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THE LONG ROAD – The limitations and possibilities of economic policy to preserve Swedish welfare by reducing the welfare state to manageable proportions

by

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PRELIMINARY TRANSLATION

THE LONG ROAD[1]

- The Limitations and possibilities of economic policy to preserve Swedish welfare by reducing the welfare state to manageable proportions.

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Thomas Andersson, Pontus Braunerhjelm, Bo Carlsson, Gunnar Eliasson , Stefan Fölster, Lars Jagrén, Eugenia Kazamaki Ottersten and Kent Rune Sjöholm.

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PREFACE

During the last 150 years the Swedish economy has gone through several dramatic transitions, mostly with a successful outcome. No transition, however, has been so troubled and so politically controversial as the crisis resolution for which the Swedish economy is currently heading. After the second world war there was practically no political interference in the economic processes, especially on the causal side of the various crisis experiences. But during the post-war period the Swedish economy has become a political economy with an increasing political involvement in the economy. Currently some 70 percent of all resources in the economy are allocated via public accounts. Therefore, deliberate and far-reaching political decision making is needed to take the economy out of the current crisis. One critical question asked in this study is whether the country, given this large political involvement, has a political decision system competent to resolve the current crisis. Never before has the economic situation been so intensively discussed. Never before has the political establishment been so criticized for what it has wrought.

The economic problems of the Swedish economy, have been discussed for many years. Nobody can argue that alarm bells have not tolled. But many, perhaps most, economic advisors have actively participated in the political decisions during several decades that have put the Swedish economy into such a situation that the generous welfare of the past is threatened forever.

The critical question right now is whether the Swedish economy, will again emerge from the crisis with flying colors, or whether it will join a growing group of former prosperous, now destroyed economies in chronic stagnation.

Despite all economic analyses, the debate has focused more on the political impotence and on attempts to control superficial symptoms than on the underlying, basic structural problems. The superficial symptoms - high unemployment and interest rates and exchange rate volatility - will persist until these basic problems have been corrected.

Stockholm, June 1993

Gunnar Eliasson

CONTRACT

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CHAPTER 1

THE LONG ROAD

Sweden has long been a member of the small, exclusive group of the very wealthiest of industrial nations. This is no longer clearly so. Each worker produced and each individual benefited from very large resources in any international comparison. In an increasing number of areas, however, the Swedish economy is no longer delivering the welfare Swedes have gotten used to receive. Economic growth has vanished, the economic system is becoming increasingly unstable, income distribution is threatening to become increasingly skewed, putting Sweden in a worse position than when redistributional policies began, and unemployment continues to increase. After the oil crises of the 70s the capacity of the Swedish economy to provide increasing economic resources for current and future generations has been lagging the corresponding development in other industrial nations.

It has sometimes been argued that this is inevitable for an already wealthy economy. We consider this a mistaken premise. A wealthy economy, with abundant resources, a competent labor force, an economic system with incentives geared for economic growth ought to be capable of generating as rapid economic expansion as any other economy. Swedish economic growth during the 30 first post Second World War years and US economic growth during the 80s show that this is possible. As will also be shown in the following chapters, Swedish manufacturing has grown very rapidly abroad during the last two decades. The domestic problems of the Swedish economy clearly originate in Swedish economic policy.

Historic Background

The acute crisis situation of the Swedish economy originates in the same structural problems as the crisis of 1975-1983. The roots date even further back. The crisis of the 70s was dramatic when oil prices quadrapled and about one quarter of Swedish exports suddenly disappeared, when the shipyards were economically wiped out simultaneously with a severe depression hitting iron ore mines, commercial steel production and parts of forest industries. The adjustment was delayed for at least a decade, first because of a gigantic industrial subsidy program and then through several large devaluations (together almost 50 percent). The purpose was to avoid the unemployment wave hitting all other industrial countries. The result appears to be the more severe unemployment situation of Sweden today. These measures conserved obsolete production structures and camouflaged the unemployment problem during the 1980s. Manufacturing and private service production in Sweden, the growth engine, however, suffered. When the next collapse of manufacturing production occured 1990-1991 (see Figure I.1) crisis awareness returned. Advance warning of what was to come, however, had been signalled long before.[2] (And the lessons, considering the debate of the summer when this book was in production, needs to be repeated).

During the first decades after the second world war economic development in Sweden was as fast as in the rest of the industrial world. After the reconstruction of the war devastated economies during the second part of the 40s industrial expansion continued rapidly. Sweden had reached the highest per capita income in Europe already before the war, and had as well not suffered from war destruction. It, nevertheless, exhibited almost the same growth in manufacturing production and GNP as the other OECD - nations, from around 1960 through 1974 (see figures I.1 and I.2). A combination of

[2] See for instance Eliasson, Carlsson, Ysander et al (1979, Chapter 1-4), Dahmén-Carlsson (1985), Eliasson (1985a, chapter III), and Dahmén (1992).

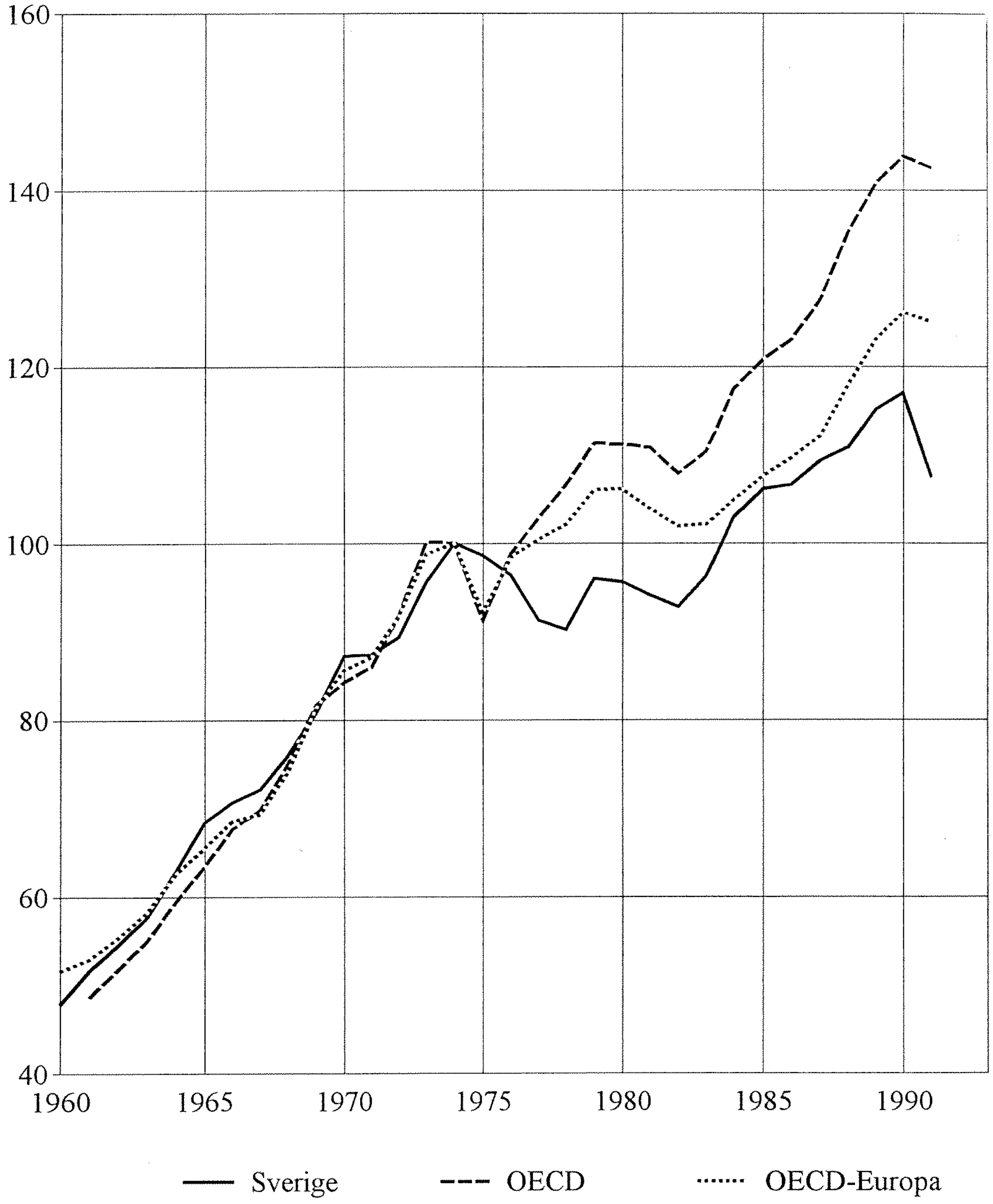
positive external circumstances explained this: strong demand for Swedish raw materials and capital goods in Europe, the great expansion potential created through Western European integration and stable exchange and capital markets. Important, however, was that foreign demand was oriented towards markets where Swedish manufacturing was already strong and/or capable of taking advantage of existing technologies. During this period Swedish engineering industry took over from basic industry as the dominant export industry. The foundation was laid for the giant corporations that now dominate Swedish manufacturing (see Chapter 3). These rapidly expanding industries and firms, however, are based in an 150 year old technology (Eliasson 1992a, 1993a). On the industrial renewal side (see Chapter 4) Swedish private production is lagging far behind.

During the early postwar period the so called *Swedish policy model* became a dominant political consensus instrument. Its originally spelled out purpose was to merge the principles of a market economy with high distributional ambitions. The favourable economic development in Sweden to the middle of the 70s was incorrectly interpreted in Sweden, as well as abroad as a result of the Swedish model (rather than of favourable external conditions), and reinforced expectations of continued rapid growth.

These conditions had, however, changed already by the mid or late 60s. Around that time the Swedish welfare system was being ambitiously expanded to include general benefits programs, regional, and increasingly extreme distributional ambitions. Public expenditures, taxes and regulation increased much faster than in any other European country. The GNP share of the public sector increased from about the average in Western Europe in the mid 60s to a global record during the 1980s.

