policy, including changes to the status of the Riksbank (the Swedish central bank) and in the exercise of fiscal power. They also included reforms to increase competition, for example liberalisations in the air transport, electricity and telecommunication sectors.

The structural and fiscal policy reforms implemented have together helped overcome the first two of the three problems. The Swedish economy was in most respects in better shape at the end of the 1990s than it was at the beginning.

The public finances had been consolidated and were, along with the other Scandinavian countries, among the strongest in the OECD area. The inflation rate had shifted to a much lower level at parity with or even somewhat below the level in other EU countries.

The labour market problem, however, remained unsolved. The labour market was characterised by weak development in private employment and growing exclusion, with an increasing number of people on sickness absence or in early retirement.

The percentage of the population with sickness or activity compensation (disability retirement) has risen continuously from just over 3 per cent in the early 1970s to over 8 per cent in 2006. Open unemployment has increased from about 2 per cent of the labour force in the 1980s to over 5 per cent in 2006.

In the early 1970s about a half million people were dependent on various benefit systems, in the 1980s they numbered about one million and in the 2000s they exceeded one million.

The weak growth in the labour market can be attributed to some serious structural problems. Too high taxes, too generous benefit systems, ineffective labour market policies and too high employers' social security contributions made labour supply and demand too low.

They also caused matching in the labour market to function poorly. The incentives to work or to move from part-time to full-time work were much too weak and it was too expensive to hire.

Employment problems were particularly evident in certain groups – young people, older people, women and people with a foreign background.

All this contributed to increased income disparities and made it more difficult for people to exercise control over their own life.

4.2 The Governments reform agenda

The Alliance Government went to the electorate in 2006 with a clear strategy for tackling Sweden's major remaining structural problems and at the same time safeguarding and developing the many successful reforms implemented by both the non-socialist and the Social Democratic governments in the 1990s.

Before I go into these proposals, I want to mention some fundamentals that are widely accepted and that formed the basis on which the reform process was built. They are to some extent a prerequisite for our reform strategy:

- *Sound public finances are the basis for a successful reform policy:* Sound public finances and stable prices form the basis for a successful reform policy to achieve good long-term growth and employment. Sound public finances and a surplus in general government net lending are also necessary in order to achieve stable public finances in the long term as the population ages.
- *Safeguarding the Swedish model in the labour market:* In the Swedish model, conditions in the labour market are primarily regulated in agreements between the social partners. It is important that the social partners are engaged in – and shoulder their share of the responsibility for – the development of modern and well-functioning labour legislation. The Swedish labour market model has delivered stability, predictability and industrial peace and it should therefore be kept.

- *Welfare systems must be jointly financed and distributed according to need:* A central feature of the Swedish model is that health care and social services are jointly financed and distributed according to need. Maintaining this principle is essential.

In order to be able to maintain the Swedish welfare model in the future and meet the demographic challenge, it is important to undertake reforms that increase the labour supply and employment as well as efficiency in the production of publicly financed services.

A broad reform programme

The Government's policy for sustainable higher employment and a reduction in exclusion takes a broad approach and has a long-term orientation. The reform strategy has three elements:

- increased incentives to work,
- simpler and less costly to hire, and
- easier and more attractive to start and run a business.

Most of the measures in these areas are of a general nature. For some particularly vulnerable groups in the labour market, particularly young people and people born outside Sweden, general measures are not sufficient. Therefore reforms targeted at improving the possibilities for these groups to enter the labour market are also being undertaken.

Increased incentives to work...

A policy making it more worthwhile to work plays a decisive role in increasing employment and reducing unemployment. The design of the tax system and the design of unemployment and sickness insurance are of major importance in an individual's incentives to move from exclusion to work or from a part-time to a full-time job.

The threshold effect in the labour market is critically important for the labour supply and for a reduction in exclusion. If we lower taxes for those earning the most at the margin, it will have a relatively small impact on employment. It may be wise to do so for other reasons, for example, for improving the premium on education, but it has relatively little impact on employment. If we lower taxes on the lowest incomes, it will become more worthwhile to shift from not working to working. In that case there will be a

substantial impact on exclusion, as shown by the experiences of other countries that have introduced a similar deduction.

