Entrepreneurial and Business Conditions in Sweden: Implications for Employment

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I plan not to talk at all about unemployment, but rather about employment. It may at first glance appear to be almost the same thing, but this is not necessarily so. Above all, focusing on employment rather than unemployment can give rise to very different policy conclusions. We know that Sweden has faired fairly badly in terms of economic growth for almost three decades, but we faired very well in terms of employment, and in terms of low unemployment, until about 1990. At that time Sweden had the highest employment rate in the world, 81 percent of the population between 18–64 years were gainfully employed. Since then, there has been a dramatic change in terms of employment. At the peak of the employment boom in 1989–90 there were about 4.5 million jobs in Sweden. That figure dropped by about 600,000 jobs in just a couple of years time. In late 1993 the economy began to bounce back, and 150–200,000 jobs were gained, but now those jobs have been lost again (Figure 1). The most recent official statistics tell us that there are 3.86 million jobs in Sweden at the moment, an extremely low figure indeed; we are back again at the extreme lows of the depression years in the early 1990s.

Therefore, looking at employment, the recovery of the Swedish economy after the severe crisis of 1991–93 has been one of jobless growth. So far there has not been any permanent change in the job level. It is also true that this applies equally well to the private sector. For a while it seemed that the jobs, which were lost, were mostly in the public sector, but the last figures show that there has also been stagnation in the private sector (Figure 2). If Sweden is going to come back to something like full employment, and perhaps come back to 4.5 million jobs again, we have to ask a couple of fundamental questions.

In this talk I will take an entrepreneurial perspective. Entrepreneurship is a key to job growth in the private sector, and new jobs in the private sector are, according to the speech given by Minister of Finance Erik Åsbrink earlier this morning, one of the government's five main objectives. Thus, the jobs have to be created in existing firms or new firms. So the challenge, as I see it, is to be build institutions and rules of the game in the Swedish economy that render strong employment expansion possible.

What do these rules and institutions look like? Posing this question brings incentives to the forefront – incentives for employing more people in existing businesses or starting new businesses if you have good, viable ideas. I will to a large extent build my analysis on research done with Steven Davis at the University of Chicago.[1]

Figure 1 Effective Marginal Tax Rates, 1980, 1994 and 1994 (real pre-tax rate of return 10% at actual inflation rates).

[1] I primarily build my presentation on: Steven J. Davis and Magnus Henrekson (1997), "Industrial Policy, Employer Size, and Economic Performance in Sweden." In Freeman, R.B., Swedenborg, B. and Topel, R., *The Welfare State in Transition.* Chicago: University of Chicago Press; Henrekson (1996), *Företagandets villkor. Spelregler för sysselsättning och tillväxt.* Stockholm SNS Förlag; and Henrekson and Dan Johansson (1997), "På spaning efter de mellanstora företagen." *Ekonomisk Debatt,* Vol 25, No. 4.

	Debt	New share issues	Retained earnings
1980			
Households	58.2	136.6	51.9
Tax exempt institutions	-83.4	-11.6	11.2
Insurance companies	-54.9	38.4	28.7
1994			
Households	32.0/27.0	28.3/18.3	36.5/26.5
Tax exempt institutions	-14.9	21.8	21.8
Insurance companies	0.7	32.3	33.8
1995			
Households	32.0/27.0	67.7/57.7	48.0/38.0
Tax exempt institutions	-3.5	25.7	25.7
Insurance companies	21.0	53.3	50.4

Note: All calculations are based on the actual asset composition in manufacturing. †Excluding wealth tax. Wealth tax on unlisted shares was abolished in 1993. *Source*: Jan Södersten.

To some extent my analysis will be backward looking. In order to obtain good guidance as to what to include in the future policy package, we have to evaluate the performance of past and present policies, sometimes loosely referred to as "the Swedish Model."