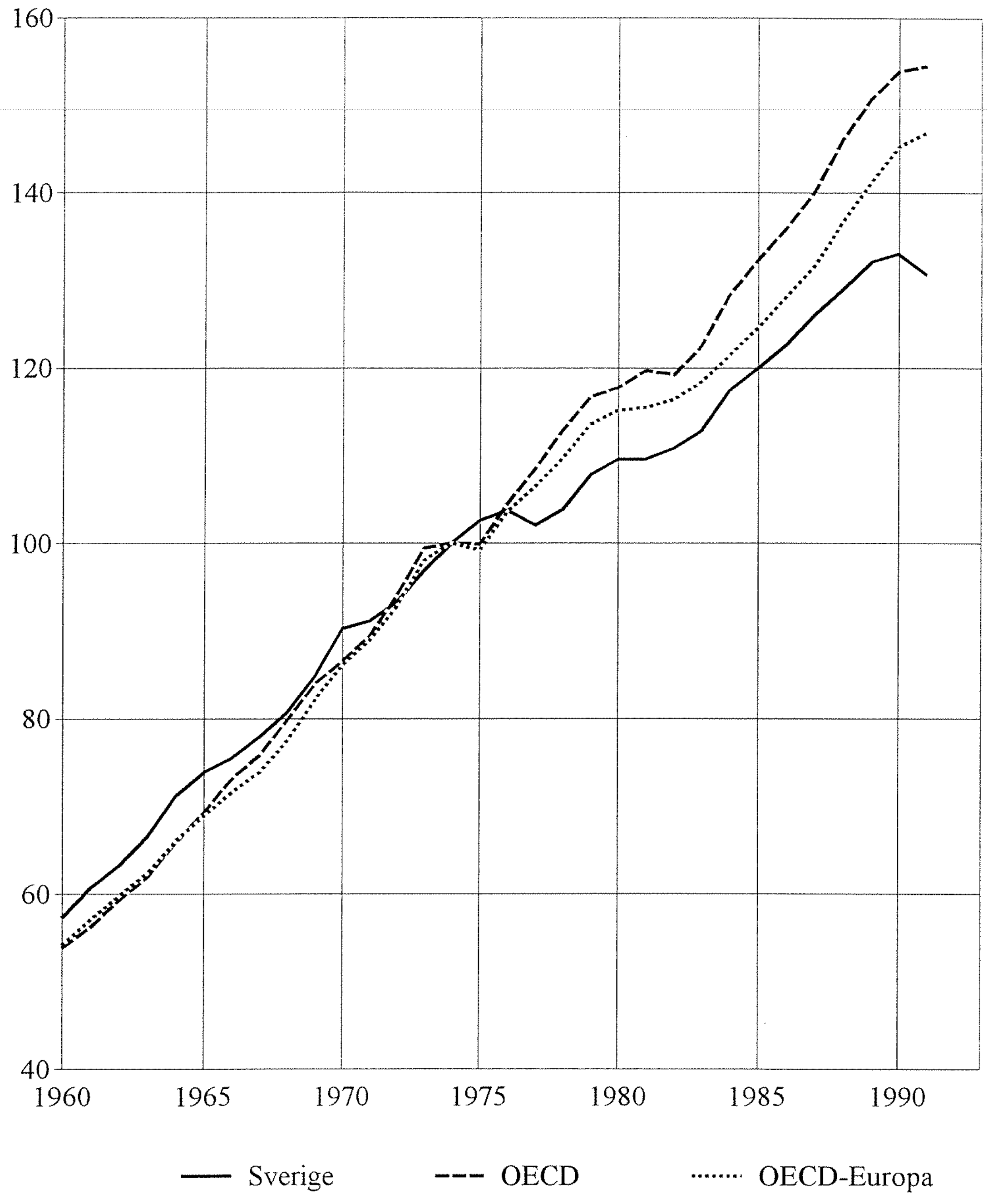
Figure 1.1. Manufacturing production in Sweden, OECD - Europe and all OECD, 1960-1992

Index 1974=100.



Source: TSDB, Statistiska centralbyrån (OECD, MEI).

Figure I.2. GNP growth in Sweden, OECD Europe and all OECD, 1960-1992. Index 1974 = 100.



Source: OECD, Annual national accounts (gross domestic product).

After the mid 1960s also external conditions changed for the worse. Increased international specialization and competition demanded faster structural adjustment on the part of Swedish firms and labor. New competing nations with significantly lower wages put increasing pressure on simple manufacturing production with low skill labor, and demand growth in the dominant Swedish markets for industrial goods slowed. This occurred parallell to a domestic reorientation of policy to create job security for labor and a benefit system that removed incentives for labor to put up the effort to perform that had earlier been the foundation of Swedish manufacturing growth performance. Together this forced manufacturing production to a stand still after the first oil price chock of 1974.

Swedish manufacturing output then fell steadily until 1978. It abruptly and temporarily rose in 1979, and then continued to stagnate. The level of output of 1974 was not reached until 1984. Manufacturing production in other OECD countries, on the other hand, recovered rapidly after the oil price chock of 1974. It continued to increase rather rapidly in the US, which allowed structural change to take place *through* the labor market and relative wage adjustment to occur freely. Industrial output, however, continued to stall in Europe to the mid 80s. While unemployment rose significantly faster and higher than in Europe for a couple of years after each oil crisis it then began to decrease. In Western Europe, it got stuck at a very high level in the early 80s, except in Sweden, where unemployment stayed *very* low until 1991 and then began to climb dramatically (see Supplement II).

While manufacturing output stagnanted in Europe and decreased in Sweden, GNP continued to increase, but more slowly than earlier (see Figure I.2.). The trend break was most clear in Sweden, but also the rest of Western Europe began to lag Japan and the US. Since GNP continued to increase and unemployment stayed low it took very long for Sweden to become aware of the seriousness of the situation that developed during 1975-1983. Most research institutes continued with their short-term macro assessments. It was taken as natural that almost all GNP growth originated in the public sector.

Increased global economic instabilities and a deterioreting competitiveness of Swedish manufacturing exports imposed increasing demands on structural adjustment that the Swedish political system was incapable of accomodating. Anaesthetic in the form of industrial subsidies and stimulus in the form of a series of devaluations 1976-1982 superficially covered up the emerging signs of a deep structural crisis. The continued attention to the symptoms and neglect of the underlying causes moved Swedish industrial structures further backwards towards a stronger dependence of basic industries and volume production of engineering goods.

Within the common market stagnation eventually, and without by far the same intense symptom softening medication led to the understanding that the adjustment capacity of the economy had to be increased to return the economy to an acceptable growth path and acceptable unemployment levels. The agreement of creating the internal market of EG 1992 should be seen in this perspective. Despite several steps in this direction, however, much remains to be done, in comparison with the development in the Japanese and the US economies. Hence, Western Europe is suffering from the same problem that affects the Swedish economy, only that Sweden has caught a very extreme variant of Eurosclerosis.[3]

The risk is that the very strong depreciation of the Swedish krona since the autumn of 1992, despite heroic attempts to defend its value, will have the same anaesthetic and short-term stimulation effects as earlier devaluations. Then the necessary restructuring of the economy, involving a significant reduction in the public sector will be further delayed. The Swedish economy then won't experience more than a temporary cyclical rebound, but a new and more severe cost crisis in a few years.

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[3] For that reason comparisons in what follows are made with the US and Japan and not with Western European countries.

What are the reasons for the current crisis, and what can be done to secure a permanent improvement, rather than an easening of the short-term symptoms? These are the questions addressed in this book. The message, in brief, is that the main reason for the distress of the Swedish economy is a flaw in the systems design related to the public sector, the Swedish model and in the inability of the Swedish political system to reform itself to face new demands and new circumstances.

The purpose of the old Swedish model primarily was to harvest the fruits of an once, market guided, internationally oriented production and to redistribute rents according to political desires. The main principles were to *(1)* keep politicians out of the production decisions, *(2)* to accept free trade and the free introduction of new techniques *(3)* to pursue an active labor market policy and *(4)* to redistribute rents from this policy through taxes and public sector growth. Distributional policy laid the foundation for solidaric wage policies (i.e. the elimination of market determined wage differences) through central wage bargaining as well as very large public investments in health care, child care, and the provision of benefits for the elderly, public housing, schools etc: these distributional policies resulted both in high (and strongly progressive) taxes and public monopolies. Through the former, large tax wedges in the price system were created. Through public monopolies competition was increasingly reduced. Public transfers via social, retirement and health care accounts in essence make up a gigantic public insurance monopoly. This very generous scheme continued to work as long as the private production system continued to deliver sufficient rents, notably from raw materials and basic industrial production. The innovative and efficiency functions of the economy were, however, gradually impaired as the economy became more political. The allocation mechanisms increasingly ceased to respond to market signals. The mechanisms that earlier had forced firms and people to adjust to changing circumstances were increasingly weakened. Even more important, innovative new establishment was seriously diminished. No economy dominated by a huge public sector and giant firms based on a 150 year old industrial technology can continue to renew itself through innovations for long. Incentives, the nervous system of the economy, were paralysed or disturbed. And the part of the economy that was governed by market signals shrunk to encompass only 20 to 30 percent of production (see Supplement IV), which was much too little to accomodate the necessary adjustment of the economy. Thus the entire economy was destabilized (see Chapter 7).

The Problems: a survey

The Swedish economy has been caught in a tangle of problems, both short-term and long-term. The short-term problems include a dramatic fall in private consumption that has followed an increase in private saving (after the tax reform and as a consequence of the severe international recession and labor market uncertainty). To this should be added the banking crisis, the bankruptcy wave among many small private companies, increasing unemployment and an exploding public budget deficit, that will soon, if not put to a halt, lock the public sector in a debt trap, that it cannot get out of without imposing significant adjustment costs on the citizens. Foreign investors and creditors should be expected to keep Swedish economic policy under particular watch and take precautionary positions if they do not see credible long-term policies pursued (see Chapter 7). The short-term problems, therefore, are undermining the conditions for future economic welfare as well as economic freedom of future generations of Sweden.

The Macro Symptoms

The macro problems should be discussed and corrected. At the same time, it is, however, important to understand that the problem most discussed (skyhigh interest rates, the exchange rate crises and high inflation) are *symptoms of fundamental structural problems*. These symptoms will persist until the structural problems have been corrected.

