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This Survey is published on the responsibility of the Economic and Development Review Committee (EDRC) of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of Sweden were reviewed by the Committee on 11 January 2007. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 23 January 2007.

The Secretariat's draft report was prepared for the Committee by Jens Lundsgaard and Felix Hüfner under the supervision of Andreas Wörgötter.

The previous Survey of Sweden was issued in August 2005.

Information about the latest as well as previous Surveys and more information about how Surveys are prepared is available at www.oecd.org/eco/surveys.

BASIC STATISTICS OF SWEDEN

THE LAND

Land area (1 000 sq. km)	410
Lakes (1 000 sq. km)	39
Arable area (1 000 sq. km) (2004)	27
Woodland (1 000 sq. km) (1998-2002)	227

Inhabitants in major cities, including suburbs (1 November 2006) thousands	
Stockholm	1 915
Göteborg	888
Malmö	613

THE PEOPLE

Population (30 November 2006), thousands	9 111
Number of inhabitants per sq. km	22
Net natural increase (average 2001-2005) thousands	4.9
Net natural increase per 1 000 inhabitants (average 2001-2005)	0.5
Net migration (average 2001-2005), thousands	28.2

THE PRODUCTION

Gross domestic product in 2005 (Kr billion)	2 670.5
GDP per head, USD	32 111
Gross fixed capital formation in 2005	
Per cent of GDP	17.2
Per head, USD	5 535
Employment	
Total civilian, thousands, 2005	4 263
Per cent of total, 2005	
Agriculture, forestry, fishing	2
Industry	22
Other	76

THE GOVERNMENT

Per cent of GDP in 2005:	
Public consumption	27.2
General government current revenue	59.0
Public gross fixed capital formation	3.0

Composition of Parliament	
Social democrats	130
Moderates	97
Liberals	28
Christian democrats	24
Left	22
Centre	29
Greens	19
Total	349

Last general election: September 2006

Next general election: September 2010

THE FOREIGN TRADE

Exports of goods and services, 2005 (per cent of GDP)	44.4
Main merchandise exports (per cent of total), January-October 2006	
Wood and paper products	11.4
Mineral products	10.5
Chemical products	12.2
Energy products	6.1
Engineering products	48.8
Other products	10.9

Imports of goods and services, 2005 (per cent of GDP)	
Main merchandise imports (per cent of total), January-October 2006	
Wood and paper products	3.0
Mineral products	15.0
Chemical products	14.0
Energy products	12.9
Engineering products	43.6
Other products	18.8

THE CURRENCY

Monetary unit: Krona

Currency units per USD, average of daily figures:	
Year 2006	7.37
December 2006	6.85

Executive summary

Sweden enjoys excellent macroeconomic performance with high rates of growth, low unemployment and stable inflation expectations. Early steps in regulatory reform, taken in the 1990s, are paying off in terms of productivity and GDP growth. However, tensions are visible at the margin. Employment rates have not recovered to traditionally high levels since the crisis of the early 1990s. Joblessness is widespread among immigrants and youngsters, and disability and sickness rates are comparatively high. As well, renewed regulatory reform is needed, inter alia to address the low rate of enterprise formation and enterprise growth that may weaken the economy's ability to venture into new business fields.

The new government, which took office in October 2006, has renewed the commitment to sound macroeconomic framework conditions and it will stick to the budget surplus target of 2% of GDP. This is necessary to keep public finances on a sustainable path in the face of future spending pressures. As concerns structural policies, the government is determined to eliminate exclusion in the labour market and reduce the administrative burden on enterprises. Some important measures are already included in the 2007 Budget. This Survey builds on these commendable efforts and presents recommendations to increase the cost effectiveness of implemented and intended reforms.

The inflation targeting framework has served Sweden well *by firmly anchoring inflation expectations. With price increases being below the inflation target over a prolonged period, partly reflecting positive supply shocks due to globalisation factors, the Riksbank has responded by allowing for a longer time horizon within which inflation can be expected to return to target in this particular environment. The Riksbank's plan to share its assessment about the future interest rate path should further improve public understanding and better guide expectations.*

There is a problem of exclusion in the labour market. *Recognising this, the government has presented ambitious reforms that will increase labour supply and demand by reducing replacement rates and the volume of active labour market programmes while waiving social charges for targeted groups and sectors. In addition, a substantial in-work tax credit will be introduced. These measures are designed to work in a context of a compressed wage structure and relatively strict employment protection. The impact of these measures will have to be carefully monitored in order to avoid unintended side effects, and if they are not sufficient, empirical evidence from other OECD countries would suggest that more flexible wage determination and less strict employment protection are promising routes to combat exclusion.*

The housing market suffers from distortions. *Rental charges are below market levels in metropolitan areas as they are determined by costs in the public housing sector, leading to queues which may reduce labour mobility and welfare. Hence, the rental market is squeezed between rigid rent determination and the booming market for owner-occupied and tenant-ownership housing. Competition in the construction sector is weak and municipalities have too few incentives to provide land for residential construction. Real estate and imputed rent taxes were below neutrality already in 2006. The upcoming housing tax reform should therefore fully finance the 2007 cut – also to avoid fuelling the house price boom. Owning individual flats should be allowed and the application of the rent determination system should be made more responsive to local market conditions.*

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Assessment and recommendations

Strong and stable macroeconomic performance

The Swedish economy has recovered strongly in recent years with annual GDP growth expected to exceed 4% in 2006. This recovery has come sooner and been stronger than in most other European countries, illustrating the relative soundness of the Swedish economy. Inflation expectations are well anchored. This successful performance is a result of the way in which Sweden responded to the deep crisis in the early 1990s, when it greatly improved its macro policy framework. With a structural budget surplus of around 2% of GDP, Sweden is preparing itself to meet future demographic challenges much better than most OECD countries. All parts of society benefit from this forward-looking policy framework. For those employed, real wage growth has averaged 3½ per cent since 1998 when a new stability-oriented wage formation framework was introduced, compared to just 2½ per cent during the inflationary 1970s and 1980s.

Regulatory reforms from the 1990s have boosted productivity

Partly owing to the large technology sector, productivity growth is impressive with GDP per hour worked growing 2½ per cent a year for the economy as a whole. Meanwhile, falling prices for a part of manufacturing exports have caused a trend decline in the terms of trade and, taking this into account, aggregate consumption possibilities have grown less fast than GDP volume. Nevertheless, so-called command GDP per hour worked, which corrects for the terms-of-trade loss, has sustained a growth rate of close to 2% – well above the average rate it had during the 1980s. Sweden is thereby now reaping the gains from the early steps it took in the 1990s with regulatory reform of publicly funded services, infrastructure, energy and communication sectors as well as deeper international integration following EU membership. Nevertheless, a 22% gap remains *vis-à-vis* the United States, in terms of GDP per capita, with shortfalls in labour resource utilisation and productivity per hour each accounting for about half of the gap. Progress in regulatory reform should be revived and barriers to higher labour utilisation should be removed.

Key challenges for Sweden are to combat exclusion in the labour market and deal with distortions in the housing market

While labour-market insiders manage well, groups at the margin like immigrants, youngsters, disabled and sick continue to suffer from exclusion. Strict employment protection and a compressed wage structure with relatively high taxes on earned income for low-income groups make it difficult for people in such groups to find a job. High replacement rates add to unemployment and inactivity traps. The problem is exacerbated by distortions in the housing market which *inter alia* may reduce labour mobility. The ambitious reform programme put in place by the government is taking large steps to combat exclusion in the labour market by making work pay and strengthening the inroads for outsiders. This *Survey* devotes its prime attention to this reform agenda and presents options for housing market reform.

The fiscal framework needs tightening

Bringing the public finances from deep deficit in the early 1990s to structural surplus today was a major achievement. It is therefore important that the new government has renewed the commitment for sound macroeconomic framework conditions and will stick to the target for general government net lending of 2% of GDP over the cycle which is necessary to keep public finances on a sustainable path. Underlying this target is the assumption that taxes can be sustained at current levels which could be difficult in the future, not least due to mobile tax bases and international tax competition. *In the current juncture, where growth could well continue above trend in 2007-08, positive fiscal surprises should not be allowed to trigger permanent spending increases or under-financed tax cuts. Lowering the expenditure ceilings could help to keep spending on track, while avoiding slippage and absorption of the rather wide margin between budgeted spending and the expenditure ceilings. To create room for more fully-financed tax cuts aimed at making work and entrepreneurship pay, consideration should be given to taking steps towards a uniform value added tax.* Finally, while the current rapid reduction in public debt helps to prepare for population ageing, it is also necessary to consider strategies for how to meet the likely future increase in demand for ever-better service standards in the areas where public funding and provision is dominant. *In particular, when expanding user choice, it is essential to implement it in ways that can give room for users to contribute financially, for example in higher education, rather than in ways that increase public spending pressures.*

Inflation stays low partly because of globalisation effects

The strong growth performance over the past years notwithstanding, average inflation has been one of the lowest among European countries since the mid-1990s. This partly reflects positive supply shocks which induced the strong growth in productivity and lower unit labour costs. Global competition and deregulation have led prices in some sectors, such as retailing, to start converging to the lower European levels. With rising trade integration, the share of imports in consumption has increased and a shift towards trade with low-cost producing countries has contributed to low import prices. The Riksbank has responded, in this particular environment, by allowing for a longer time horizon for bringing inflation back to target. That is sensible if indeed the positive supply shocks are temporary, but it will be costly if the rise in productivity growth proves to be lasting and inflation stays below target. Given the persistence of positive productivity surprises and negative inflation surprises, more research is needed to better understand the forces driving inflation and to clarify the role of house prices in the policy decisions. The Riksbank's plan to share its assessment about the future interest rate path should further improve public understanding and better guide expectations. In the meantime, long-run inflation expectations remain firmly anchored around the central bank's desired level, demonstrating that monetary policy is highly credible.

Meanwhile house prices and residential investment are booming

In contrast to consumer prices, house prices have grown on average 8½ per cent a year since the trough ending in 1996. Much of the increase may be explained by lower interest rates and rising incomes, but the recent acceleration, with annual house price increases reaching 13% since early 2006, does raise concerns. OECD calculations indicate a small but growing overvaluation. If interest rates rise from their current low levels, the level of house prices that can be justified by "fundamentals" will decline, magnifying this estimated overvaluation. In this context, it is unfortunate that housing taxes have been cut this year by one quarter of their revenue, as that adds to the risk of overheating in the housing market.

With higher house prices, residential investment has grown by double-digit rates since the beginning of 2004, and over half of all construction firms now point to a lack of qualified labour as the main hindrance to expansion. Such pronounced labour shortages have not been seen since the late 1980s. It helps that Sweden has no special restrictions on worker mobility from the new EU member states. Net immigration from Poland, for example, has grown considerably in 2005-06, and this may be part of the reason behind continued wage restraint in construction. *Informing workers from abroad, who consider migrating to Sweden, about ongoing qualification needs of the labour market could be considered to guide the skill composition of inflowing workers.*

The recovery is an excellent opportunity for combating exclusion

Although growth is strong, the number of persons excluded from the labour market has still not fully come down to where it was before the crisis of the early 1990s. From a peak of 23% in 1993, the share of 20-64 year olds who depend on public income transfers has declined to 20% in 2006, but it remains well above the 15-16% of 1990-91. Overall employment rates are among the highest in the OECD, in particular for women. Nevertheless, with 85% of the men and 81% of the women aged 25-54 being in work, employment rates for prime age workers remain well below what they were in 1990. As the economy may now be hit by more frequent structural shocks than some decades ago, reallocation of labour may be increasingly important and add to the pertinence of traditional insider-outsider problems.

Making the labour market more inclusive and flexible is therefore a key challenge and calls for a variety of responses. Recognising this, the government has presented ambitious reforms to make work pay and increase labour demand for targeted groups and sectors. These measures are designed to work in the context of a compressed wage structure and relatively strict employment protection. If these measures prove not to be sufficient, empirical evidence from other OECD countries would suggest that more flexible wage determination and less strict employment protection legislation are promising routes to combat exclusion. Economically, the essential elements to combat exclusion are the following.

- *To make work pay and support active job search*. The 2007 adjustment of unemployment benefits, with replacement rates now declining gradually from 80% initially to 70% after 40 weeks and with the transfer of the unemployed person to a job and development guarantee with a benefit rate of 65% after 60 weeks, will encourage jobseekers to be more mobile both geographically and with respect to professional orientation. It may reduce structural unemployment by as much as half a percentage point, and increase employment rates by even more. The adjustment of unemployment benefits should be seen in combination with the in-work tax credit which means that the income groups affected by lower unemployment benefits will gain from the in-work tax credit if accepting a job. Meanwhile, as planned, more should be done to enforce requirements for active search and participation, supported by moderate benefit sanctions. Counselling and job search assistance is particularly important at the current juncture in order to ensure that those at the margin of the labour market benefit fully from the current upswing.
- *To make labour more affordable for certain targeted groups*. New-start jobs waiving employers' contributions when hiring someone having received unemployment benefit, sickness benefit, disability pension or social assistance for more than a year, or for newly arrived refugees or their families will help labour market outsiders when introduced from this year. The general employer contribution rebate planned for various service sectors is expected to increase demand for low-skilled workers, increase labour supply to the extent the services are substitutes to do-it-yourself work or leisure, and reduce shadow market activities, but may also prove difficult to administer and prone to rent seeking with firms trying to reclassify activities so as to receive the rebate. Employer contribution rebates are also introduced for the young and elderly. The effectiveness of these measures will depend on whether labour costs for these groups will be reduced. If not effective, social partners should search for ways to increase wage flexibility at the local and individual level.
- *To reduce the risk associated with hiring someone who turns out not to be the right person for the job.* The plan to prolong the maximum duration of temporary contracts to 24 months will help in this regard, but it may aggravate labour market dualism. Indeed, the significant liberalisation of temporary employment regulations, introduced between the late 1980s and late 1990s, did not succeed in effectively resolving the insider-outsider problems. No other Nordic country has job security laws for regular contracts as strict as those in Sweden.

A series of measures are now being introduced with the new government's reform programme. All can be expected to have positive effects, but in some cases it will be essential to evaluate and maybe refine targeting and implementation. Looking ahead, it remains an open issue whether Sweden as a small open economy can continue to reap the full benefits of accelerating globalisation without reform of employment protection and more flexible wage determination.

Immigrants suffer disproportionately from exclusion

Net immigration adds ¼-½ per cent to the Swedish population each year, and as most come from countries in South-Eastern Europe, the Middle East, Africa and Asia, diversity in the labour force is increasing. Better including these people in the labour market is a key challenge, as currently their employment rate in Sweden is below the high employment rate for natives. Youth unemployment among immigrants stands out in particular, at a rate above 30% – compared to 10% for young people in general.

Because of their wide individual diversity, immigrants may suffer disproportionately from insider-outsider problems on the labour market. Given their origin, some lack the basic literacy and other skills needed to command a wage higher than the benefits offered when not working. Others are highly educated, but potential employers may feel uncertain about their exact competence. For both groups, strict labour market regulations and a compressed wage structure may entail *de facto* discrimination, as immigrants are discouraged or even prevented from seeking work on conditions that match their competence and education. Moreover, they may be disadvantaged by moderate ethnic discrimination as found by a recent experiment of sending CVs with similar content but different names to employers with job vacancies.

The general economic recovery will help immigrants, and the challenge is to make sure that increasing demand for their labour is not hindered by adverse structural factors. The best strategy would be to pursue general labour market and welfare reform. But to really help marginalised immigrants, such reforms would have to include substantial easing of job security rules, more individual wage flexibility and considerable reductions in benefit levels. If general reforms are less ambitious, targeted measures may need to be considered.

- *Adjust benefit withdrawal and maybe the level of benefits to avoid unemployment and inactivity traps.* Social assistance and housing benefits for families with numerous children seem particularly problematic in creating such traps.
- *The social partners should allow for lower initial wages followed by stronger earnings progression during the first years of employment, thereby making it easier for immigrants to get established on the labour market while improving knowledge of Swedish language and other local conditions.*
- *Introduce a youth package with enhanced education and training offers, activation and benefit reform, so that it never pays to remain unemployed or inactive compared to working or taking up training.* Such a package has been highly successful in Denmark. It would benefit all young people, but immigrants in particular, by reducing the negative impact of inactivity on hopes and habits in working life. Experience from other OECD countries shows that apprenticeships and enhanced vocational training for young persons could also be helpful. To be fully effective, basic literacy improvements earlier in school, ideally with enhanced educational content in pre-school, are also needed.
- *Improve language training for newly arrived migrants,inter aliaby enhancing the professional ability of teachers and integrating language training in the workplace. Introduce early childhood action for migrants' children having language problems.*
- *Do more piloting to develop non-bureaucratic procedures for filling job vacancies in ways that avoid possible discrimination based on name or ethnicity.*

Improvements in sickness absence and disability pension must be sustained

Sickness absence among those employed and the number entering disability pension increased rapidly from the late 1990s. The numbers are now falling, although the stock of disability pensioners remains among the highest in the OECD. The aim of sickness and disability insurance must be to protect the security of those who suffer illness or an accident. At the same time, it must provide incentives and early action to promote a return to work for those who recover, fully or partially. The new-start jobs and the in-work tax credit introduced this year are important steps in this regard. *Administrative improvements in local social insurance offices therefore need to continue, including both enforcement of rules and development of reliable procedures for medical assessment. To ensure that rehabilitation takes place at an early stage, sickness benefit should not be received for longer than a certain period of time. The use of partial disability benefit should be monitored closely and the many cases of disability pension granted during the past five years should be revisited to assess options for rehabilitation. Disability pensioners should have incentives to take up jobs where they can use their remaining work capacity.*

Could it be made less risky and cumbersome to start a firm?

To ensure demand for the increased labour supply as well as to enhance the economy's capacity for change, it is necessary to look into why business formation occurs less often and firms are less likely to grow than in other countries, for both manufacturing and services. *Reviewing bankruptcy laws is particularly important. Making taxation and other rules simpler is also important, and the 2007 Budget takes steps in this direction. As planned, the size and scope of public ownership in business sectors should be reduced and competition among providers of publicly funded services should be enhanced so as to promote innovation and entrepreneurship in new areas.* Extensive job security could be another factor behind limited business formation and also make it harder for start-ups to attract experienced employees, as it means that experienced employees lose something when quitting a safe job. *Consideration could be given to making the safety net acquired via long job tenure more transferable.*

Tax cuts are important for both labour supply and entrepreneurship

Letting people keep a bit more of the value they create is vital to encourage both labour supply and entrepreneurship. *The plans to abolish the wealth tax should therefore be endorsed,* as it sets in at a rate of 1½ per cent already from wealth slightly above the average price of a metropolitan-area one-family house. Abolition of the wealth tax might lead to repatriation of capital, possibly making more investment capital available for new small firms. Marginal income taxes are also important, though, because high rates kick in already from slightly above average full-time earnings. The combination of social contributions, income and consumption taxes drives the effective marginal tax rate above 70% for over a third of the full-time employed, helping to explain why working hours for those employed are below the OECD average. With recent tax reforms for closely held companies, the net income gain accruing to the entrepreneur in case the start up proves successful is considerably higher, but there is still scope for improvement.

These factors need to be considered alongside labour supply arguments when deciding on the relative importance of alternative income tax cuts. From 2007, an in-work tax credit worth over 1¼ per cent of GDP has been introduced with the purpose of making work economically more rewarding compared with receiving income benefits. In combination with the reduced income replacement rates in unemployment benefits, it will improve employment rates and lower structural unemployment. Meanwhile the effect on average

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hours worked by those already employed is uncertain, because the positive substitution effect from lower effective marginal taxes, is weakened by the income effect which ís likely to reduce working hours a bit for large groups. *For future changes, several options should be considered in order to maximize the effects on employment and hours worked. One option is to expand the in-work tax credit targeted at low- and middle-income earners in combination with benefit reform further reducing the barriers for those presently out of work. Another option is to reduce the rate of state income tax or shift up the threshold from where it is paid.* Moving up the threshold by SEK 100 000 from 105% to 135% of average full-time earnings, for example, would halve the number of persons exposed to the above-70% combined marginal tax rate, which results when the state income tax sets in on top of social contributions, municipal income tax and consumption taxes. Nevertheless, with a narrow earnings distribution and many workers paying relatively small amounts of state income tax, only a quarter of the revenues would be lost. In fact, completely abolishing the state income tax would cost just 1½ per cent of GDP – only slightly more than the in-work tax credit just introduced. Of course, the effects on income distribution would be quite different.

Distortions in the housing market exacerbate exclusion

While Sweden has succeeded in deregulating a number of sectors, the housing market remains highly distorted, *inter alia* hindering the matching of supply and demand and excluding many Swedes from their preferred housing tenure. Regional demand differences for housing are large – as reflected in strongly increasing house and apartment prices in the metropolitan areas, but rents are not allowed to reflect market prices. The rent-setting framework, where private rental contracts are based on the negotiated cost-oriented rent in public housing companies, has led, in metropolitan areas, to large differences between what rents tenants are prepared to pay and the rents actually charged. With extensive queuing, many who might have preferred to rent, are driven into the tenant-ownership and owner-occupied segments. Other consequences of rent regulation are black-market trading of rental contracts, frequent conversion of rental flats to tenant-owned dwellings and low construction activity of rental dwellings. The effects of the changes in rent legislation concerning new rental dwellings implemented in 2006 remain to be seen.

More market elements in the rental sector should be introduced

Although rent regulations for newly constructed dwellings have been eased somewhat, the rent setting framework still remains rigid and rents do not reflect the demand and supply situation, preventing an efficient allocation. *Ideally, rent regulation should be phased out to make the market function better.* But reforms can also take place within the system, by introducing rent differentiation across municipalities in the public housing sector, foremost in the Stockholm region where the problems are most acute. In order to achieve this, *regulation of rents in municipal housing companies should be reformed, and closer cooperation between concerned parties should be encouraged*. Successful examples can be seen in Malmö, where more rent differentiation has been gradually implemented. As the public sector rents serve as the basis for the private sector, such reforms would benefit the whole rental sector.

Housing taxation is moving further away from neutrality

Radical reforms in property taxation and subsidization were enacted with the 1990/91 tax reform, significantly reducing the direct and indirect fiscal costs of housing policies. However, more still needs to be done to make the system less distortionary. With 2006 rules, taxes for owner-occupied housing and tenant-ownership associations and their members were only about half of what would be required for neutrality *vis-à-vis* other capital taxes and interest deductibility. Yet, from 2007, imputed rent taxation has been abolished, value assessments frozen and taxes on land values capped, thereby cutting total housing tax revenues by almost a quarter. In a next step, it is planned to abolish the real estate tax, partly replacing it with a municipal fee decoupled from real estate prices. The government plans to fully finance the second step within the housing sector.

From an economic perspective, it would be much better to focus tax cuts on where it matters for employment and entrepreneurship. And decoupling housing taxation from value assessments cannot be an appropriate long-term solution, as misalignment from neutrality *vis-à-vis* other capital taxes and interest deductibility will gradually grow. The best would be to retain housing taxation levied on a recurrent basis. *As a minimum, the future reform of housing taxation should fully finance also the cuts made in 2007, while restoring the link to value assessments. Furthermore, the authorities should try to minimize the current problem with horizontal inequity stemming from inaccurate assessments of the market value of properties. Given the overall favourable tax treatment of home ownership, capital gains taxation should be strengthened: an interest could be levied on accrued (but not realised) capital gains, the tax could be based on the full capital gain, rather than two thirds as currently, and capital gains could be considered as realised at death. Similarly, measures to reduce the effective tax deductibility of interest expenses should be undertaken. Regarding direct subsidies, housing benefits should be made independent from the level of housing consumption, for example by introducing a flat rate benefit as in the United Kingdom. The interest grant scheme should be phased out as planned, as well as the state credit guarantee scheme.*

Supply could be made more responsive to demand

Construction of new residential housing has grown significantly, but as a share of GDP it still remains well below other OECD countries. To some extent this reflects earlier investment activity which was heavily subsidized by the government. Rent regulation also contributes as construction of rental dwellings is particularly limited. However, low construction is also due to an uncompetitive construction sector with high entry barriers and a strong labour union resulting in construction costs being higher than in most other European countries. In addition, the planning process is cumbersome and municipalities lack incentives to make more land available. *Introducing the broad existing proposals for reforming the Planning and Building Act would help to make the planning process more flexible. In addition, introducing a local real estate or land tax would improve the incentives for municipalities, but would have to be linked to property valuations. In addition, legislation should be introduced to allow direct ownership of individual apartments, which would also encourage investment in rental dwellings.*

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Chapter 1

Key challenges for the Swedish economy

Sweden enjoys excellent macroeconomic performance with high rates of growth and stable inflation expectations. However, tensions are visible at the margin. Joblessness is widespread among immigrants and youngsters, and disability and sickness rates are comparatively high. Combating exclusion both in the labour and housing markets is a key challenge for policymakers. Early steps in regulatory reform, taken in the 1990s are paying off in terms of productivity and GDP, but renewed regulatory reform is needed inter alia *to address the low rate of business formation. Progress on this reform agenda – employment in particular – is vital also for the long-run fiscal outlook which is shaped by population ageing. This chapter identifies such key challenges after first assessing recent macroeconomic developments including the housing and construction boom.*

Macroeconomic performance is strong

The Swedish economy has recovered strongly in recent years. Since 1998, GDP growth has outpaced the euro area as well as the Nordic average every single year, except for one (Figure 1.1). Unemployment is low in a European perspective, and now falling. Yet inflation remains low and stable. Both the general government fiscal balance and the current account show large surpluses. In sum, the key macroeconomic indicators paint a picture of a solid economy.

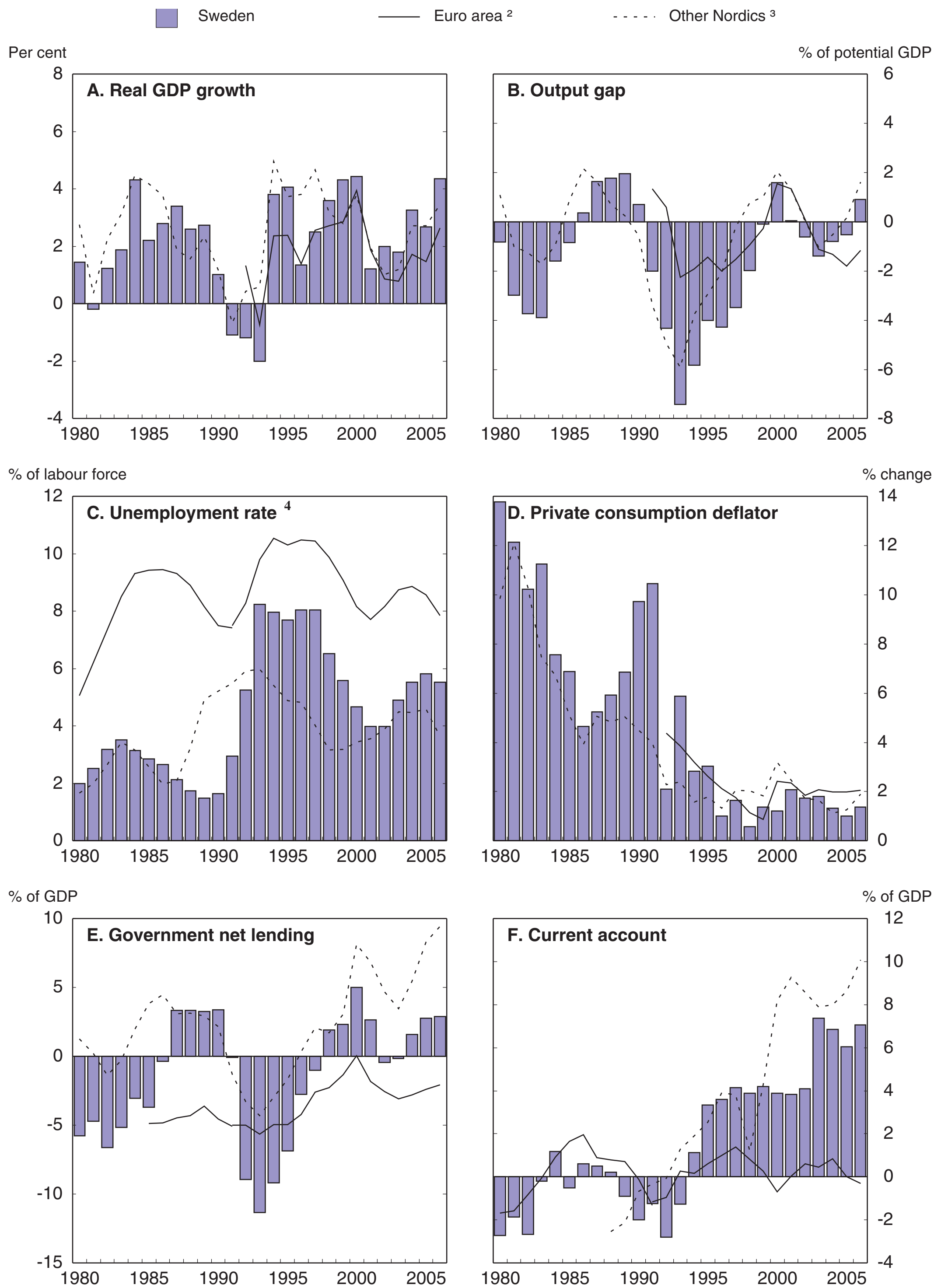
These impressive outcomes are the fruits of how Sweden responded to the deep economic crisis it went through in the early 1990s. During the 1970s and 1980s, macro policies zigzagged from fiscal stimulus seeking to "bridge over" the oil crisis, *via* "super devaluations" aiming to kick-start the economy, to a fixed exchange rate regime which became hard to defend following excessive credit expansion and financial crisis (Jonung, 1999). Against this background, the stability and the outcomes achieved by the current macro policy framework are indeed remarkable. The independence of the Riksbank under an inflation-targeting regime has anchored the inflation expectations of economic agents firmly at the 2% target. Similarly, guiding fiscal policy by a clear medium-term objective has secured a stable structural fiscal surplus of around 2% of GDP – and achieved so without the oil production windfalls helping some of Sweden's neighbours.

Impressive productivity growth reflects ICT and regulatory reform

The level of GDP per capita has, however, not fully regained its position relative to the leading OECD countries. At the trough of the crisis in 1993, GDP per capita was 24% below that of the United States and, despite Sweden's recovery, this gap has still been at around 22% since 2000. Lower utilisation of labour resources and lower productivity are equally important in explaining the gap *vis-à-vis* the United States. That such a gap remains illustrates the need for enhanced efforts to improve employment and productivity, but it is also a reminder of the cost of neglect: in the late 1980s, the same gap was only 17% on average, not to mention the 11% average during the first half of the 1970s. Also, Sweden has progressed less than its neighbouring countries despite the similar welfare orientation in public policies. Denmark maintains a slightly higher GDP per capita, and Sweden's clear lead *vis-à-vis* Finland in earlier decades is almost gone (Figure 1.2).