A disaggregation of the employment record (Figure 3) shows that employment growth looking over the entire post-war period has been bleak for the private sector. In fact no net jobs have been created in the private sector, since 1950. There are fewer jobs in the private sector now than there was 47 years ago, despite the fact that there are almost 2 million more Swedes now than in 1950. Thus all new jobs, net, were created in the public sector. Creating jobs in the public sector through political decisions is of course a totally different matter compared to stimulating private individuals and firms in the private sector to take decisions to expand employment in existing and newly started firms.

Before I proceed to discuss the rules of the game for employment creation I will just briefly highlight a few important traits of the Swedish economy. Large corporations play a very dominant role. There are a number of studies showing that Sweden is perhaps the single industrial economy with the highest dominance of large firms in the whole OECD area. We also have the highest government employment share, about 35 percent of total employment is in the public sector. There has been a low share of self-employment, and corporate ownership has been very concentrated. This reliance on large corporations has persisted up until very recently, whereas in the U.S., for instance, there was a break in the relative role of larger firms as early as around 1970. Thus, almost 30 years ago the relative role of the large corporations in terms of output and employment began to decline in the United States. This did not start happening here until a few years ago. I want to suggest that these particular traits of the Swedish economy may have something to do with our particular institutions and rules of the game.

First of all let us look at taxation. Corporate taxation is, of course, from an entrepreneurial perspective, very important. Since time does not permit going into details let me just state (see Figure 1) that Sweden has historically had corporate taxation which has been very beneficial to institutional owners and to debt financing. It has been an extreme characteristic of the Swedish tax system benefiting institutional ownership to the detriment of private, individual ownership. The tax system has encouraged a high debt-equity ratio.

What kind of firms can benefit from this kind of tax system? Well, of course institutional ownership is most suitable for large firms listed on the stock exchange. And a high debt-equity ratio is easy to live with if you have a great deal of collateral, if you are, e.g., a paper mill or a car producer. So the Swedish engineering industry, Swedish raw material based large companies and construction companies benefited from these tax rules. Whereas small and new firms, almost by definition, have to be individually owned. Also firms which are labor intensive or knowledge intensive have very little collateral, so they have to work with a high-equity ratio. Likewise, new firms based on a new innovation, where it takes a long time for the finished product to reach the market, and where the risk level is high require a low debt-equity ratio.

Equity has to be a major source of financing particularly during the first phase of the firm, when it develops from 0 to, say, 10–20 employees. But with a corporate tax system as extreme as the Swedish one throughout most of the post-war period, it is no wonder that these traits of the system actually benefited the kind of production units that we observe so much of, namely, large capital intensive corporations. But the problem with this is of course, looking at it from a U.S. perspective, that this is not where the jobs have been created, net, in recent decades. They were created, to a large extent, in small, new firms or firms that grew from being small to becoming large, so-called *gazelles*. So labor intensive and knowledge intensive firms in Sweden had a disadvantage, and I judge that many potential jobs have been lost there. Under the current tax system, many of these problems have been removed, but we still have a much higher taxation of equity – which is taxed at about 50 percent (so-called double taxation), whereas borrowed capital is only taxed at 30 percent – which benefits those firms that need little equity and can work with a great deal of debt. It also benefits institutional owners who, in many cases, do not pay any tax on their dividends.