Policies, therefore, ought to be directed towards correcting the long-term problems, even though this requires a massive reallocation of labor and a high unemployment rate for the rest of the 1990s. The policy measures we suggest at the end of this chapter therefore are directed towards altering the institutions that contribute to the self regulation (through markets) of the economy, not attempts to move the economy to preset policy targets by traditional policy instruments. In this situation *it is particularly important to change the institutions that today put the citizens of Sweden in a destructive income game against its Government in which the citizens adjust their strategies to changing risks in order to protect their private income and wealth.* These institutional changes affect the core of the Swedish welfare state and the failed income distribution policies that have been attempted for half a century through taxes and public sector growth. Our policy suggestions are credible measures towards creating more welfare (through faster growth) as well as a more even distribution of incomes than the distribution that will be realized after the year 2000, if the current economic order is continued. Above all, a radically altered social insurance system has to be designed for Sweden to socially and politically "manage" the massive structural adjustment that a return to growth requires.

Continuing present policies aimed at the short-term symptoms, postponing paying attention to the unpleasant structural adjustments needed is an "oistrich policy" that will soon transform the once wealthy Swedish economy into a chronic stagnation economy with permanent welfare – and employment problems for the next generation.

Our analysis and our policy proposals are designed to put the economy on the right tack *beyond* horizon 2000, and to deal with current problems as they arise, as much as can be done without changing the desired long-run course. We want to emphasize that our proposals have been designed to protect Swedish welfare in the long term, and to solve the short-term adjustment problems at a lower social cost than the current, inefficient and monopolized social insurance system is capable of. The long-term problems are still unsolved and it would be socially irresponsible to announce that the economy is out of danger, even though the depreciation of the Swedish krona has temporarily improved the business cycle. A bad post-care of the depreciation and a sloppy acceptance of high demands for wage compensation would guarantee a new cost crisis within a few years. The depreciation of the Swedish krona temporarily eliminated the potential gains from speculating against a weak krona, but the unemployment problem remains and unemployment will continue to increase. A new wave of speculation will return as soon as inflation has reduced the positive devaluation effects for industry, if a credible restrictive economic policy has not halted inflationary expectations and put Sweden on the right course. Credibility here requires hight employment for some years.

Structural problems

Unresolved structural problems have been observed in many places for years. They all have their roots in the large and growing political economy. Incentives have been destroyed or distorted, and the necessary adjustment processes halted or misdirected. In what follows we will discuss in more detail how distorted incentives have misdirected the allocation process in four different areas.

1. Investments are localized out of Sweden

Domestic institutional problems have contributed to an outward allocation of investments in Swedish firms (see Chapter 2). Foreign subsidiary production has grown much faster than average OECD production. Thus, there is no evidence that Swedish manufacturing industry has lacked competence to compete internationally, only that investors have found Sweden to be a less attractive economy to invest in. If the economic environment in Sweden had been better and more comparable to that in the OECD, there would have been no reason to expect Swedish economic growth to be slower than that in the OECD. Hence, the prime policy task has to be to restore Sweden to an attractive country for investments of Swedish and foreign firms, and there is no reason to start from the premises that this is not possible. On the contrary, (Eliasson 19xx), with the enormous competence endowment in Swedish industry, notably at the high end of the labor force it should be possible, in principle, to create much faster growth than in the rest of the industrial world. On the competence side, hoever, (see Chapter 5) Sweden appears to be on its way down. It is, therefore, urgent to redirect policies towards long-term achievements fast. This conclusion, that it may soon be too late for a fast and reasonably effortless turnaround is reinforced by the observations in Chapter 2 that foreign direct investments have been changing character in the 80s toward increasing sophistication and less dependence of Swedish parent support, and that the services of employment supporting devaluations and depreciations, has shifted Swedish export structure backwards towards a higher dependence on its basic industry and less competence industrial production than is good for the long-term.

2. Dominant giant companies make Swedish production more exposed to competition

Policies favouring the large companies for years have contributed to an extreme dominance in Swedish manufacturing of those technologies that have been successful for decades in the already large companies. The dependence of giant multinationals is larger in Sweden than in any other economy. New innovative activity has mainly been created within already existing firms or within their technology range. This conservative orientation of innovations has made the technoological base more narrow and the industrial structure more exposed than would have been the case in a more diversified economy.

3. Diminishing new establishment results in long-term stagnation

New establishment is always associated with large risks. Laws and policies during the postwar period put small business in a tangle of nontransparent regulations that has increased their risk and cost levels. Public sector expansion and the dominance of big business together have reduced new business formation to levels far below what is good for the Swedish economy. The private service sector is much less viable than in the U.S. economy. As new business formation has diminished the small business sector has stagnated (see Chapter 4) and big business has increasingly shifted their investments abroad.

4. A weak competence development creates unemployment and threatens to create an extremely skewed income distribution in the long term

Increased international competition and a modified industrial structure places tough demands in the future on workers' competence. The Swedish labor market of today is characterized by a combination of rigid relative wages and a destructive regulation that destimulates individual competence development. An absolute condition for the recreation of a labor force that matches the future demands of an advancing industry is that wage differences strongly in favour of labor competence develop.

This in turn is a necessary condition for moving the Swedish economy out of its current stagnation, avoiding in the process an extremely negative development of the income distribution and unemployment.

Crisis Diagnosis

The analyses to be presented in what follows thus winds up in a rather pessimistic crisis diagnosis. Obviously parts of this diagnosis cannot be documented scientifically. But the analysis is nevertheless founded on modern economic theory, and crisis indications are very strong. Our conclusions are that it would be very risky and politically irresponsible to base policy on the assumption that the crisis will go away of itself and that correcting the basic structural problem may not be necessary. At the same time the economic and social costs associated with basing policy action on a pessimistic diagnosis are minimal. It is, however, still possible to push the crisis correction ahead, but at rapidly accelerating future social costs. This avoidance may be tempting because the depreciation of the krona may give the erroneous impression that the problem has gone away.

The national objectives that our analysis is based on are (1) stable growth beyond year 2000 in pace with other industrial nations, and (2) a reasonable income distribution after tax, that is significantly more uneven than the distribution we currently think we have, but much more even that what we will get if we do not take the necessary measures today.

Medication includes (A) a deliberate policy decision to drastically reduce public direct involvement in the economy and (B) a number of institutional reforms aimed at restoring private incentives, efforts and individual competence applications needed to reach the same national targets and to remove the tax wedges that distort resource allocation.

THE INSTITUTIONAL CAUSES OF ECONOMIC MALPERFORMANCE

A too big public sector

The public sector has two unique functions: (1) to produce public goods and services that will not be produced in markets and (2) to redistribute income such that incomes are more fairly distributed than the market would do. In recent years it has become increasingly clear that markets may in fact be much more innovative and efficient producers of collective services than protected public authorities. Redistribution of income can be seen as such a collective good that the markets won't supply. Theoretically the ambitions to redistribute income are infinite. They determine how large a share of total national resources that will be allocated over public accounts, however, not the ex post distributional effects achieved. The decision to redistribute income is taken politically. There are, however, technical and economic restrictions on what is possible to achieve through policy. Individuals, firms and markets may behave strategically to counter policy decisions (see chapter 7). And the results of several studies (see Chapter 6) indicate that an enormous flow of resources allocated over public accounts have produced very little in the form of intended income redistribution.

More resources than in an other industrial country, or currently some 70 percent is allocated over public accounts in Sweden. Significant parts of these resources are used for education, health care and social insurance, services that are very much demanded in wealthy countries but also produced privately in many countries. The bulk of this production in Sweden is either monopolized by public or local Government or protected by law, regulation or subsidies from private competition. This service production, hence, is neither efficient nor innovative, which significally reduces positive, externalities associated with such service production. While half of service production is public in Sweden, this share is only about one quarter in the US.

Competition regulated away

Private ownership is not sufficient to achieve efficiency. Effective competition is necessary (see Chapter 6 or Fölster et al 1993). A recently published report on productivity in five service sectors in five countries shows that effective market competition in the organization of work and the attitude of management are the most important explanations behind productivity differences (see McKinsley Global Institute 1992). As supplement IV shows the bulk of Swedish production occurs under protection from market competition, and this protection extends far beyond the public sector. Perhaps as much as 70-80 percent would not survive under current organizational forms and definitely not with current financing and levels of staffing, if left alone in an open, competitive market. The small part of Swedish production – not more than 30 percent – that is subjected to competition has grown increasingly efficient (even though also this sector has experienced a reduced productivity increase during the last few years (see Chapter 2), but not enough to compensate for deficient efficiency in the public sector. A rough data compilation shows that the proportion of production exposed to market competition, and protected production in the US, is reversed in Sweden. This means that the capacity of the economic system to respond to market signals is significantly reduced. Potential economic systems instability, therefore, is larger in Sweden than in most other economies.

In most advanced industrial countries private services grow much faster than the rest of the economy. Business services is the fastest growing sector. Financial services, information and management consulting services belong to this category. As shown in supplement I, this private service production has grown sufficiently fast during the post war period to cancel the decline (as a share of GNP) in manufacturing goods production. The revised manufacturing industry sector has stayed at a constant share of GNP (above 45 percent) since 1950.

The growing private service production is typically small scale and competence intensive. Regular (salary) contracts are not the most efficient employment contract in this kind of production, but rather self ownership and similar performance related contractual forms. We therefore foresee (see chapter 5) a development whereby work compensation will be increasingly related to the marginal economic value of work effort, i.e. that conditions more simular to those of a competitive market will be established.