Labour productivity growth has been strong in recent years, led by the manufacturing sector. With output volume per hour worked growing almost 6% annually during the five years 1999-2003, manufacturing productivity is growing faster in Sweden than in other countries (Table 1.1). Production of ICT equipment, and the telecom giant Ericsson in particular, accounts for a significant part of this, but productivity gains have also been strong in vehicle and machinery manufacturing as well as the pharmaceutical industry. An important factor in this respect is structural adjustment due to reallocation of resources across industries (Lind, 2003). Another factor is the intensive investment in research and development with business sector R&D at 3% of GDP being higher than in any other OECD

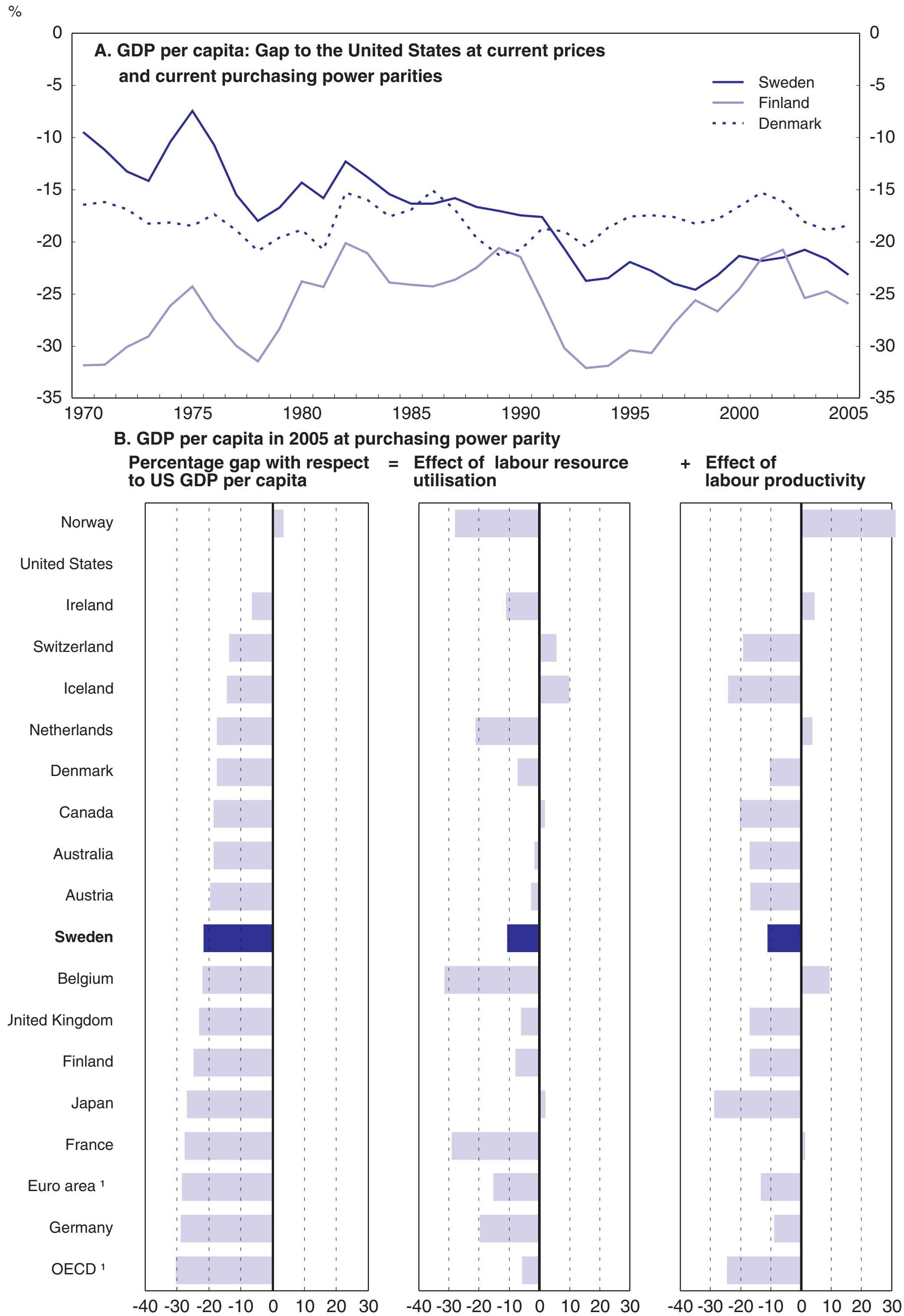
Figure 1.1. **Key macroeconomic indicators**[1]



1. OECD estimates for 2006.
2. Break in series in 1991: western Germany up to 1990, total Germany thereafter.
3. Denmark, Finland and Norway.
4. Labour Force Survey, *i.e.* open unemployment not including participants in labour market programmes.

Source: OECD Economic Outlook 80 database.

Figure 1.2. **GDP per capita and why it differs across countries**



1. Excluding Luxembourg.

Source: OECD Productivity database, September 2006, OECD SNA database.

Table 1.1. **Productivity growth by sector**

Value-added per hour worked, average annual change 1999-2003

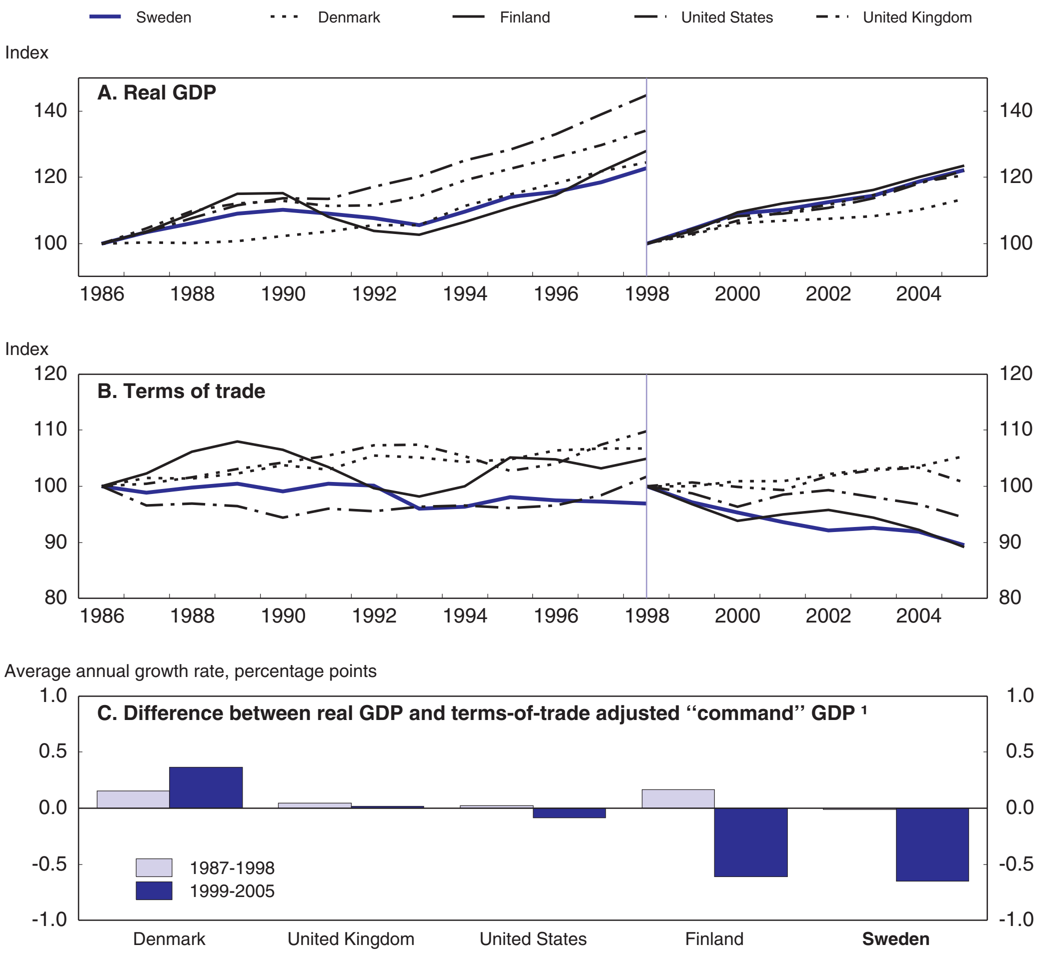
	CAN	DNK	FIN	JPN	NLD	NOR[1]	**SWE**	*Memorandum item* Share of total Swedish value-added, %
Total[2]	**1.9**	**1.8**	**2.0**	**1.7**	**0.7**	**2.7**	**2.4**	**100.0**
Agricultural, hunting, forestry and fishing	3.4	2.0	5.6	–2.1	–0.3	4.3	4.8	1.9
Electricity, gas and water supply	–0.4	–1.4	6.6	3.5	3.8	9.5	2.9	2.6
Construction	1.1	1.1	–1.9	–0.5	0.0	–2.6	–0.3	4.3
Total of manufacturing	**2.6**	**3.4**	**4.4**	**4.5**	**1.6**	**3.0**	**5.9**	**20.9**
Food products, beverages and tobacco	2.1	3.3	3.3	0.1	1.0	5.5	1.3	1.4
Pulp, paper, printing and publishing	3.2	0.1	2.5	..	–0.1	2.1	3.5	2.6
Chemical, rubber, plastics and fuel products	3.5	2.9	1.4	..	4.5	1.0	7.8	2.5
Basic metals and fabricated metal products	2.1	3.2	1.5	–0.3	0.8	4.0	2.6	2.2
Machinery and equipment, including ICT	–0.4	4.1	8.4	8.3	0.9	1.2	9.3	3.9
Transport equipment	2.7	2.4	0.2	5.5	0.6	0.0	7.3	2.3
Total of services	**2.0**	**1.4**	**1.0**	**0.9**	**0.6**	**2.8**	**1.5**	**70.0**
Producer services								
Business and professional services	2.6	–0.7	–0.5	..	1.5	0.4	1.0	7.8
Financial intermediation	1.0	3.9	5.0	6.6	1.6	2.8	4.3	3.6
Real estate	2.7	–0.4	–0.1	3.8	–1.0	–0.6	0.4	8.6
Distributive services								
Wholesale and retail trade; repairs	3.3	2.1	2.6	..	0.8	5.0	3.1	10.5
Transportation	2.7	6.0	1.1	..	–0.8	1.6	2.0	4.5
Communication	4.3	4.6	10.1	..	9.1	11.5	6.4	2.0
Hotels and restaurants	0.4	–2.9	–1.0	..	–1.2	0.9	0.4	1.5
Community and personal services	1.1	0.2	–0.3	..	–0.4	1.4	0.6	25.1

1. 1999-2002.
2. Sub-sectors accounting for less than 1% of value-added in Sweden are not listed separately, but are included in the totals.
Source: STAN database; OECD calculations.

country, on top of which comes public R&D spending at 1% of GDP. In services, productivity growth does not stand out compared to other countries. The reasons for this are not obvious, but one possible explanation is that several service industries remain sheltered from effective competition, either because they are dominated by public provision or because they are protected by sector-specific regulations. Thus, looking further into measures to improve service sector productivity should be made a policy priority. For the economy as a whole, capital accumulation added about ¾ percentage point to annual labour productivity growth during 1999-2003, thereby continuing at a roughly unchanged pace from previous decades. Consequently, the residual part of output growth that cannot be ascribed to increased inputs, so-called multi-factor productivity, has accelerated. It accounted for 1¾ percentage points of annual labour productivity growth 1999-2003, compared to 0-1½ percentage points in most other countries.[1]

With GDP volume and productivity growth being so strong, it may be surprising that the level of GDP has not advanced more relative to other countries. The explanation has to do with the large weight of manufacturing and notably information and communication technology. Technological innovations make it possible to produce ever bigger volumes of IT equipment, and this is correctly measured as GDP volume growth and thereby productivity growth. But the mirror image of productivity growth is that prices of ICT equipment continue to fall. The consequence is that aggregate real income grows less rapidly than real GDP, because the prices of the average goods and services consumed and invested in Sweden do not have a similar downward trend. In national account aggregates, this is reflected in downward-trending terms of trade, as export prices fall relative to import prices. The effect has grown strong as technology production has gained importance and, since 1999, it has meant a steady difference larger than half a percentage point between annual growth rates of volume GDP and a volume GDP measure corrected for the terms-of-trade loss, sometimes referred to as command GDP[2] (Figure 1.3). A similar mechanism is at play for Finland, whereas Denmark and the United Kingdom are examples of the opposite. Small open economies can be particularly exposed to such effects. International comparisons of GDP levels over time will capture the effect of terms-of-trade trends if based on current purchasing power parities. Figure 1.2 therefore correctly shows that the gap in GDP per capita *vis-à-vis* other countries has remained more or less unchanged despite the recent Swedish productivity surge.[3] The conclusion to draw from this is *not* that a specialisation in technology production is detrimental to the economy. Rather the conclusion is that the associated high GDP volume growth rates should not be a reason for complacency with respect to structural reforms that can enhance the economy's overall growth potential.

Figure 1.3. **Strong growth of GDP volume but declining terms of trade**



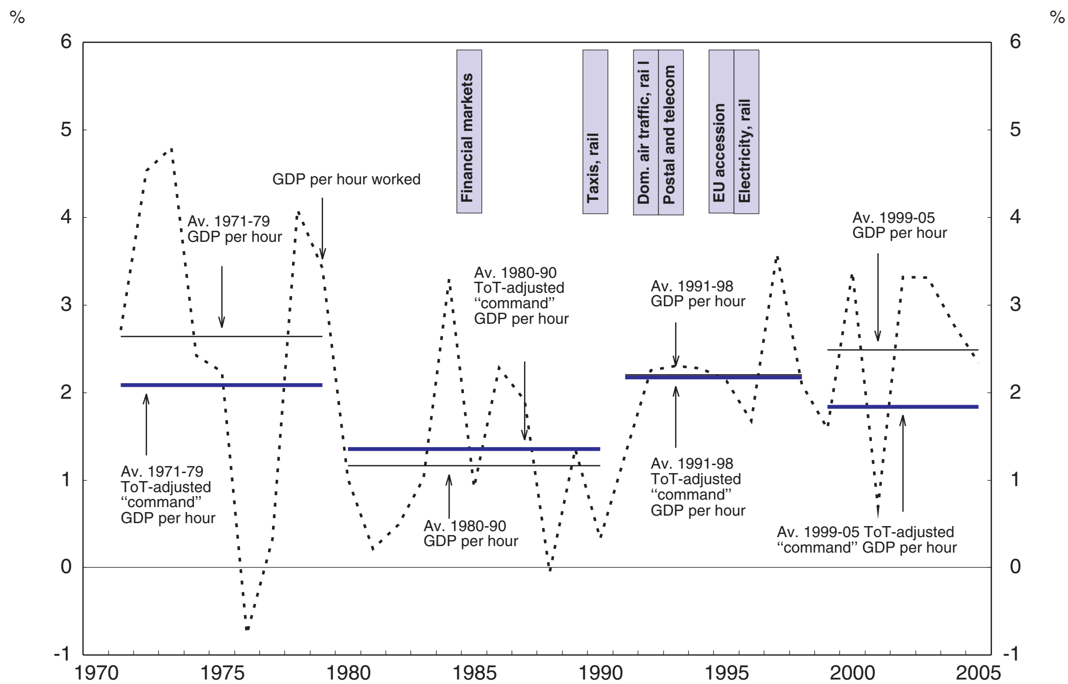
1. Terms-of-trade adjusted command GDP = TDDV + XGSV * (PXGS/PMGS) – MGSV, where TDDV is real domestic demand, XGSV and MGSV are, respectively, volume exports and imports, and PXGS and PMGS are the export and import deflators.

Source: OECD Analytical database and OECD calculations.

During the early and mid-1990s, a process of regulatory reform was initiated across the OECD area with Sweden being a frontrunner in several areas at that time. A number of important service sectors were liberalised and, along with increased market openness and integration associated with EU accession and the gradual deepening of the internal market, these reforms have paid off in terms of solid growth after some years (Figure 1.4). In fact, sectoral studies often hold up Sweden as an example of early success in infrastructure liberalisation, for instance in telecom and electricity, although there is still room for improvements (IEA, 2005). Although the first generation of reforms during the 1990s have been largely successful in terms of the productivity and efficiency gains made, major challenges remain and some sectors of the economy are still subject to various barriers that stifle competition and hence innovation. A new momentum for reform is therefore needed to sustain future growth. A review of how Sweden has followed up on recommendations made in previous *OECD Economic Surveys* shows quite some progress in particular with labour market measures included in the 2007 Budget (Annex 1.A1). Continuing to remove barriers to higher labour utilisation is of paramount importance, but progress on reforms to enhance productivity are also important. The long-standing recommendation to ensure rigorous cost-benefit analysis in environmental policies could warrant fresh attention – not to be less ambitious, but to ensure environmental sustainability in a more cost-effective and administratively less cumbersome way. Competition is vital for productivity growth as it stimulates incumbent firms to innovate. In conjunction with a strategy to increase the multitude of operators and selling government-owned enterprises, competition could be enhanced not least in the parts of the economy where the public sector has traditionally played a dominant role. In addition

Figure 1.4. **Productivity growth and the timing of regulatory reform**

Whole economy, annual growth rate



Source: OECD Analytical database and OECD calculations.

to the recommendations in previous *Surveys*, options for how to proceed are set out in the *OECD Review of Regulatory Reform* which has been prepared simultaneously with this *Survey* (OECD, 2007b).

The expansion is set to continue

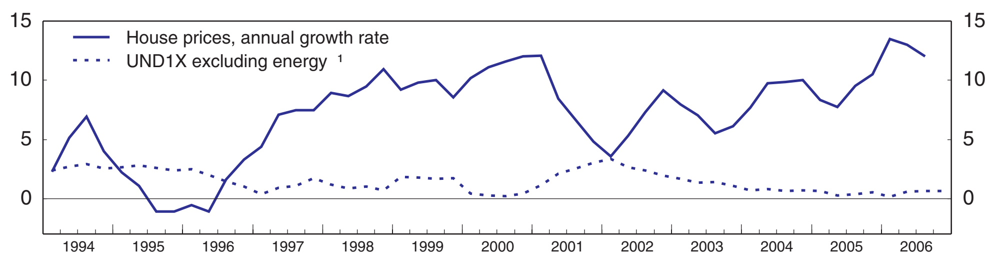
The current recovery strengthened from summer 2005 onwards, and it primarily reflects domestic demand. Private consumption has been supported by the improving labour market and increasing house prices, which have also boosted residential investment. Corporate investment is contributing strongly to overall growth, and business confidence has reached historical highs. Exports have expanded at a fair pace, but with imports rising in tandem with domestic demand, the contribution to GDP growth coming from net exports has been modest. During 2006, fiscal policy has given moderate stimulus to aggregate demand *via* both public spending growth and income tax cuts. On the other hand, part of the monetary stimulus has been withdrawn as the *repo* policy rate has been brought up from 1½ to 3% during 2006.

While headline inflation has increased, due to energy prices, measures of underlying inflation remain at very low levels, reflecting global as well as domestic factors. A rising share of imports from low-cost countries is holding down consumer price inflation. Foreign competition is also reducing domestic wage pressures, while high productivity growth is keeping unit labour costs down. In addition, globalisation is fostering competition that is contributing to low price increases in some sectors, such as retailing. Inflation remains well below the Riksbank's 2% target, where it has been for most of the time since the target became operational in 1995. The causes behind these inflation dynamics and the implications for monetary policy are analysed in Chapter 2.

The housing market is a factor behind consumption growth, but how it will shape the expansion going forward is hard to predict. House prices as well as prices for tenant-owned apartments have been increasing steadily over the past decade at a pace much faster than consumer prices (Figure 1.5). This reflects a combination of fundamental factors, the most important being lower financing costs (including the growing importance of loans on adjustable rate terms), increasing disposable income and rigidities in land supply (Chapter 4). However, the acceleration to double-digit annual house-price increases at the end of 2005 is difficult to explain with fundamentals, and house price dynamics may therefore be a source of surprises in the near-term outlook (Box 1.1).

Figure 1.5. **Divergence between consumer prices and house prices**

Year-on-year, percentage change

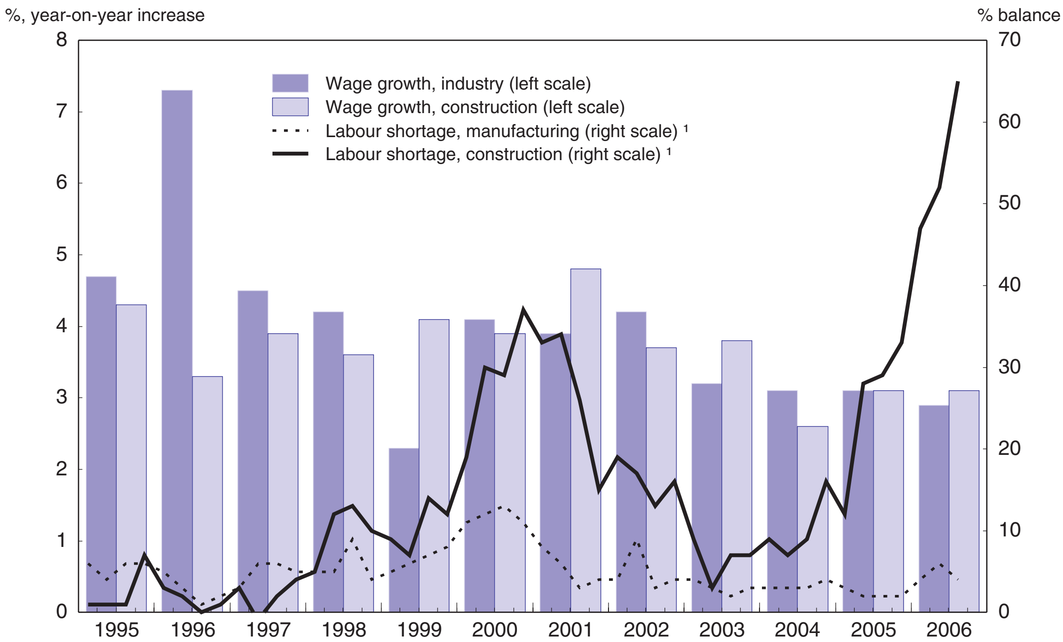


1. CPI excluding interest costs for owner-occupied houses and adjusted for changes in indirect taxes and subsidies.

Source: Statistics Sweden and Riksbank.

The house price boom has boosted residential investment; labour shortages are now very pronounced in the construction sector with more than half of the firms indicating labour shortages as the main obstacle to expanding activity. This is significantly more than in the last cyclical boom at the beginning of the decade and similar shortages have not been seen since the late 1980s. The situation is gradually spreading to other parts of the economy as order books, production and sales volumes have been rising continuously in all major sectors during 2006 (NIER, 2006a). Service sector firms are increasingly experiencing difficulties finding suitable workers. In manufacturing, production capacity utilisation surpassed its 2000 peak already in the second quarter of 2006, but the share of firms pointing to labour shortages as the main hindrance to growth remains close to its long-run average. Meanwhile, nominal wage growth has remained flat across all sectors (Figure 1.6).

Figure 1.6. **Labour shortages are strengthening but wage growth is so far benign**



1. Business tendency survey. Seasonaly adjusted share of firms reporting labour shortages as the main obstacle to higher growth.

Source: National Mediation Office, Statistics Sweden and National Institute of Economic Research.

In this context, it helps that Sweden has no special restrictions on worker mobility from the new EU member states. Net immigration from Poland, for example, has grown considerably in 2005-06, helping a bit to ease labour shortages and wage pressures in construction, and thereby reduce divergence in sectoral capacity pressures. By “greasing the wheels” in this way, migration may improve the labour market flexibility and reduce equilibrium unemployment (Borjas, 2001; Jean, Jimenez and Causa, 2007). However, to fully reap these benefits of migration, it is essential that the labour market is effectively open to accompanying family and that construction workers themselves are not caught in unemployment traps when one day labour demand diminishes, as discussed in Chapter 3.

Box 1.1. **House prices and wealth effects could give surprises**

House prices have grown strongly and persistently in many OECD countries during the last 10 years. In several markets, notably in some of the English-speaking and Nordic countries, real house prices may have grown out of line with financial fundamentals, as analysed in the *OECD Economic Outlook* (OECD, 2005a, 2006a and 2006b). Rapid price increases and a subsequent downward correction, can affect macroeconomic dynamics substantially via private consumption and construction activity. For Sweden, Chen (2006) estimates an elasticity of total consumption with respect to net housing wealth of 0.11. It may also pose risks in terms of household indebtedness. The analysis in Chapter 4 indicates that Swedish house prices are growing overvalued relative to what fundamentals can explain. It is therefore worthwhile to consider alternative scenarios, especially as the plans in the 2007 Budget to abolish imputed rent for apartments, freeze real-estate value assessments and cap taxes on land – worth almost ¼ per cent of GDP – risk adding to housing market overheating. Three scenarios could be considered:

- **House prices slow down.**.Monthly data indicate that annual house price increases decelerated to around 10% in late 2006, and this could reflect a sound reaction to higher short-term interest rates. If this slowing continued, rising income could then work off the current light overvaluation over time.
- **House prices continue to accelerate and grow out of line with fundamentals.** After a full decade of solid gains, the average homebuyer now has little experience with the historic fact that house prices tend to not only rise but also fall. In this context, property tax cuts, still low interest rates, improving employment and income prospects and clear supply constraints could be a cocktail that leads to speculative market behaviour. In Denmark, to everybody's surprise, house prices seemed to have reached a plateau, but then suddenly accelerated during 2005 to annual increases of 25%, possibly fuelled by new mortgage products, including interest-only loans (OECD, 2006c). It may not seem likely *ex ante*, but irrational or speculative reactions cannot be excluded. The subsequent downward price correction would then be harder.
- **House prices fall triggered by higher interest rates.** It would seem highly unlikely in the short term but, looking a bit ahead, the picture could quickly change. If house prices continue to grow at their current annual rate for another year, while long-term interest rates go up by 2 percentage points – possibly caused by the unwinding of global current account imbalances – then there could be a 50% probability of a decline in Swedish real house prices (OECD, 2006b).

From a macroeconomic perspective, house price cooling would be welcome now, in particular because it would help ease demand pressures and labour shortages in construction. But more likely, house prices will continue increasing faster than CPI for still some time. In combination with an improving labour market, home-owners might begin spending more of their housing capital gains. Already for some time, mortgage borrowing has exceeded residential investment, but the connection between borrowing and consumption has weakened since 2000, indicating that some of the housing equity withdrawal has been channelled into financial investments (Riksbank, 2005). Consequently, the savings ratio has declined only slightly over the last five years and at around 8% it is well above the 2% low of the late 1990s. This may reflect a combination of labour-market weakness and precautionary savings following the stock market decline at the beginning of the decade. The *OECD Economic Outlook* projections are based on the assumption that the savings rate will continue its gradual decline, but a steeper fall, as in the mid-to-late 1990s, cannot be excluded and, if it materializes, the consumption-driven economic boom would intensify.

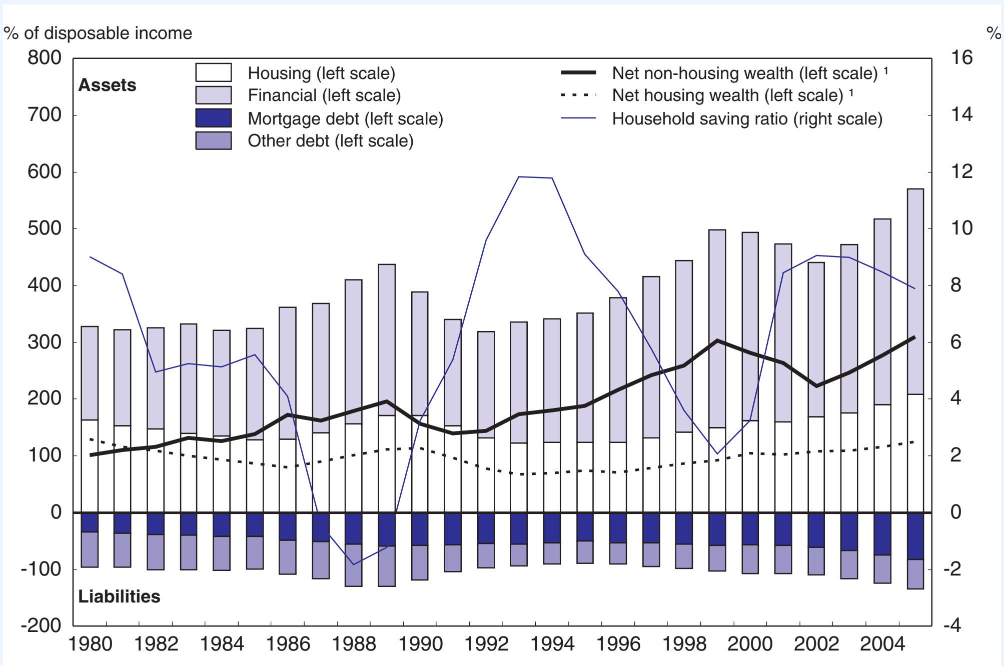
Box 1.1. **House prices and wealth effects could give surprises** *(cont.)*

As the increase in mortgage indebtedness has been outpaced by house price increases, net housing wealth is unusually high, exceeding one year's disposable income. Net non-housing wealth is also high, exceeding two years' disposable income (Figure 1.7). Both of these wealth measures are based on current asset valuations but, given the strong financial position of households, it would require dramatic weakening of housing and financial markets to create a scenario of serious balance-sheet stress.

In the event that the housing market overheats with continued strong house price growth leading to a subsequent downward correction, policy may have to deal with the opposite situation with wealth effects slowing consumption demand, and a construction sector moving towards excess capacity. How a house price correction would affect the economy depends very much on when it might occur. The worst scenario would be if house prices continue to gather momentum, leading to a more abrupt correction at some point. Sweden would then benefit from having an autonomous monetary policy, unless inflationary pressures prevent an expansionary policy. Interest rates could quickly be eased, in contrast to discretionary fiscal policy which suffers from time lags in both decision and implementation.

Figure 1.7. **Household savings and wealth**

Percentage



1. Net housing wealth is defined as the value of the housing stock less outstanding mortgage debt. Net non-housing wealth is defined as the value of financial assets less outstanding non-mortgage debt.

Source: Statistics Sweden, Riksbank and OECD calculations.

The central scenario for the OECD's short-term economic projection is a continued expansion. GDP growth is expected to reach more than 4% in 2006 and ease to 3½ and then 3% in 2007 and 2008, partly reflecting the impact of higher short-term interest rates on corporate and residential investment (Table 1.2). Although consumer spending will also be

Table 1.2. **Short-term economic outlook for Sweden**

As published in the *OECD Economic Outlook*, 28 November 2006

	2003	2004	2005	2006	2007	2008
	Current prices SEK billion	Percentage changes, volume (2000 prices)				
Private consumption	1 202.7	1.8	2.4	3.2	3.2	2.9
Government consumption	691.7	0.1	0.7	1.4	1.4	0.8
Gross fixed capital formation	392.8	5.1	8.5	8.5	5.7	4.7
Final domestic demand	2 287.2	1.9	3.0	3.6	3.2	2.7
Stockbuilding[1]	9.9	–0.3	–0.2	–0.4	–0.1	0.0
Total domestic demand	2 297.1	1.5	2.7	3.2	3.1	2.7
Exports of goods and services	1 070.2	10.7	6.6	7.9	7.8	7.5
Imports of goods and services	907.9	6.8	6.6	7.6	8.2	7.8
Net exports[1]	162.3	2.1	0.6	0.7	0.5	0.5
GDP at market prices	2 459.4	3.3	2.7	4.3	3.6	2.9
GDP deflator	–	1.3	1.2	1.3	2.1	2.6
Memorandum items						
Consumer price index	–	0.4	0.5	1.4	2.2	2.5
Private consumption deflator	–	1.3	1.0	1.4	2.5	2.5
Unemployment rate[2]	–	5.5	5.8	5.5	5.3	4.3
Household saving ratio[3]	–	8.5	7.9	7.8	7.1	7.0
General government financial balance[4, 5]	–	1.6	2.8	2.9	2.4	2.6
General government financial balance after reclassification[4, 6]	–	0.6	1.8	1.0	1.3	1.5
Current account balance[3]	–	6.9	6.0	7.1	7.5	7.6
National accounts published 1 Dec. 2006						
GDP at market prices	2 459.4	3.6	2.9			

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. See OECD Economic Outlook Sources and Methods *(http://www.oecd.org/eco/sources-and-methods)*.