Let us now turn to the effects of labor taxation. We know that in the U.S. the number of jobs in the private service sector have increased by about 90 percent since 1970, whereas in Sweden the number of private sector service jobs have increased by only about 11 percent. Services differ from goods in a fundamental way: the cost almost entirely consists of labor costs, which is not the case if you produce cars, pulp or the like. And after the tax reform in 1991 we had basically two tax rates, 30 and 50 percent, but the tax rates have increased quite considerably in the last few years. At an income of about 2,500 USD/month the marginal tax rate is now 59.2 percent, and for low income earners it is typically about 38.5 percent on the margin. For all practical purpose one can say that Sweden now has a 40–60 percent tax rate schedule, rather than the 30–50 schedule that was instituted in the 1991 tax reform. A very recent report shows that Sweden has the highest tax burden of all countries on low incomes, about 62 percent of labor income for a typical low income earner is taxed away. And of course, with such high tax burdens, these services, should they be produced, will have a very high price in order to give a take home pay for the producer that leads to, at least, a subsistence level income. Also, looking upon this issue from the consumer's side, demand may be very low because those who are going to buy the service will have to pay out of their own after-tax income, so we have double tax wedges here. Whereas, if you have from the individual perspective, private services produced in the public sector and given away for free, or sold at a very low price, the tax wedge problem is greatly alleviated. But if Sweden is going to create new jobs net in the private service sector like the United States has done for decades, then the high rate of taxation on labor will need to come down.

A very high total tax burden also makes it very difficult to save. We know from many studies that the availability of equity is very important for someone who has a business idea, and wants to transform this idea into a business venture. High taxes render it very difficult to accumulate wealth so when somebody comes up with a business proposal he or she is unlikely to have any capital, and this leads to less venture capital and fewer firm start-ups. And we know that to create many jobs net you need a high gross flow of jobs, and you need to have many new firms which start because only a small share of them survive, and an even smaller share of the new firms grow to become medium-sized or large.

I would now like to talk very briefly about a few other things. Firstly, labor security legislation. There is evidence suggesting that the employment security provisions fall more heavily on smaller firms and some other classes of firms. In the United States, both the rate at which workers separate from jobs and the rate at which employers destroy job positions decline with the size, age and capital intensity of the employer. This suggests that any costs imposed by a regulation similar to the LAS (Employment Protection Act) are likely to fall more heavily on younger, smaller and less capital-intensive employers and to distort the distribution of employment towards industries characterized by more stable establishment-level employment and longer job tenures.

Furthermore, we know from U.S. studies that wages, all else equal, increase with the age, the real capital intensity and the size of the firm. In Sweden, with a much more centralized wage formation structure and a narrower wage dispersion, this does not happen to the same extent. This means that, in the Swedish setting, small firms have to pay a higher wage in the initial stage of their life cycle than otherwise, and this, of course, increases their wage costs and makes it more difficult for them to get started and obtain the impetus to finally become a large firm.

I have already mentioned that all new jobs in the post-war period have been created in the public sector. Most of these jobs concerned private (from the consumer perspective) service production which could just as well have been performed on a private basis. Especially noteworthy is the dramatic increase in employment in health and medical care and social services. These services are labor-intensive, and in many instances are very suitable for production by a small firm. One alternative to public production might have been private production with public financing. There is good reason to believe that the political decision to produce these services through a public sector monopoly has been a key factor in the weak growth of private sector employment and the dominance of large firms and establishments in the Swedish economy.

My assertions in this presentation are backed by research, where a detailed comparison with the U.S. shows that Sweden has less employment in: (i) private services; (ii) U.S. high and low wage industries; (iii) small-establishment industries;

and (iv) low-wage manufacturing. For the most part, the pattern of these differences fits well with the distortions anticipated from my characterization of Swedish economic policies and institutions.

My main conclusion is that the rules of the game and economic policies play an important role in fostering entrepreneurial behavior, employment growth, and quite likely, economic growth. However, this does not mean that the politicians should come up with a batch of new measures that would benefit small or new firms or which would specifically favor a certain type of production. The entrepreneurial process is such a pervasive feature of a market economy that the most efficient way to encourage firm births is to enhance the environment for all business activity. Thus, Sweden should work to create a stable and internationally competitive economic framework for all types of firms. This framework should offer sufficient incentive for change and for investment in real capital, education, and knowledge capital, and it should be neutral in terms of an enterprise's orientation, size, and organizational principles. If Sweden succeeds in this endeavour I am confident that in the long run Sweden can become as powerful a job machine as the United States.