The crisis sector of Sweden is its public sector

The true crisis sector of the Swedish economy is its public sector, including the transfer system. Its current output can be produced at a much reduced labor input, and it is likely that if subjected to competition, reorganization and the elimination of redundant not demanded activities the quality of services will even be increased. The massive reallocation of labor that would follow has been going on continuosly in the private sector and will of course increase the open unemployment rate further. The problem is that if public sector restructuring would have began earlier the cost situation, including interest escalating speculative runs on the krona would have been diminished and pressure to restructure in the private sector lowered. Instead, large reductions of employment have occured in the wrong places i.e. in the private production sectors (manufacturing and private services). So far, hence, most of the restructuring in the public sector remains undone. Unemployment, hence, will continue to increase, and real wages, especially for less competent and not trained labor will diminish. Restructuring of the public sector can be largely administered through deliberate budget policies. If privatization and restructuring of the public sector is carried through fast, there will be a large and immediate increase in unemployment. This would have been the optimal policy in 1982 simultaneously with the large devaluation of the krona. It is optimal policy right now after the even larger depreciation of the Swedish krona and an excessively stimulated export sector. To avoid this restructuring through myopic subsidizing policies in order to hold down unemployment as was done a decade or so ago is no longer a credible policy alternative. International speculators will rapidly take positions in which inflation and a future cost crisis are discounted, creating a new spectrum of financial crisis symptoms. In addition, at this late stage with an overstimulated industry these policies may not even produce any desired employment effects, only inflation and result in a much more difficult adjustment in the future. If Sweden cannot find ways of rapidly privatizing large parts of public production and putting it under market discipline it can say good bye to the welfare of a rich industrial nation beyond the horizon 2000. Instead of resumed growth the rest of the 1990s will be characterized by recurrent political-economic crises and the shutting down of the wrong production activities.

Lacking incentives

Post war Swedish policy has been increasingly preoccupied with income and wealth transfers over the public budget, gradually deemphasizing the earlier concern with quality infrastructure provisions through education, health care and similar initiatives where the market did not come up with solutions spontaneously. In practical numbers this means that more than 70 percent of total resources are currently allocated over the public budget, but, as recent studies are beginning to show, occasioning a neglible transfer of life time disponsible income between individuals (see more in Chapter 6). In practice most of the income transfers have been in the form of transfers over the life cycle of the same individual (i.e. on a high tax take during the job career and subsidies when a child, at school, when sick, unemployed and when retired etc). There have been minimal private incentives to economize on the gigantic political transfer system, enormous incentives for politicians to pass out benefits to voters at the expense of future generations and a steady undermining of vital incentive structures of the economy (Fölster et. al. 1993, Eliasson 1985a). This income and wealth transfer would have been a mere question of book keeping if industrial growth of the 60s would have continued through the 70s and 80s, but the accounting question suddenly turned real in the 70s, inducing strong negative incentives that increasingly distorted the resource allocation mechanisms in a conservative, structure preserving way. With the Swedish economy also subjected to increasingly strong international competitive forces to restructure "adjustment" took the form of inflation and a series of cost and exchange rate crises. The giant political economy, the organization of the public sector and the negative influence of its tax financing on incentives since then constitute the core of the Swedish economic problem. The policies required to pull the economy out of its current doldrums will expose the public sector in its true garb; a crisis sector in immediate need of radical restructuring through privatization, reorganization and partial shut down.

Equalitarian politics have genuinely failed

During the 80s income distribution has become more uneven in almost all industrial economics (see e.l. Blackburn, Bloom & Feeman 1990, Davis 1993). Practically all studies look at cross sections of the income distribution. If we instead measure disponsable life-time income, including capital gains we will probably find an even more skewed distribution (Eliasson 1985a). Our conclusion (in chapter 5) is that this development first of all originates in production initiated changes in the demand for labor, not in changes in the supply of educated labor. We also observe (in chapter 6) that increasingly ambitious egalitarian policies have not achieved much in the form of redistribution. More than 70 percent of total economic resources have been reallocated or distributed through public accounts. Yet, the same redistribution could have been achieved with a transfer system comprising less than 10 percent of GNP. It is shown in chapter 5 that the massive correction of the production and employment structures of the Swedish economy needed to restore economic growth will dramatically affect income distribution unless effective educational and labor market policy can be organized.

Swedish manufacturing lacks innovative change

Industrial innovation and reorganization occurs constantly, predominantly through new entry. The rejuvenation of Swedish manufacturing and the creation of new firms in new technologies, however, have been effectively held back through regulation, protection from competitive entry and legislation attempting to prevent evasion of the extreme tax rules of Sweden. The not particularly positive entrepreneureal climate gradually developed through policies since the end of the 60s has not improved upon this situation. The observed lack of innovative entry probably also depends on gaps in technological and economic competence in the new technologies on which a sizable new industry has been built, notably in the US, but also in Japan.

Inflation reduces growth

Market price setting (and therefore also resource allocation) has been seriously disturbed by large tax wedges between supply and demand prices (see Södersten-Lindberg 1983, Eliasson 1985b), created by the extremely high tax take. Thus excess demand for certain goods and services has been maintained artificially, and relative prices for these goods and services do not fall because of regulations and subsidies. Not demanded goods and services therefore continue to be produced despite low economic values, and have to be financed through taxes taken from people's pockets. This results in a constant inflationary pressure that has been characteristic of Swedish post war economic policy. Inflation is a symptom of a structural allocation problem, and inflation in turn disturbs the possibilities of effectively coordinating the market economy. Resource allocation becomes inefficient, the structural problem worsens and economic growth is reduced.

The citizen against the state - a destructive game about incomes

This evil circle is currently the most serious problem in the Swedish economy. The origin is its huge political economy and the existence of a gigantic, public production sector protected from competition, that shuts off market mechanisms. The destructive income distribution game that follows puts citizens' attempts to preserve their relative incomes and their wealth against the attempts of the state to finance public expansion from a shrinking income base. There is no other solution to this game than a radical reduction of the public sector and its consequent demands on financing. The large part of public service production that is demanded will have to survive on its own in the market, and it will, but at dramatically reduced costs and employment.

THE STRUCTURAL PROBLEMS

Swedish manufacturing grows abroad and stagnates in Sweden

As we observerd earlier, domestic manufacturing output stagnated during the second half of the 70s. It reached the 1974 level in 1984. Between 1974 and 1990 manufacturing output increased 15 percent, but fell back to a level barely above the 1974 level during 1991-1992 (see Figure 1.1). Global Swedish manufacturing production (including value added in Swedish foreign subsidiaries), on the other hand (see Chapter 2) increased faster than the OECDs average since 1978. Swedish foreign production, in addition has become less and less linked to domestic production of the Swedish parent company. Towards the end of the 80s subsidiary production in the EC furthermore increased faster than in the parent company. Swedish industrial competence apparently has been capable of creating very rapid economic growth, but firms have decided that it is more profitable to grow outside Sweden

Reexports increase fast

Another worrying tendency can be observed within the EC. Swedish acquisitions have increased rapidly and the acquired EC firms do not import from the Swedish parent factories. Reexports to Sweden from acquired EC companies on the other hand, have increased strongly. R&D spending has largely been concentrated to Sweden but the degree of technical sophistication of factory production has increased in foreign subsidiaries relative to that in Sweden. Swedish production has been rapidly reoriented towards delivery of components instead of final products (systems). This reorientation can be observed most clearly for Swedish manufacturing firms operating in mature markets, while basic industries have been upgrading the degree of sophistication of Swedish production plants. The reasons for this reorientation of production are partly to be found in the integration process occurring in Europe and the still unclear political relationships between Sweden and the common market; but also in the deterioration of the investment climate in general in Sweden in the last two decades.

This reorientation of production has been observed since the 70s but gained speed during the second half of the 80s even though outward investments decreased during the last two years. It should, however, be observed that restructuring of firms takes time and that once completed influences investment allocations of firms for decades. The previous infrastructure advantage of the Swedish domestic economy of a large and varied local industrial production base has therefore been significantly diluted during the 80s. The anti-entrepreneural business climate of the post war period and the uncertainty surronding the relationships between Sweden and the EC have of course influenced investment decisions, especially investments that are highly mobile, in this, for Sweden negative direction.

The now emerging Swedish production structure can be said to have three parts. Large international firms, *first* of all have gained considerable economies of scale by continuing product development in Sweden for global markets and products (Eliasson 1985c). Many of these firms have rather light production units and base their competitiveness on unique competence inputs.

That means that new investments in physical production units can be easily shifted to countries with the best long term conditions, without loosing the scale advantages that originate in the central competence capital. The more sophisticated and competence intensive production the more internationally mobile this production. (Braunerhjelm 1993b). This, however, is not (*secondly*) the case for basic industry, where classical volume advantages of scale still prevail. *Third,* traditional Swedish firms unable to globalize – notably Swedish subcontractors – are threatened by increased competition and shut- down as their large customers outlocalize their activities.

The dominance of large firms makes the economy vulnerable

Compared with GNP Sweden has more firms on the Fortune 500 list than any other country (see chapter 3). During recent years, however, most expansion among these firms has taken place abroad. The increased world market shares of those companies is a clear signal of competence and competitiveness. Without their successfull 80s the state of the Swedish economy would be catastrophic.

The dominance of these firms, however, at the same time poses a problem. Their average age is high and most of them are operating in markets with slow technical progress and slow market growth. In the medium-term this may mean stability and continued reliance on old Swedish manufacturing structures, but in the long-term it spells vulnerability. With increased concentration to traditional product areas exposure to competition increases, while new and rapidly growing high tech production is underrepresented in Swedish output. Specialization also increases vulnerability; if one or two of the larger corporations stumble, the vacuum left from their exit will be very large since a whole range of subcontractors will also be affected.

The dominance of the large firms is no accident. During the high time of the

Swedish model industrial policy ambitions were characterized by centralism (see Eliasson-Ysander 1983). The efficiency and productivity development of manufacturing firms were taken for granted. Policies were oriented towards allowing firm management to make the local production decisions, but resource use beyond that was increasingly forced through a central policy filter, heavily biased by short-term social and ideological considerations. It was considered particularly important that investments in Swedish firms were localized to Sweden and in such a way that Government supervision of total resource allocation (inter alia through credit controls) could be maintained. To achieve that the "planning council" was created in 1962, and remained until the late 70s.