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. Based on monthly Labour Force Surveys. The 2005 unemployment rate is based on quarterly statistics and deviates from the annual rate published by Statistics Sweden.
3. As a percentage of disposable income.
4. As a percentage of GDP.
5. Maastricht definition.
6. In 2007, the defined contribution Premium pension will be reclassified in official statistics from social security to private sector.

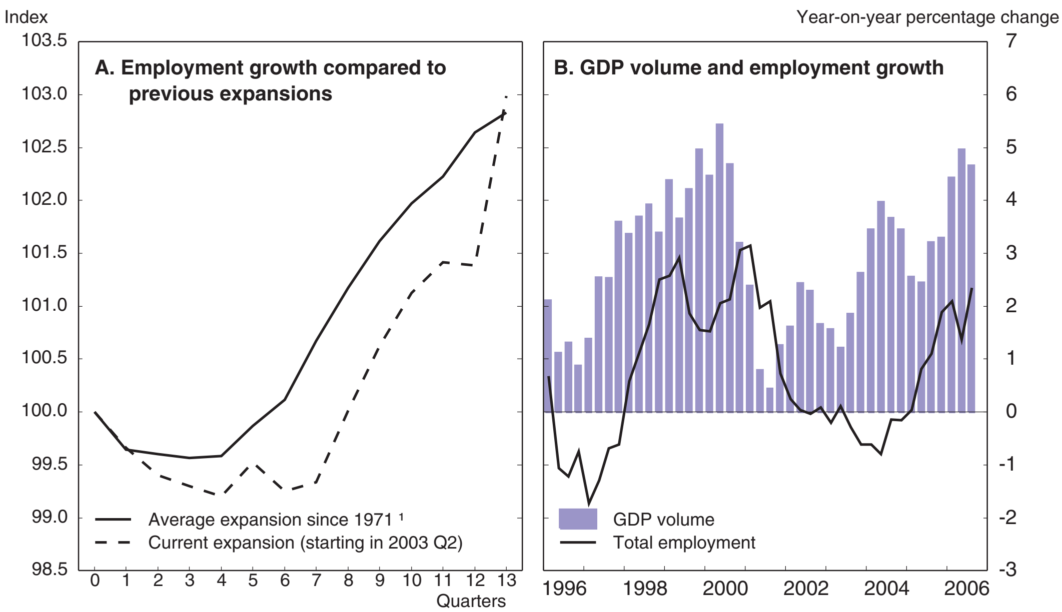
Source: OECD Economic Outlook 80 database and Statistics Sweden.

affected by higher interest rates, for example via the large share of flexible rate mortgage loans, this effect will be compensated by rising incomes due to the improving employment situation and tax cuts for households. The measures introduced with the 2007 Budget imply a reduction in net lending of general government by 0.7% of GDP; it is estimated that this will raise GDP growth by 0.3 percentage point, as part of the disposable income gain from tax cuts is likely to be saved rather than spent immediately.[4] Fiscal stimulus of this magnitude will not damage the economy, but it is not needed either, as even without such stimulus, aggregate demand should be strong enough for the new labour market reforms to pay off relatively quickly in terms of higher employment. National accounts releases in December have confirmed the strength of the recovery with real GDP growing 1.0% in the third quarter and upward revisions to growth during 2004-05.

With strong demand, the continuation of the current expansion will depend much on how labour supply reacts. In that sense, the economy seems to have turned around during 2006 as, until recently, speculation about jobless growth led to political calls for programmes taking people out of the labour market on paid sabbaticals and similar arrangements. Indeed, the downturn beginning in 2001 led to several years of declining employment and rising unemployment. But it is now clear that the basic cyclical properties of the economy have not changed. Once the current recovery had started in early 2003, employment growth resumed with only a slightly longer delay than in previous cycles (Figure 1.8). As labour supply increased significantly however, rising employment was not accompanied by a decline in the unemployment rate until late 2005. Now the output gap is estimated to have closed, and despite an expanding labour force, the unemployment rate is projected to fall towards 4% in late 2008. In the absence of reforms to raise labour supply, the economy would be forced back to trend, *inter alia* via the Riksbank hiking interest rates beyond neutral levels.[5] In such a medium-term scenario, growth would be reduced to below 2% as an average over the years 2009-13, after having averaged over 3% since 2004.[6] Because a fair part of the current growth is likely to be cyclical rather than structural, the only way to avoid such a scenario is continued reform to boost labour supply and productivity. The 2007 Budget initiatives to improve the functioning of the labour market are therefore highly commendable and, incorporating their effect, calculations made by the Ministry of Finance suggest that growth over the medium term could be somewhat stronger than indicated above. This shows that structural reforms are crucial to secure high growth when the negative effects on the economy of an ageing population start to kick in.

Meanwhile, strong labour demand is likely to smoothen the introduction of initiatives to combat exclusion and improve the functioning of labour markets. As part of the reform

Figure 1.8. **Business cycles and employment growth**



1. The start of an expansion is defined by when GDP accelerates. Q0 is the last quarter of negative annual growth, followed by positive growth rates. The expansions included in the average are dated with Q0 in 1971:4, 1977:2, 1982:4, 1986:2, 1993:1, 1996:4 and 2001:3. See also Cotis and Coppel (2005).

Source: OECD Analytical database and OECD calculations.

package, a number of labour market programmes will be terminated, although participants already enrolled before the end of 2006 will complete the programmes they have started. This has attracted a lot of attention, with expectations that open unemployment would increase, at least temporarily, in 2007 before the new measures replacing the programmes

Box 1.2. **Manufacturing has become an anchor for responsible wage formation**

In 1997 a major agreement was established on the aims and processes surrounding wage formation in manufacturing, mining, forestry and agriculture, the so-called Co-operation and Negotiation Agreement (*Industriavtalet*). The model has been successful at setting wage growth that ensures macroeconomic balance and at limiting production disruptions from conflict. Moreover, it has led to a situation where agreements reached for manufacturing become a benchmark/norm for wages in other sectors. While Sweden has moved gradually towards more decentralised wage setting, the new framework has strengthened the consensus among social partners concerning the conditions and discipline needed for achieving low inflation and sustainable growth of real wages. The agreement starts by emphasising the importance of manufacturing firms' international competitiveness as the precondition for steady improvements in living standards and employment. The agreement sets standards for streamlining the collective bargaining process, requiring that negotiations should start at the latest three months before the current collective agreement would end, and tightening the conditions for when strikes or lockouts can be called. Furthermore, an institution of impartial chairpersons was established with the right to intervene early as mediators to move the negotiating process forward. So far three collective wage agreements have been settled under the new framework, in 1998, 2001 and 2004. The framework is by now firmly rooted as witnessed by the fact that all three agreements were concluded in the stipulated time while completely avoiding strikes and lockouts in the manufacturing sector during the last decade.

The National Institute of Economic Research considers that responsible wage formation can durably reduce structural unemployment and thereby produce higher incomes for all over time. They have set out a scenario where all parties show a substantial degree of macroeconomic responsibility through nominal wage increases of 3.5% a year in 2007-9, employment rises strongly, nearly reaching 80% of the population aged 20-64, even when excluding those employed in labour market programmes, and unemployment shrinks permanently below 4%. In a less responsible scenario, where the parties take less macroeconomic responsibility with nominal wage increases of 4.7% a year, the upswing in employment ceases by 2008 and unemployment rises to 5.7% in the long run. The temporary wage restraint leads to a permanent reduction of unemployment by 93 000 persons compared to the less responsible alternative, and a permanent increase in employment by 140 000 persons, as more seek to enter the labour market when it is easier to find a job. Nominal wage restraint holds down inflation, thereby supporting real wage growth; at the same time, higher employment boosts public finances, *inter alia via* less expenditure on unemployment benefits, so that there is more room for tax cuts. Thus, real disposable incomes of wage earners as a group are higher from 2009 onwards thanks to the restraint. In the longer term, the indirect effects in the form of higher employment and lower taxes are even greater; in 2015, real disposable incomes of wage earners as a group differ between the two scenarios by 2.5% or SEK 7 500 per person employed.

Source: *Agreement on industrial development and wage formation*, *www.industriavtalet.com*, SOU (2006), *God sed vid lönebildning*; The National Mediation Office, *www.mi.se*, and NIER, *Wage formation in Sweden 2006*, *www.konj.se*.

get full effect. Although it is likely that some of the people no longer going into labour market programmes will join the open unemployment queue, this effect will probably be dwarfed by the cyclical labour demand pull. The projected reduction of open unemployment towards 4% in late 2008 remains realistic, even with programme participation being reduced from 3 to 1½ per cent of the labour force; the labour market developed in this way in the late 1990s (SEB, 2006).[7] The really important issue is therefore not about discontinuity in 2007, but about getting the implementation of the new measures and their interaction with the remaining programmes right for the longer term. This issue is analysed in Chapter 3.

The scene should be set for the upcoming wage negotiations to reach agreements that support macroeconomic balance. Collective agreements covering 1½ million employees in manufacturing, services and construction expire in the spring 2007, most of them on 31 March, followed by agreements for a similar number of employees in local and central government expiring in June and September. With the majority of wage-earners negotiating three-year contracts, the outcome could seem unpredictable, but it is expected that agreements will follow the precedent having developed over the past decade, whereby wages in large parts of the economy shadow manufacturing (Box 1.2). In this way, wage formation has acquired an external anchor as the concern for manufacturing firms' international competitiveness is what determines general wage developments, and inflationary pressures from domestically oriented sectors, such as construction, are less likely to lead to overheating, loss of competitiveness and subsequent high unemployment. The increasing inflow of construction workers from the new EU member states may also be one explanation for the benign wage growth (Chapter 2), making unions prefer a cautious strategy of demanding modest wage increases. Indeed, workers have benefited from this stability-oriented framework as real wages have grown at an annual average of 3½ per cent since the first agreement in 1998, compared to just 2½ per cent during the inflationary 1970s and 1980s.[8] If a macroeconomically responsible settlement can be reached, there would be less need for withdrawing monetary stimulus, while with a prolonged expansion, those currently excluded from the labour market would have greater chances of finding a job.

Combating exclusion is a key challenge

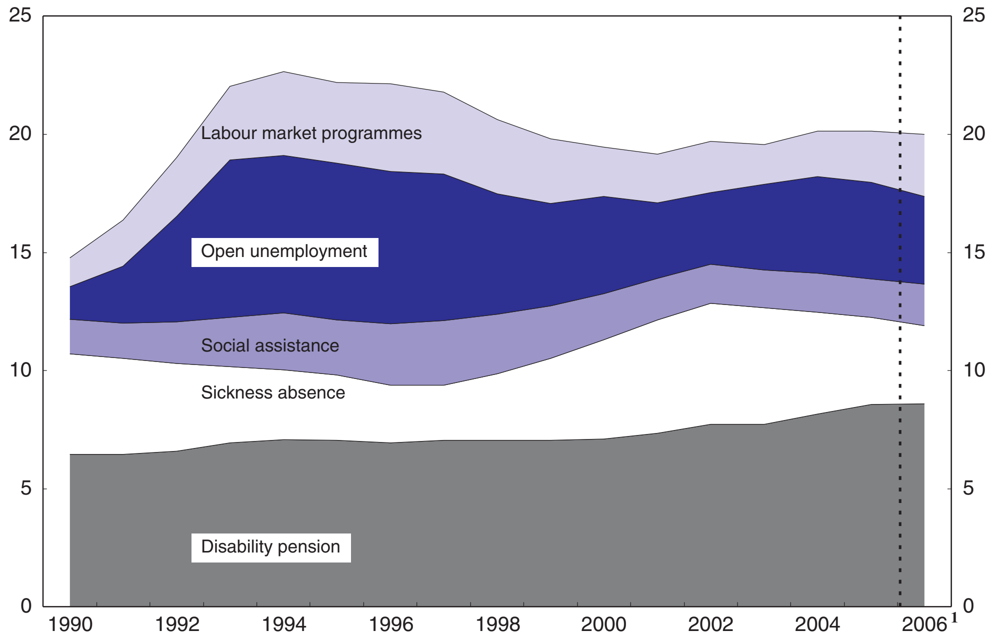
While things are fine for insiders, outsiders are often disadvantaged by unintended side-effects from excessive regulation (Lindbeck and Snower, 2001). These insider-outsider problems show up in the form of some groups, including many immigrants, having difficulties getting into the labour market; in the segmentation of housing markets; and also in a growing, or at least persistent, grey market. Some of the side-effects from regulations, in combination with other structural weaknesses, may also show up in the form of limited business formation. Addressing these issues will help enhance the economy's growth potential, but also bring benefits that are not captured in measures of GDP.

Labour market exclusion generated in the 1990s remains important

The most striking feature of exclusion from the labour market is that the share of the working-age population depending on public income support has not come down to the level it had before the crisis of the 1990s. From a peak of 23% in 1993, the share has declined to 20% in 2006, but it remains well above the 15-16% that prevailed in 1990-91 (Figure 1.9).

Figure 1.9. **Exclusion generated in the 1990s remains**

Persons (full-time equivalents) receiving income support as percentage of population aged 20-64



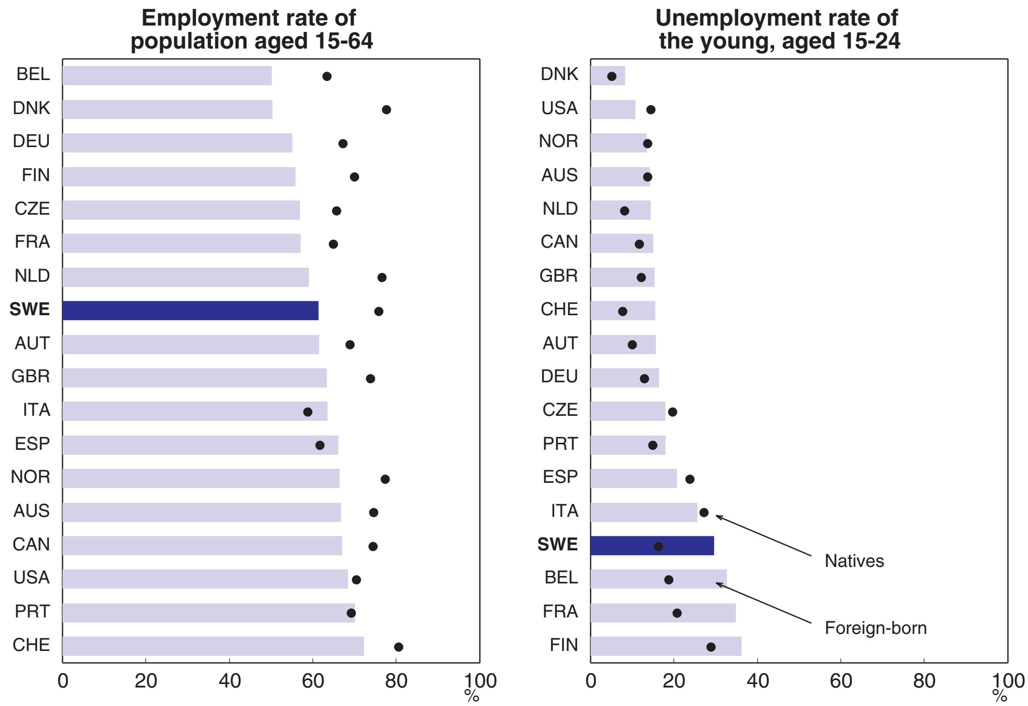
1. Estimate by the National Institute for Economic Research.

Source: Statistics Sweden and the National Institute for Economic Research.

One group that is particularly disadvantaged by insider-outsider dynamics is the growing immigrant population. At 62%, the employment rate of immigrants is lower than in most English-speaking and southern European countries, albeit higher than in many northern European countries (Figure 1.10). When differences in immigrant composition (refugees *vs.* labour migrants, origin, skills, etc.) are taken into account, the labour market outcomes in Sweden compare more favourably, and in particular immigrant women fare better than in other host countries. Yet, it would seem that there is scope for improving the labour market outcome for immigrants when considering the 13 percentage point gap *vis-à-vis* the employment rate of native Swedes. In particular, the high youth unemployment stands out; the rate is almost twice as high as for native Swedes, and for every five young immigrants in work, there are two unemployed. Although few are long-term unemployed, the unemployment rate for young immigrants, being above 30%, is among the very highest in the OECD. It is four times higher than in neighbouring Denmark which has a more flexible labour market with stronger incentives for youth to take up training or work (Figure 1.10).[9] That young persons find it so hard to get into the labour market is deeply worrying as it may have a profound impact on their hopes and habits in working life, generating benefit dependency, eroding the motivation to take education and weakening confidence in society in general. Bringing down youth unemployment in general and for immigrants in particular, is therefore a key challenge. To achieve an adequate improvement in employment outcomes for excluded immigrants, it may be necessary to increase the overall flexibility of the labour market, as appropriate employment policies tend to benefit marginal groups like excluded immigrants even more than others.

Figure 1.10. **Labour market outcome for foreign-born *versus* natives**

2003-2004



Source: OECD, *International Migration Outlook* – 2006 edition based on labour force surveys.

Chapter 3 deepens the analysis of immigrants' integration on the labour market and sets out such a wider employment reform strategy.

In some respects, exclusion can be generated by excessive regulation, and the Swedish economy is in some respects strongly regulated. Each regulatory element may serve a legitimate purpose, but the overall systemic effect may be counterproductive. For natural reasons, economic policies have been shaped by the very successful industrialisation where large firms have played a key role, and certain policies that may have worked well in that context may now turn out to be creating excessive rigidities. One example is the relatively strict job security or employment protection legislation (EPL). In times when technological changes require only limited structural and organisational changes, as may have been the case in the 1950s and 1960s, the positive effect of fewer layoffs may have dominated, but in times when structural and organisational changes are essential, the adverse effect of less frequent hiring may dominate (Ljungqvist and Sargent, 2006). In this way, the relatively strict EPL may have been a limited problem some decades ago, but the very same regulations may have made it difficult for Sweden to reinvent itself after the deep economic crisis of the 1990s. This may provide some explanation of why Sweden has not fully regained the GDP level it had relative to other countries in the late 1980s, with the associated limited job creation partly explaining why employment rates are also well below their pre-crisis levels. In particular, strict job security rules may be an impediment to the adoption of new technologies and innovation where this requires worker turnover (OECD, 2003). Other studies, both theoretical and empirical, find similarly that EPL may magnify the impact of exogenous shocks and raise unemployment persistence (Blanchard and Wolfers, 2000; Nickell *et al.* 2001 and 2003). The tricky thing is that strict EPL may *in equilibrium* not produce more overall employment or protection because, although insiders who are already in a job face less risk of losing it, the lower turnover on the labour market makes it more difficult for outsiders to come in. As a consequence, overall life satisfaction is not higher among workers in countries with strict employment protection legislation; rather workers in these countries are more worried than workers in countries with more dynamic labour markets (OECD, 2004a).

Distortions in the housing market generate exclusion

Exclusion is also present in the housing market, above all in the rental market which remains highly distorted. As rents are not allowed to reflect demand and supply, many Swedes are prevented from having their preferred housing tenure, in particular in Stockholm where demand is high. Examples are manifold: 8% of the population in Greater Stockholm is queuing for an apartment in the municipal housing sector and the average waiting time is 10 years. Meanwhile well-connected people seem able to "jump the queue". At the same time, an active "exchange market" has developed, benefiting the insiders who have a rental apartment to offer for exchange whereby they can move without first having to wait in the queue. Side payments are involved in around half of all exchanges and, when asked, 30% of young people in Stockholm say they are prepared to buy a rental contract on the black market (Lind, 2005; Henriksson and Lindström, 2005). Effectively, the more attractive apartments are rented by people with higher incomes, better education and less dependence on social assistance payments (Lind and Hellström, 2006). Those for whom rent regulation generates the largest insider advantage – in terms of a rent well below what others would be willing to pay for a similar apartment – are therefore typically persons who are already privileged.

The best way to deal with these problems is a broad effort to improve the matching of demand and supply in the housing market, *via* less invasive regulation. Making the rent setting framework more flexible would be most important. Moreover, the supply of housing must be made more responsive so that it occurs where it is most needed. Sweden still has one of the lowest shares of residential construction in GDP and construction of rental dwellings is particularly low. Besides the rent regulation framework, which mutes incentives to build rental dwellings, overall high construction costs and the cumbersome planning system provide obstacles. First steps towards making the rental market more responsive to market forces have recently been taken for newly constructed dwellings, but much more can be done. How to approach reform in these areas is analysed in Chapter 4.

Entrepreneurship is held down

Entrepreneurship and innovation are important ingredients to ensure demand for the increased labour supply as well as to enhance the economy's capacity for change. The business climate for large corporations is comparatively good. Despite a high overall tax pressure, Sweden is among the OECD countries taxing corporate income relatively mildly and the marginal effective tax on capital is generally considered to be fairly low in Sweden (OECD, 2006d). Furthermore, effective marginal tax rates on inward foreign direct investment (FDI) are relatively low (Yoo, 2003) and Sweden often ranks high in international comparisons of where it is attractive for firms to locate. However, the fact that there are few start-ups in manufacturing as well as services indicates that the climate for entrepreneurship is not as good as it could be (Figure 1.11). All the more so because the

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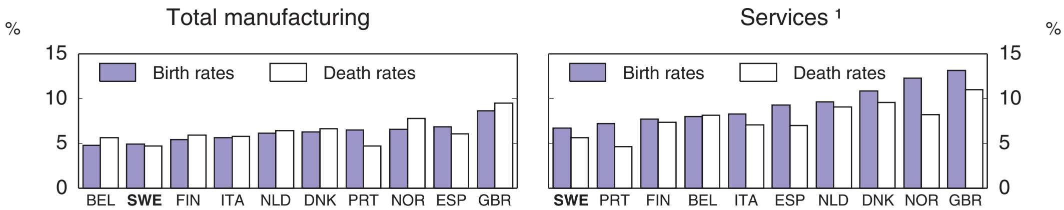
Figure 1.11. **Birth and death rates of firms**

Average rate 1998-2003



1. Includes NACE category G to K, *i.e.* trade and repair, hotels and restaurants, transport and communication, financial services, real estate, renting and business activities. Education, health, social services and public administration are not included.

Source: Eurostat.

firms that are established and survive tend to grow more slowly than in other countries. How many new businesses are being started and grow is determined by a number of factors: general attitudes in society towards entrepreneurship; the extent of rewards retained by the entrepreneur if the business succeeds; the risk of poverty if it is a failure; and how cumbersome it is to operate a business. Strict regulation of employment contracts and job security may reinforce other factors holding back entrepreneurship as, for example, an experienced person quitting to start a new business is much more exposed than if staying in a safe job (Box 1.3).

The low rate of business formation does not seem to hold back R&D or patenting. Indeed, business sector research and development spending is nowhere higher than Sweden's 3% of GDP (OECD, 2006e). It may reflect that the large Swedish firms are talented innovators in their established business fields, possibly due to good corporate governance and exposure to international competition.

Nevertheless, more entrepreneurship might enhance the economy's ability to venture into new business fields and also spur less tangible innovation, competition and job creation in domestically oriented sectors. The very low firm turnover therefore warrants a review of whether unnecessary barriers are holding back business formation, as a recent OECD study showed that Sweden's entrepreneurship policies are far from best practice (OECD, 2005b). Addressing this weakness calls for a wide policy strategy involving taxes, regulatory burdens for firms, bankruptcy laws, entrepreneurial education, access to finance and other factors holding back risk-taking and entrepreneurship. The 2007 Budget includes a number of initiatives in these areas (Box 1.4). A detailed review is beyond the scope of this *Survey*, but in particular strategies for administrative simplification is covered by the *OECD Review of Regulatory Reform* and a recent thematic study (OECD, 2006f and 2007b).

State ownership of business companies is comparatively wide in Sweden and may in some sectors hold back entrepreneurship and make potential competitors less keen on entering. It is therefore welcome that the government has announced plans for considerable privatisations at a volume of approximately SEK 50 billion a year. First in line are shareholdings in the financial sector (Nordea, OMX, SBAB), communication (TeliaSonera), properties (Vasakronan) and retail (Vin&Sprit). Thereafter comes areas like transport (SAS). The revenues will be used to reduce central government debt.

Another area that would benefit from renewed attention is the balance between public and private roles with respect to providing publicly funded services. Involving a wider set

Box 1.3. **Security is lost if an experienced employee quits to start a new business**

Consider a woman entering a large or medium-sized Swedish company at the age of 25. If twenty years later, at age 45, she wishes to start a new firm on her own, she will face a difficult trade-off between uncertain business success and a very secure job. Her current employer cannot lay her off individually without first trying an internal transfer and retraining to enable her to carry out different work. If she is ultimately laid off, she must be given notice six months in advance and, should the layoff be judged as unfair, the employer must pay her a compensation equal to 32 months' salary – larger than in any other OECD country. In case of collective dismissal, the last-in-first-out rule reinforces the safe position of experienced staff. This security is lost if leaving the job. If the new business fails, she would not only go through a period of low earnings while striving to keep the business alive; when subsequently closing down, there will not be a notice period with full salary while looking for a job. Moreover, as the level of unemployment benefits is calculated on the basis of previous earnings, failing entrepreneurs are disadvantaged relative to someone laid off from a job, as pointed out by previous *Surveys* (OECD, 2004b; Annex 1.A1). In some cases, large companies have circumvented these adverse effects by allowing employees a leave while starting a new business and this could be used more. But this still solves only part of the problem, as the extra job security enjoyed if having long tenure may still make it difficult for new firms to attract highly talented experienced staff.

Tough bankruptcy procedures add to the risk of starting a business – in particular if based on innovations for which it can be difficult to assess the market potential other than by trying it out in practice. In Sweden, creditors have claims on a person's assets for 10 years following a bankruptcy. Consequently, failing entrepreneurs risk not only losing their savings; they will have to live modestly for a long time to come. In most European countries, creditors' claims on a bankrupt's assets expire after less than 10 years, and regulations are fundamentally different in North America, where claims expire after just one year (United States) or even shorter time (Canada), thereby making it possible for failed entrepreneurs to use their experience to start up a new firm (OECD, 2001 and 2005b). A recent Danish poverty study revealed that the downside can be hard for entrepreneurs, as self-employed were found to be the socio-economic group most at risk of poverty – several times more at risk than for example single parents as a group (Danish Economic Council, 2006). Fluctuating income, small shops and similar factors may explain most of the poverty among self-employed, but the finding nevertheless suggests that a study of whether social security and bankruptcy rules make the downside excessively hard for Swedish entrepreneurs might be worthwhile.

Should the new business prove successful, the net income gain is limited by high marginal income taxes which set in early. Until this year, wealth tax at a rate of 1½ per cent applied already from SEK 1.5 million, or SEK 3 million for couples (for comparison, an average one-family house in greater Gothenburg, Malmö or Stockholm costs SEK 2.8 million), further limiting the upside associated with entrepreneurship. Finally, the tax rules for closely held companies have until this year been unfavourable to fast-growing firms set up by entrepreneurs, as a large part of income accruing from these firms was classified as wage income (Henrekson, 2005). The recent changes in wealth and business taxation are therefore welcome (Box 1.4).

of alternative providers may nurture innovation and competition. Without changing its social model, Sweden can benefit from seeking inspiration from countries like the Netherlands, where the majority of long-term care institutions for older persons are non-

Box 1.4. **Recent policy initiatives that will promote entrepreneurship**

As part of the 2007 Budget, the new government has introduced a number of policy initiatives aimed at improving the conditions for entrepreneurship:

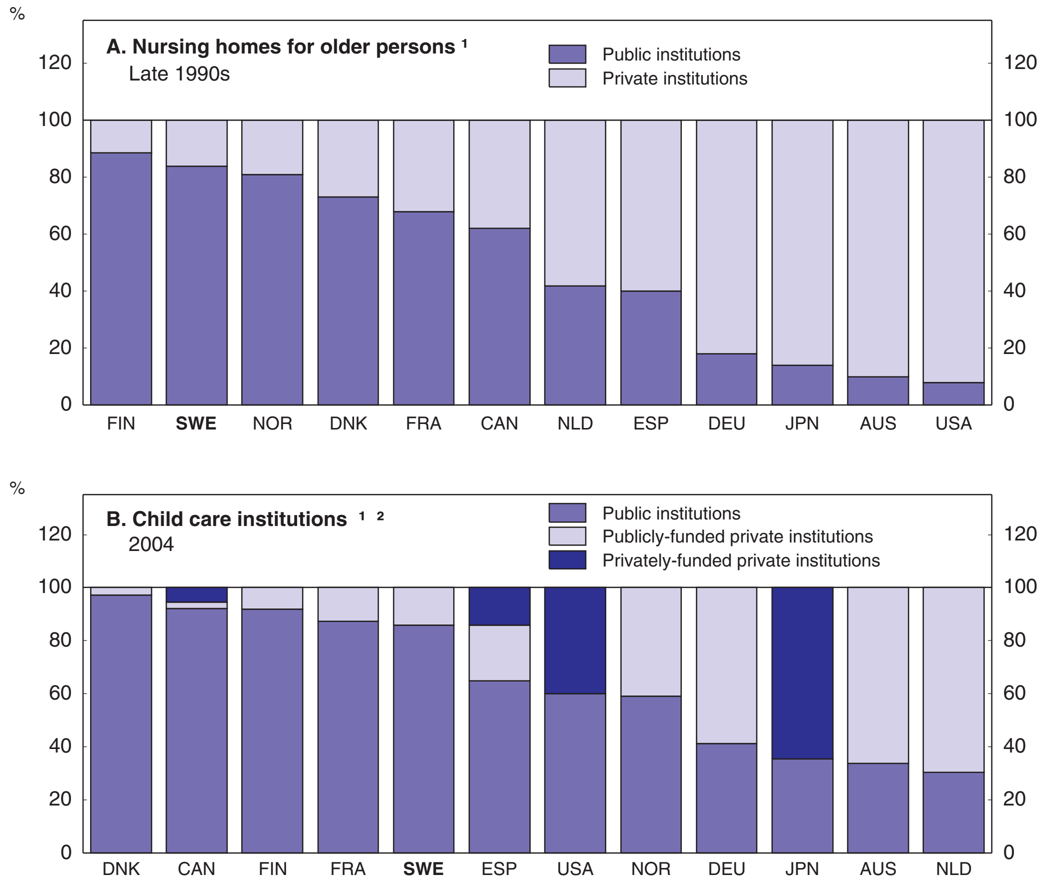
- The wealth tax will be halved from 1.5% to 0.75% as a prelude to abolishing it later in this electoral period.
- Taxation will be simplified for closely held companies (the so-called 3:12 rules which apply for companies with a small number of owners). Pending broad review, changes will be introduced in 2007, *inter alia* making it easier to employ more staff and sell companies. More of the entrepreneur's own income will be taxed as capital income for which the rate is lower than for income from work.
- To enhance the role of women in business, a set of initiatives will be taken to enhance support and advice for women entrepreneurs as well as research on women's entrepreneurship.
- The regulatory burden for firms should be reduced by 25% over a period of four years, and a special task force has been established to achieve this.