I believe there are strong arguments for why the negative impact from taxes is most evident for groups with low income and low education.¹⁴

These groups tend to be working in jobs that are heavy, in a hierarchical organisation and with tasks that to a very limited degree can be described as self-awarding. It is also true for groups of people without prospects of higher future wages arising from a long record of continuous work.

A group of people that appears to be more responsive to economic incentives is people in families with weak work attachment. In particular, partners in couples where one spouse is not working (usually married women) and single-parent families are generally found to be the most responsive to incentives, both in terms of hours supplied and participation in the labour market.

Furthermore, social security systems often tend to provide more income security for people working in jobs that are typically low income and have low education requirements. This is partly because unemployment, sickness and early retirement benefits often include an income ceiling and indexation that makes the systems less generous for groups with higher incomes or that expect a higher future wage.

In many cases, there is also a combination of support from different social systems, often in the form of means tested housing subsidies, which reinforces the benefits at a low income level.

High taxes in combination with good social security opens an opportunity for low skilled groups to migrate out of heavy and low prestige jobs to sickness, unemployment or early retirement systems.

From this perspective it is of utmost importance to reduce taxes on earned income at the intensive margin. By changes to the income tax, the financial returns on working may increase, which will encourage an increase in the labour supply. The Government has introduced and proposed an in-work tax credit of about SEK 60 billion. Together with a reduced tax take from state

¹⁴ Carone G, and Salomäki, A (2001), "Reforms in tax-benefit systems in order to increase employment incentives in the EU", European Commission Economic Paper, Nr 160.

income tax, taxes on work will have been lowered by SEK 65 billion, or approximately 2 per cent of GDP since 2006.

The aim of these tax cuts is to strengthen the incentives to work, particularly for low- and middle-income earners, and to create better conditions for those outside the labour market. But by lowering marginal taxes, it will also help increase the labour supply from broad groups of those who already have a job.

In order to strengthen incentives to work we have also made changes in unemployment insurance. Unemployment insurance is meant to be a readjustment insurance. Generous insurance for a short or normal period of unemployment can oil the wheels of the labour market, promoting increased mobility by giving more people the courage to try out new jobs. If the period of compensation drags out, a high replacement rate can, however, reduce people's chances of finding a new job. Work must always pay better than unemployment. Therefore the benefit level of unemployment insurance has been reduced, eligibility criteria tightened, the requirement to look for a job reinforced and work requirements in active measures strengthened.

The aim of sickness insurance is to provide security to those who suffer illness and for that reason are unable to work. Sickness insurance should not drive people far from the labour market and create situations in which there is exclusion with weak economic growth. We have decided on a number of measures to provide more ways to return from sickness absence to work and workmates. The link to the labour market while on sick leave has been strengthened and the risk of long-term absence reduced. The gate keeping function of the system as well as the insurance administration has also been strengthened.

Improving the conditions for returning to work has been important in light of the steady increase in sick leave and early retirement during the past thirty years. In an international comparison, Sweden has had a very high fraction of the labour force receiving sickness benefits and on sickness absence.

More worthwhile and easier to hire...

A cost structure where the cost of employing people with low qualifications and low productivity is comparatively high will increase their risk of unemployment. This also means that people with relatively low

qualifications, or people who have lost some of their skills owing to lengthy exclusion, will have difficulty finding a job.

In addition, rigid job protection provisions put those outside the labour market at a disadvantage and favour those with a strong position in the labour market. Job protection thus has a redistributive effect on unemployment and hence contributes to a lingering high level of exclusion. However, there is not any clear-cut proof that job protection legislation would have any observable impact on the average level of unemployment.

In order to make it more worthwhile to hire, we have lowered employers' social security contributions for young people and older workers.

We have introduced what we call new start jobs. People who have been unemployed, in early retirement, on sickness absence or dependent on social assistance for at least one year, will now be able to have the employer's social security contribution waived for a period equivalent to the time that they have been away from the labour market.

We have made it easier for asylum seekers to enter the labour market quickly.

We have lowered the tax on the purchase of household-related services.

We have made it easier to hire people for up to twenty-four months and we have re-introduced the option of seasonal employment.

...and better matching in the labour market

Measures for facilitating and improving matching in the labour market can contribute to lower unemployment and higher employment. One important factor in boosting the labour supply and improving matching in the labour market is how the requirement for the unemployed to actively look for work is monitored, and what sanctions are available if this requirement is not met. Here employment offices play an important role. It is important that the application of sanctions be explicit. At the same time, it must be possible to apply sanctions without making too large an intervention in the individual's benefits.