Such centralized monitoring of resource allocation is only possible with a small number of agents and national borders controlled by currency and tax authorities. Monitoring and regulation were combined with discretionary benefits to big business to make them cooperate voluntarily in the short-term political interest, and an unholy alliance between industry and Government was created. This was typical of most of the Swedish post-war period. It was quite appropriate to refer to the 50s, the 60s and the 70s as a period of soft industrial planning through a limited number of large companies. The competence of management in big business exercised a decisive influence on the Swedish post war economic success. The political system contributed with a pro big business tax policy that added to further concentration of investment and production to the existing core of larger companies (Modén in 1993), a labor and job security legislation that made the organization of work cumbersume and that raised the business risk level in small scale businesses, a selective credit rationing system that dominated and destructed the allocation mechanisms of the credit market well into the 70s and the so called "foreign borrowing norm" that induced an even further concentration to the already large companies. The back side of this development (for Sweden) was:

- small and medium sized firms were placed in an economic backwater being disfavoured by policy and regulation. The entire sector gradually went into a stagnation phase during the post war period.

- the dominant international firms attracted high quality resources, notably talent and educated labor, at the expense of innovative new establishments.

- continued expansion of large scale businesses in engineering could only occur through internationalization.

Successful Government control and "guidance" of big business during several decades paradoxically resulted in lost control in the 80s. Firms adjusted through increased internationalization, probably beyond what was economically optimal at the time. The attempts by unions to take over big firms through so called wage earners funds contributed to this development. Paradoxically one can, hence, observe how attempts during the 60s and the 70s to achieve national and union control of big business has made Swedish industry more dependent on big business and more international than would have been the case without the same policy (Eliasson, Björklund, Pousette et. al. 1985, se i.a. p. 21).

Our analysis indicates a continued trend towards increased specialization of large international firms, a subcontracting industry with severe adjustment problems and the abscence of a varied, flexible and expanding new establishment.

New establishment on a long downward trend

New entry in manufacturing (see Chapter 4) has been on a continuous downward trend since the 1920s, excepting a few temporary increases in the mid 30s, just after the second world war, and in the mid 80s.

Exit of existing establishments, especially among the very small firms (a normal pattern in competitive markets) has resulted in a reduced number of firms in manufacturing. New establishment in Sweden is remarkably small in Sweden compared to that in the other nordic countries (where institutions are fairly similar). New establishment (compared to the stock of all firms in manufacturing) was (during the 80s) half of that in Norway, one third of that in Denmark and one quarter of that in Finland. Comparable figures from all private industry unfortunately do not exist. In Sweden the private service sector accounted for 70 to 80 percent of new establishments during the 80s. While the big international firms were successful, small and medium sized firms have been living a depressed life in the shadow of the big, international firms.

Today there are no visible candidate firms in manufacturing ready to fill the vacuum large firms leave when they expand production abroad. In an experimentally organized market economy it is of course always impossible to identify the giant success stories ahead of time. The situation, nevertheless, gives cause for concern: a vital, innovative new establishment is decisive for long-term growth, and this vital new establishment cannot be seen. Foreign direct investments in Sweden, furthermore have been very low throughout the 80s. It would be very unwise, indeed, to base policies on the assumption that new candidate firms stand ready behind the scene to move in and expand when the big companies stumble or fail. Previous experience predicts that at least two of our 20 largest firms will encounter significant difficulties or fail before the year 2000 (see Chapter 3 and references there). The situation is as alarming in the private service sector as it is in manufacturing.

Industrial innovation and reorganization takes time, requires initiatives and demands competence inputs of new kinds. If innovation has taken a long pause, as in Sweden, it will also take a long time for the negative effects to become visible. This is one reason for the slow awareness of the problem. We have tried to get a quantitative grasp of the time dimensions involved (see Chapter 4 and Taymaz 1993). The IUI micro based macro model has been used to study the macro economic effects of new establishment and exit. All different scenarios about new establishment simulated show at least a 15 year lag before any visible macroeconomic effects appear. Positive effects from the new competition of new establishment in the form of higher productivity effects and a faster exit of bad firms are, however, immediate. Hence, policies aimed at achieving improved conditions for small business also require patience.

The time needed to influence the macro picture differs from area to area. The faster technical change, however, the larger the risk for failure and the larger the number of firms needed to guarantee successes. Biotechnology and electronics exhibit very fast technology change and lead times are very much shorter than in traditional industries. Therefore it is not surprising that a large part of those new firms that are known by name throughout the world, that are also less than 20 years old (for instance Apple, Micro soft, Bell and Genetech) are all to be found in those markets. It can also, however, be observed that Sweden lacks those examples. Lack of incentives to establish new firms or enter entirely new technologies is one probable reason, lack of competence in new technologies among firms may be another. Neither should one expect to see much innovative activity in an economy dominated by publicly run production protected from competition and by giant manufacturing corporations in mature product technologies.

The Swedish markets for new establishment and small business are also inhabited by destructive institutions placed there to control firms, in particular to prevent them from speculating in the enormous potential opportunities for profitable tax evasion that exist in an extreme tax economy like the Swedish one.

Chapter 2 shows how Swedish manufacturing output in Sweden has been gradually shifted towards more simple and less competence demanding production.

Lack of viable new industries in Sweden as well as in Europe may depend on a lack of both competent industrial leadership and of competent labor and/or on a bad business climate. Whatever the reason, for the dismal development in new establishment such a situation spells economic disaster if allowed to continue. The only clear conclusion to draw is that Sweden, together with Europe, has fallen into a defensive situation compared to many non-European competitor nations.

Increased demand on competence will create distributional problems in the 90s

Economic growth breeds on increased resources and increased productivities of all factor inputs. Labor hours and machines yield no productivity without innovative and intelligent coordination. Productivity growth originates in the industrial competence residing in the country. This in turn is embodied in human beings and manifests itself in the form of innovative new establishment, reorganization, rationalization and shut-downs of unprofitable production.

The competence to discontinue production is not least important.

Economic growth will increasingly be restricted by the availability of appropriate organizational competence. This ability to organize and run large business operations is largely beyond the policy domain of Government. Knowledge at all levels, on the other hand is very much influenced by the educational system of the country; high school, university, vocational training, internal training in firms etc. Our analysis has been largely concerned with workers' competence (see Chapter 5), the economic problems that follow from lack of such competence and the social adjustment that occurs when jobs at all levels are subjected to increased competence specifications. We envision an increasing supply of labor with low and insufficient education and qualified work experience that will only find jobs that pay very little compared to current Swedish standards.

The success story of big Swedish business for several decades created favourable conditions for workers in the sense that large rents from volume production could be appropriated by the workers in the form of very high wages. This situation continued through most of the 80s but problems began to exhibit themselves earlier. The crisis of the 70s began with a dramatic shift in competition such that a significant part of Swedish basic industries found themselves paying workers much more than the value of their work contribution to the firm. Such production has since then been gradually trimmed or eliminated, a rationalization process that has been parallelled with attempts to save jobs in those industries through a sequence of devaluations (1976, 1977, 1981 and 1982) and subsidization programs (Carlsson 1983).[4]

The current situation, hence, is worse than it would have been if reorganization and rationalization of industrial structures had been allowed to continue undisturbed. Reconstruction of industrial structures has been held back by an increasingly overdimensioned public sector that has attracted labor, but also repelled attempts to self reorganize and eliminate redundant labor. An excessive wage level for low quality labor has gradually established itself.

The Swedish labor market can thus best be characterized as structually unsound. Simple jobs in manufacturing have been eliminated, more than should have been done had wage dispersion been larger. The public sector can

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[4] Carlsson, B. 1983, Industrial Subsidies in Sweden: Macro-Economic Effects and an International Comparison, *The Journal of Industrial Economics,* Volume XXXII, Sept. 1983, No. 1., also published in IUI Booklet No. 148. *To* Bibliography at the end.

no longer afford to absorb redundant labor in artificial labor market programs. The earlier, very efficient vocational training schools run by firms have furthermore been destructed by an ideological school policy (see Chapter 5), nationalizing vocational training and removing it from the work places. An excess supply of low quality labor is therefore emerging, experiencing great difficulties of finding jobs, because market forces have been regulated and unemployment for the young people has escalated because their relative wages cannot be adjusted downward by union agreement.

There is considerably risk that a social underclass, permanently outside the labor market will be created, a problem that has earlier been avoided in Sweden. At the same time, however, an increasing number of each youth cohort has been filtered on into higher education. This more educated and probably also talented supply of young people has *not* been employed by private industry (as in the US), excluding consulting, but has been absorbed by the public sector.

During the 80s firms experienced increasing difficulties of recruiting skilled labor for volume production in large firms. Hence, those firms outlocalized their production facilities for reasonably sophisticated production to countries with an ample supply of skilled labor (see Chapter 2, Braunerhjelm 1991 and Milopoulus 1993 p. 92). At the same time, large firms apparently were unable to take advantage of the increased supply of academically trained labor.

This structural problem can only be corrected through the introduction of new labor market institutions that encourage educational investments and that also encourage a more efficient use of existing competences. This solution requires that relative wages for low quality labor be deliberately reduced in order to allow for a non-inlationary increase in the compensation of high quality labor that both stimulates and forces people to attend to their own competence development. This requires that the solidaric and equalitarian wage policies be terminated.

THE SOCIAL AND ECONOMIC CONSEQUENCES

Political authorities are responsible for the basic institutions of society. Only in a limited way should they be made accountable for tasks that belong to individuals and firms and that individuals and firms are more competent to handle. Government on the other hand has to make sure that the basic functions of an orderly society are maintained in places where markets do not function spontaneously. When individuals and firms are not confronted with the real costs and incomes associated with their actions the rules of the game have to be corrected. The task of politicians then is to help create functioning markets, for instance in environmental areas, or compensate through charges for the absence of functioning markets, such that all costs and incomes accure on those who have caused them.

The core problem of the Swedish economy is that Government through its ambitious distributional policies has taken responsibility for tasks that individuals are more competent to handle on their own. Another problem is the unclear statistical boundaries of the national economy that makes it increasingly difficult to define national policy targets.

Those structural problems that we have discussed affect activities both at the micro- and the macro levels. The purpose of the next section is to clarify the relationships between the structural imbalances and the social economic consequences. It is particularly important to identify those policy parameters that can influence development positively such that our policy suggestions at the end of this chapter can be concretely defined both in terms of national targets and necessary linkages to the micro levels. We also discuss the adjustments needed in current unstable structures of the economy towards a more balanced allocation of resources for growth beyond the year 2000.