Consideration is being given to introducing state guarantees for borrowing by small and medium-sized firms and to adjusting capital taxation in a way that would stimulate the availability of risk capital.

profit and other private institutions, and in neighbouring Norway, where 40% of the children in day care attend private institutions that are publicly funded (Figure 1.12). Aside from improvements in the services provided in Sweden, increased competition and innovation in these areas can bring gains in terms of service exports. Back in the early 1990s, Sweden carried out a wave of reforms to involve alternative private suppliers in publicly funded services. This has paved the way for a number of business successes including a Swedish company winning the largest-ever contract made by the UK National Health Service with a private provider for care.[10] In light of the recommendations made in the 2005 *Survey*, where health care was the in-depth topic, it is therefore encouraging that measures are now being taken to allow more involvement of private sector health care providers (OECD, 2005c; Annex 1.A1). The 2007 Budget stresses the importance of encouraging higher quality, greater accessibility, and increasing the diversity of provision and competition between different actors in health care and social services. The first step will be to allow more choice for users of elderly care.

Tertiary education, in particular, is an area where more market orientation involving loan-financed tuition fees could enhance dynamism and also encourage students to start tertiary education at a younger age and finish earlier, as pointed out in previous *Surveys* (OECD, 2002b; Annex 1.A1). Being almost 23, the average student starting tertiary studies is currently older than in any other OECD country, apart from Denmark, and there is a wide gap to the average age of student enrolment of 21 in Norway and 19½ in the United Kingdom. Loans with income-contingent repayment, as introduced in the United Kingdom in 2006, could be a source for inspiration, although such financing models need to be adapted before introduced in a Nordic context with high marginal taxes (OECD, 2006c). Alternatively, the aim of getting student to start their tertiary education at a younger age, and to finish earlier, might be achieved *via* incentives in the study grant system.

Figure 1.12. **Who provides publicly funded services?**



1. Based on the number of users. Private institutions include both non-profit institutions and private firms.
2. Includes pre-primary education and organised centre-based programmes designed to foster learning and emotional and social development in children from 3 years to compulsory school age. For Germany and Norway, some of the private institutions may be predominantly privately funded, but the available data cannot determine the exact share of private and public funding for private institutions. Reference year 2001 for Canada and 2000 for Denmark.

Source: Lundsgaard, J. (2003), Competition and efficiency in publicly funded services *OECD Economic Studies*, No. 35 and OECD Education database.

Globalisation is often pointed to as posing a number of challenges for the Swedish economy. Given the persistent and large current account surplus and the fact that Sweden has risen steadily in international rankings of business climate and competitiveness during recent years, Sweden seems relatively well placed to benefit from globalisation. Nevertheless, globalisation accentuates the importance of dealing with insider-outsider problems and the lack of entrepreneurship, so as to enhance the economy's ability to "reinvent itself" in the context of restructuring associated with international relocation of activity and to ensure that increased mobility does not produce large groups of inactive outsiders. Similarly, globalisation accentuates the importance of handling fiscal pressures in a way that does not lead to increasing taxes, as international mobility will most likely increase the distortions generated by high taxes. There is no room for complacency, and in order to get broadest possible debate on the challenges and opportunities that follow from globalisation, the Government intends to appoint a public inquiry a Globalisation Council.

Continued fiscal surpluses are vital for the long run

Restoring public finances from deep deficits and spiralling debt in the early 1990s to a sustained structural surplus was a major achievement. In 1994, the deficit of general government exceeded 11% of GDP and, although part of it was due to cyclical effects associated with the crisis, OECD estimates indicate that the cyclically adjusted structural deficit was larger than 4% of GDP during 1992-95. By contrast, the structural balance has been kept positive since the late 1990s, while the automatic stabilisers have been allowed to work, allowing the fiscal balance to fluctuate in the -½ to +5% of GDP range. The fruits of this policy are that the consolidated gross debt of general government has been brought down from 73% of GDP in the mid-1990s to 47% in 2006; when also considering assets in public pension funds and government shareholdings etc., the net financial position is positive with general government net assets equalling 16% of GDP. Compared to the majority of OECD countries running unsustainable deficits, Sweden's debt reduction gives a much stronger platform for maintaining the core of the welfare state when facing future demographic challenges.

The truly impressive aspect of this drastic consolidation is that it has been achieved without large increases in the tax-to-GDP ratio, which has shown only a slight upward trend since the late 1970s where it has remained in a rather narrow interval around 50% of GDP. Rather the crisis in the 1990s led to careful reform and prioritisation with total expenditure coming down to around 53% in 2005-06, after having stayed at around 60% or above from the late 1970s to the mid-1990s. However, Sweden is still the OECD country with the heaviest tax burden, total tax revenues amounting to 51% of GDP in 2005 compared to the OECD average of 36% and the EU15 average of 40% (OECD, 2006g). Part of this difference reflects that most income benefits like unemployment insurance and social assistance are liable for income taxation, like in other Nordic countries, but even corrected for this, the tax burden is high both in a European and wider OECD context. In so far as a high tax-to-GDP ratio is associated with high marginal taxes and disincentives contributing to generating labour market exclusion and holding back entrepreneurship, it should be a priority to gradually reduce the tax wedges on labour as well as other distorting marginal tax rates.

The new government has affirmed that it will adhere to the target of an average fiscal surplus of 2% of GDP over the economic cycle, which was established by the previous government. Continuing to bring down public debt in this way is vital as a preparation for population ageing, but as official projections effectively show, it is barely a sufficient strategy. Until 2015, the fiscal impact of a rising number of older persons is partly offset by a falling number of children and teenagers. The primary fiscal balance therefore declines only slightly between 2010 and 2015, and as debt reduction leads to less interest expenditure, the fiscal net lending surplus of 2% of GDP is supposed to continue past 2015 (Table 1.3). From 2015 to 2030, both the old-age ratio and the youth ratio climb, and public expenditures therefore increase on both transfer payments and consumption. Government debt reaches a low between 2020 and 2030, but with a primary fiscal deficit of 1½-2% of GDP from there on, the debt rises rapidly again and passes its current level in 2050, from where it continues going up.

Fiscal sustainability is very sensitive to developments with respect to employment, and even just staying on the track assumed in the sustainability calculations will be a challenge. The fact that Swedes on average retire later than in most OECD countries gives a strong starting point, and so does the progress made in recent years of reducing sickness absence and stemming the inflow to disability pension. The labour market and tax reforms introduced with the 2007 Budget will further strengthen the starting position, as they are

Table 1.3. **Long-run fiscal challenges**

General government finances and economic aggregates in the government's long-run fiscal projection

	2006	2010	2015	2020	2030	2040	2050
	Per cent of GDP						
Primary revenue	53.3	49.5	49.2	49.3	49.6	49.3	48.8
Primary expenditure							
Transfer payments	21.2	19.2	19.8	20.0	20.4	20.2	19.5
Consumption	26.8	26.1	25.8	26.5	28.7	29.0	29.1
Investment	2.9	2.7	2.5	2.3	2.1	1.9	1.7
Primary fiscal balance	2.4	1.5	1.2	0.5	–1.7	–1.9	–1.5
Fiscal balance, net lending	2.8	2.0	2.0	1.6	–0.7	–1.6	–1.9
Financial position							
Consolidated gross debt	46.5	31.2	21.7	14.3	15.1	29.6	45.8
Net debt	–15.5	–22.5	–30.0	–35.7	–32.2	–15.0	–1.2
	Level	Index, 2006 = 100					
Population aged 20-64, thousands	5 356	101	102	101	102	103	106
Employed, thousands	4 335	104	105	106	106	108	111
Total hours worked, millions	6 943	103	104	104	101	101	102
Economy-wide productivity	100	108	120	132	156	188	227
GDP per capita, SEK thousands, volume	306	111	122	131	148	174	207
	Per cent						
Old-age dependency ratio[1]	29.4	32.0	35.1	37.9	42.1	44.6	43.5
Youth dependency ratio[1]	40.5	39.2	38.3	40.4	41.9	41.7	41.0
Regular employment rate, 20-64[2]	77.7	80.5	80.9	81.8	81.3	81.9	81.8
Open unemployment[3]	5.6	4.1	3.7	3.6	3.7	3.7	3.7

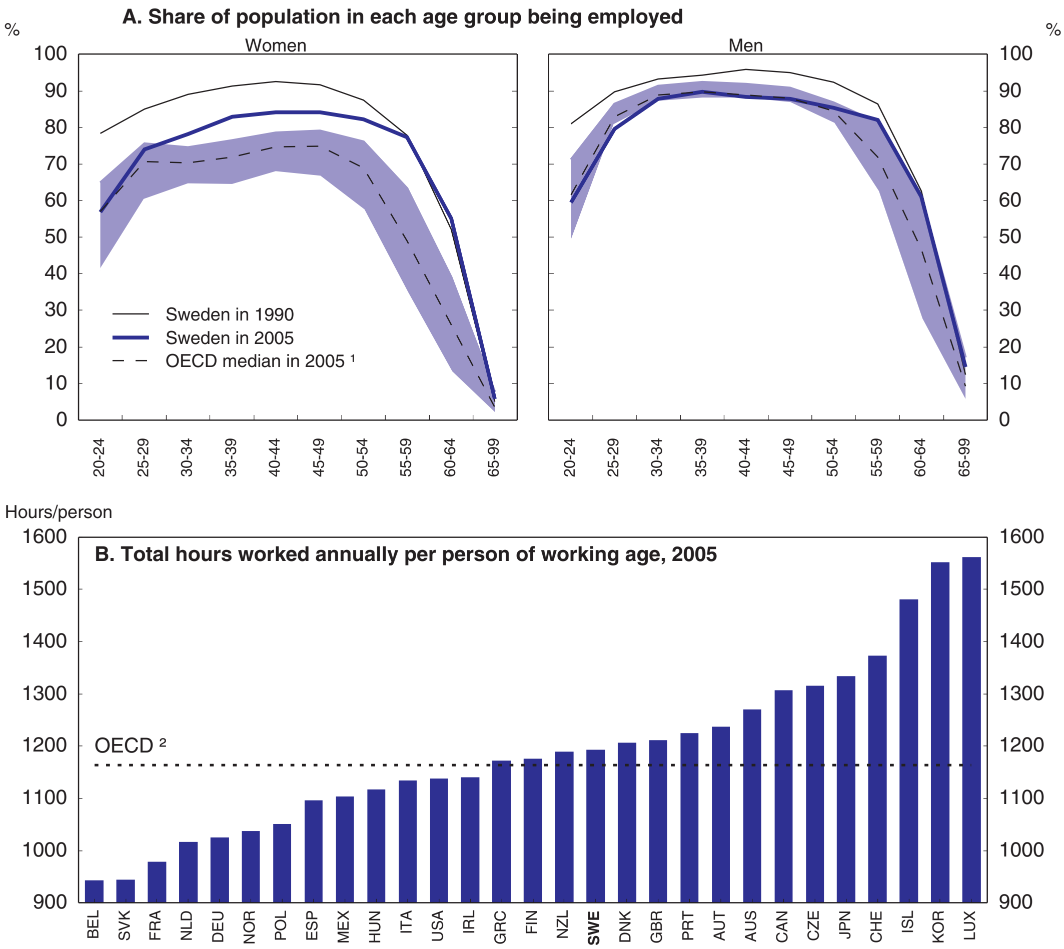
1. The old-age dependency ratio is the size of the population aged 65 and over relative to the population aged 20-64. The youth dependency ratio is the similar measure for the 0-19 year olds.
2. Employment-to-population ratio for the 20-64 year age group, excluding those employed in labour market programmes.
3. National definition excluding students looking for work who are counted as unemployed in international statistics.

Source: Ministry of Finance (2006b), Sweden's Economy, October.

expected to raise employment by a cumulative 0.9% in 2010-12, most of which is due to lower structural unemployment. However, other factors will put a downward pressure on labour supply. First, with growing incomes, workers are likely to increase their demands for holidays, leave and other forms of spare time. Even when assuming that the resulting trend decline in average hours worked will be only 0.2% per year, it means that the 11% increase in employment up to 2050 will be neutralised, with total hours worked being virtually unchanged. And given historic trends in average hours worked, a 0.2% decline would seem to be an optimistic assumption under current policies. Second, according to official population projections, the share of foreign-born among the population aged 20-64 would increase from 15.5% in 2006 to 21.6% in 2030, reflecting mostly people born outside the EU. As immigrants often suffer from labour market exclusion, such a change in workforce composition will tend to reduce employment. The government's long-run fiscal projection hinges on a third of the current gap in employment rates between immigrants and natives being closed over the next 15 years and then staying constant, with 65% of the foreign-born being employed. Achieving this should be realistic, but it will require reforms (Chapter 3).

If staying on the track just described, it will be possible to continue providing today's standards in welfare services and support for those in need even when the number of "clients" grows because of population ageing. However, on top of this, growing incomes will probably drive up demand and expectations for what kind of service a person with given characteristics should receive, as has happened in the past (SOU, 2004). Healthcare is a prime example where technological advances are likely to open a wealth of treatment opportunities, including many for life threatening diseases. Incorporating these factors, public consumption would tend to increase its GDP-share by several percentage points more than included in the government's long-run fiscal projection (OECD, 2006h). Moving some services to private funding can help and, with the government's intentions to expand user choice, it is essential to lay the foundations for choice in ways that can give room for users to contribute financially to services improvements rather than in ways that simply increase public spending pressures users seek expensive providers (Lundsgaard, 2003). At the same time, extending reforms – to reduce sickness absence and disability, make students enter university earlier and in general enhance labour supply and employment beyond the measures in the 2007 Budget – would provide room for meeting future demands for enhancing public service standards. Indeed, as the average 16-64 year old person is spending only a little more time working than what is average in the OECD area (Figure 1.13), it might

Figure 1.13. **Employment rates and total hours worked**



1. The shaded area shows the middle of two quartiles (*i.e.* half of the OECD countries fall in this range).
2. Considering the OECD as whole, but excluding Turkey.

Source: OECD Labour force statistics database; OECD Economic Outlook 80 database; OECD Productivity database, Sept. 2006.

well be that future generations would have a collective preference for spending a bit more of their time working in order to finance the adoption of medical advances and other service improvements. But realising that fiscal potential will be challenging, as the individual incentives with today's high income taxes is to seek more free time.

Right now, the challenge on the expenditure side will be to stick to the requirement underlying the long-run projection, namely that when demographics imply less users, then the service-providing institutions must adjust. Specifically, municipalities must manage to downsize in childcare, schools and other services for children and teenagers, as the cohorts coming through in these years shrink (Ministry of Finance, 2006b). Under such circumstances, expenditure control has previously been a problem, as identified in previous *Surveys* (OECD, 2002b). It is therefore promising that the new government has indicated a strengthened emphasis on adhering to the spending ceilings. The 2007 Budget implies a declining profile for public expenditures as a share of GDP in 2007-09. However, as the spending ceiling declines at a more gradual pace, the gap between the two, the so-called budget margin, widens to over 1% of GDP in 2009. It will therefore be an important challenge to avoid that actual spending slips. This is all the more so, because the current fiscal framework may not adequately guard against pro-cyclical spending, and previous *Surveys* have therefore recommended a set of adjustments to both central- and local-government fiscal frameworks that have not been implemented so far (Annex 1.A1; OECD, 2005c).

Notes

1. For 1986-90, annual labour productivity of 1¼ per cent was mostly explained by capital accumulation. During the crisis and subsequent recovery years 1991-98, annual labour productivity of 2¼ per cent was due to capital accumulation and multi-factor productivity in roughly equal proportions.
2. The term "command GDP", which has sometimes been used in the literature, conveys that the terms-of-trade adjustment leads to a measure of the volume of consumption and investment that GDP can buy or "give command over".
3. Comparisons of GDP levels over time based on current PPPs use a sequence of benchmark PPPs to construct time series of PPP price level indices. These are then applied to GDP time series in current national prices. With such a method, the effect of terms-of-trade trends on aggregate real income is captured *via* its effect on nominal GDP (OECD, 2002a). By contrast, the *OECD Going for Growth 2007* includes a figure for each country comparing the GDP level with that of the United States where, for consistency, all of these figures are based on constant rather than current purchasing power parities (OECD, 2007a). When using constant PPPs, the time series are derived by applying GDP volume growth rates for each country to the common-currency GDP levels of the base year. Such an approach implies that terms-of-trade trends are not taken account of, meaning that the figure in the *OECD Going for Growth 2007* overstates the extent to which Sweden's gap in GDP *per capita* has narrowed in recent years.
4. SEK 6 billion of the total SEK 19 billion are due the full-year effect of measures introduced with the 2006 spring budget. Meanwhile, cyclicality in revenues and outlays, as well as one-off effects in previous years, means that the actual fiscal balance is likely to fall by less than 0.7% of GDP.
5. According to the Riksbank, the neutral level of the *repo* rate is between 3½ and 5% (Riksbank, 2006).
6. This medium-term baseline scenario is based on the *OECD Economic Outlook*, No. 80. It does not include the long-run effects of the reforms introduced with the 2007 budget. Rather it presumes roughly constant structural unemployment and trend participation rate throughout 2006-13, while working-age population continues growing until 2010. The lower GDP growth rate in the medium-term years 2009-13, compared to 2004-08, results from a closing of the output gap which is projected to reach more than 1½ per cent of GDP in 2008, and a slowing potential growth rate as population growth ends.

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7. Participants in labour market programmes are not counted as part of open unemployment. Total unemployment, defined as the sum of open unemployment and programme participation, is therefore expected to fall by several percentage points towards late 2008. Separate from total unemployment, some training programmes exist where participants are not counted as part of the labour force.
8. Based on total compensation of employees deflated by consumer prices: Average annual increase of 2.5% during 1970-90; 3.5% during 1998-2006.
9. The low unemployment rate for young immigrants in Denmark is all the more remarkable because labour market integration of immigrants in general is rather poor in Denmark – the gap between immigrant and native employment rates is the largest of any OECD country.
10. Capio, which started in Sweden in 1994 and listed on the Stockholm Stock Exchange in 2000, now has activities in France, Germany, Spain, the United Kingdom and a number of other European countries. In 2004, it won the largest health care contract awarded to a private healthcare provider by the UK National Health Service. Under the Spine chain project, Capio is running 9 clinics including the provision of health care as well as facilities operation and maintenance. Some clinics are in existing facilities, others have been build by the company.

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ANNEX 1.A1

Progress in structural reform

This table reviews action taken on recommendations from previous *Surveys*. About half of the recommendations were made in the 2005 *Survey*, but key recommendations made earlier are also included. Recommendations made in this *Survey* are shown in the boxes at the end of each chapter.

Recommendations made in previous *Surveys*	**Action taken since the latest *Survey* (Summer 2005)**
LABOUR MARKETS	
Raise efficiency and equality in administration of labour market policies by amalgamating the National Labour Market Board and the county labour market boards.	The National Labour Market Board will be restructured with a new organisation to be in place in January 2008.
Strengthen sanctions for inadequate job search activity and for refusing job offers or offers of a place in active labour market programmes.	From 2007, a comprehensive strategy to combat social insurance fraud is launched. Mild sanctions for inadequate search, etc., are also being considered.
Terminate inefficient labour market programmes. Limit the length of the Activity Guarantee while enforcing it rigorously, including with firm sanctions for non-compliance. Reserve the Activity Guarantee for those that really need intensified programmes.	From 150 000 in 2006, the number of participants in labour market programmes will be scaled down to 90 000 in 2007. Meanwhile, New-Start Jobs waiving employers' contributions will be introduced. The Activity Guarantee will be replaced by a Job and Development Guarantee which will apply to all after 60 weeks of unemployment benefits.
Terminate the sabbatical leave scheme introduced in 2005. Limit study leave allowances to only those courses that are clearly job-related.	The sabbatical leave scheme is terminated by the end of 2006. The possibilities to join labour market education within the regular education system will be stopped from 1 January 2007.
Review replacement rates of unemployment benefits to allow the wage structure to adapt to differences in unemployment risk. Reduce the generosity of part-time unemployment benefits.	From 2007, the higher ceiling during the first 20 weeks of unemployment benefits is abolished. The replacement rate is lowered from 80% to 70% after 40 weeks and 65% after 60 weeks (90 weeks for parents with children under 18).
Improve female labour market outcomes by increasing the share of parental leave that is not transferable between parents. Avoid measures that increase the duration of mothers' leave further in order not to aggravate gender segregation and human capital loss. Abstain from making the leave benefits more generous.	A gender equality bonus will be introduced to encourage equal sharing of parental leave between spouses.
Ease employment protection legislation to improve the job prospects for marginalised groups.	Firms with less than ten employees have been exempted from the last-in-first-out rule for the first couple of layoffs. From 2007, a new temporary contract is introduced.
Integration of immigrants: Shorten the time of reaching a final decision on asylum applications so that full economic integration can start earlier. Continue working towards more individualised integration programmes that focus on language and job training, using time-limited wage subsidies or introductory wages and continue to improve the process of validation of foreign qualifications.	Ongoing. New-Start Jobs will also be available for newly arrived refugees and their families for the first three years after receiving residence permits.

Recommendations made in previous *Surveys*	Action taken since the latest *Survey* (Summer 2005)
SICKNESS AND DISABILITY	
Responsibilities for the social insurance office	
Improve the assessment process: Require a medical certificate earlier. Reassess eligibility more frequently, and reintroduce occasional random checks. Social insurance doctors should undertake an independent medical assessment, possibly after a few weeks but certainly before granting permanent disability benefits. The decision to grant a disability pension should be made by a panel comprising social insurance and rehabilitation experts, not by local politicians.	Legal changes are planned allowing employers to require a medical certificate from the first day of sickness absence, and abolishing lay assessors. Assessment of diffuse symptoms and assessments will be focused on remaining work capacity.
Carefully monitor how partial benefits are being used to ensure they are not just an income top up for people who want to scale back their working hours. Make it easier for people on partial benefits to change employer.	No action.
Responsibilities for the employer	
Increase financial responsibilities on employers, but only if other parts of the system are tightened up as well. Monitor their response to the 15% co-payment. If it does not have the intended effect, replace it with a higher up-front cost but with a limited duration (*e.g.* full responsibility for the first 2-3 months only). Involve employers in vocational rehabilitation, and ensure this starts earlier. Introduce employer or industry risk weighting. As a first step, the premium could be differentiated between the public and private sectors.	Instead of increased, employers' financial responsibilities will be reduced as the 15% co-payment is abolished from 2007.
Separate out the workplace injury scheme, and have it fully funded by employers. Consider allowing this scheme to be run by the private sector. In negotiating labour market agreements, ensure that these agreements do not overrule policy objectives (*e.g.* through top ups to benefit levels).	No action.
Responsibilities for the sick person	
Increase the focus on active measures – in most cases, receipt of a benefit should depend on participation in employment, vocational rehabilitation and other integration measures.	No action.
Extend the waiting period beyond one day. Sickness and disability benefits should not count towards pensionable income (at least beyond a certain age) so as to reduce the incentives for using these benefits as a pathway to early retirement.	The government intends to reduce the pension rights for people with disability pension. The pensionable income will be reduced from today's 93% to 80%.
Align the SI and UI ceilings. If all other reforms fail to deliver a significant reduction in absenteeism, then as a last resort the generous benefit rates may have to be cut.	The sickness-benefit ceiling is lowered from 2007, and the income on which benefits are based is calculated in a different way.
TAXATION	
Tax increases should be avoided because they are likely to be costly in terms of their impact on labour supply. Reduce marginal income taxes including by raising the threshold for the state (central government) income tax rate.	A multi-year programme has been completed in 2006 with income tax reductions to compensate for increased employee pension contributions. Higher "green" taxes have been matched by increasing the basic income allowance. From 2007, an in-work tax credit worth over 1¼ per cent of GDP is introduced, making work more rewarding relative to unemployment or inactivity and also reducing marginal tax rates for low- and middle-income earners. No action has been taken on the state income tax (Chapter 3).
Raise the effective rate of VAT to make room for greater income tax cuts.	The VAT commission has recommended to move towards a uniform VAT, but no action has been taken yet.
Broaden the tax base by restoring and eventually increasing the property tax level.	No action. By contrast, the effective property tax rate has been lowered by capping the tax payment at a certain percentage of household income ("limitation rule"). From 2007 real estate taxes is further reduced and imputed rent taxation for apartments abolished.
Reduce the adverse effects on marginal effective tax rates arising from the housing allowances for young people and families with young children.	No action.

Recommendations made in previous *Surveys*	Action taken since the latest *Survey* (Summer 2005)
FISCAL FRAMEWORK	
Augment the surplus target with a medium-term debt target to reduce the risks of slippage from year to year.	A review of the fiscal framework has been initiated and will be presented in the 2007 Spring Budget.
Tax expenditures should not be used to circumvent the central government spending ceilings, and the ceilings should be set at a level that is consistent with the surplus target. Operate the ceiling for operational expenditures and non-entitlement transfers as a hard budget constraint on a three-year-ahead basis. Introduce a specific cyclical margin that is ring-fenced from anything but business-cycle related spending changes.	From the 2006 Budget, revenues are reported in accruals and cash; tax expenditures are reported on special items. The 2007 Budget reduces some tax expenditures that substitute for direct expenditure. The system of expenditure ceilings is so far unchanged, but the new government has announced that it intends to enhance transparency.
Reduce the pro-cyclical effects of the balanced-budget requirement for local governments by basing it on average taxable income over a number of years. Revenues could also become more stable by giving local governments access to property taxes. Alternatively, central government grants could be adjusted counter-cyclically.	No action, although the government is considering introducing a local property fee (Chapter 4).
Strengthen the accountability of the state agencies and ensure that they have clear and measurable performance targets to achieve.	No action.
HEALTHCARE	
Improve access to healthcare by removing barriers and strengthen incentives for family doctors and by adjusting the waiting time for treatment so that those most in need are treated first.	No action.
Ensure quality of healthcare provision across regions through greater benchmarking, improved co-ordination between municipalities and county councils and a reduction in the number of counties.	No action.
Introduce more private market elements in the hospital sector and in long-term care for older persons by encouraging more private service provision. Abolish Apoteket's monopoly at least for non-prescription drugs.	The state monopoly for pharmacies (also prescription drugs) will be abolished from January 2009. The government is preparing initiatives to expand choice in particular for long-term care for older persons.
Make financing more stable and sustainable by reducing the cyclical influence on county council budgets and increase the role of user charges.	No action.
EDUCATION	
Identify and pursue cost-effective ways of improving the performance of the education system, particularly in mathematics and science. Develop better indicators of school performance in order to increase transparency and to help identify the factors that influence outcomes.	The government is preparing the introduction of systematic evaluation of each student's achievements in years three, five and eight of compulsory school. Teacher training and a peaceful and secure school environment will be prioritised.
Look at ways of truncating the years spent in school by raising the number of hours spent in instruction each year towards international averages, and re-examining the balance between instruction time and after-school care.	No action.
To advance the start of tertiary education the option for improving upper-secondary grades in municipal adult education could be removed along with the option of substituting locally designed courses for normal courses so that extra points could be awarded for relevant work experience only. To avoid study duration beyond schedule, the study-activity requirement for study allowance eligibility should be tightened. Grants should be provided only for the stipulated duration of a study programme and loans with income-contingent repayments should be offered thereafter. Tuition fees combined with income-contingent loans could also be introduced, but if that is not acceptable, an alternative could be to convert some of the student's loans into grants if studies are finished within the prescribed period.	An admission reform have is to take effect from autumn 2010. Persons basing their application solely on upper secondary grades will be given some priority over applicants that base their application on grades that have been improved in adult education.

Recommendations made in previous *Surveys*	Action taken since the latest *Survey* (Summer 2005)
	INNOVATION AND ENTREPRENEURSHIP
Strengthen incentives to commercialise publicly-funded research by sharing intellectual property rights between the researcher and the institution. Develop the organisational structure and expertise to effectively commercialise research.	A review is underway on the holding companies and capital base used by academic institutions to commercialise research. A national property protection insurance to strengthen small companies' chances of asserting their rights under patent law might be introduced. A study of tax deductions on donation to research is underway.
Remove the quantitative restrictions on venture capital investments by institutional investors including private pension funds.	No action.
Eliminate those elements of the tax system that discourage individuals from accumulating wealth outside of pension plans: Eliminate wealth, gift and inheritance taxes, or at least raise their thresholds.	The gift and inheritance taxes were abolished in 2005. From 2007, the wealth tax rate is halved to 0.75% for non-housing wealth, as a prelude to abolition.
Address the 3:12 rules affecting closely-held companies, so that they provide greater recognition of the entrepreneurial nature of high earnings.	The 3:12 rules were simplified in 2006 and made more beneficial for investments in closely-held companies. Further steps have been taken in 2007.
Adjust how previous earnings enter the calculation of unemployment insurance benefits to give failed entrepreneurs a more neutral treatment *vis-à-vis* their earlier employment status.	No action. A committee has been set up in order to review the issue.
	COMPETITION
Strengthen the Competition Authority's capacity to combat hard-core cartels and other serious breaches of competition law. Improve the leniency system by providing for substantial, non-criminal sanctions on individuals.	In November 2006, a committee has proposed authorising the Competition Authority to set fines in non-contested cases and make other improvements in enforcement processes. The committee recommended against adopting a criminal penalty, proposing instead to authorise orders disqualifying individuals from management positions.
Streamline the process and reduce the time for competition cases to be dealt with. Reconsider the need for two separate judicial reviews of the rulings of the Competition Authority.	The above committee has proposed changes to procedures that slowing down application of the Competition Act.
Strengthen the legal framework governing market activities of municipalities and other public institutions, bringing them within the scope of the Competition Act and providing greater opportunity for competitors to seek redress. Rationalise the present supervisory structure for public procurement into a single agency with scope to impose sanctions, and ensure that tenders from internal and external suppliers are treated equally. Increase outsourcing of public services. Specify clearly in government's mandates to the agencies what are their core activities and place limits on expansions in other directions. Improving efficiency via dispersion of best practices in the public sector by further developing comparative datasets at all levels of government.	No concrete action, although the government has stated intentions to open publicly funded services more to competition from private-sector providers. A government committee will be assigned to forward this. The government also intends to merge the public procurement regulator into the Competition Authority.
Reduce state ownership, with emphasis on separating natural monopolies from competitive activities. Privatize government owned companies currently operating in competitive markets.	The government has announced plans to privatise state owned enterprises worth SEK 50 billion a year 2007-09.
Continue efforts to dilute incumbent power in electricity. Make further investments in Nordic transmission infrastructure to reduce bottlenecks and prevent market power.	Five interconnections are prioritised for the coming years, including Fennoskan (SWE-FIN), a local cross-section (NOR-SWE), and one cross-link in Sweden.
Expose all the activities of the state-owned passenger rail company to competition and require it to operate under a hard budget constraint with no prospects of further government capital injections to bail it out.	No action.
Consider alternative regulatory mechanisms that would allow the introduction of competition in alcohol retailing without sacrificing control over access to liquor.	No action.
Modify the planning process to require that the benefits of increased competition be explicitly taken into account when local authorities decide on application for supermarket sites.	The number of shopping centres and large-scale formats has grown, partly because municipalities apply existing zoning laws in a more flexible way. An inquiry on spatial planning is taking place.