Labour market policy can and must serve to oil the wheels of the labour market. It must help enable people to move as speedily as possible from one

job to another or from unemployment to a position in the regular labour market. In such a way, labour market policy can contribute to better matching.

Efficient employment offices, which provide contacts with employers and actively coach jobseekers, increase the possibilities for the unemployed to find jobs. Likewise, labour market training that is adapted to employers' needs can contribute to better matching.

Labour market policy resources must have a clear focus on matching jobseekers with vacancies, increased competition in the employment service and improved control and more consistent application of unemployment insurance rules.

Our reform strategy to streamline labour market policy includes emphasising job search activities, giving priority to support for hiring over labour market training and focusing measures on those most excluded from the labour market.

We have introduced a job and development guarantee with individually designed measures such as job searching activities with coaching, clearer routes into the labour market with job training, work placement, employment opportunities and skills enhancement. The number of labour market policy programmes has been reduced, making it possible to focus more on quality.

More worthwhile and easier to start and run a business

The way to full employment and rising prosperity is through a dynamic business sector in which entrepreneurs and business leaders want and dare to take new ventures.

The conditions for entrepreneurship are good in Sweden in many respects – a highly educated population, an innovative business sector with extensive research and development and a good financial capacity. In recent years, Sweden has risen steadily in international rankings of competitiveness and business climate.

As I said earlier, it is, however, important to keep making improvements in the overall business climate to maintain the strong position of Swedish business in an increasingly integrated world economy.

A number of factors perceived as obstacles to entrepreneurship in Sweden have been found repeatedly by several business climate surveys conducted in recent years. Among these obstacles are limited access to risk capital for small and new enterprises, high taxes and social contributions, labour market laws, the regulatory burden on enterprise, the distortion of competition in markets in which the public sector is active, bankruptcy laws and difficulties finding workers with the right skills.

Private ownership and private capital are essential for entrepreneurship. Venture capital, business angels and an entrepreneur's own capital are important in this respect. Research shows that having private capital affects the probability that an individual will become an entrepreneur and expand his or her business activities.¹⁵ The previous government abolished inheritance and gift taxes. To further stimulate private capital formation and thus more entrepreneurship and higher growth, we have abolished the wealth tax and conducted and proposed changes in the taxation of companies, meaning a substantial cut in taxation.

In addition to these reforms, a number of measures have been introduced to make it more worthwhile and easier to start and run enterprises: Employer co-financing of sickness benefit costs on and after the fifteenth day of absence has been abolished, the VAT accounting period has been changed, the regulatory burden will be reduced by 25 per cent, more competition in the production of welfare services will be introduced, and bankruptcy and insolvency legislation is under review.

To sum up, our reform strategy focuses on:

1. in-work tax credits to make work pay,
2. unemployment insurance and sickness insurance,
3. labour market policy (employment protection legislation, new start jobs, youth strategy),
4. education and skills, and
5. companies and entrepreneurship.

¹⁵ See, for example, Henrekson, M. & Stenkula, M.; (2007) "*Entreprenörskap*", SNS Förlag. Stockholm.