National targets beyond year 2000

We start from the presumption that a return to stable and fast long term economic growth beyond the year 2000 is the priority target of economic policy. More manufacturing output or GNP per capita does not necessarily mean more welfare. A large production volume per capita, however, is a *measure of the level of resources available for Swedes* that can be used in more or less intelligent ways to the benefit of current and future generations (see Chapter 7). For a country already rich economic growth increasingly means more quality rather than more quantity. Quality is less and less a matter of more material goods and services and more a question of more choices, a better environment etc.

The second priority target is to increase the competence of the labor force in order to create future competitiveness and to soften the negative effects on the income distribution that follow from the shut down of plants and simple jobs and lay offs of low quality labor. Rather than trying to do this through artificial means (taxes, subsidies, regulation etc.) it ought to be achieved in harmony with markets through creating a competence dependent wage distribution, such that the individuals are both encouraged and forced to show initiatives, supply effort and pay attention to the education and training that will be necessary to capture and hold good jobs in the future.

The national economy that Swedish politicians try to guide towards national targets is no longer as well defined as it once was. International integration, the increased importance of quality change in both outputs and inputs (notably labor) and the rapid market and technology induced change of the Swedish economy mean that the economy is gradually loosing its traditional, statistical contours (see Chapter 7). This is only partly due to a badly defined statistical nomenclature. The additional difficulty is that economic theory has barely recognized that the changing organization of the economy has also changed the conditions for conventional economic and policy making.

Conventional economic policy of the past is seriously misconceived today. And economic theory capable of reliable policy guidance for a structurally unbalanced economy does not exist. This necessary theoretical guidance is keenly felt among politicians. Whenever such theory is ready and tested, however, it will most probably show (Chapter 7) that optimal policy making means much less policy making and policy involvement in the economy than has traditionally been the case in post war industrial economies. Target instrument analyses of the kind so popular during the 60s and the 70s are no longer relevant policy options for the simple reason that we have finally learned that an open economy like the Swedish one is not controllable from a central location.

This places politicians in a precaurious dilemma. Ambitious policy making during the post war period has made them centrally responsible for an enormous number of details in the economy, a task that they are not competent to manage. In the public eye they are, nevertheless, still held responsible for these matters. To withdraw from this impossible range of responsibilities, however, involves radical central policy making with far reaching local social consequences, for which politicians will aslo be held responsible. The political tecnique will have to be to shift responsibilities back to the individuals by political decisions. If politicians cannot dismantle the centralist "welfare state" they have created in Sweden, welfare for the next generation is at stake and the economic value of retirement benefits of the current generation will vanish faster than we think.

Lack of adequate theoretical guidance for politicians and their advisers is illustrated by the focus of crisis medication on the symptoms rather than on its causes. The exchange rate crisis, the extremely high interest rates during the autumn of 1992 and inflation are symptoms on underlying structural problems. This conclusion is not altered by the fact that Swedish Government reliance on monetary policy rather than fiscal policy concentrated all the symptoms to the financial variables. Refocusing policy will, however, mean that the symptoms will become as manifest elsewhere. The crux of the matter is that the Swedish structural misallocation of resources is so deep that increasingly severe symptoms will continue to exhibit themselves until the underlying causes have been corrected, and that this correction itself is going to give rise to significant transactions costs in the form of unemployment and a *changed* income distribution. If, however, the basic foundation for a return of reasonably fast growth is not restored, the situation will get increasingly worse and Swedish politicians will soon lose all possibilities of defending the welfare of those worst off. The judgement of the next generation will be hard. To achieve the necessary change, however, we first have to realize the seriousness of the situation.

The mechanisms of economic growth

The seriousness of the situation, can however not be understood if the fundamental investment mechanisms of economic growth are not understood. They are (see Eliasson 1992a, 1993d):

(1) new establishment (entry)
(2) reorganization of existing firms
(3) rationalization of existing firms
(4) exit

Economic growth is a matter of decisions in firms taken by competent people or groups of people; not about sectors, technology and raw materials. Sustained, long-term growth requires a balancing of the above four different investment mechanisms. With rapid economic growth comes rapid structural adjustment. During the past two or three decades the delicate balancing of the four mechanisms has been disrupted. While Swedish big business has exibited considerable competence under (2) and (3) (reorganization and rationalization), the new establishment and exit functions (items 1 and 4) have not worked well. New establishment lays the ground for the long term technological capacities of industry to grow. If new establishment slows down or falls below critical levels the consequences won't be visible until after many years, and for very long if a successfull development among the big firms under (2) and (3) conceals the bad performance in the entry and exit ends. Also exit plays an important role through releasing resources, notably labor, and making them available at non-inlationary prices. This is exactly what has happened in the Swedish economy. As shown in Chapter 4, the consequence of bad and deteriorating entry performance is now finally showing up, when the big firms decide to shift their expansion investments out of the country.

The four investment growth mechanisms operate through different time scales. Exits (disinvestment) and rationalization give immediate effects on productivity but have to be complemented with expansion elsewhere for released resources to be absorbed. New establishment, on the other hand takes very long, several decades, to give visible effects at the macro level. On the other hand, new investment works cumulatively on the economy, and in the long run the effects are very strong. For politicians, working under the three year horizon (in Sweden) it thus becomes natural to pay exessive attention to the immediate negative effects of the exit process and on rationalizations, and forget about the uncertain long term positive effects. Swedish policy making has clearly taken on such a flavour. Politicians therefore also carry a fundamental responsibility for what is currently happening to the Swedish economy, even though the actions of their predecessors at each point in time have been very rational and seemingly in pursuit of the joint interest of themselves and their voters. Therefore politicians also have the responsibility to take the unpleasant decisions that are needed to change the institutions of the economy such that resources are massively reallocated from the public to the private sector, and within the sectors; as much as is needed to restore sustainable economic growth.

Protected public service production destablishes the entire economy

As demonstrated in Fölsters et al. (1993) study of privatization in Western industrial countries it is not privatization per se that creates increased efficiency. What matters is the establishment of competition, and privatization is an instrument to achieve competition. If privatization is not organized such that increased competitive exposure of formerly public production be achieved, the efficiency effects won't follow.

An economy which is 58 percent tax financed and in which as much as 74 percent of total resource use are allocated over public accounts of course shares a large part of the special properties that afflict the formerly planned East European countries. Above all, lack of effective market competition has allowed production structures and employment to become increasingly unresponsive to demand and costs and hence also increasingly inefficient. Under such a protected regime all adjustments in the economy forced by outside influencies are forced onto the small and shrinking private sector exposed to competition, which therefore now and then gets dramatically destabilized. Hence, factor prices, notably wages are kept higher than they should be, and jobs are disappearing in the private sector while they should be eliminated in the public sector.

The open part of the economy, exposed to competition, accounts for almost all foreign trade, and almost all cross border financial transactions. When the small competitive sector is destabilized by domestic economic policies, the entire financial system of Sweden is also destabilized (see Chapter 7), with dramatic consequences for the entire economy. The destabilized price system makes effective economic coordination impossible and resource allocation less efficient. Attempting to fight the deep structural problems through fighting their symptoms (inflation, unstable exchange rates and high interest rates) therefore comes close to fighting windmills. There is only one effective medication; to radically reduce the extent of political engagement in the economy.

Destabilizating the Swedish economy by way of its public sector and financial system (see Chapter 7) has meant recurrent acute crises at the macro level where agents, especially in financial markets, speculate against policies in expectation of future devaluations, on the assumption that promises to correct the structural problem won't be realized. Such speculation immediately exposes policy makers to the enormous extent of the structural problem, and attempts to counter speculation with monetary policies only shift the immediate reflection of the structural problem onto other macro variables. These speculations will keep returning until the structural problem has been corrected, i.e. until the necessary reallocation of labor has been achieved. The only way to avoid this destructive expectations based game against Swedish policy makers, is to remove expectations by way of credible policies, geared to balanced growth beyond year 2000. With a balance sheet like the one of Sweden, the scope for autonomous policy action of any other kind and desire is indeed limited.

This adjustment that is needed will subject policy makers to great conflicts between social long-term and private short-term interests. *First* of all, incentives to solve problems beyond the political three year horizon are simply lacking. Second, to make people accept the immediate social adjustment that follows from a privatization of significant parts of the public sector, requires the establishment of a functioning and credible social security system.

A system that meets these requirements furthermore has (according to our analysis) to be individually based and privatized in the sense of being subjected to open competition. *Third,* not the same people will carry the adjustment burden as those who benefit from the results. We have an inter-generational problem to cope with. Those who will carry the adjustment costs currently excercise the political power. Their chosen representatives have to take responsibility for the long-term solution as well as for all details of the immediate structural adjustment. We do not pretend to be capable of predicting the political economic outcome, but reality only has place for three feasible scenarios.

(1) In *the optimal solution* Government withdraws immediately from significant parts of its operational involvement in the economy, such that the public sector of Sweden is reduced to *at the most* the average level in Europe.

(2) *The second best solution* is to continue to "treat" the symptoms (exchange rate and interest rate instabilities, inflation and so on). This *may* eventually force the same solution as in alternative (1), but at significantly higher social adjustment costs.

(3) The third possibility, the case when not even alternative (2) is realized, is not nice. The agents of international financial markets will see through the political rethoric and act on the assumption that the Swedish krona will soon again be in trouble. Through a sequence of cost, exchange rate and inflation crises Sweden will be reduced, over a few decades to a second order industrial nation of the past, afflicted with the chronic symptoms of a latin american inflation economy.

POLICY PROPOSALS

Our policy proposals take aim at the institutions that regulate economic *incentives, innovation* and *competition,* or briefly expressed at the core dynamic mechanisms of economic growth. There is no question of pursuing traditional policy ambitions to steer the economy towards preset policy targets using classical policy instruments. There is simply not enough knowledge to run an economy in such a way, and there will never be.