Recommendations made in previous *Surveys*	**Action taken since the latest *Survey* (Summer 2005)**
HOUSING	
Allow owners to charge market rents for new housing, and progressively strengthen municipalities' incentives to supply suitable land sites for housing construction, for example through instituting a municipal property tax.	Legislation has been introduced for rent setting in newly constructed dwellings. If the rent for new dwellings has been negotiated and accepted by a local, established Tenant's Association the rents shall be presumed to be reasonable and not liable to be contested in a Rent Tribunal or to be compared with other, similar dwellings for a period of ten years. After that time, rents shall be determined according to the ordinary utility value rules.
Resolve the outstanding obstacles to implementing the EU directive for building materials, and encourage municipalities to facilitate competition in construction.	No action.
PROMOTING ENVIRONMENTALLY SUSTAINABLE GROWTH	
Ensure that rigorous cost-benefit analysis is systematically used to evaluate environmental policy options.	No action.

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Chapter 2

Why has inflation been persistently low?

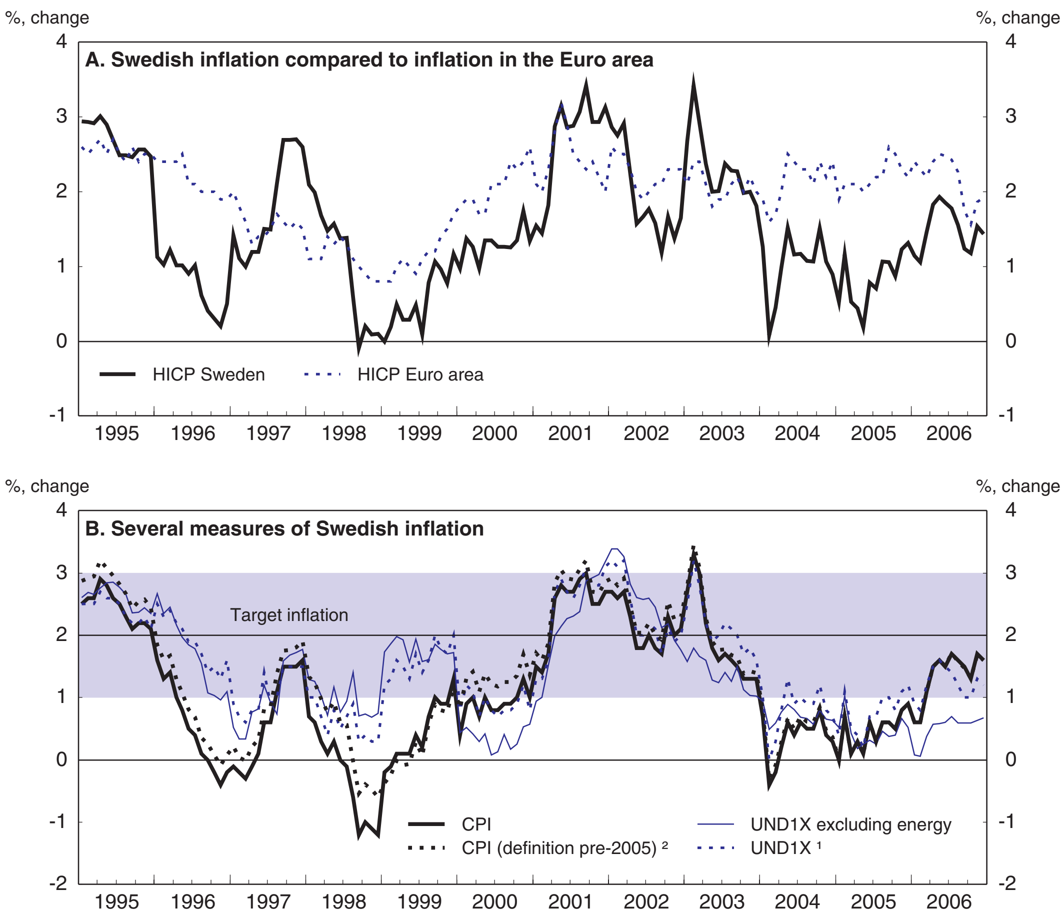
Average inflation in Sweden has been one of the lowest among European countries since the mid-1990s. Three supply-side factors help to explain this phenomenon, all related in some sense to increased global integration. First, a shift towards imports from low-cost producing countries has resulted in falling import prices. Second, deregulation and increased product market competition with foreign companies entering the market has led to price falls in some sectors, notably in retailing. Third, wage growth has lagged productivity and kept unit labour costs down. This chapter reviews these factors and analyzes the policy options for the central bank.

Inflation has been below target most of the time

Since the start of the inflation targeting regime, which was introduced following the breakdown of the fixed exchange rate system in 1993, Sweden has achieved a remarkable stability of prices. In contrast to the occasional double-digit price increases in the 1980s and early 1990s (average 1981-1993: 7.3%) and despite the sharp depreciation of the krona in 1993, inflation rates have remained very contained (average 1993-2006: 1.4%; Figure 2.1). The shift towards this low inflation environment has been a great success of the new monetary framework, benefiting consumers in terms of greater purchasing power and the economy at large by anchoring inflation expectations.

Figure 2.1. **Inflation rates**

Year-on-year percentage change



1. CPI excluding interest costs for owner-occupied houses and adjusted for changes in indirect taxes and subsidies.
2. CPI according to definition used before 2005.

Source: Statistics Sweden and Eurostat.

Consumer price inflation has also moderated considerably in all other OECD economies over the 1990s, coinciding with increased global integration and a broad-based shift of central banks towards price stability orientation and increased credibility of monetary policy. However, the impact on Swedish inflation has been stronger than for other countries, with Sweden consistently being below the OECD average and recording the lowest annual inflation rate among European countries during 6 of the years since 1995. Inflation has also been lower than the Riksbank's target (to keep consumer price inflation at 2% over the medium term with a tolerance band of +/-1%) for most of the time.

Two factors have to be taken into account when interpreting the low inflation rate. First, due to a technical change in the inflation calculations implemented in January 2005 by Statistics Sweden, the historical inflation series had been revised downward somewhat (as substitution effects from relative price changes were taken into account). Monetary policy decisions taken before 2005 were thus based on a somewhat higher inflation rate. However, even using the unrevised historical consumer price inflation data, the lower band of the 2% target was undershot in more than 40% of the time since 1995. Second, as the consumer price index includes mortgage interest expenditures of households, one reason for the lower inflation rate is the decrease of both long and short term interest rates since the mid-1990s. In order to compensate for this effect, the central bank also looks at the UND1X measure of inflation, which excludes this effect.[1] The UND1X measure of inflation has been below 2% in two-thirds of the time since 1995 and in one-third of the time below the lower bound of 1% (based on the unrevised UND1X inflation series, the lower bound has been undershot in 20% of the time). If, in addition, one excludes energy from UND1X, one has a picture of a core inflation index (Figure 2.1) which remains at very low levels. This is supported by alternative measures of underlying inflation which exclude components with large temporary price changes and do not yield a higher trend of inflation (Box 2.1).

Box 2.1. **Measures of underlying inflation**

Measures of core inflation are usually constructed by permanently excluding particular components from the headline inflation index such as food and energy. The rationale is to prevent price changes that are more likely to reflect supply shocks rather than aggregate demand from affecting the inflation measure. Such one-off price changes should normally fade out over time without requiring a monetary reaction.[1] However, it is increasingly argued that leaving out commodity components neglects the fact that their increases are at least partly driven by demand from fast-growing emerging markets, which simultaneously supply cheap imported goods. Thus, the traditional core measure might understate the true extent of prevailing inflationary pressures.

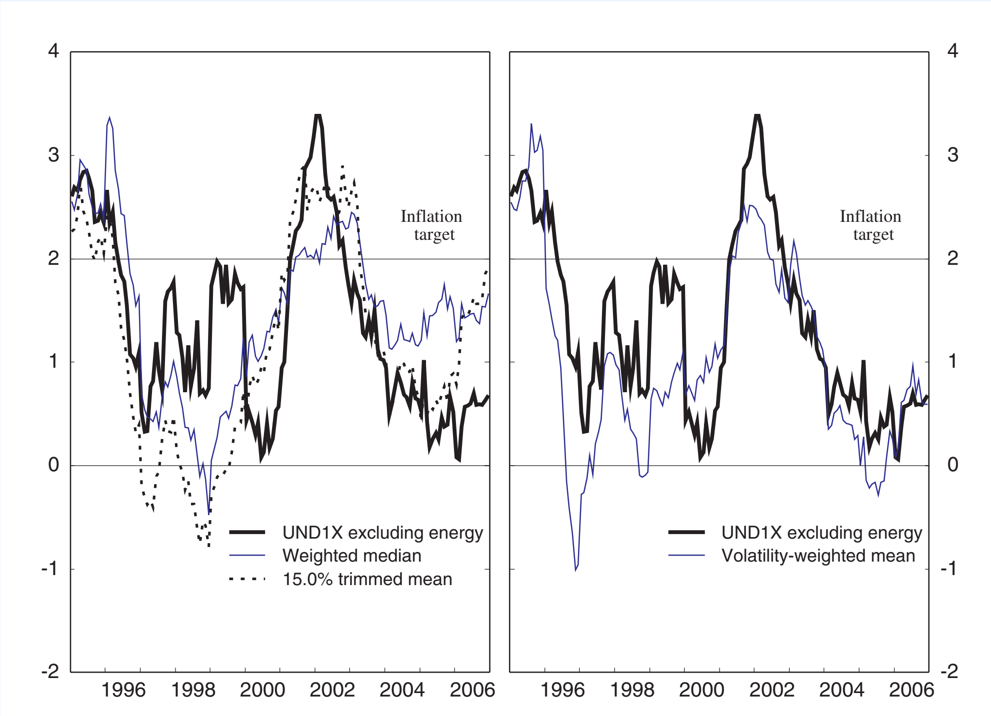
An alternative method of detecting the underlying inflation trend is to exclude different components on a period-by-period basis, such as neglecting the items with the largest price changes (positive or negative) when they occur.[2] Indicators based on this method are *trimmed means*, which exclude a certain percentage of items from the top and the bottom end of the price change distribution. The 15% trimmed mean, for example, excludes 15% of total CPI weights from each side of the price change distribution. As a special case, the *weighted median* corresponds to a trimming percentage of 50% excluded from each side. A third method is to re-weight the CPI components according to their volatility (*volatility weighted mean*) (with the weight being inversely proportional to their standard deviation relative to the overall index).

Box 2.1. **Measures of underlying inflation** *(cont.)*

It can be seen that the underlying measures that exclude components on a period-by-period basis, although being somewhat less volatile, paint a picture that is very similar to the headline and traditional core measures regarding both the cyclical movements and the low average level of inflation (Figure 2.2). This suggests that the low inflation environment indeed reflects a trend in the underlying rate, rather than being driven by temporary factors.

Figure 2.2. **Core inflation measures**

Year-on-year percentage change



Source: Statistics Sweden and OECD calculations.

1. Of course, monetary policy needs to react in case the price changes affect prices in other parts of the economy, for example through second-round effects on wages, or alter the longer-run inflation expectations of the public.
2. See Catte and Slok, 2005.

The influence of increased competition and globalisation

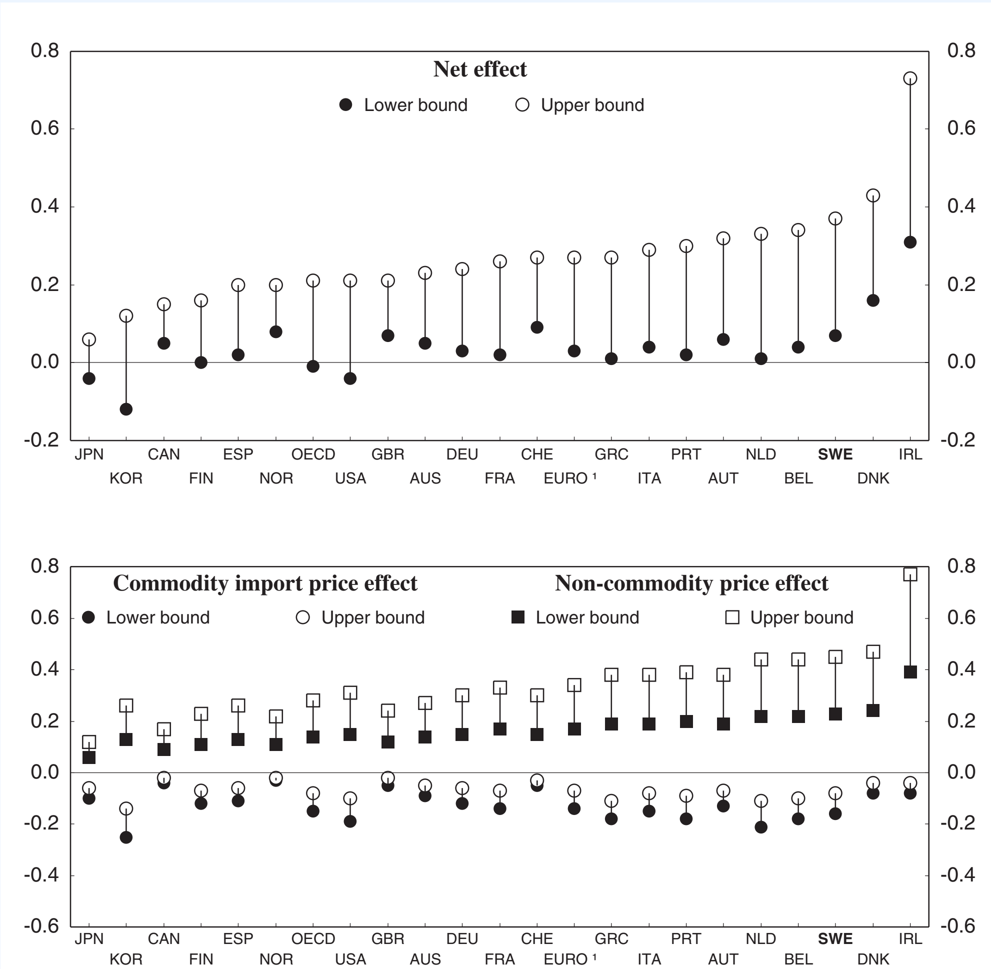
Looking at the consumer price index subcomponents shows that the low inflation is driven by goods prices rather than by services prices (which have remained close to 2% on average over the past years) – as one would expect in an open economy where a large share of the goods sector is exposed to foreign competition (Rosenberg, 2005). Within the goods price component, it is foremost the price increases of imported goods that have been low and even negative over long periods in the last ten years; even so, prices of domestically produced goods also exhibited low increases. As goods inflation has remained low on average across past business cycles, this suggests that there is a structural aspect to it. In this respect, several studies find that Sweden is particularly exposed to the disinflationary forces of globalisation (BIS, 2006; Pain *et al.*, 2006), which have become more pronounced since the 1990s (Box 2.2).

Box 2.2. **Globalisation and inflation**

Implications from increased globalisation for inflation are multi-faceted. First, besides a general increase in the share of imports in domestic demand, enhanced trade integration with low-cost producing countries dampens import prices in the importing countries. Second, the integration of fast-growing countries like China and India in the world economy is likely to have been one factor behind the rise in commodity prices, thus providing a counterbalance to the disinflationary pressures from globalisation.

Figure 2.3. **The impact on consumer price inflation from removing the globalisation effect**

2000-05, percentage point per year



Note: The figure shows how much higher consumer price inflation had been in the absence of globalisation-related import price effects. The lower (upper) bound of the total impact of globalisation is calculated assuming that non-commodity import price inflation was 1 percentage point (2 percentage points) per annum above baseline and that commodity import prices reflect a 20% (40%) lower oil price (the metals price effect is 10% in both cases). The effects are calculated with regard to the private consumption deflator.

1. Euro area.

Source: Pain *et al.* (2006).

Box 2.2. Globalisation and inflation *(cont.)*

Pain *et al.* (2006) provide estimates of the impact of globalisation on consumer prices for OECD economies via these trade channels, taking into account both the increasing effect from higher commodity prices as well as the decline in non-commodity import price inflation. For most countries, globalisation is estimated to have been associated with a decline in consumer price inflation of between 0 and ¼ percentage point per annum since 2000 (Figure 2.3). For Sweden, the effect could be as high as 0.4 percentage point, about twice as large as for the average OECD country.

A further channel through which globalisation affects inflation is that competition increases with greater integration, as barriers to market entry by foreign producers are lowered, thereby reducing the mark-ups of domestic producers and affecting domestic wages and costs (Kohn, 2006a; IMF, 2006). As workers have less scope to negotiate higher wages when faced with potential off-shoring or use of migrants, the effect of higher activity on labour costs is diminishing (Bean, 2006). Related to this, global capacity measures might have become more important – and domestic measures of slack less so – for determining domestic inflation compared to previous periods. Indeed, estimates of traditional Phillips curves relating inflation to domestic capacity measures suggest a significant flattening across countries, *i.e.* the relationship between the domestic output gap and inflation has weakened. BIS (2006) find that the relationship has weakened more in Sweden than in any other country in their sample of advanced OECD economies.

… on import prices

The most direct effect of globalisation on inflation is through foreign trade and here Sweden benefits from its significant market openness (OECD, 2007). Import price inflation as measured by the UNDIMPX (excluding energy) has exhibited a negative trend and on average has been slightly negative since 1995. Exchange rate fluctuations might have reinforced this trend during certain periods of krona appreciation, in particular during the period 2001 to 2004. Overall, however, structural changes also underlie the longer-run trend according to recent studies (Riksbank, 2005). First of all, foreign trade has become more important over time, with the import share of GDP rising from around 20% at the beginning of the 1990s to close to 30% recently. Also the import content of domestic demand has increased. Second, the composition of imports has changed as imports from low-cost producing countries have gained in importance with greater integration of the world economy. The share of China and Poland in total Swedish imports has more than doubled since 1998 (Figure 2.4) and is now as high as the United States and some euro area countries. Estimates by the Riksbank indicate that the shift in market shares towards low-cost countries (substitution effect) has brought down import prices in every year since the mid-1990s. The effect increases over time, reaching over two percentage points per year recently (Riksbank, 2005).[2] Regarding the impact on consumer prices, Pain *et al.* (2006) estimate that imports of non-commodity goods and services have reduced the growth of the private consumption deflator by between 0.23 and 0.45 percentage points per year since 2000 (Figure 2.3).

… on domestic prices

Apart from lower imported goods prices, there is also an indirect domestic perspective linked to increased integration and globalisation. By enhancing competition, the power of

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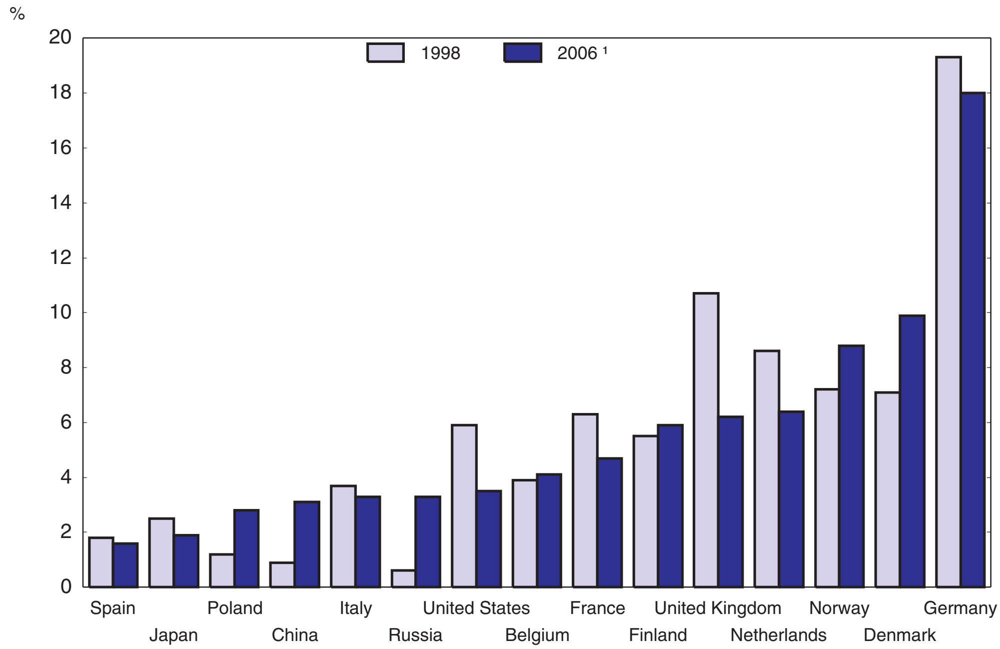
Figure 2.4. **Origin of Swedish imports**

Share of total Swedish imports



1. Average over January-October 2006.

Source: Statistics Sweden.

domestic monopolies and labour unions is weakened. In Sweden, major efforts to strengthen competition in the 1990s were undertaken with the accession to the European Union in 1995.[3] Apart from exercising a price level effect, product market competition can also lead to reduced average inflation rates over a prolonged period of time (Przybyla and Roma, 2005). The *2004 Survey* had identified several areas in which product market competition could still be enhanced, among them retailing, construction, and electricity (OECD, 2004). Adjustment has been taking place since around 2000 with Swedish price levels in some sectors converging downward towards the European level. Communications prices, in particular, have benefited from deregulation as Sweden was one of the first countries to liberalise the telecoms and postal sectors (Table 2.1). Telephone charges in Sweden are now among the lowest of all OECD countries (OECD, 2004).

A further example of an increase in competition is the retail sector, as large-scale shopping malls as well as foreign supermarket chains have entered the market. While in 1999 only 20% of the food retailing sector was exposed to competition (compared with 50% in the European Union), this picture has changed with the emergence of discount chains. The Danish chain Netto and the German Lidl entered the market in 2002-03; by 2004 they already had 134 shops and sales of SEK 3.3 billion (McKinsey, 2006) and they are rapidly gaining market share.[4] This has contributed to a downward adjustment of Swedish food prices, which were still considerably higher than in Germany or the Netherlands in 2004 (Table 2.1; Konkurrensverket, 2004). There is further scope for adjustment across goods prices: the price level for private consumption was 14% higher in Sweden than in the EU15 in 2005. The Swedish Competition Authority calculates, that if this difference were only to be halved, a Swedish family with children would save around

Table 2.1. **Relative price levels in Sweden compared with EU15**

	Cumulative change in the price level relative to EU15, %	Average annual change in the price level relative to EU15, %		2005 price level (EU15 = 100)
	1996-2005	1996-2000	2001-2005	
Actual individual consumption	–3.1	0.5	–1.0	114
Food and non-alcoholic beverages	–6.9	0.4	–1.7	112
Clothing and footwear	3.6	2.3	–1.3	110
Housing, water, electricity, gas and other fuels	–14.6	–0.1	–2.9	110
Household furnishings, equipment and maintenance	4.7	0.5	0.8	113
Health	7.4	0.6	1.3	122
Transport	2.1	–0.5	1.0	117
Communication	–36.3	3.5	–8.5	76
Recreation and culture	–0.7	1.1	–1.0	114
Education	–0.1	1.6	–1.5	107
Restaurants and hotels	0.9	0.0	0.8	119
Miscellaneous goods and services	7.3	1.6	0.0	119

Source: Eurostat.

SEK 30 000 per year (Konkurrensverket, 2005). Supermarket arrival coincided with the more flexible granting of building permits by municipalities for such purposes – something the Competition Authority had long been advocating (Konkurrensverket, 2005).[5] As there has not been a formal change in legislation, this seems to reflect increased integration and the associated higher competitive pressures from abroad.

Going forward, the momentum coming from international competitive pressure should be used for further efforts to enhance the competition environment within Sweden, in particular in the legal framework and the capacities of the competition authority. The *2004 Survey* has a number of recommendations in this regard which have not been followed up so far (OECD, 2004; Annex 1.A1).

… on wages

Another indirect channel from increased integration and globalisation to domestic inflation is through the wage-setting process. Wage-setting could be directly affected through foreign workers coming to the country willing to work at lower wages, as has recently happened when Latvian construction workers came to Sweden (Bank of England, 2006, and Chapter 4). But there might also be indirect effects, namely that already just the possibility of foreign workers coming into the country (or of a Swedish company outsourcing its activities abroad) dampens wage pressures. According to Posen and Gould (2006) the increase of wage restraint (defined as wage growth lagging productivity growth) in Sweden over the past decade has been among the highest among EU countries.[6]

There has indeed been evidence that wage setting behaviour has changed over time. A simple estimated wage equation, relating nominal hourly earnings growth in manufacturing to inflation and a survey-based measure of labour shortages (lagged one year as a proxy for the strength of the bargaining power of labour), would have overstated actual wage growth since 2000 by an annual average of 1.5%.[7] While the underlying reasons for this change are difficult to pin down, it is likely that the wage formation agreement (*Industriavtalet*) in 1997 is an important explanatory factor (Chapter 1). The agreement explicitly emphasized the importance of maintaining the competitiveness of the

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manufacturing sector in times of increased competition (and the manufacturing sector wage agreements serve as a benchmark for other sectors). One example for why competitiveness has become a more important element of wage setting is the increasing internationalisation of the Swedish automobile industry in the 1990s with the purchase of Saab and Volvo by General Motors and Ford, respectively. In the most recent past the trend of muted wage growth has been further reinforced with the increased inflow of immigrants from non-Nordic countries coming to Sweden for work and the entry of new member states to the European Union in 2004 (Chapter 3).[8] While the absolute inflow of such immigrant workers is still quite low, amounting to only a little more than 0.1% annually of the labour force in 2005, it is increasing strongly. As this is a fairly recent phenomenon, the effects of globalisation on wages are still discussed controversially and solid empirical evidence remains scarce. On the one hand, Dumont *et al.* (2006) find that globalisation has a negative impact on union bargaining power in large EU countries, with potentially restraining effects on labour costs. On the other hand, Ball (2006) suggests that muted wage developments might simply be related to lower trend inflation as well as increased central bank credibility (anchoring inflation expectations) which has reduced the frequency of nominal price adjustments.

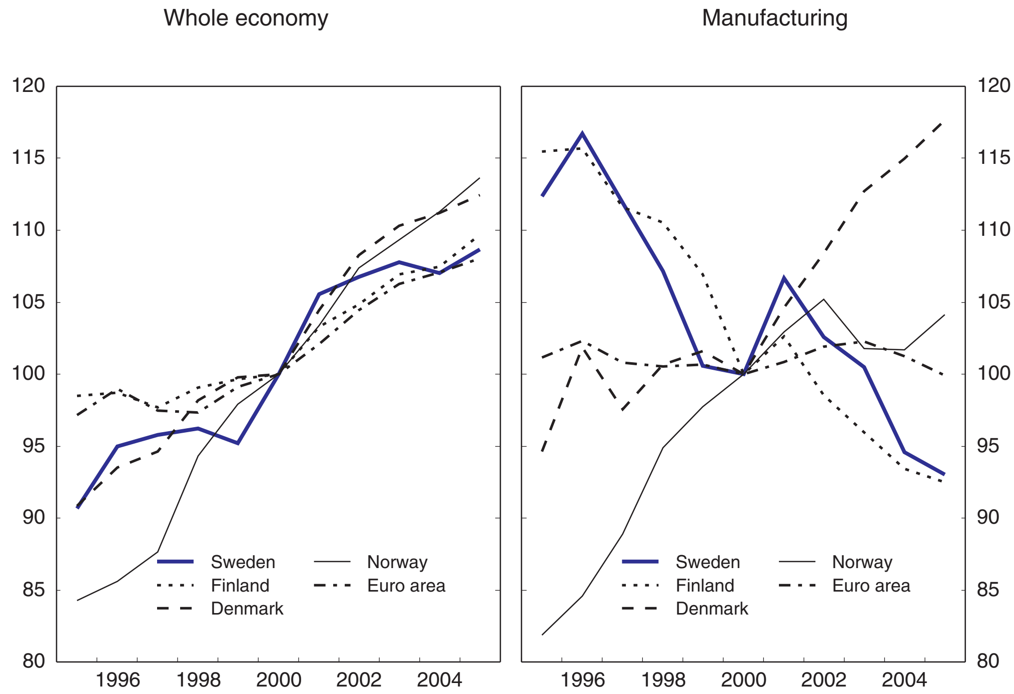
Looking across sectors in Sweden, firms more exposed to international competition (measured either as a higher average export share of production or higher import penetration) tend to have higher productivity growth and lower growth of unit labour costs.[9] Compared with other countries, unit labour costs in Swedish manufacturing, in particular, have undershot those of various competitors (apart from Finland), as a result of muted wage growth and strong productivity developments. As wage negotiations in other sectors broadly follow the results in manufacturing, this is to some extent translated into the economy as a whole (Figure 2.5). Some of this wage restraint is related to the specific sectoral composition of Swedish manufacturing, with a high share of IT which is usually characterized by a strong productivity performance. When compared with other countries, it is indeed visible that productivity performance is strong in Swedish manufacturing with average annual productivity growth of 5.9% (1999-2003), higher than in the other Nordics and more than twice as high as in Canada. Apart from the automobile sector, the importance of the IT-sector is one of the main explanations. On the other hand, IT products decline in price over time and therefore labour costs cannot fully compensate for the strong productivity gains. This is one factor behind the relatively favourable development of unit labour costs in IT-producing countries such as Sweden and Finland.

The rise of the IT sector might also have wider implications for the assessment of inflationary pressures from a more cyclical perspective. If potential growth estimates do not adequately take into account the structural change towards IT contributing to a more permanent productivity growth, they are likely to underestimate the true growth potential of the economy (Chapter 1). Strong actual GDP growth rates might then be wrongly interpreted as being above potential, thereby creating the expectation of emerging inflationary pressures. However, determining the cyclical and structural components of productivity growth is far from being an easy task, in particular if the economy underwent a structural change like Sweden in the 1990s.

In sum, the evidence suggests that supply shocks associated with globalisation have had quite some impact on inflation. The quantitative assessment available shows that the trade effect as estimated by Pain *et al.* (2006) has reduced inflation by between 0.1 and 0.4 percentage points since 2000. Convergence of consumer prices relative to the euro area

Figure 2.5. **Unit labour costs in sectors**

Indices 2000 = 100



Source: OECD Main Economic Indicators database.

made up 1 percentage point on average per year (up to 2005). Both estimates might to some extent be driven by the same factors. Relating these quantitative estimates to the fact that average monthly inflation rates have been 0.6 percentage point below the 2% target and around ½ percentage point below euro area inflation since 2000 shows that inflation would probably have been closer to target without such globalisation related effects.