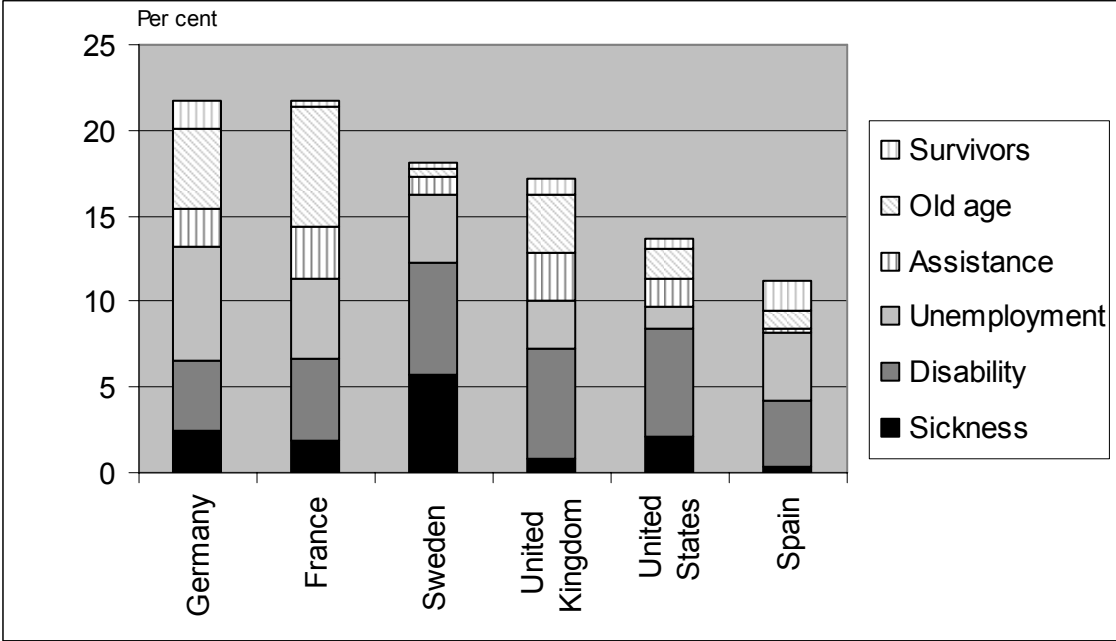
5. Some reflections on reforms for Europe and Germany from a Swedish perspective

I have presented a very broad picture of the development of the Swedish model and the Swedish economy until 2006 when the Alliance Government entered office. I have also said some words on the principles of our reform strategy. I will now try to put our experience in a European – or more specifically German – context and also make some general conclusions.

The gradually increased exclusion in the form of a large number of people relying on various forms of benefit schemes that we have experienced since the early 1970s is far from a uniquely Swedish problem. On the contrary, many countries in Europe are facing similar problems, with far too large a part of the population outside the labour market. The problems, however, look different in different countries; in some countries the main problem is older workers not being able to find a job, in other countries, youth unemployment is high. Some countries have a low employment rate; others have true high employment, but at the same time high sick leave.

These differences make comparisons difficult. I want to present some examples however, illustrating social exclusion and the substantial potential that exists in the EU to increase labour supply and employment, with a particular focus on Germany.

Figure 3 Percentage of working age population dependent on various benefit systems, 1999



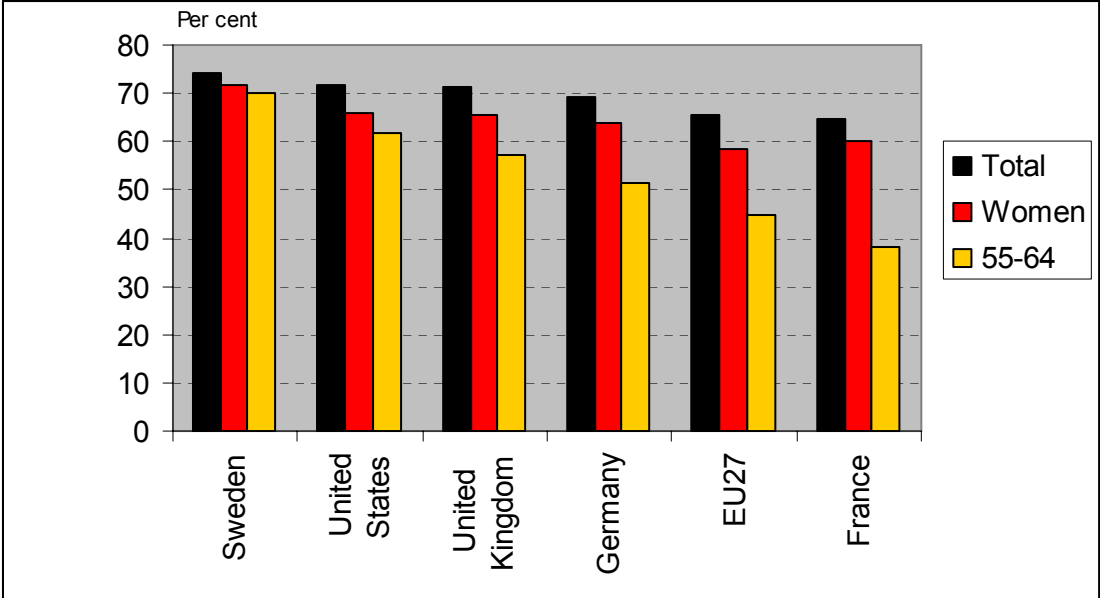
Source: OECD Employment Outlook 2003, Table 4.A.1.1

Even if there is no clear definition of social exclusion, the percentage of the working age population dependent on various benefit systems can give an illustration of the magnitude. Benefit systems are of course different in different countries, but the OECD has made an attempt to make a comparison. The figures are some years old, but I think they illustrate the problem of social exclusion rather well. They also serve to illustrate the differences in social security systems.