The policy proposal includes three critical policy packages:

I. A reduction of the public budget and taxes to at least the average OECD level, through privatization of the social insurance system and the instituting of private citizens' *investment accounts.*

II. Policies to promote innovative entry.

III. A reorganization of the educational system and its financing to increase the supply of competence and to counter a growing skewness in the distribution of incomes

Policy package I; Reduction of public economic involvement

The necessary reduction of the public budget and the tax take of the economy is not a question of reducing the supplies of the services currently offered by the public sector. Rather the contrary, appropriately designed social insurance services will become more important in the future, because of the increased demands on labor market mobility. Instead, the problem is to find ways to produce more economic value with less resource inputs. The only method to achieve that in the heterogeneous and complex activities of the public sector is to subject previously protected service production to competition, and to allow the market to sort out a more varied service product mix. The production of not demanded services, therefore, exactly as in the private sector, will automatically be shut down. For this to be achieved, competition has to be established in the markets for (previously) public services (Fölster et al.1993 and Chapter 6). Furthermore, payments will have to be made by the user, not indirectly and anonymously over a public budget. We expect that the part of the public sector financed through taxes can then be reduced to less than half.

Citizens' investment accounts

The social insurance system is the largest single item in the public sector, accounting for 26 percent of public expenditures in 1993-94. This item can largely be removed from the public sector and be replaced by privatization through the introduction of *citizens investment accounts.* They are defined and described in Chapter 6, and as concerns the labor market in Chapter 5. The main purpose of the citizens' accounts is to give the *responsibility for over the life cycle transfers of income back to the individual and to take it away from the public budget.* This essentially amounts to returning previously nationalized household savings back to the individual. This reform alone would reduce the public budget as a percentage of GNP to half its present level (1992). The transfer of life-time disposable income *between* individuals will still be a policy responsibility of Government. But so far in the post-war history of the Swedish welfare state, the achieved redistribution of life time *disposable* income has been close to *negligible.*

With this system of citizens' investment accounts, citizens can still be offered a choice between staying in the old public system or using the same tax money to build a private citizens' account. There will also be the choice of joining both publicly and privately run citizens' accounts and the option to shift between them. In this way the social insurance system is placed in the market, own contributions (financing) can be increased and the incidence of parasitation (moral hazard) significantly reduced. Social security becomes a right to insurance, the benefits of which increase with the number of years in the job market. On top of this the invisible financing of very unevenly distributed public insurance benefits through a replacement of labor market security legislation with a private and transparent insurance system can be organized. The main reason for the latter reform is the unfair distributional consequences of the current legislation on job protection, depending on which firm the individual happens to work in, or which employment contract has been negotiated. In the future organization of a viable economy it is no longer obvious that the majority of income earners be wage on salary earners (see Chapter 5).

Partial attempts have already been carried out to privatize part of the public health insurance plan to reduce parasitation. One such change is the introduction of a first period covered by the employer, including some days with no coverage, and a reduction in the level of benefits.

The most urgent reform concerns the *labor market insurance.* In its current form it both invites all kinds of moral hazard, and reduces labor market flexibility. This insurance system ought to be made transparent, general and individual, tied to the financing of recurrent education and partly financed through accumulated individual pension benefits. A sketch of such a labor market, recurrent education system is presented in Chapter 5.

The current social insurance system, furthermore, includes a large number of badly designed "insurance" items and benefit arrangements, that invite private exploitation by employers as well as employees. The "wage guarantee" is one such novelty in this flora of social benefits.

The reform we suggest is not only necessary. It is urgent. We therefore also suggest that a committe be appointed to oversee the social insurance system in its entirety and that – at the same time – the individual is offered the option to terminate his or her insurance contract with the public system and take it private. The corresponding tax charges will – by the exercising of that option – be transfered as premia to the new private system. This option to take your insurance private should be unlimited, except for a mandatory minimum participation that is guaranted by the public sector, that also defines the responsibility the public sector is willing to take for the individual.

The social insurance system that we suggest be investigated and reorganized in one single context includes;

- health care
- work accidents
- unemployment
- the financing of recurrent education
- early retirement
- normal retirement (ATP etc)
- job security legislation

Recurrent education has been included to account for the fact that education leading to a marketable competence is an effective substitute for regular unemployment insurance as well as job security legislation and early retirement (see Chapter 5).

Taking your public insurance private means that accumulated benefits in the old public systems are transferred to a private contract and indexed, or tied to the achieved value growth rate of the invested money. The option to take a public insurance private ought to be offered for different categories. The possibility to obtain a social insurance arrangement founded on private, deductible charges against personal income has the additional advantage that the government tax take is screened by the citizens through a competitive market. This means that the public insurance monopoly is subjected to competition. If acceptable public solutions are not offered, citizens will transfer "tax resources" to the private sector, or vice versa.

The most problematic part of the social insurance system are the *retirement plans.* When the individual has taken his or her insurance private he or she is also excluded from the public system. It is therefore mandatory for him or her, exactly as with the third person automobile insurance coverage, to take a minimum private or public insurance, the charges on which are drawn automatically from his income. Beyond that there should be an unlimited right to deduct insurance charges from income to sign up for voluntary private or public insurance arrangements.[5]

Many of the different types of insurance arrangements in the social insurance system are afflicted with such fundamental risks for moral hazard, that private insurance companies, having lived for years in a protected market, have no experience from dealing with such problems. We also know that similar private insurance arrangements in other countries have suffered from the same problems, sometimes meaning that the public sector has stepped in, or stepped back in (see Fölster et al. 1993).

It is therefore possible that the private market won't respond properly and offer the insurance solutions that the reform requires. It is therefore necessary to provide for alternative supplies, if existing (incumbent) insurance does not offer solutions. This can be done as follows.

a) the old public social insurance system (now subjected to investigation) remains. The citizen can choose to remain with it and/or to buy private insurance.

b) remove restrictions to start new competitive insurance companies,

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[5] The individual, of course has to participate through tax payments in the financing of the politically decided redistribution of life time disposable incomes, as politically decided. But this is an entirely different matter, and this property, as we now know, has not been an important ex post achievement of Swedish distributional policy.

replacing existing entry regulation with control of financial solidity, and revision.

c) Open the domestic market completely for foreign competition.

Policy package II; release innovative new establishment

The Swedish production system is currently not structured to support rapid, sustainable economic growth and full employment. And if Sweden cannot be reinstitutionalized to become an attractive investment country or at least equally attractive as the rest of the OECD area, structure will continue to be wrong. Getting the investment environment right requires a politically stable market environment with significant predictability of the legal and regulatory system. What Sweden also needs is a significant, advanced, competence demanding production that can carry internationally competitive production. This, in turn, requires the existence of a basic competence capital within Sweden (see policy package III).

Thus, long term economic growth requires a lively new establishment in combination with effective destruction of commercially non-viable production capacity. Concretely, this means that the economy has to be cleared from institutions that hold back new establishments and self employment. Removing the monopoly protection of large parts of public service production would significantly improve the rate of new establishment. New establishment is also directly affected by a widespread tangle of inconsistent regulation that can be listed under five headings:

1) tax law
2) job security law
3) co-determination law (MBL)
4) the law regulating social insurance benefits

5) laws and regulation controlling venture market institutions.

Swedish labor market law is in general formulated such that the *wage and salary contract* is confirmed (supported) as the preferred judicial frame of work; and the large firms benefit as compared to newly established, small and medium sized firms. Favoured treatment of the big firms, as mentioned, has permeated Swedish law making during the entire post-war period. To this set of law should be added a smaller set that affects the credit system. A badly functioning credit system always hits the small firms harder than the big firms.

1) *Tax law*

For many years Swedish corporate tax law in an international comparison was very generous to business. The problem was the combination of corporate income and the very progressive personal income taxation. This destructive tax combination hurt small and medium sized firms harder than the large corporations with an already large cash flow. Wealth taxes and inheritance taxes in combination with personal income taxes furthermore, not only drained the small businesses of its financial resources on the occasion of generational shifts. Also family wealth was easily depleted. Standard incentives were detrimental both to innovative new establishment and the running of small businesses.

Normal Swedish procedure in law making has been to formulate rules as politically desired and then to add exemptions and special law for small businesses. Special tax law – notably special law for single ownership firms (fåmans företag) – has been written to prevent tax evasion, (that politicians think is more common in small business), and to prevent private wealth accumulation. These reasons are clearly stated in the motivation of earlier tax law. These rules will be irrelevent in the future Swedish low – tax economy that is the one and only solution for Sweden's economic woes.

The structure of law that has been continuously accumulated to prevent tax evasion has not worked as intended, only created a tangle of complex and non-transparent legal restrictions, that nobody, and especially not small business people can be expected to know. To have time for his business, the small business man will constantly break a number of for him unknown law paragraphs. From this follows two serious problems; respect for law is lowered and the economic risks of the little firm are increased, since these offences can be discovered.

Private capital is the foundation of a market economy. One cannot say that Swedish post second-world war tax legislation has made private wealth accumulation impossible, even though this was the explicit intention, but wealth has been created notably through tax evasion and speculation in inflationary and capital gains in the markets for wealth objects; Inflation has in turn been created by high taxes aimed at expropriating privat wealth and to finance an expanding public sector. This incentive system of course, eventually became detrimental to economic growth and gradually moved the economy closer to its current collapse like situation. For the future, private wealth formation ought to be stimulated, not prevented, and rules should be formulated such that individuals can become rich through investing in, or managing firms successfully. The reformulation of the tax and legal system necessary to promote such incentives is a prerequisite for correcting Swedish investment allocation mechanisms such that economic growth can be restored.

2) *The law of job protection* (LAS, together with the law of codetermination, making up job security legislation, see Supplement II) starts from the

presumption that wage or salary employment is the dominant contract form in the labor market. This law incorporates the following elements:

- rules regulating temporary employment
- lay off rules
- seniority rankings in "lack of work" situations
- rules for part time work.

This complex of law can be seen as an unsystematically composed implicit unemployment insurance system for employers. This insurance protection varies wildly, depending upon type of firm, size of firm etc. Such law again implies a hidden social security charge on firms. Our suggestion is that this cost is made explicit through remaking the entire law complex according to uniform insurance principles, and that the complex is removed from the firm by way of an insurance contract with well specified benefits. Then firms should be able to lay off their employees in an uncomplicated and rational way according to contracted explicit agreements. Clear and simple rules that can be easily understood and cannot be misused are important. This change is necessary against the background of what is going on in private industry, meaning that the old company configurations with significant internal risk-distribution are replaced by smaller, specialized units, much more exposed to failure and exit, and where the risk-taking of owners has been shifted into specialized investment institutes. Traditional firms, even very large firms, will be much more exposed to competitive break-up or shut-down than before. It is therefore important that a new labor market insurance concept is developed ahead of the problem.