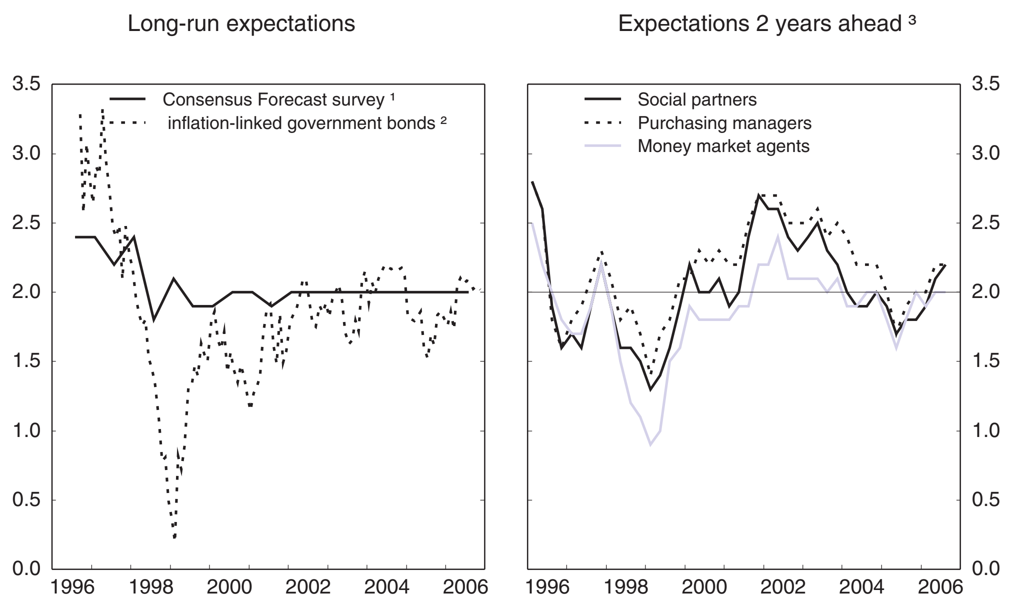
Implications for monetary policy

Globalisation affects relative prices, but not necessarily the aggregate price level: lower or even falling import prices can be compensated by higher domestic prices.[10] The general price level thus depends on the preferences and actions of the monetary policy authority and an inflation-targeting central bank can always stabilize domestic inflation at a desired level in the medium- to long-term (Bean, 2006). However, whether to fully accommodate the supply shock coming from globalisation (thus allowing prolonged deviations from the inflation target) or to offset it remains a key issue for domestic monetary policy. Part of the globalisation impact, in particular the effect coming from import prices and deregulation, is likely to be a one-off price level effect (although it nevertheless can be persistent as it is likely diffused over time). The monetary policy reaction to it should depend on whether price setters in the economy perceive the effect to be permanent and change their inflation expectations. The other part of the globalisation impact, namely the reduced sensitivity of wages to domestic labour market slack is likely to have a more lasting impact on inflation dynamics and implies that the traditional transmission channel from monetary policy to prices via interest rates and domestic demand components is now weaker. This would require larger shifts in the policy stance to achieve a given effect on inflation.

The fact that inflation has remained below target on average since 1995 suggests that the Riksbank has accommodated the supply effects on inflation, explicitly allowing for deviations. This claim is supported by recent statements. While admitting that inflation had been overestimated (and the supply shocks underestimated), in particular in the recent past, the Riksbank argues that even with more accurate forecasts it remained unclear if policy should have been more expansionary (Riksbank, 2006a). The main explanation given is that strong house price rises and household debt increases needed to be taken into account, warranting a cautious policy. Furthermore, in a recent memorandum, the Riksbank specified that in certain circumstances of large deviations of inflation from its target, policy may allow inflation to return to target only beyond the usual two-year horizon (Riksbank, 2006b). However, as the central bank also stresses, it is essential that this more flexible interpretation of the strategy does not undermine confidence in monetary policy and that the inflation target remains firmly anchored. Figure 2.6 displays long-run inflation expectations, taken from surveys and bond market prices which can be taken as a measure for the credibility of the inflation target. Some volatility in the second half of the 1990s notwithstanding, long-run expectations are very close to the 2% target. The same holds for expectations at the two-year horizon, even though fluctuations are somewhat larger. In sum, there is no evidence so far that faith in the central bank's ability to achieve the inflation target has been reduced and that the inflation target does not remain highly credible.[11]

Figure 2.6. **Inflation expectations**

Year-on-year percentage change



1. Based on semi-annual survey of inflation expectations 6-10 years ahead among Swedish commercial banks and research institutes.
2. Calculated as the difference between nominal and inflation-indexed Swedish government bond yields for 10 year maturity. This measure also includes liquidity and inflation risk premia and thus should be interpreted with caution.
3. Based on quarterly survey by Prospera Research AB.

Source: Consensus Forecast, Datastream and Prospera Research AB.

Whether the Riksbank has responded appropriately to the low inflation environment is controversially discussed in a recent evaluation report on Swedish monetary policy between 1995 and 2005 (commissioned by the Swedish Riksdag Committee on Finance and prepared by Frederic Mishkin and Francesco Giavazzi). While acknowledging that the Riksbank "compares favourably with the best central banks in the world", it gives a number of suggestions for improvement (Annex 2.A1). Given the persistent undershooting of the inflation target in recent years, it is criticized that monetary policy had been too restrictive with hindsight. While the report admits that some of the policy mistakes have to do with the forecast errors that the Riksbank (and almost all other forecasters) had made, two more substantive issues are raised:

- First, the increased focus on the role of house prices in policy-making over and above their immediate impact on inflation is viewed critically as it has prevented a more expansionary policy in recent years.
- Second, more focus should be put on inflation targeting being flexible in the sense of reducing both inflation and output (employment) fluctuations. This means, for example, that after a negative supply shock such as an oil price increase, inflation should be allowed to return gradually to target (rather than be forced back within the target horizon). The report also suggests that in order to compensate for a period of inflation being below target, inflation should be allowed to remain above target for some time, so as to take price level effects into account. However, communicating such a policy will not be easy and it should therefore be considered with prudence.

The role of house prices

With respect to house prices, it is an open issue whether in hindsight the Riksbank acted rightly by taking them into account (the role of the Riksbank in preventing a house price crash would probably never be visible). Above all, the academic discussion about whether monetary policy should consider house prices over and above their immediate impact on inflation is still ongoing (Box 2.3). In particular, the issue surrounds the longer-term implications for price stability related to the risk of the build-up of an asset price boom-bust cycle which might have deflationary consequences beyond the usual time horizon for achieving the inflation target. Such a scenario is difficult to include in the usual inflation target as it has a low probability but could have larger consequences and the Riksbank states that it tends to let asset price developments affect the timing of their interest rate changes somewhat (for example by starting a tightening cycle earlier than would be justified by conventional forecasts of inflation and real economic developments alone).[12]

In any case, it is important that the costs and benefits of such a policy are weighed against each other and communicated. But more importantly, the Riksbank should provide more evidence on the empirical assessment of the sustainability of house prices and household indebtedness, the channels through which they impact price stability as well as of the effects that monetary policy can have in countering it. OECD calculations suggest that house prices have only recently surpassed their fundamentally justified value and the undervaluation has turned into a slight, albeit growing, overvaluation (Chapter 4). Similarly, while household debt levels have reached very high levels, the debt service burden remains fairly low. Public understanding of the Riksbank's chosen way to deal with asset prices and indebtedness would benefit from a more thorough analysis of the issues involved. In addition, misunderstandings would be avoided by repeatedly clarifying that asset prices are not an independent target for monetary policy.

Box 2.3. **Monetary policy and asset prices**

How central banks should deal with asset prices is controversially debated. While asset prices are not usually part of the consumer price index, asset price boom-bust-cycles can well have negative effects for price stability over the long run. For example, a fall in asset prices reduces the wealth of consumers and might negatively impact their spending plans. In addition, excessive household indebtedness might also lead to cutbacks in consumption if an asset price bubble bursts. Such falls in demand can lead to deflationary trends and risks to price stability, which the central bank might want to take into account when setting policy rates. In this context, should central banks try to prevent bubbles from inflating or should they instead deal with the consequences once a bubble bursts?

The Federal Reserve is pursuing the latter strategy, on the grounds of three arguments (Kohn, 2006b): First, recognizing bubbles in a timely fashion is inherently difficult. Second, it remains unclear to what extent a modestly tighter interest rate policy can effectively prevent the built-up of bubbles. Third, the economic gains from preventing the bubble must outweigh the losses that a higher interest rate will generate in other parts of the economy.

Proponents of a strategy of leaning against the build-up of asset price bubbles argue on the contrary that the uncertainty regarding the existence of a bubble is no different from other uncertainties a central bank has to face. Insuring against potential negative effects of a boom-bust-cycle requires a somewhat tighter monetary policy than would be justified in a macroeconomic environment without an inflating bubble (ECB, 2005). The European Central Bank broadly follows this line, arguing in addition that an asymmetric approach to asset price bubbles would risk creating moral hazard problems as investors know in advance that they will be bailed out in an asset price bust.

The case for flexible inflation targeting

There is broad agreement today that best-practice inflation targeting has to be flexible by caring about both inflation and output fluctuations.[13] This interpretation becomes particularly important in the face of supply shocks which move both measures in opposite directions. The Riksbank's decision to vary the time horizon over which inflation will be brought back to target is one way to introduce more flexibility and also to gain more insight in the inflation/output relationship under uncertainty. In the presence of a temporary supply shock this might be a suitable way to avoid output fluctuations resulting from forcing inflation back to target within two years, provided it is applied symmetrically, *i.e.* also when inflation overshoots. However, given that there is considerable uncertainty about the persistence of the supply shocks stemming from globalisation, such an approach at the moment bears the risk of output losses due to an overly strict policy stance. Therefore, it might be advisable in certain circumstances to lean towards a more expansionary policy in case of prolonged undershooting, also to get more insight into how inflation behaves in the new environment.[14] This kind of "constrained discretion" about the horizon over which inflation will be brought back to target after a shock is one of the strength of the inflation targeting strategy (King, 2005). At the same time, it has to be acknowledged that the current situation with double-digit growth of real estate prices, the scaling back of housing taxation by the government and the rapid credit growth is special. Given this, a more cautious monetary policy might therefore be required currently.

As short- to medium-run inflation becomes more uncertain and deviations from target more persistent, long-run inflation expectations should be closely watched as more flexibility is introduced into the policy making process. Besides clarifying the policy approach in speeches and in publications, public understanding of the factors that underlie the forecasts as well as of the weight of inflation and output in its policy decisions is likely to be helped by the Riksbank's recently announced plan to base the forecasts for inflation on its own assessment of the future policy rate.[15] This may also improve guidance of the public regarding the future policy stance, thereby potentially increasing the effects of monetary policy. In addition, devoting more resources into analysing whether the forces driving inflation have changed over the past is an important challenge for the future, which would improve the basis for forecasting. In this regard, communicating more clearly whether inflation has been affected by domestic or foreign factors might help motivating policy steps better.

Conclusion

The effects of globalisation on inflation are changing character and are still surrounded by uncertainty, in particular regarding their persistence. How monetary policy reacts will be important for Sweden's macroeconomic performance and will be serving as an example for other countries confronted by similar inflation dynamics. This also holds for the Riksbank's recent decision to publish its preferred path for future interest rates, which was a key recommendation during the preparation of this report. Remaining recommendations are summarized in Box 2.4.

Box 2.4. **Recommendations regarding inflation and monetary policy**

- The downward adjustment of the price level in certain sectors following increased competition and deregulation is to the benefit of Swedish consumers and should be welcomed. Regulatory reform should continue, in particular to promote competition in the construction and in the electricity sectors, where price levels are significantly above the European average.
- The central bank's decision to sometimes lengthen the time horizon for achieving the inflation target is sensible if indeed the positive supply shocks are temporary, but it will be costly if the rise in productivity growth proves to be lasting. With short- to medium-run inflation becoming more uncertain, long-run inflation expectations should be closely watched, to ensure that these remain well anchored.
- Given the apparent persistence with which globalisation, increased competition and productivity growth have kept actual inflation outcomes below projections, more resources should be devoted to analysing these underlying mechanisms of inflation developments, thereby improving the basis for forecasting.
- In speeches and publications, the Riksbank has clarified that it considers house prices only in so far as they can be expected to impact on future consumer price stability, but these clarifications could need repetition to ensure that they are well understood by the public. The Riksbank's policy could be supported by a more thorough empirical assessment of the sustainability of house prices and household indebtedness, the channels through which they impact on price stability as well as of the effects that monetary policy can have in countering it.

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Notes

1. In addition, UND1X also excludes direct effects of changes in indirect taxes and subsidies.
2. Due to measurement problems of the trading-partner countries' export prices and due to the fact that a share of imports from non-EU countries reaches Sweden via another EU country, the effect of the import switch is probably even underestimated.
3. Examples of deregulation in the 1990s include the deregulation of rail transport, taxis, domestic air travel, postal and telecom markets and electricity generation and distribution. Furthermore, a new competition law had been introduced in 1993 and regulations were harmonised with EU rules.
4. Netto and Lidl both more than doubled their market shares from 2004 to 2006 with each of them having a share now of around 2% (Linnhag, 2006).
5. The Planning Act traditionally gives municipalities the right to regulate the use of available space for agricultural, industrial, business and recreational purposes. Municipalities thereby play a crucial role in the establishment of local businesses, arguably contributing to the highly oligopolised structure in the retail grocery trade in Sweden (OECD, 1999).
6. Posen and Gould (2006) compute the difference in average wage restraint between the periods 1991-98 and 1999-2004.
7. The equation is estimated over the period 1975Q1 to 2000Q1 using the labour shortage data for the manufacturing sector from the National Institute of Economic Research's Business Survey results, annual consumer price inflation and data on nominal hourly earnings growth in manufacturing from the OECD Main Economic Indicator database. From 2000Q2 onwards a simulation is performed, using the estimated coefficients from the model and actual values for inflation and labour shortages.
8. This is being helped by the fact that Sweden has no special restrictions on worker mobility from the new EU member states.
9. Based on data from the OECD STAN database over the period 1996-2002. IMF (2006) presents evidence for a negative relationship between growth in openness and producer price inflation across countries and sectors.
10. Rogoff (2006) states that, seen from this perspective, emerging markets are even exporting inflation (rather than deflation) to the other sectors in the global economy.
11. This is in line with Gurkaynak *et al.* (2005), who analyze global long-run inflation expectations in more detail and find that they remain more firmly anchored and react less to temporary shocks in countries where the central bank has an explicit inflation target, such as Sweden and the UK.
12. While recognizing that the theoretical discussion surrounding an optimal policy approach is ongoing, Ingves (2006) argues that this should not prevent the Riksbank from ignoring the risks of an asset price bubble to future inflation and economic activity.
13. Bank of England governor Mervin King described central banks that are only concerned with inflation, thereby not taking output considerations into account, as "inflation nutters".
14. King (2005) describes monetary policy in practice as "a continuous process of learning embedded" (p. 8).
15. This is practised by Norges Bank and the Reserve Bank of New Zealand. Until February 2007, the Riksbank used market expectations of the future interest rate path in its inflation forecast models.

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ANNEX 2.A1

The Giavazzi-Mishkin report

The following recommendations were made in the report *An Evaluation of Swedish Monetary Policy between 1995 and 2005* by F. Giavazzi and F.S. Mishkin.

The conduct of monetary policy

1. The Riksbank should more clearly explain that flexibility in its inflation targeting regime implies that the conduct of monetary policy should try to reduce both inflation and employment (output) fluctuations.
2. The Riksbank should clarify that asset prices (housing prices, stock prices and exchange rates) are not independent targets for monetary policy.
3. Persistent undershooting of the inflation target suggests that monetary policy should lean towards more expansionary policy (while persistent overshooting should bias monetary policy to be relatively more contractionary).
4. The Riksbank should provide more information on the future path of policy rates that are used in producing its forecasts of inflation and the economy, but should make clear the uncertainty surrounding such a path.
5. The inflation target should be defined in terms of a price index that is not directly affected by the costs of housing.
6. There is no compelling reason to change the level of the inflation target from the 2% number. But further study of the appropriate level of the inflation target could be beneficial if it is conducted by technical experts.

Governance of monetary policy

7. The dialogue between the Sveriges Riksdag and the Riksbank needs to be enhanced by separating the release of the *Inflation Report* from its discussion in the Finance Committee.
8. A main venue for public debates on monetary policy is in the parliament.
9. Individuals who are nominated to the Executive Board of the Riksbank should be asked to appear in parliamentary hearings before they are appointed.

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Chapter 3

Making employment inclusive – for immigrants and natives alike

Swedish employment rates of prime-age men and women have not recovered to the level they were at before the deep crisis in the early 1990s. This is problematic because labour supply is crucial for long-run fiscal sustainability and because lower employment rates partly reflect involuntary exclusion generated by factors like taxes, benefits, labour-market institutions and attitudes. Policy reform is therefore needed. This chapter first assesses the ambitious initiatives concerning unemployment benefits, employers' contribution rebates and in-work tax credits introduced from 2007. It then focuses on immigrants: some come from deprived backgrounds with limited skills while others are highly trained. Better integrating this wide diversity on the Swedish labour market is a key challenge. It requires attention to wage flexibility as well as employment protection rules that make it risky for firms to hire immigrants whose capabilities are often difficult to gauge. Finally, progress on reducing sickness absence is reviewed.

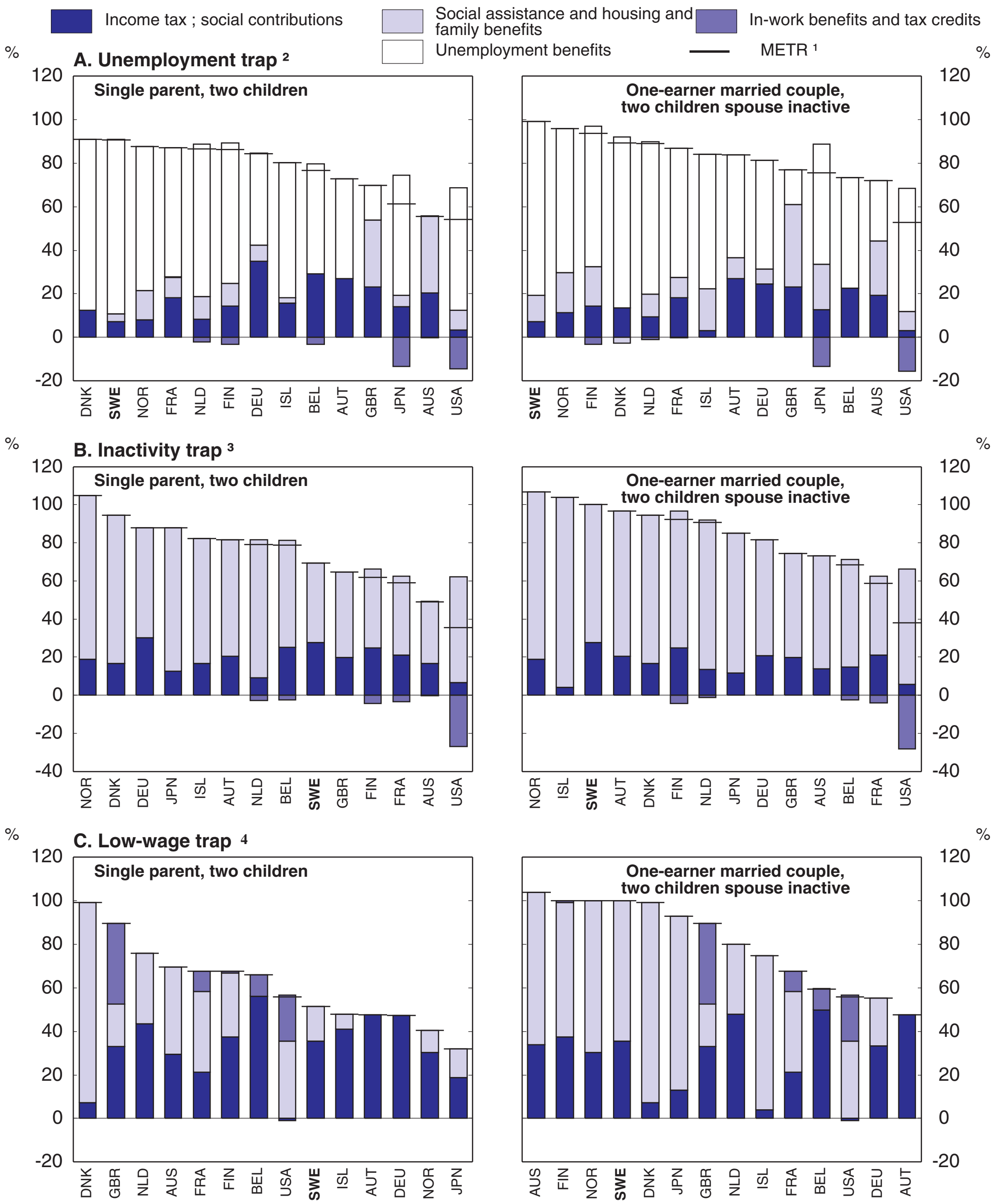
Taxes, benefits and work incentives

Sweden has some of the highest tax rates on earned income and some of the most generous welfare benefits in the OECD. The economic reward for working is therefore relatively limited for large parts of the population. A "fact sheet" describing Swedish tax and benefit rules as of 2006 is included as Annex 3.A1. Here is how Sweden compares internationally prior to the reforms introduced by the 2007 Budget:

- The income replacement provided by unemployment insurance is among the most generous in the OECD for persons with low income. This makes the effective tax on moving back to work very high, reflecting a 80% gross replacement rate in addition to social contributions, income taxes and withdrawal of other benefits (Figure 3.1, panel A). For those who can command an income above 70% of average full-time earnings, the unemployment benefit ceiling means that effective replacements rates are lower, thereby attenuating the effect of unemployment traps.
- The one-for-one withdrawal of social assistance against earned income means that some persons have no net income gain at all when moving from inactivity to employment, or if advancing from very-low to low pay (Figure 3.1, panels B and C). As in other countries, housing benefits and social assistance favour households with children in order to prevent children from growing up in poverty and work disincentives from benefit withdrawal therefore affect parents more than other adults. The one-for-one withdrawal of social assistance implies a marginal effective tax rate of 100%, but it is concentrated on a fairly short segment of the income scale. For a typical single parent with two children, social assistance withdrawal would extend up to gross income a bit above a third of average full-time earnings. For a couple with two children where both adults are inactive, social assistance is higher, and if one of them is offered work, they would need to be paid more than half of average full-time earnings before having any immediate financial reward for going into employment.
- After withdrawal of social assistance ends, withdrawal of housing benefit starts, but as it is more gradual, the resulting marginal effective tax rates are relatively moderate. This is why both the inactivity trap and the low-wage trap for a single parent getting a job paying 50% or progressing from 50% to 55% of average full-time earnings are less pronounced than in most comparable OECD countries (Figure 3.1, panels B and C).
- The state income tax implies strong progression from just above average full-time earnings. In combination with employers' and employees' contributions, municipal income taxes and consumption taxes, it means that 35% of the full time employed face marginal taxes above 70%, giving a strong incentive to work short hours and leaving the individual with only little of the economic gain from entrepreneurship and increased effort. Even compared to other Nordic countries, this is high, and Sweden and Denmark are the only two OECD countries to have such high marginal effective tax rates from just above average full-time earnings (Figure 3.2). The disincentives are exacerbated for incomes above 150% of average full-time earnings, where an additional 5% marginal tax

Figure 3.1. **Work incentives for low-income persons**

Combining employee contributions, income taxes and benefit withdrawal, 2004

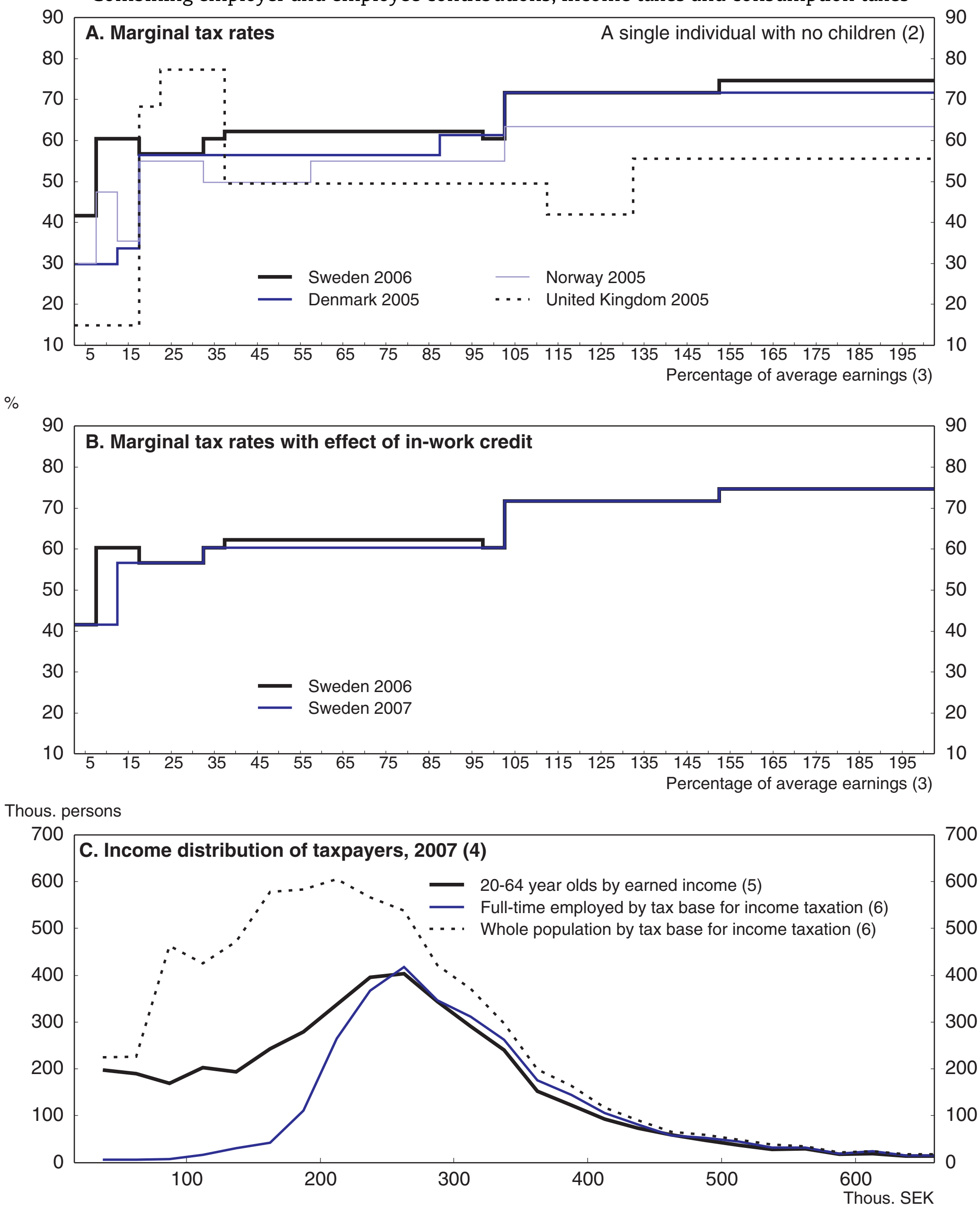


1. The marginal effective tax rates (METR) are calculated as one minus the ratio between the change in net income and the change in gross income.
2. Unemployment trap: METR on the gross income gain from moving from unemployment benefits to full time work earning 67% of average full-time earnings for someone having earned 67% also before becoming unemployed.
3. Inactivity trap: METR on the gross income gain from moving from inactivity to part-time work earning 50% of average full-time earnings. As in Sweden, working time does not directly affect benefit entitlement or taxes, the METR would be the same for someone moving from inactivity to full-time work earning 50% of the average.
4. Low wage trap: METR on a 10% pay increase from 50% to 55% of average full-time earnings.

Source: OECD (2005a), OECD *Employment Outlook*, Chapter 3, updated with 2004 data from OECD tax-benefit models.

Figure 3.2. **Marginal tax rates for average and high income persons**

Combining employer and employee contributions, income taxes and consumption taxes[1]



1. Average consumption taxes are 31.1% for Denmark, 26.2% for Norway, 29.3% for Sweden and 17.5% for the United Kingdom.
2. In Sweden, the family situation only matters for benefit entitlements, whereas social contributions and taxes are strictly individual. The Swedish tax schedule shown in this figure therefore applies to everybody.
3. Recently, the OECD has redefined the average income concept to base it on a wider group than just production workers. Average worker (AW) full time earnings were SEK 309 854 in 2005, compared to average production worker (APW) full time earnings of about SEK 259 000. The difference is larger than for other countries, thereby "compressing" the curve for Sweden relative to other countries compared to previous OECD publications.
4. The income distributions are based on the FASIT model and the 2004 HEK household survey updated to 2007 level. The horizontal scale matches the AW% shown in panels A and B.
5. Earned income is the base for the new in work tax credit.
6. The tax base for income taxation includes earnings, fringe benefits, unemployment and other income support and pensions, etc. It does not include capital income which is taxed separately.

Source: OECD, *Taxing Wages 2004/2005* and the associated tax equations; OECD Analytical database; Ministry of Finance, Statistics Sweden and OECD calculations.

(*värnskatt*) was introduced as a temporary measure of fiscal austerity in the mid-1990s, but never removed again.

In the recent literature, calculations have become available that weigh together the tax incentives faced in different situations based on the actual prevalence of different household types in Sweden. Based on a detailed sample, it is estimated that the average person being out of work and receiving unemployment benefits or participating in a labour market programme would retain an annual income increase of SEK 44 400 if moving into a full-time job with gross wage costs of SEK 300 000. Measured as a percentage, the average person retains 14.8% of the gross wage cost incurred by the employer. Although additional taxes and contributions only amount to 20% of the gross wage cost, the generosity of benefits available for the unemployed and programme participants means that their withdrawal amounts to 65% of gross wage costs in the new job. Meanwhile, the average person in – work would retain 40.2% of a marginal pay increase, while the rest would be absorbed by larger employer and employee contributions, income taxes, reduced income benefits, and consumption taxes when the money is spent (NIER, 2005 and 2006b; Öberg and Hussénius, 2006).[1]

Taking the actual prevalence of difference household types into account is important, and it should be noted that one-earner couples are not common in Sweden, as women and men are more-or-less equally likely to be working. If one spouse has no income, the other's income would effectively provide insurance, reducing the recourse to social assistance. Female labour market participation reached its current level several decades ago, and therefore social security arrangements have been optimised to resolve other disincentives than the rather severe unemployment, inactivity and low-wage traps for low-income one-earner couples, shown in Figure 3.1, which do not matter for most Swedes.

If a significant share of immigrants arrive with a different gender and family model, however, the current Swedish social security system may discourage labour market integration for those with limited skills.[2] This schism illustrates very well the challenge that Sweden is facing regarding work incentives and labour market institutions more generally. Careful ongoing reform has ensured that work incentives are reasonable for the situations in which most people would typically find themselves. For example, a multi-year programme has been completed in 2006 with income tax reductions to compensate for increased employee pension contributions. With relatively generous benefits, and the highest tax-to-GDP ratio in any OECD country, however, it is unavoidable that substantial disincentives arise somewhere. The challenge of making employment more inclusive is to a large extent a matter of resolving such disincentives affecting various specific groups. Questions arise like: can exclusion be tackled via refinements to the tax system to reward work, or are tighter conditions for receiving benefits also needed? Can the general model be made more inclusive, and what would that require? Or should more targeted measures be sought for to address the problems of particular groups? These questions recur throughout this chapter when discussing how everyone can be given a fair of chance of getting inside the labour market, and then progress to higher earnings.

New policy initiatives to make work pay

With the 2007 Budget, the government is introducing a range of policy initiatives aimed at giving more room for individuals to improve upon their economic situation via working. A set of changes in unemployment benefits, income taxes and employers' contributions will raise both labour supply and demand for those with low-to-average earnings potential (Box 3.1).