In Germany over 20 per cent of the working age population received benefits during 1999 (only Slovakia had a higher figure). This was almost 4 percentage points higher than in Sweden. It is also very clear that the composition of the benefits differ substantially between the countries. In Sweden, benefits for sickness and disability dominate, in Germany the other four benefits - unemployment, assistance, old age and survivors benefits - are of much more importance than in Sweden. The differences between Sweden and Germany in old age and survivors' benefits is striking; these systems are very small in Sweden, but important in Germany. The differences mirror the differences in the social benefit systems between the countries.

It is clear that a policy for combating exclusion needs to focus on increasing employment, rather than solely on decreasing open unemployment.

Figure 4 Employment rate, total and in different groups, 2007



Source: Eurostat

The employment rate for women in the EU is highest in Denmark (73.2 per cent) and Sweden (almost 72 per cent). The differences in the female employment rate in the EU are large. At 64 per cent, the female employment rate in Germany is significantly above the average in the EU (58.3 per cent).

But it is not only the employment rate that matters. The percentage of part-time employment is also an important component. In Germany part-time work among women is common - 45.8 per cent of the employed women are working part-time, compared with 40 per cent in Sweden. In particular, part-time employees in Germany work fewer hours than in any other OECD country.¹⁶ About 22 per cent of all female workers in Germany work less than 20 hours a week. Taken together, the potential increase in female labour supply in Germany is quite large.

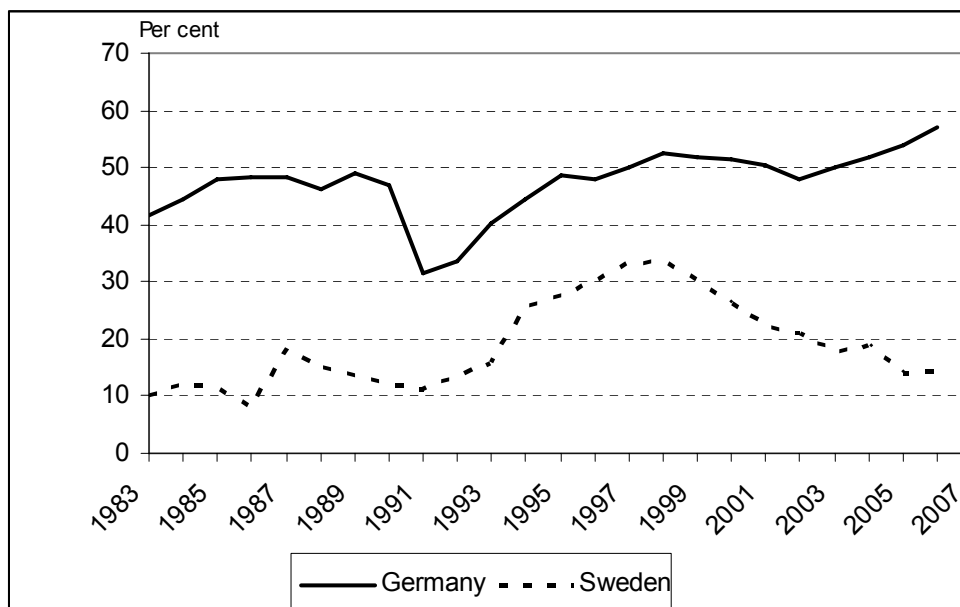
Another group in Germany where there must be a good potential for an increase in labour supply is among older people, i.e., those over 55. The employment rate for this group in Germany is just over 50 per cent, compared with over 70 per cent in Sweden.

¹⁶ OECD Economic Surveys: Germany 2008.

As I mentioned earlier, long-time unemployment is an important source of social exclusion and poverty. In this light, the very high long-term unemployment in Germany is serious. Long-term unemployment has been increasing since the beginning of the 1990s, even though it has fallen in recent years. A considerable part of the long-term employment in Germany appears to be a regional problem linked to the closing down of production in the eastern part of the country after reunification in 1989. German long-term unemployment is one of the highest in the EU.