Such insurance ought to be individual and be offered by any insurance company. Cost should be fully deductible and mandatory but be applied as an insurance charge, not as a tax.

Insurance for lost income should be arranged outside the public budget and be financed jointly by the employee, the employer and Government, to minimize moral hazard without extensive monitoring contracts and bureaucracy. The coverage should be formulated as a private claim on the insurance, company of the employee.

3) *Codetermination law* (MBL) as currently in force gives the employer and the union increased control over the firm, while costs and risks associated with such influence are carried by capital owners. The same law can also be used to protect the employee from lay offs even when lay offs can be rationally motivated. Such direct and indirect costs hit small firms harder than big firms.

Coodetermination law, however, has been formulated such that the employer finally decides. Union representatives can, nevertheless, prolonge the decision process. The following paragraphs have also been inserted:

a) unions can veto the use of external contractors

b) unions can block single ownership firms (fåmansföretag) with no employees.

The veto possibility can be formally applied with the motivation that the contractor is not reliable. Such laws leave considerable scope for arbitrary obstruction of an employer. The possibilities for the firm to use efficient external contractors, rather than employing additional labor is furthermore reduced.

The conclusion is that special legislation aimed at preventing tax evasion should be removed and that job security legislation should be replaced by a clearly defined insurance system, external to the Government budget, and that coodetermination law should be replaced by voluntary agreements, and not remain possible instruments for unrelated obstruction by unions and employees.

The legal structure that should be removed, however, is tremendously complex, fragmented and integrated with law that should remain in force. It won't be possible to engineer that change politically under Swedish procedure with special interest group participation in the preparation of legislation. Sweden, according to our assessment has not got the time to wait for that to happen, and will not benefit from a compomise retaining essential parts of the systems defects. We therefore suggest that the Swedish parliament *decides separately* how the well defined law complex that has to be changed, shall be and shall not be interpreted. Such *enabling* instructions for interpretation can be formulated such that parts of the destructive rule system reigning in newly established and small firms will no longer apply. In addition to that, the political debate will clarify what the laws should be used for in the sense that unintended obstruction will now have to be brought into the open.

The carrying through of this legal reform will not diminish employee protection and will not, in practice, change the local workshop climate. On the other hand obstruction and hassle will diminish. Above all, enforcing this law in an uncompromizing way will be a political signal to existing and potential entrepreneurs that their work is appreciated and therefore contribute to the improved investment climate needed to stimulate and increase new establishment and growth beyond the year 2000.

4) Social insurance benefits have already been discussed under policy package I above.

5) *Venture capital institutions* require separate comment in this context. New entry and small businesses depend on a functioning supply of venture capital, the efficiency of which is wholly dependent on the institutions of the capital market. It can be observed here, that entrepreneurs and private capitalists are the most important capital market actors for small businesses.

During recent decades entrepreneurs and private capitalists have had difficulties finding each other, because the latter have been almost totally absent, or engaged in easy money transactions in the property market. The nouveau rich in Sweden of the 80s have almost all already disappeared. They built their temporary wealth on speculation in inflationary gains and tax policy. This income and wealth game (see Chapter 7) against policy makers has been another destructive force in the economy, stimulated by the tax state. Above all, the new private wealth has rarely been combined with the industrial and financial competence needed in the venture markets by new and recently started companies. Rather than adding to the supply of venture capital it has been a drain on the venture capital markets. It can also be observed that almost no innovative entry has been registered in the parts of the Swedish capital markets that are responsible for venture financing. The reason is the destructive regulation of these markets for decades, with the consequence that no such market activity has existed for almost all the postwar period. Thus no venture capital market has been created for the financing of new innovative entry. We find again that the political authority has destructed basic economic functions of utmost importance for industrial development.

A viable venture capital market is part of the economic infrastructure. When this infrastructure is lacking, small business are first affected. Credit and exchange controls were based on legislation that not only limited the capacity of the economy to finance businesses that depended on rationed credits. 50 years of credit regulations also created an incompetent, conservative and non-innovative domestic financial system.

The financial services demanded by a differentiated production system can never be supplied by a small number of standardized and conservative financial institutions that are protected from competition. A viable market economy requires many differently minded evaluations when new projects are to be assessed and financed. This is synonymous to many competing capitalistics with individual wealth to invest. The tax system, hence, ought to be designed such that private wealth formation at all levels is stimulated, but in such ways that it occurs through saving on innovative entrepreneurship.

POLICY PACKAGE III; a very skewed income distribution can only be prevented by effective education

New and different technology and increased international competition is currently making income distributions in the old industrial economies increasingly skewed (see Chapter 5). In the future, individual incomes will be much closer to individual work place productivities than before, and work performance will increasingly depend on individual competences, i.e. on the quality of education at school as well as on-the-job, and on individual effort. The labor market will become more efficient. We predict that this development, moved by new technology and markets, will severely undermine the pillars of the standard Swedish welfare contract. In a short time income distributions may be radically changed from the flattest among the industrial nations to an extremely skewed distribution of a kind we have not seen in Northern Europe before. To counter this development of income distribution and the increasing unemployment the labor market has to be organized far more efficiently. Education, furthermore has to be encouraged such that a differentiated competence supply is created that is better suited for producers.

Paradoxically, this policy implies that a widening distribution of wages and salaries be intentionally induced, but that the widening of the income distribution depends on the corresponding distributions of competence and work performance, not on vested interests, established norms and other market imperfections.

Competence at all levels sets the limits of economic growth and standards of living. Therefore it has to be effectively allocated and used. Lack of competence has often been cited as a reason to outlocate Swedish production (see Chapter V). Competence exists in firms and with individuals. Individual competence is a matter of knowledge as well as ability and willingness to perform at the work place. Its value also depends on the extent to which he or she finds suitable work. The massive reallocation of work needed to restore Swedish economic competitiveness and growth is largely a matter of enhancing human embodied job competence and get it better allocated on job tasks.

In this Government has the following tasks:

- to make the labor market effective
- to make school more effective
- to improve incentives to engage in own competence development.

An efficient labor market presumes a much more flexible wage adjustment to changing circumstances than currently in Sweden. Growing unemployment depends on a slow relative downward adjustment in wage compensation of not demanded labor. If this downward adjustment, furthermore, has to be occasioned through inflation the macro economic problems are increased. In addition there are no patent solutions to the educational task of country. A viable solution presumes pluralisms and experiments (see Chapter 5). The method has to be to engage students actively in acquiring the core of intellectual capacities that new jobs increasingly require, and to continue to develop their competence. Without the receiver competence and the active efforts of a performance based compensation system, the required recurrent on-the-job training and reeducation needed to prevent lay offs or to get laid-off people back to work, won't work.

This educational sector has to be supported by large income differences for competent labor, and a clearing of the tangle of laws, rules and union restrictive work practices that lock workers to their first job.

Three necessary policy measures follow from this:

1. School has to be opened up further for local initiatives such that improved methods can be tried out through experimentation. Basic communicative skills are particularly important. They are difficult to acquire and have to be acquired early to serve as a foundation for continued learning at school and on-the-job. It is as important that students learn to organize their work (studies) effectively, something that again is a question of learning to continue to learn more efficiently *(receiver competence),* not a matter of accumulating knowledge.

2. Significant competence related wage differences (incentives) have to be allowed and stimulated.

3. Mobility hindering rules, conventions and collective agreements in labor market laws have to be removed (allocation).

<u>Summarizing</u>

Throughout our discourse, we have distanced ourselves from the simple target – instrument policy idea of the 60s that assumes that politicians (with the help of advice from economists) can control the economy through manipulation of well defined policy parameters. (See Chapter 7). The national economy we know is populated by live people and businesses. They create the economic dynamics that moves economic growth, if centralistic policy does not restrict it. Such hindrances have been continuosly imposed on the Swedish economy throughout the post-war period; they explain the economic problems of today.

Our proposals therefore include two elements; to remove those hindrance and to reform institutions such that growth be stimulated. Once done, there is no reason to expect that Swedish industry will grow more slowly than the industry and the economy of any other country. The large (most serious) institutional obstacle for economic growth is the dominant public sector and its tax financing system.

The three policy packages proposed, hence, are directed towards 1) the public budget, 2) incentives to enter new business and to invest and (3) the functions of the labor market, especially those influencing individual competence development and wage setting. These three policy packages are necessary and sufficient to restore long term sustainable growth in the Swedish economy and, thus, conditions for the continued welfare provisions of a wealthy nation, albeit on a radically different foundation than provided by the earlier income and wealth reshuffling tax state.

Serious questions, however, remain concerning the capacity of the political system to take the necessary decisions, especially its capacity to take a long term perspective on the current crisis and to execute the necessary measures.

What possibilities exist to force the necessary and sufficient long term decisions in the interest of future generations against some of the current voters and politicians? The problem we see with current debate is that this imposition has been discussed without considering the necessary, supporting institutional change. Keeping the current institutional order means inflation and again a future cost crisis, a new depreciation of the Swedish krona, and increasingly frequent repetitions. Social and economic costs associated with such policy rapidly escalate, as does inflation. The political alternative to the necessary radical structural change is to transfer Sweden, over some decades, into a Latin american inflation economy. Compromises between radical structural correction and increased inflation in order to hold down unemployment, unfortunately are no longer credible. Such politicies send unclear signals in markets. They allow arbitrary ad hoc policy actions and make speculation against policies profitable. The result is bad solutions, exactly what happened before the krona was forced to float the autumn of 1992. When markets have no faith in policy makers and their capacity for long term policy, policy is destructed by speculation.

When the proposed policy measures have been enacted incentives to speculate against politicians and the Swedish krona, and in future inflation are removed. There will be no need for policies directed against any macroeconomic symptoms. If the proposed policy package is carried through without hesitation and compromising, market expectations will be favourably affected and the foundation of speculation against Swedish economic policy removed earlier, before the policy program has been executed. Success is all a question of political credibility and the ability of the political system to behave rationally and to execute measures with immediately unpopular consequences, but positive results beyond the three year political horizon.