Box 3.1. **Initiatives in the 2007 Budget to make work pay**

Unemployment insurance will be adjusted to ensure that moving into work is always economically rewarding. The SEK 680 a-day maximum currently setting in after 20 weeks will apply throughout, and the gross replacement rate will decline from 80% to 70% after the first 40 weeks. Exceptions allowing prolonged benefit duration will be narrowed, so that the 60 week maximum becomes binding, except for those with dependent children who will be able to claim unemployment benefits for 90 weeks. When the benefit period ends, the person will be transferred to a job and development guarantee with a gross replacement rate of 65%. Hitherto, the level of unemployment benefits has been calculated based on the last 6 months' income, but this will be changed to 12 months. Moreover, the government intends to make unemployment insurance compulsory so that all would have similar benefits in case of unemployment.

An in-work tax credit (*jobbskatteavdrag*) will reduce unemployment and inactivity traps, by letting the person keep an additional SEK 5-11 000 annually of the income generated when going into work. Those going into low-paid part-time work will also have a considerable gain, and the credit will grow with income so that it effectively reduces marginal effective tax rates for those with incomes over the range from 40% to 95% of average full-time earnings by the equivalent of 4 percentage points on the schedule shown in Figure 3.2. For those aged 65 or more, a higher credit worth SEK 13-20 000 will be available.

For a number of targeted groups, new rebates will reduce employers' contributions below the general 32¼ per cent. These measures apply also to the self-employed.

- For everyone aged 65 or older, non-pension contributions will be abolished, so that total employers' contributions will be reduced to 10%.
- For everyone aged 19-24, non-pension contributions will be halved, so that total employers' contributions will be reduced to about 21%. Pending technical preparations, this can only take effect from July 2007.
- Under a New-Start Job scheme (*nystartjobb*), all private employers' contributions will be waived for those coming into work after more than a year in unemployment, sickness or disability pension. Employers' contributions will be waived for as long as the preceding joblessness spell lasted, though only up to a maximum of five years. For those older than 55, contributions will be waived for twice as long. Unemployed youth aged 20-24 will be eligible already after six months, but for them contributions will be waived for at most one year. For refugees and humanitarian immigrants as well as their close relatives, contributions will be waived during the first three years after gaining residence permission. Eligibility will be conditional on wages and working conditions being in accordance with the normal collective agreements. Employees will also be covered by the general employment protection legislation. To facilitate wage growth, the scheme will not be limited to a particular income level.

An income tax credit will be introduced for private households' purchase of domestic services. Pending detailed preparations, implementation is expected by mid 2007. It is envisaged that the tax reduction would amount to half of the labour cost with an annual ceiling of SEK 50 000 per person.

For restaurants, repair of household machines, catering, hairdressing and similar sectors where do-it-yourself or the grey market is a relevant alternative to purchasing professional service, the government intends to waive non-pension contributions, so that total employers' contributions would be cut to 10%. But because such general rebates have to be examined in the light of EU rules on state aid, introduction of this measure is not expected before mid-2008.

The in-work tax credit is by far the most expensive element in this package as this measure alone implies a revenue reduction of SEK 40 billion, equal to 1.3% of GDP. For comparison, lower employers' contributions for 19-24 year olds and for certain service sectors will each cost a bit more than 0.1% of GDP, while deductibility for domestic services and the New-Start Jobs will each cost a bit below 0.1% of GDP when having full effect. Part of the financing comes from ending tax deductions for union and unemployment insurance membership fees. Moreover, a number of labour market programmes will be abolished. These include paid sabbaticals (*friåret*), bonus jobs (*plusjobb*) where long-term unemployed, seniors in particular, are employed by local authorities to do less-needed work, replacement positions for someone on study leave, special jobs for recent graduates, and general job subsidies.[3] The reforms are thereby more-or-less financed in a static sense, and the government expects that dynamic effects with increased employment will improve public finances sufficiently to give room for extending these tax cuts in a second stage already in 2008. Ending programmes like paid sabbaticals should be welcomed also because evaluations have found that paid sabbaticals not only failed to increase participants' future labour supply, but even had a negative effect on their subsequent earnings in the order of one year's normal wage increase (Skans and Lindqvist, 2005).

All of these initiatives will help to raise the number of persons in employment, but they are not equally important. Reducing replacement rates and duration of unemployment benefits has a large positive effect. Estimates made as part of the update of the OECD Jobs Strategy indicate that a reduction of the magnitude now implemented in Sweden would bring down structural unemployment by about half a percentage point, and increase employment rates by even more (Table 3.1). The effect comes *inter alia* from unemployed persons searching more intensively and being more flexible with respect to commuting and types of jobs considered. Collective agreements may also be more attentive to the risk of increased unemployment if wages are raised too much, and this may allow more people to enter the labour market.

The in-work tax credit is hard to assess because, in the absence of studies modelling such measures in detail within a Sweden context, much of the policy debate relies on studies for the United States and the United Kingdom. There, evaluations typically find in-work tax credits to be successful at getting more people into work and thereby contributing positively to social inclusion and avoiding that children grow up with workless parents. Getting into work is also an important step towards earnings progression. Furthermore, ensuring that it does pay to move from benefits to work, may enhance the effect of other labour market policies and, for example, make it easier for case managers to convince a de-motivated unemployed person that she has to exert more effort trying to find a job.

However, the costs of achieving these positive effect *via* in-work tax credits may be higher in Sweden. While unemployment and inactivity traps are clear, the narrow earnings distribution makes it difficult to ease the tax on moving into employment without generating other problems. In fact, a four-country comparison of stylised in – work tax credits found that such instruments were somewhat less suited for the Swedish economy than for a German, UK or US context. If the in-work tax credit is targeted at low-income earners, the withdrawal of the credit as income grows will add to effective marginal taxes, and because of the narrow earnings distribution, this will affect a large part of the workforce. If not withdrawn for middle and higher income earners, even a modest in-work tax credit becomes very expensive as it is given to everyone in employment. Moreover, the credit is likely to lead some to work shorter hours; even if the income elasticity of labour supply is

Table 3.1. **Effects of adjustments to unemployment benefits**

Likely long-run effects of the changes of unemployment insurance benefits introduced January 2007 based on estimates for an average OECD country, percentage points

		Low estimate	High estimate
Unemployment rate		– 0.4	– 0.6
Employment rate of:	20-24 year olds	+ 0.7	+ 1.2
	of 25-54 year old men	+ 0.5	+ 0.9
	of 25-54 year old women	+ 0.9	+ 1.6
	of 55-64 year olds	+ 0.6	+ 1.0

Note: Empirical analysis being part of the update of the OECD Jobs Strategy has estimated that a 10 percentage point reduction in the gross replacement rate, in an average OECD country, would reduce the equilibrium unemployment rate by 1.2 percentage points, while increasing the employment rate of 25-54 year old men and women by 1.7 and 3.2 percentage points respectively. For 20-24 year olds and 55-64 year olds, employment rates would increase by 2.4 and 1.9 percentage points respectively, women and men combined (OECD, 2006a; Bassanini and Duval, 2006).
The measure of gross replacement rates underlying these estimates is the so-called summary measure of benefit entitlements (OECD, 2004a). It is the unweighted average of two earnings levels (average earnings and two-thirds of this level) over three time periods (the first year, the second and third years, and the fourth and fifth years of unemployment). It also considers three household types (single, dependent spouse and spouse in-work), but in Sweden unemployment benefits do not depend on the family situation. The changes introduced with the 2007 Budget have the following effect: For the average-earnings person, the lower ceiling will reduce the gross replacement rate by about 5 percentage points during the first 20 weeks, and the 65% rate applying from week 61 will marginally reduce gross replacement rates. For the -of-average-earnings person, gross replacement rates will be reduced 10 percentage points during week 41-60, and then to 15 percentage points when the activity guarantee starts from week 61. Until the changes introduced with the 2007 Budget, unemployment insurance benefits could, in practice, be claimed for 120 weeks, as the official 60 week duration was prolonged by an additional 60 weeks. This will no longer happen, implying a considerable reduction in gross replacement rates in week 41-120. If the summary measure of benefit entitlements is calculated based on changes over the first 120 weeks, then it moves just below 3 percentage points. This is what lies behind the table's *low estimate*. Alternatively, comparing the new 65% rate with the old 80% rate all to the of the summary measures horizon, the summary measure is moved slightly more than 5 percentage points. This is what lies behind the table's *high estimate*.
Source: OECD calculations.

small, the aggregate effect can be important as everyone is affected. In stylised model simulations of a phased – out credit, the reduction in average working time is so large that it dominates the effect from more persons being employed, meaning that total hours worked contract in the Swedish context, as opposed to being unchanged in the German context and increased in the UK and US contexts (Bassanini, Rasmussen and Scarpetta, 1999). This result can also occur if the credit is not phased out for those with middle and high earnings, due to the stronger income effects (Rasmussen and Lundsgaard, 1999).

There is no doubt that the in-work tax credit will help reduce exclusion and raise the number of persons in employment – but the effect on total labour supply might be bigger from other income tax cuts. Based on cross-country correlations of the employment effects of tax-wedge differences, the National Institute of Economic Research estimates that the in-work tax credit introduced from 2007 might reduce structural unemployment by 0.2% while having a somewhat larger effect on employment as inactive are attracted to enter the labour market (NIER, 2006a). Encouraging more persons to move into employment is indeed the prime aim of the in-work tax credit. Meanwhile, it should be noted that the effect on total hours worked is mixed. Some of those already employed earning low and middle incomes are likely to choose somewhat longer hours, for example shifting from part time to full time. However for persons already employed with above-average earnings, the credit has no effect on effective marginal taxes and thereby no positive substitution effect. It is simply a lump-sum with a negative income effect making them choose slightly shorter hours.[4] A thorough model-based comparison of alternative tax reforms is available for Denmark, which has a broadly similar income tax scale. Despite unemployment benefits being even more generous for low-income groups than in Sweden, it is found that although the in-work tax credit can draw more persons into employment, the effect is not very large, and tax reforms equivalent to moving up the income threshold above which the Swedish state tax is paid, or reducing the rate of state tax, would boost total labour supply by more. Even with cautious behavioural assumptions, about half of the initial revenue loss from such tax cuts is estimated to come back due to the dynamic effect of increased labour supply, which is more than for the alternative of in-work tax credits (Danish Ministry of Finance, 2002 and 2004). Other studies find even stronger dynamic effects of cutting the high marginal taxes for above-average income earners (Kleven and Kreiner, 2006). One reason for this outcome is that the balance of income and substitution effects is better: reductions in the state income tax rate imply negative income effects only for those who will be affected by the positive substitution effect.

In sum, the merit of the in-work tax credit may well hinge on the fact that it is introduced in combination with a reduction in unemployment benefits. These two measures are indeed linked in the government's programme following the logic that the income deciles affected by benefit reductions should also be the ones to have income tax cuts, thereby making it clear that below-average income groups gain from the reform package.

Going forward, more analysis is needed to disentangle the likely effect of tax and benefit reforms in a Swedish context. Indeed, measures of marginal taxes and gains from moving into work for the average person may hide significant heterogeneity, and the most economically warranted policy initiatives are therefore likely to involve a mix of adjustments focused on the persons facing the most severe disincentives. The following routes would seem promising for continued tax-benefit reform:

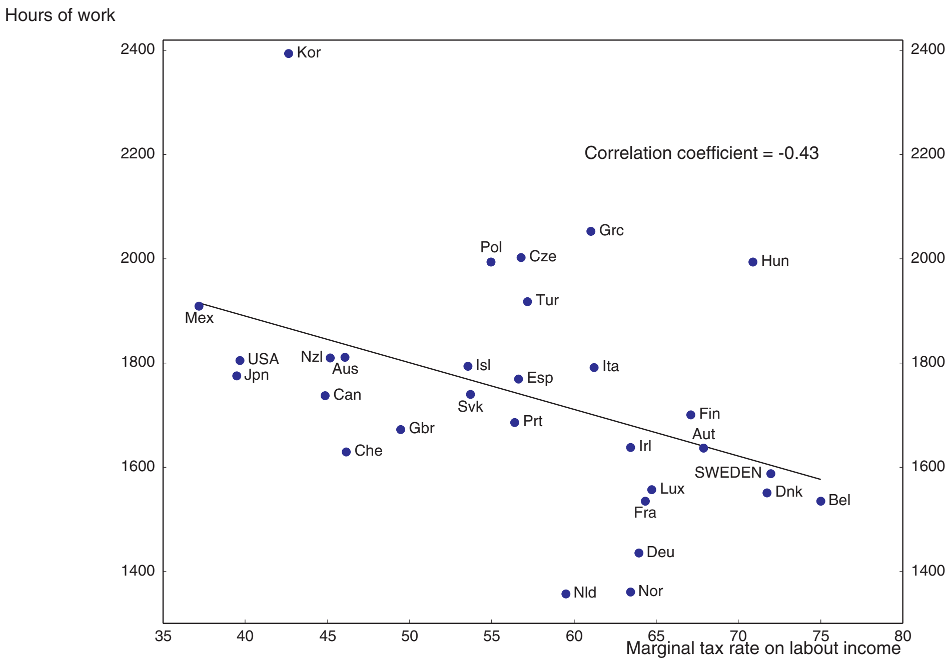
- The basic reason why the income gain from moving into work is modest for some is that income support is relatively generous for those out of work. Emphasising that these benefits are conditional on the person's active efforts to find work is therefore essential. Benefit sanctions exist that can underpin this obligation, for example in case a person does not show up when convened for a job interview, but they are applied less frequently in Sweden than in other OECD countries (Grubb, 2001). Developing the way sanctions are used might be warranted, however, as a recent official survey found that 4 out of 10 unemployed did *not* search for any job during the month of October, despite the growing number of vacancies.[5] Getting a wider palette including moderate sanction to be used for moderate faults might, as planned, be a way forward. Clearer requirements for the unemployed to search and accept job offers outside their narrow professional field might also be enhanced. It would all help to ensure that more of those currently unemployed would benefit from the upswing.
- Given the high level of youth unemployment, the employer contribution rebates introduced now may need to be paralleled by stronger incentives acting directly on the young person. Indeed, some countries have been very successful at bringing down youth unemployment by a combination of short benefit duration and enhanced training offers. In Denmark, youth unemployment was 1-2 percentage points above the overall unemployment rate in the late 1980s and early 1990s, but since the mid 1990s, when the unemployment duration was shortened to half a year for those below 25 without children, youth unemployment has been 2 percentage points below the overall rate (Welfare Commission, 2006). One particular element to consider in Sweden is the special

rule making housing benefit available also for persons without children if they are younger than 29. These people can get up to SEK 13 500 a year, which are withdrawn in a way that adds 33 percentage points to marginal taxes for income in the range from SEK 41 000 to up to SEK 81 500. Abolishing this special housing benefit would contribute appreciably to making work more rewarding than unemployment or inactivity, but attention might be needed to avoid that vocational training becomes unattractive relative to unskilled work.

- Tax reform should be continued by complementing the in-work tax credit with reductions in the marginal taxes generated by the state tax. The in-work tax credit reduces marginal income taxes over the SEK 100 000-300 000 range. Meanwhile more than 35% of the full-time employed face very high marginal taxes resulting from the state tax (Figure 3.2). As a share of all tax payers, the number concerned is expected to increase to over 18% in 2007, despite an explicit intention from the 1990/91 tax reform that this share should remain below 15%.[6] Comparison across all OECD countries would indicate that the high marginal taxes setting in early is part of the reason for the low average hours worked in Sweden (Figure 3.3). The state income tax could be reduced in a number of different ways combining increases in the income threshold from where it is paid or cutting the rate. One option would be to cut the general state income tax rate from 20% to 10% while increasing the additional state income tax setting in above 150% of average full-time earnings from the current rate of 5% to 10%. The highest rate of state income tax would thereby come back to what was intended with the 1990/91 tax reform,

Figure 3.3. **Taxes and hours worked**

Combining employer and employee contributions, income taxes and consumption taxes
A single individual with no children earning 110% of average full-time wages, 2005



Source: OECD, *Taxing Wages 2004/2005*; OECD Analytical database.

while the reduction in marginal taxes would be strongest for incomes in the interval from 100 to 150% of average full-time earnings.

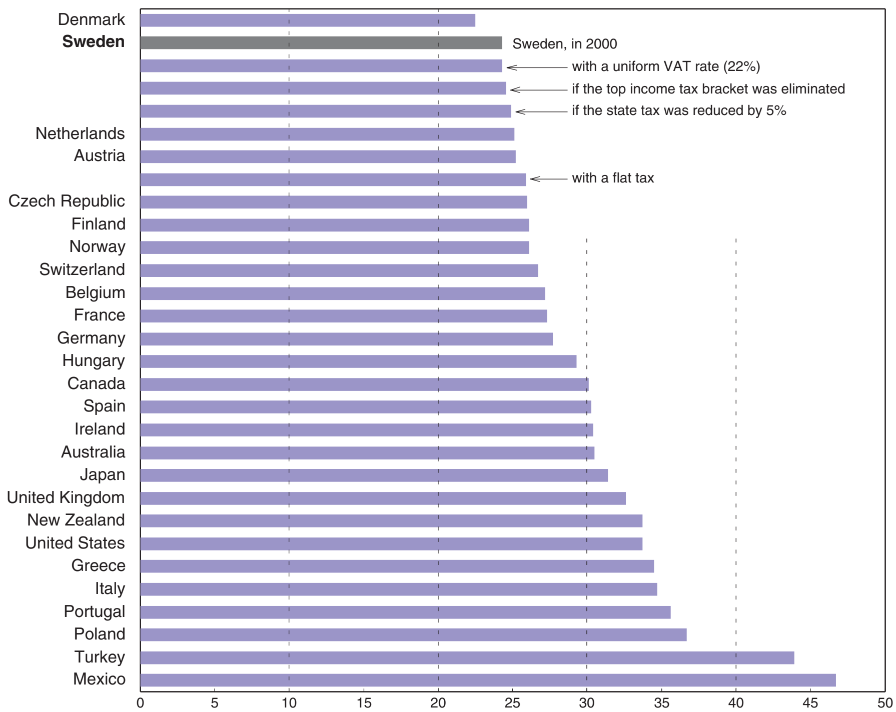
Because the state income tax applies already from a point where there is still a fairly high concentration of tax payers, moving up the threshold by SEK 100 000, for example, would halve the number of persons liable, but cost less than a quarter of the revenue. In fact, with total state income tax revenues being 1½ per cent of GDP, making the income tax scale flat by completely abolishing the state income tax would cost only slightly more than the in-work tax credit just introduced – even without considering positive dynamic effects. And even in this extreme case, the income distribution would still be more equal in Sweden than, for example, in Norway (Figure 3.4).

A natural way of financing cuts would be to reconsider the easing of property taxes, as recommended in Chapter 4, and to move towards a uniform VAT, as recommended recently by a government commission (SOU, 2006). Such measures could free substantial resources for income tax cuts.

- The situation of single parents may also require attention, although concerns about repercussions on child development means that benefit reduction is not a straightforward route. Effective marginal taxes are rather high due to the withdrawal of housing benefits. With three children, there is a maximum housing benefit of

Figure 3.4. **Income distribution with and without state income taxes**

Gini coefficients in 2000[1]



1. A higher GINI coefficient implies greater income inequality. It can range from 0 (everyone having the same income) to 100 (one person having all the income).

Source: OECD calculations; Swedish Ministry of Finance; Förster, Michael and Marco Mira d’Ercole (2005), “Income distribution and poverty in OECD countries in the second half of the 1990s”, OECD, Social, Employment and Migration Working Papers No. 22.

SEK 57 000 which is withdrawn in a way that adds 20 percentage points to marginal taxes for incomes in the range from SEK 117 000 to SEK 402 000. For most single parents, housing benefit withdrawal implies effective marginal taxes similar to those implied by the state tax. But in extreme cases it can overlap with the state tax. This is an additional reason to raise the threshold for the state tax. Child care provisions are generally very good and have helped substantially to facilitate more labour supply.

Reducing employers' contributions for particular sectors will give rise to a number of difficult practical problems about how to define the exact line between those sectors that are covered and those that are not covered in a way that is sufficiently clear to be put into law. Doing this in a way that avoids distorting competition is particularly difficult with respect to firms that are active in multiple activities and sectors.

The tax credit for domestic services can incur some of the same delimitation problems, although to a smaller extent. Moreover, the employment effects may be larger because it helps notably high-income groups to expand labour supply by freeing time when some domestic tasks are referred to someone from outside. The National Institute of Economic Research has estimated that a scheme broadly similar to what the government intends to introduce would increase employment by 0.1-0.5%, equal to 3 000-19 000.

Abolition of the income-tax deductibility of unemployment insurance fees will to some extent counteract the effect of the in-work tax credit, as membership fees are only paid by those in-work. However, in combination with the introduction of some fee variation across funds it may enhance attention to administrative efficiency and fraud control. With most insurance funds being linked to unions, it may also discipline wage formation as labour-market insiders will see a direct personal cost if excessive wage growth leads unemployment to rise.[7] Starting from completely uniform fees, differentiation will be introduced, with a cap meaning that no fund will be required to raise contributions by more than SEK 300 a month. Although fee differentiation may bring some advantages, but probably larger gains could be achieved by replacing the current system of numerous union-organised, but publicly paid, funds with a simpler national system thereby making the same benefit available to all unemployed citizens and probably reducing administrative costs.[8] Making unemployment insurance mandatory, as the government intends, will help avoid adverse selection in response to the heightened costs of membership.

Those suffering from exclusion on the labour market can also be helped by improving the publicly funded employment services. Australia has made positive experience exposing the former public-monopoly employment service agency to competition via a quasi market. When the contractual incentives and tendering procedures are appropriate, a relatively high success rate can be achieved in terms of employment outcomes for disadvantaged clients (Box 3.2). Given the complexity of the service, a gradual piloting approach might be warranted. Indeed, the experience from Australia shows that the full benefits come gradually as the system is continuously improved, providers gain experience and the market matures.

Box 3.2. **Contracting for employment service – experience from Australia and the Netherlands**

Involving alternative providers and introducing competition in publicly funded employment services can be rather complicated. Exactly what type of services each person needs varies more for training and job-search assistance than for most publicly funded services. Therefore, agencies will need quite some flexibility to tailor the service provided to each job-seeker; it cannot be stipulated ex-ante in a detailed contract. On the other hand, as many job-seekers may lack motivation, this difficulty of contracting cannot be resolved by competition via vouchers and user choice either. In particular so, because de-motivated job seekers might opt for an agency being lax on benefit sanctions rather than actively seeking the agency giving the most adequate and effective service. The best model for involving alternative suppliers in employment services therefore appears to be competition based on competitive tendering with relatively flexible contracts and payment based on elaborate outcome indicators. Letting funding depend on outcome indicators, however, strongly enhances the incentive for cream skimming; even if the training or job-search assistance is highly effective in raising the likelihood of subsequent employment, individual characteristics and abilities may still matter much more. To avoid cream skimming, job-seekers are assigned to contracted suppliers of employment services by a government agency in both Australia and the Netherlands.

In **Australia** the public Commonwealth Employment Service (CES) was replaced by Job Network in May 1998. Under the new scheme a broad range of non-profit organisations and private firms now provide publicly funded employment services, including the matching of job-seekers with existing vacancies, job search training and individually-tailored intensive assistance to more disadvantaged job-seekers. To access Job Network services, job-seekers must be referred by Centrelink, a national agency that also processes claims and payments for a range of benefits including unemployment assistance. The internet site *www.jobsearch.gov.au* which carries job vacancies and online CVs is also under public management.

Providers are paid according to performance with the exact formula evolving over time. Initially, a commence-ment fee created teething problems with agencies seeing an incentive to enrol many clients, without necessarily providing much service. Beginning with the re-tendering in 2000, the authorities therefore now selected among the market participants based on their placement performance in the preceding contract period. This reinforces the incentives from the funding formula, where providers are now paid a combination of fee-per-consultation, some funds earmarked for training, etc., and a substantial payment when a client gets a job and keeps it for at least 13/26 weeks.

Opening the provision of employment services to competition has entailed a marked restructuring through entry of new providers, some aiming at narrow user segments, such as disabled or indigenous people, others being broader in coverage. Meanwhile the market has matured: in 1998-2000, there were 300 contracted providers, then 200 in the 2000-03 contract round, and then 110 since September 2003; as the fittest providers have survived, outcomes have improved continuously. Community-based/charitable organisations and private companies each cover about half of the market, while the public agency succeeding CES has gone out of business.

Enforcement of active participation by job-seekers lacking motivation is important for employment services to be effective. In Australia this has been solved by a procedure whereby the private providers notify Centrelink if a job-seeker does not show up for training or other appointments. Centrelink then has the legal authority to withhold income support payments until the person attends an interview at Centrelink. If a reasonable excuse is provided, payments will be restored from the date of suspension. This procedure is, in fact, similar to what exists in most countries with public employment service agencies.

Box 3.2. **Contracting for employment service – experience from Australia and the Netherlands** *(cont.)*

In the **Netherlands** a contracting system has been in operation since January 2001. Dutch workers becoming unemployed go through the public Organisation for Work and Income (CWI) which provides advice and matching of job-seekers with vacancies based on its national database. Contracting for other employment services is based on a relatively detailed system of target group segments defined by different conditions or handicaps that make it difficult for the job-seeker to find employment. Providers bid for contracts by stating a price per job-seeker served, and are then typically paid half this rate when a job-seeker has received assistance and the other half, plus a bonus, if the person is subsequently employed. Vocational training is funded separately. Competition has led to considerable restructuring dominated by large suppliers associated with the former social insurance agencies, insurance companies and health and safety services. The privatised former public agency, Kliq, went bankrupt in 2005. The improvement in outcomes appear less clear than in Australia, and they also vary considerably across segments. Part of the problem would seem to be an in-transparent tendering procedure adding to transaction costs for bidders and thereby reducing competition.

Sources: OECD (2001 and 2005b), Grubb (2006), Lundsgaard (2003), Dykstra and Koning (2007).

Integrating migrants

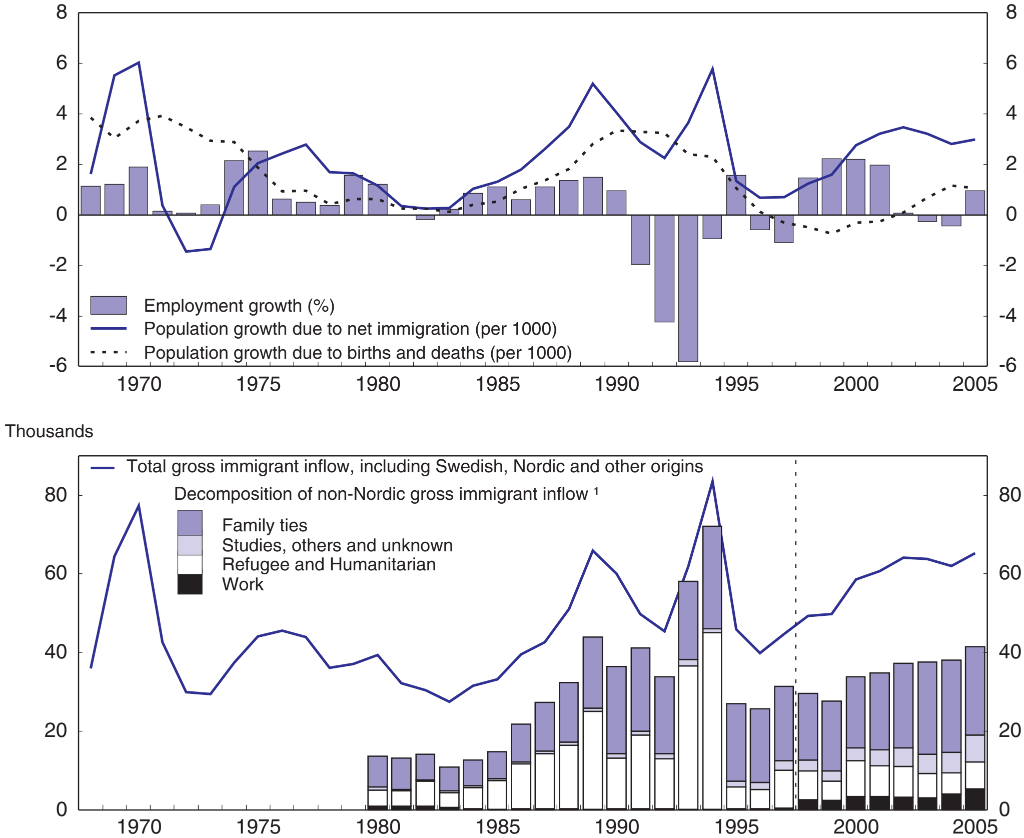
Some migrants seem to be affected by the tendency to exclusion in the labour market, and given the particularity of their situation, they warrant focused analysis. In 2004, an OECD study was made of immigrants' labour market integration in Sweden which will be published in the spring (OECD, 2007). The following draws on this study while extending the analysis with more recent material and widening the perspective on how general labour market and welfare institutions affect immigrants. To understand the situation, it is useful to start by looking at who comes to Sweden.

Migration flows and labour force diversity

For natural reasons, migration flows fluctuate, but the drivers of these fluctuations have changed over time. From the end of the second world war to the early 1970s, labour mobility played a large role. The manufacturing industry and service sector expanded rapidly, with workers immigrating from other Nordic countries as well as Germany, Austria and Italy during the 1950s and Yugoslavia, Greece and Turkey during the 1960s. At the end of the 1960s, immigrants accounted for over 6% of the working-age population. Being motivated by job search, migration flows were highly responsive to changes in labour demand. During 1969-70, net migration added over ½ percentage point to annual population growth as up to 80 000 Finnish citizens emigrated to Sweden in a context of financial and economic crisis in Finland, but growing labour demand in Sweden. Right after, net immigration turned negative as employment growth stalled during 1971-73 (Figure 3.5).

Since the late 1980s, migration flows have been much less responsive to the labour market situation, as refugee and humanitarian migration and immigration for family reasons took over as the main reason for coming to Sweden.[9] Inflows even increased during the Swedish crisis years and peaked with asylum seekers from ex-Yugoslavia when labour demand reached an absolute low in 1993-94. This implies that many of the

Figure 3.5. **Net immigration and reasons for coming to Sweden**



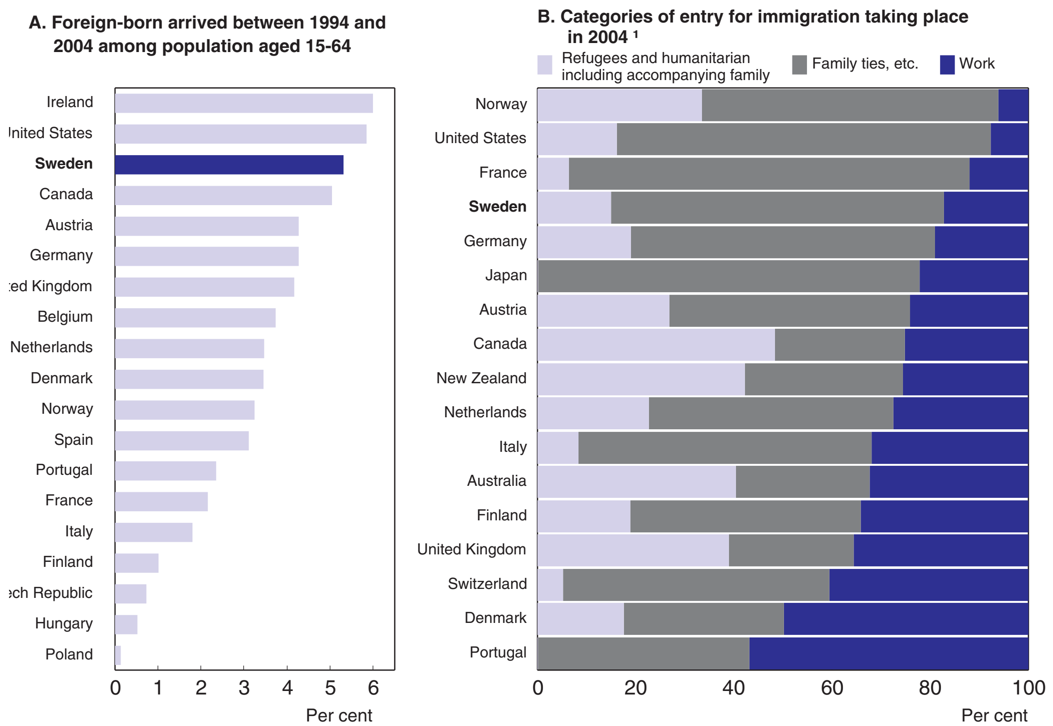
1. The decomposition by reasons for coming to Sweden can only be made for immigrants from outside the Nordic region, because citizens of Nordic countries can settle in each other's countries without prior residence permission. In addition to the immigration numbers shown by the bars, an average 15 000 Swedish citizens and 10 000 citizens of other Nordic countries have arrived each year during 2000-05. For the period 1980-97, the decomposition is based on the number of permanent residence permissions granted rather than the number of persons actually immigrating. This understates the magnitude of work-related immigration, which is to a large extent based on temporary permissions. However, the number of work-related temporary permissions was typically lower before than after 1998. In both panels, the curves include migrants of all origins and citizenships.