In most European countries, unemployment is substantially higher for low-educated people than for high-educated, although the figures vary between countries.

Figure 5 Long-term unemployment in Germany and Sweden, 1983 – 2006



Source: OECD

To summarise:

- female labour supply in Germany is low
 - the female employment rate in Germany is above the EU average, but significantly lower than, for example, in Sweden, and
 - women work to a large degree short part-time hours,
- the labour supply among older people is low in Germany, and
- long-term unemployment in Germany is very high.

5.1 Reforms and recommendations

Even if the problems differ from country to country, most European countries, not least Germany, need to increase the number of hours worked in order to be able to finance the demographic changes ahead. As we have seen, the challenges differ and thus the economic policy measures needed.

I will try to highlight some experiences from Sweden that I believe could be interesting in this respect. Let me just stress that I am not an expert on the German economy – my starting point therefore is analyses of the German economy and recommendations by the OECD and others.

As I have said earlier, the Swedish Government's reform principles for employment and growth are:

1. the in-work tax credit to make work pay,
2. unemployment insurance and sickness insurance,
3. labour market policy (employment protection legislation, new start jobs, youth strategy),
4. education and skills, and
5. companies and entrepreneurship.

I am convinced that these principles are also relevant for Germany where reform packages must improve labour supply among women and older people, reduce long-term unemployment, reform the education system and maintain a competitive business sector.

Increased female labour supply

To increase the low female labour supply in Germany, the OECD has recommended that Germany bring in reforms that make work pay by abolishing the system of joint taxation and phase out the free health care coverage for non-working spouses. In order to increase possibilities to work, Germany is urged to continue with its plans to increase childcare places.

The recommendations are well in line with the Swedish experience. Individual taxation and a well developed childcare system of high quality are important explanations for the high labour supply in Sweden. The recent introduction of the in-work tax credit has increased the incentives to go from part-time to full-time work.

Women and men should have the same possibilities to develop their skills and to combine work and parenthood. For me it is fundamental that taxation and welfare systems are constructed in a way that contributes to this.

Labour supply by older workers.

Another group in focus in the OECD recommendations to Germany is older workers. The OECD recommends that Germany carry out reforms that make work pay: more specifically, to continue to phase out early retirement options and subsidised part-time work.

The Hartz IV reforms increased the incentives to work among older workers by lowering replacement rates. The OECD, the IMF and the “*Sachverständigenrat*” point out the importance of not squandering the gains of these reforms.

In Sweden, the pension reform of the 1990s created a pension system that provided financial incentives for older workers to participate in working life. Employed people also have the right to keep their jobs until they turn 67. To further strengthen the financial incentives to work, the in-work tax credit for older workers is twice that of others. To make it more attractive for businesses to retain and hire older workers, the Government has abolished the special payroll tax on earned income as well as on income from active business activity for people over 65.

Long-term unemployment

To combat the very high long-term unemployment, the OECD recommends that Germany make work pay better by changing the unemployment benefit. The OECD also recommends actions to increase labour demand by easing employment protection legislation. If minimum wages are to be introduced in more sectors, they should be applied nationwide and be at a sufficiently low level to avoid job losses.

The reforms in Hartz IV increased the incentives to work. Since long-term unemployment still is very high, more needs to be done.

If supply reforms really are going to increase employment in the short term, they must be combined with reforms on the demand side. That is why we also focus on measures making it less expensive and easier to employ individuals, particularly those with a weak position in the labour market, and

to improve conditions for entrepreneurs and for those who want to start and run a business.

The new labour market policy in Sweden contains several reforms to make it less expensive to employ people who have been out of work for more than a year, “new-start jobs”. To increase the demand for youth, and thereby avoiding the inflow of young people into long-term unemployment, payroll taxes for young people have been lowered.

The new job and development guarantee in Sweden with individually designed measures such as job searching activities with coaching, clearer routes into the labour market with job training, work placement, employment opportunities and skills enhancement, is important to combat long-term unemployment and exclusion. As the OECD has concluded, an activation strategy is also essential for ensuring that adequate benefit levels are consistent with strong work incentives.¹⁷

Education and skills

Investments in education and regular upgrading of skills are also important means to increase employment. A well educated labour force is also of utmost importance in order to meet the challenges facing us as a result of ongoing globalisation. Education and skills increase our ability to adapt to changes.

Investment in education is also a way to limit future unemployment, since unemployment, particularly long term unemployment, is higher for individuals with a low level of education.

The OECD has recommended that Germany reform its education system. Germany should concentrate its efforts on decreasing the educational selection based on socioeconomic background and increase the number of university students. The IMF also points out that there is a growing shortage of skilled labour in Germany and that highly skilled workers are leaving Germany in increasing numbers.

In Sweden a large majority of students continue after compulsory school to upper secondary school. All youth are guaranteed a place in upper secondary school. The Swedish higher education system has expanded in recent years

¹⁷ OECD [2005], Employment Outlook 2005.

and we have a generous study allowances system enabling people to study at university, regardless of family background or financial circumstances.

However, far too many young people have not completed their studies in upper secondary school, and this group have experienced substantial problems in the labour market. There are clear indications of the importance of measures taken early in school in order to avoid this exclusion. We have presented substantial reforms to strengthen the quality of education; by improving competence among teachers and headmasters, strengthening evaluation and introducing grades at an earlier stage. The upper secondary school will be reformed putting a stronger emphasis on knowledge.

Companies and entrepreneurship

An innovative and dynamic business sector with a good ability to adapt is key to international competitiveness. New companies put pressure on existing ones, forcing them to innovate, increase their productivity and introduce more efficient production methods. Therefore, barriers to start and develop businesses must be as low as possible. New and growing companies are also important for employment.

The German business sector has been successful in recent years and Germany has been able to maintain its share of the global export market.

Still, according to the OECD and the EU, more could be done to increase competition. Product market competition needs to be strengthened, notably in network industries such as the energy and railway sectors. Germany has also been advised to relax restrictive rules in regulated trades and professions and improve public procurement.

A successful reform policy must have a broad approach

I would also like to comment on the importance of having a broad approach when reforms are implemented. Broad reforms are an essential element for measures to be efficient. It is sometimes argued that tightening eligibility criteria for one social benefit may lead some recipients to move to other benefits. Such substitution effects would reduce the net impact of policy changes. For example, if reductions in unemployment have been achieved only through transfers of beneficiaries from unemployment insurance to early retirement and disability schemes, the improvement is deceptive.

Political reforms in one area are interconnected through economic mechanisms to other political areas. A broad programme aimed at harmonising different systems is thus expected to have a greater impact on employment when its various measures complement and reinforce each other. For example, in Sweden the changes in unemployment insurance have been followed by reforms in the sickness benefit system.

To summarise, in order to be better prepared to meet the coming challenges and in order to combat social exclusion, Germany could:

- increase female labour supply by making work pay better and by expanding childcare of high quality,
- refrain from rolling back reforms in the unemployment benefits which have made work pay better
- increase the labour supply of older workers and to reduce long-term unemployment.
- increase demand for long-term unemployed,
- invest in an education system to meet future challenges, and
- increase competition in the business sector.

7. Conclusions

We are all facing challenges due to globalisation and an ageing population. These challenges stress the importance of well-educated individuals, more hours worked in the economy and competitive businesses and industries. To a large extent the challenges are country specific, but within the EU we do share a common market, and thus we have a collective responsibility to cope with long term challenges. This is also in line with the objectives of the Lisbon agenda.

In principle there is a potential trade-off between efficiency and fairness. My view is, however, that even in Sweden, the scope for efficiency gains is such that there is room for making progress in both dimensions, i.e., finding solutions that are both fairer and more efficient.

I am convinced this is valid also in many other countries, even if measures taken may vary. And since I believe it is possible for all countries to improve growth and fairness, this is not a right wing – left wing problem. The challenge is to find the best solution for each country in order to combine these two aspects of development.

Our experience shows that by once again stressing the basic cornerstones in the Swedish model – the importance of good education, high labour participation and work that pays – it is possible to combine high growth and an equal distribution of prosperity in the future. To my mind this will also make it possible to achieve sustainable development built on a highly competitive social market economy aimed at full employment and social progress as expressed in article 3 of the Lisbon Treaty.

This is also a policy in line with the social market economy introduced by Ludwig Erhard sixty years ago which laid the foundations for the German economic miracle.

Thank you for your attention.