Source: Statistics Sweden and the Swedish Migration Board.

immigrants who are living in Sweden today have had a very difficult start to their labour market integration, as many of them arrived to unemployment and inactivity during the 1990s. From the mid 1990s, family ties have become the dominant reason for immigration, and the timing of these flows is also not very responsive to the labour market situation. Part of this is accompanying family or family reunification where spouses or children can rejoin someone previously migrated to Sweden, but family formation plays an increasing role as Swedes find a spouse abroad or as immigrants or their children find a spouse in their country of origin.[10]

A large and diversified inflow means that it is increasingly important for Sweden to have effective policies to help those immigrants for whom labour market integration is difficult. Out of a total population of 9.0 million, 1.1 million are foreign born, making Sweden's population quite diversified.[11] Immigrants having arrived over the last ten years account for a larger share of the working age population than in any other European country except for Ireland (Figure 3.6). Moreover, the share of immigrants coming for work is low compared to most other countries. The effect is that the Swedish population and workforce become more and more diversified. While there is a net outward migration of Swedish born, there is a net inward migration of people from all other origins, notably from poor countries. On average during 2000-05, 17 000 Swedish-born left the country each year while only 12 500 went in the other direction. This has been mirrored by gross migration flows of persons born in the other EU25 countries being of a similar magnitude, but implying a net inflow to Sweden, notably from Germany and Poland. Persons born in Australia, Canada, New Zealand and the United States add net immigration of about 500 a year. By contrast, inward migration is over three times higher than outward migration for people born in non-EU South-Eastern Europe, the Middle East, Africa, and Asia, the net immigration of these groups adding over 20 000 or ¼ per cent to Sweden's population each year. In 2006, net immigration to Sweden has soared to 42 000 in the first three quarters alone, similar to annual population growth of 0.6% due to net immigration.[12] One implication is that language barriers in the labour market may be more important than some decades ago, as the number of people not capable of speaking Swedish from the outset is growing. Even in the early 1970s, after the large waves of work-motivated migration during the 1950s and 1960s had brought the number of foreign citizens living in Sweden to almost the level it has today, 59% of these were from other Nordic countries and therefore able to understand Swedish without need of training, compared to just 35% in 2005.[13]

Figure 3.6. **Size of foreign-born populations and reasons for immigrating compared internationally**



1. Data are standardised to facilitate international comparison and therefore not identical to those in Figure 3.4.

Source: EU Labour Force Survey, US Current Population Survey and OECD International Migration Outlook, 2006.

It helps to balance the composition of immigration that Sweden has no special restrictions on worker mobility from the new EU member states. Net immigration to Sweden of workers from Poland and other new EU member states has increased considerably during 2006. Informing workers from abroad, who consider migrating to Sweden, about ongoing qualification needs of the labour market could be considered to guide the skill composition of inflowing workers.

Meanwhile, it is a rather young migrant population that arrives in Sweden, something that should be conducive to labour market integration. In 2005, half of all immigrants arriving in Sweden were aged 18-34, a quarter were children and teenagers, and a quarter were aged 35-64. Very few arrive at an age older than that.[14] This pattern, with more of the immigrants being rather young, is also seen in other OECD countries and is even more pronounced in countries where many immigrants come for work purposes, such as Ireland, Portugal, and the United Kingdom.

Labour market outcomes and policy options

Some immigrant groups fare better than others, but all are less employed than the native Swedes. Even for immigrants from other EU countries, the employment-to-population ratio was 5 percentage points lower than for native Swedes in 2003-04, and for immigrants from North Africa and the Middle East, there was a gap of no less than 29 percentage points. These differences are large, but the employment-to-population ratio for each immigrant group is not grossly different from how the same group fares in other host countries, except in Canada (Table 3.2). This could indicate that the large under-employment of immigrants relative to native Swedes to some extent reflects factors that are specific for each immigrant group, such as language capabilities, skill mismatch, different family models etc. Other mechanisms must be at play as well, though, as immigrants from Africa, the Middle East and Latin America are more likely to be employed not just in Canada, but also in the Netherlands, the United Kingdom and Australia.[15]

Nevertheless, it is important to raise employment rates for immigrants, because the ability to finance the elaborate Swedish welfare state with generous income benefits and public services relies on high employment rates generating tax receipts. The traditional welfare state model has been able to give relatively generous benefits because everyone has been ensured a reasonable skill level during early childhood and school. With increasing and heterogenous immigration, the distribution of skills and earnings potential has widened, notably stretching down to income levels traditionally not existing in Sweden. The consequence is that, although labour market institutions and income benefits have remained stable over the recent decade, they may now generate more substantial unemployment and inactivity traps as migrants from disadvantaged backgrounds now make up a larger share of the workforce.

Sweden has no official policy target for the average immigrant employment rate, but long-run fiscal sustainability relies on a third of the difference in employment-to-population ratios *vis-à-vis* natives being closed (Chapter 1; Ministry of Finance, 2006). That may be realistic, but it will require committed reforms to better adapt the Swedish labour market and overall economic model to increased diversity.

Table 3.2. **Labour market outcome by country of birth**

Per cent, 2003-2004

	Sweden	Germany	Netherlands	United Kingdom	Australia[1]	Canada[1]
Participation rate						
North Africa and Middle East	60	58	57	57	54	71
Latin America	71	54	73	70	–	81
Sub-Saharan Africa	68	64	62	72	78	82
East/South/Southeast Asia	68	55	62	61	65	73
Central and Eastern Europe	68	66	65	62	61	78
North America/Oceania/Japan	73	71	79	81	78	80
European Union[2]	75	76	75	73	75	76
Natives	79	73	78	76	77	78
Employment-population ratio						
North Africa and Middle East	46	44	50	–	47	62
Latin America	61	41	66	64	–	76
Sub-Saharan Africa	52	49	56	66	74	77
East/South/Southeast Asia	58	46	57	56	60	67
Central and Eastern Europe	59	52	56	56	57	70
North America/Oceania/Japan	64	65	74	77	73	74
European Union[2]	70	69	71	69	72	73
Natives	75	66	75	73	73	74
Unemployment rate						
North Africa and Middle East	23	24	13	–	13	13
Latin America	14	–	10	9	–	6
Sub-Saharan Africa	24	23	11	8	6	6
East/South/Southeast Asia	15	16	8	8	8	8
Central and Eastern Europe	14	21	13	–	6	9
North America/Oceania/Japan	–	–	–	4	6	8
European Union[2]	7	10	6	6	5	4
Natives	5	10	3	4	6	5

1. For Australia and Canada, the data refer to 2003. For Australia, the category North America/Oceania/Japan includes Latin America but excludes Japan; Japan is excluded in Asia; Central and Eastern Europe Central and Eastern Europe also includes Southern Europe, which is then excluded from the European Economic Area.
2. Includes the whole European Economic Area and Switzerland.

Source: OECD Migration database.

Broadly speaking, two alternative reform strategies are possible:

- Keep the traditional labour market and welfare model, but introduce targeted measures for newly arrived immigrants. That would include eligibility for full income benefits being phased in only gradually as the person gains work experience in Sweden.
- Reform the general labour market and welfare model applying for all. That would include less generous income benefits for all and a much more mobility-oriented labour market with less job security. Strengthening incentives for youth, as discussed earlier, is an example of a general measure that would benefit migrants over-proportionately.

General labour market and social security reform should generally be preferred over targeted measures, as argued also by a recent OECD paper on migration policies (Jean and Causa, 2007). The important point here, though, is that the package of reforms introduced with the 2007 Budget is not likely to have a large effect for those migrants that are poorly skilled and rather distanced from the labour market. Unless much larger general reforms are made, targeted measures might therefore be considered, continuing the line of the successful migrant-targeted labour market programmes (Box 3.3). In any case, high-quality language training and measures to combat any discrimination will be important.

Box 3.3. **Labour market programmes targeted at immigrants**

The general labour market policy is designed with the ethnic and cultural diversity in society as a point of departure. This means that, in principle, the policy should meet the needs of all persons in the labour force in Sweden irrespective of, for example, their ethnic origin. Nevertheless, due to the significant differences between immigrants and Swedish-born with regard to their unemployment rate and employment ratio, the general policy is complemented with special efforts in different respects to enhance the integration of immigrants in the labour market.

- ***Work Place Induction*** (WPI). It is a well known fact that many immigrants lack contacts and networks that are so very important in the search for a job. The pilot scheme Work Place Induction (WPI) for certain immigrants attempts to compensate for this lack. The scheme has been in place since 2003 and will be made permanent from 2007. The scheme is managed by the Public Employment Service (PES). The intention is to give refugees and other immigrants extra support prior to employment and during the initial period on a new job. Support is also given to the employers, when needed, by specially trained employment officers. A recent report by the National Labour Market Board with a follow-up on WPI from 2005 shows that service was given to 4 800 immigrants. Over 60 per cent of the participants had found permanent work 3 months after the WPI. An evaluation of the effects of the programme has recently been presented by the Institute for Labour Market Evaluation. According to this evaluation the WPI increases the probability of getting a job by 15%.
- ***Trial Opportunity.*** This is one of the new LMP initiatives in the Joint Declaration of Intent on measures for better integration, signed by the Government and some of the social partners. This programme is a three months´ work experience scheme that will be given to the immigrant soon after registration at the PES. The idea was first raised in a working group with representatives from the Confederation of Swedish Enterprise and the Government. The purpose of the programme is to give the immigrant an opportunity, at an early stage, to demonstrate his knowledge and competence. The trial opportunity can take place with private or public employers or non profit organisations. A certificate shall be signed by the employer if the trial opportunity is not followed by an employment and it can be combined with procedures on the job for the assessment of professional skills. The PES is responsible for the programme in co-operation with the social partners. A follow-up study by the National Labour Market Board shows that a majority of the men that took part in the measure were given their opportunity at a private enterprise. This was true also for half of the women, of which a large proportion were at workplaces in municipalities and in the health sector. Half of the participants were employed six months after the programme had finished.
- ***Skill Assessment on the Job.*** This is another joint initiative from the Confederation of Swedish Enterprise and the Government. The background is the agreed importance of having the immigrant's previous education and work experience properly assessed; this has been identified as one of the cornerstones for better integration. With this measure the immigrant is offered an opportunity to receive a vocational assessment at their place of work. The purpose is to make a quick assessment – maximally three weeks – of foreign credentials, individual skills and work experience. After the assessment, a certificate will be issued which can be included in future job applications. For some immigrants this can be the beginning of a more comprehensive validation. For others it can be all that is necessary for an employer to get an understanding of the immigrant's skills. The PES is responsible for the implementation of the measure in co-operation with the social partners. There is not very much experience of this measure yet. Some problems have been reported regarding the regulation of the measure. The regulations have now been changed and it has been made clear that the Skill Assessment on the Job is part of the programme Trial Opportunity.

According to a recent report from The National Labour Market Board the proportion of foreign born who take part in general labour market programmes has decreased.

It is important to notice that differences in labour market attachment are not just a low-skill phenomenon. Over a third of all recent immigrants to Sweden have tertiary education, and that is a somewhat larger share than for the native population (Figure 3.7). This is a more advantageous skill composition than the immigration coming to most other countries. Meanwhile, the difference in employment-to-population ratios between immigrants and natives is more or less the same across skill levels. Along with this, many immigrants with high formal qualifications work in jobs where they don't really use their professional training (Ekberg and Rooth, 2004). One reason can be inadequate procedures for recognising formal qualifications. Indeed, a recent report found that only 25% of newly arriving refugees had an assessment of their previous training and diplomas, and even after two years in Sweden only a limited share had obtained Swedish validation of their previous work experience (Swedish Integration Board, 2006). Against this background, it is being considered to offer general tests through which immigrants can document their skills shortly after arriving in Sweden.

Learning outcomes for immigrant children are poor, whereas immigrants' children born in Sweden achieve better results. Based on the PISA study's assessment of 15-year olds, Sweden's gap between native and immigrant students is among the very highest among the OECD countries for which data are available. This result holds for reading as well as math and science. By contrast, the gap between students of Swedish origin and immigrants' children born and raised in Sweden, sometimes referred to as the second generation, is smaller than in the average country (OECD, 2006b). This is an indication that school integration is working better than in most other countries.

By contrast, the interaction between public agencies concerning newly arrived immigrants does not seem to function well, and this may hinder swift labour market integration. The 2005 *Survey*, recommended to shorten the time of reaching a final decision on asylum applications so that full economic integration can start earlier, and to continue working towards more individualised integration programmes that focus on language and job training (Annex 1.A1; OECD, 2005c). However, a recent report by The Swedish National Audit Office pointed to substantial administrative deficiencies in virtually all public agencies involved, and notably the Swedish Integration Board (Riksrevisionen, 2006).

Employers' reluctance to hire immigrants is at times clear, but because of its intangible nature, it is hard to quantify how much of this reflects genuine ethnic discrimination. The Swedish Integration Board, in its analyses of the differences in employment between Swedish and foreign born, has emphasised discrimination against foreign born as a possible explanation. However, discrimination can be hard to distinguish from non-discriminatory selection due to the importance of a good command of the Swedish language. Another factor is that many vacancies are filled by the help of informal networks to which most immigrants have limited access (Segendorf, 2005). Workplace segregation is therefore a reality as immigrants are highly likely to be working among colleagues from their own birth region (Åslund and Skans, 2005), and living in ethnic enclaves is even helpful for immigrants' labour market outcomes (Edin, Frederiksson and Åslund, 2003). Such network effects might be part of the explanation behind the finding of recent studies that even migrants' children born in Sweden have more difficulties entering the labour market that children of Swedish-born parents, still when controlling statistically for educational achievements, language fluency, etc. (Behtoui, 2006; Nekby and Özcan, 2006). Nevertheless, ethnic discrimination would seem to be documented, as studies find for example that children adopted from Africa, Asia or Latin America have higher unemployment rates than children adopted from countries more similar

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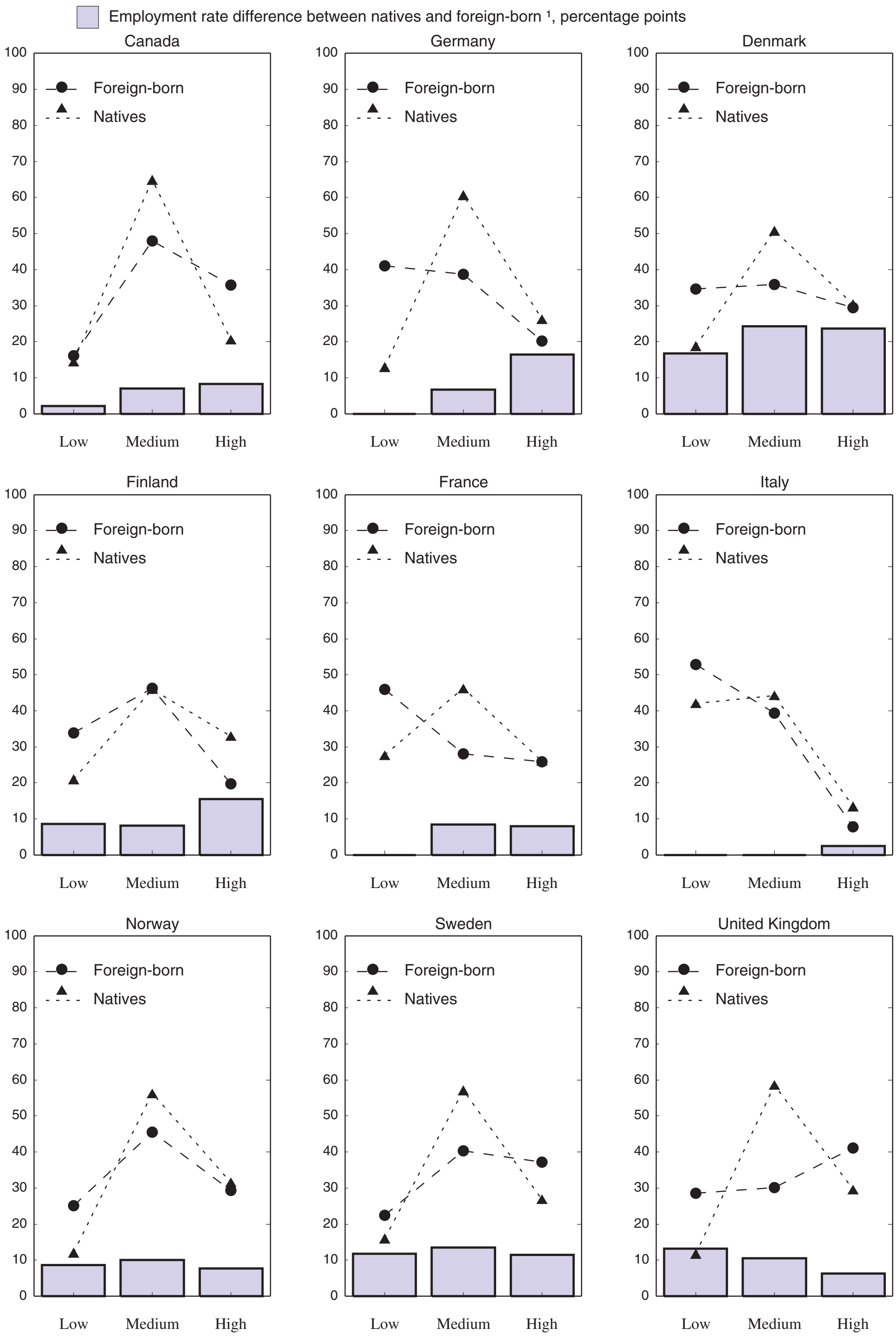
Figure 3.7. **Educational attainment among foreign-born and natives**

Per cent having below upper secondary, upper secondary or tertiary as their highest educational attainment, 2004
Foreign-born arrived between 1994 and 2004 and natives, aged 15-64



1. All foreign-born irrespective of their year of arrival.

Source: OECD Migration database and EU Labour Force Survey.

to Sweden. Moreover, in a recent experiment, researchers sent applications to over 1 600 vacant jobs between May 2005 and February 2006. For every vacancy, two applications were submitted: one with a Swedish name and one with an Arabic name, but with identical qualifications. In 527 cases at least one of the applicants was called for interview, but in almost 30 percent of those cases, only the applicant with the Swedish name was invited to interview (Rooth, 2006).[16] In any case, the operable question is what can be done about discrimination. One approach is to increase fines for firms caught discriminating.[17] Another approach is to pilot alternative procedures for filling job vacancies, such as via anonymous CVs, thereby seeking to avoid possible discrimination based on name or ethnicity. A wide set of approaches would be needed, because while anonymous CV's may work in large organisations, this may be less adapted to ensuring that immigrant-owned businesses like greengrocers and kiosks are not discriminating against persons of Swedish ethnicity when hiring. An obligation to involve the public employment agency at least on a consultative basis could perhaps be piloted.

If part of the problem is that, for natural reasons, immigrants' diverse qualifications are poorly understood by employers, and that some formal qualifications acquired abroad need to be complemented to be fully functional in a Swedish context, then the relevant adjustments to the labour market institutions should focus on the following:

- Reduce the risks for employers hiring immigrants whose capabilities can be difficult to gauge, thereby allowing a learning process where employers can increase their insight into immigrants' qualifications.
- Reduce the costs of hiring newly arrived immigrants at least for a transitional period while the person improves her or his knowledge of the Swedish language and other local conditions.

The New-Start Job scheme is the appropriate instrument to address the second point. It is therefore welcome that asylum seekers, quota refugees and their close relativeswill be eligible for New-Start Jobs during the first three years after a residence permit has been granted.

More flexibility in collective wage agreements could also help to address the second point. Three years ago a proposal for giving immigrants the opportunity to take work at a wage below the normal collective agreement was presented by three unions and the Association of Swedish Engineering Industries. The idea was to create an "employment stepladder" involving a relatively low introductory wage that could be combined with time off for language training. However, the proposal was rejected since such kind of employment could imply both positive and negative discrimination which is forbidden by law. Revisiting this proposal might nonetheless be worthwhile. As the conditions of collective agreements are shaped by the native majority, a strict legalistic insistence that the same collective agreement should apply for all, may *de facto* be discriminatory as some immigrants will be discouraged or even prevented from seeking work on conditions that suit their capabilities. Such barriers can arise for immigrants from disadvantaged backgrounds with very limited skills and language capability: jobs paying the salary they would be able to command may not exist in Sweden due to the compressed wage structure set by collective agreements. But such barriers can also arise for highly skilled migrants who despite solid formal qualifications may still need a bit of time to get into the Swedish *modus operandi* in their professional field before being fully productive. If pay scales are overly rigid, the likely consequence may be that such persons fail to find work in their professional field and instead end up in low-skilled jobs. The earnings distribution has widened in Sweden over recent decades, but this is fully explained by increased between-plant variation, indicating that local wage coordination remains strong (Skans, Edin and Holmlund, 2006). Finding ways

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of structuring low introductory wages followed by steep earning progression may therefore be needed, as local wage flexibility could seem to be limited.

However, an introductory employer contribution rebate or introductory wages cannot really alleviate the risk associated with employing someone whose qualifications the employer does not feel sure about. The problem here is again that the traditional labour market model favours a homogenous predictable population, because high job security and difficulty of dismissal makes it costly for employers to hire someone who turns out not to be the right person for the job. Options for reform of the employment protection legislation are analysed below in a general context because of its importance for wider insider-outsider problems.

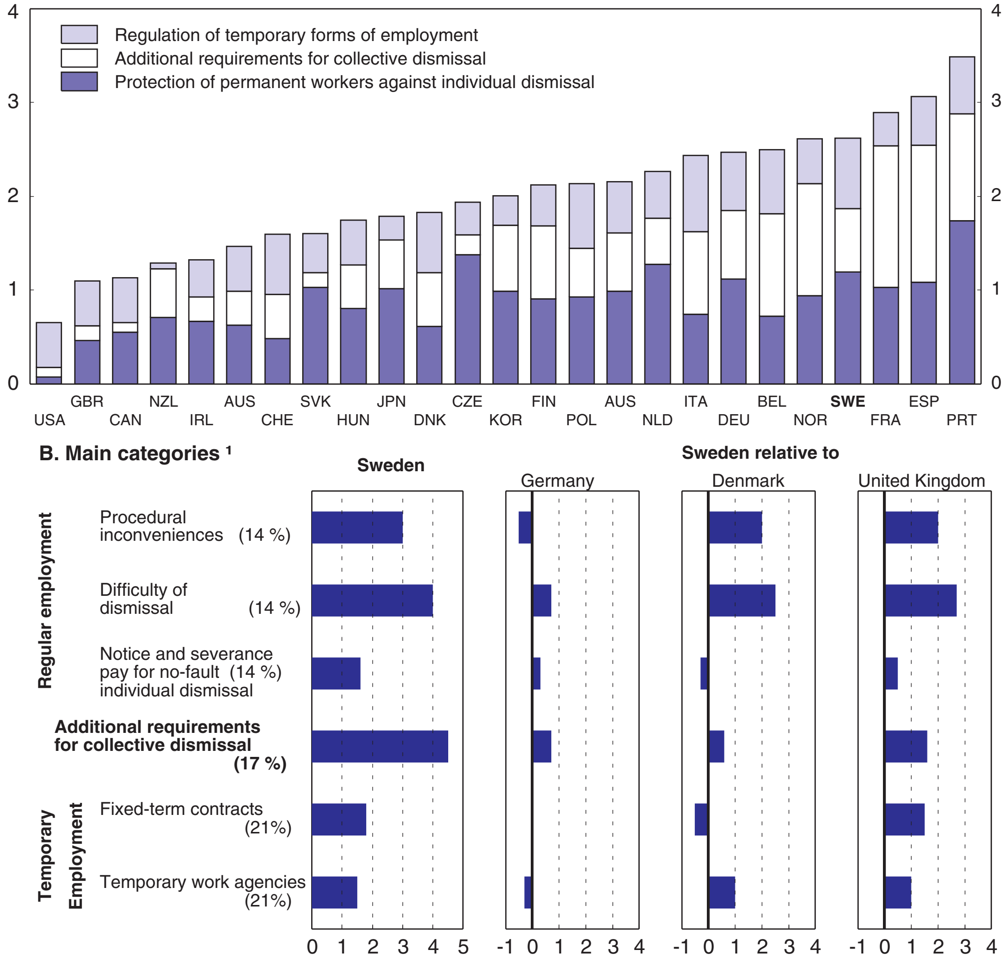
Employment protection contra labour force diversity

Regulations giving security for those who have a permanent contract are relatively elaborate in Sweden, reflecting the country's traditional corporate structure dominated by large firms where employees would stay with the same employer for many years. In fact, France is the only high-income country having more restrictive employment protection legislation (Figure 3.8, panel A). The various aspects of this legislation are here compared to Germany, Denmark and the United Kingdom. Differences are most remarkable for procedural inconveniences and difficulties involved with dismissal of an employee on a regular contract. For example, worker capability or redundancy of the job are adequate and sufficient grounds for individual dismissal in Denmark and the United Kingdom, whereas in Sweden and Germany, a transfer and/or retraining to adapt the person to different work must be attempted prior to dismissal.[18] Moreover the trial period during which the employer can easily end a contract, must end after 6 months in Sweden, compared to 6, 10½ and 12 months in Germany, Denmark and the United Kingdom respectively. By contrast, notice periods for individual dismissal are not much longer than elsewhere, and Sweden has no severance pay. For collective dismissal, collective agreements may prolong the notice period, but the other additional requirements are not stricter than in other countries. For fixed-term contracts, the one substantial restriction in Sweden is that their cumulated duration is limited to a maximum of one year unless, for example, the nature of the task requires longer duration. A new so-called "free 24 months" contract will soon be introduced, thereby easing the time limit on temporary contracts.[19]

Sweden's last-in-first-out rule for regular employment has been a particularly controversial issue. It was introduced in the 1970s and it remains a nationally legislated rule saying that when reducing staff numbers, employers shall lay off staff in reverse order of seniority within each professional segment.[20] In the public sector the employer is even defined so narrowly that a teacher or childcare worker will lose their position in the last-in-first-out hierarchy if they shift to work in another municipality. The law allows collective agreements between employers and unions to set aside the last-in-first-out rule. Firms undergoing large restructuring therefore often say that the last-in-first-out rule is not a hindrance, as they would anyway have a close dialogue with unions in an effort to make the restructuring smooth. In parts of the labour market, the main effect of the last-in-first-out rule may therefore be to elevate union bargaining power and ensure high union membership, as collective agreements may set the rule aside also for employees that are not union members, at least in principle. Recently, an amendment to the law has exempted small firms with ten or fewer employees from the last-in-first-out rule for the first two lay-offs. Nevertheless, small firms still complain that the last-in-first-out rule makes things

Figure 3.8. **Strictness of employment protection legislation**

Index scale of 0-6, from least to most restrictive, 2003



1. Percentage in bracket indicates how large weight the indicator has in the overall index.

Source: OECD (2004b), *OECD Employment Outlook*, Chapter 2, Paris.

difficult. The biggest problem is, however, that if many consider that maybe they would be protected against layoff if they stay in their current job, then the labour market becomes less dynamic, and experienced people will feel discouraged from quitting to start a business or to take a job for a new entrepreneur (Chapter 1). The best solution would therefore be to confront the issue, and abolish the legislated last-in-first-out rule.

Theoretical considerations as well as empirical studies find that strict employment protection legislation is at best neutral with regards to aggregate employment and unemployment, as fewer layoffs of current staff are matched by less frequent hiring of new staff. However, for those less established on the labour market, for example youth, the adverse effect of less frequent hiring dominates and, by the same token, long-term unemployment increases (OECD, 2004b and 2006a). Youth, immigrants and similar groups would therefore benefit if job security regulations were eased.

The effects may depend on the interaction with other institutional features of the labour market. For example, employment protection legislation may reinforce the bargaining power of core workers to determine wage and other conditions without taking the needs of labour market outsiders into account. These mechanisms may explain why "outsidership" (*utanförskap*) has become a major issue in Sweden, and reforms of employment protection legislation may be required to effectively address the problem.

Many countries with strict employment protection legislation have focused reform on temporary forms of employment. This is also the case for Sweden. While the regulations for regular employment have remained unchanged for decades, the restrictions on fixed term contracts and temporary work agencies were eased between the late 1980s and late 1990s. Unfortunately, this may further entrench insider-outsider problems in a rather unfair manner. In such a setting, employers tend to use temporary forms of employment more frequently as a way of circumventing strict rules, particularly for youth and low-skilled. In Sweden, 15% of all employed are on temporary contracts, well above the share seen in Denmark, Germany and the United Kingdom. In the event of an economic downturn, these groups may then have to bear the brunt of adjustment as they are the least difficult to lay off (OECD, 2004b).

The new government is planning two adjustments. It will not implement the previous government's plans to give those working part time a legal right to shift to full time. Secondly, as mentioned above, it will prolonged the maximum cumulated duration of fixed term contracts, from one year to two years. These steps should be welcomed, but the best would be to scale down job security rules for regular contracts. To avoid further segregation or dualism in the labour market, reforms should not deepen the difference between permanent and temporary contracts. Making exemptions for small firms can also be a mixed blessing, as it may discourage employees from taking jobs in small firms. Rather, it should be examined whether the criteria for what is a fair dismissal under a regular contract are too strict.

If wider reform of employment protection legislation is not feasible, then the question is whether the adverse effects can be offset. Various possibilities could be considered:

- Prolonging the trial period when a person is employed on a regular contract. It could either be in the form of a longer trial period for all, such as the United Kingdom's twelve months, or it could be targeted at those who employers are likely to feel uncertain about. For example, the New-Start Jobs could be augmented with an extended trial period lasting for half of the duration of the employers' contribution rebate.
- Making the security obtained in a long-term employment relationship more transferable. The Austrian model could serve as inspiration (Box 3.4), although it would need to be adapted.

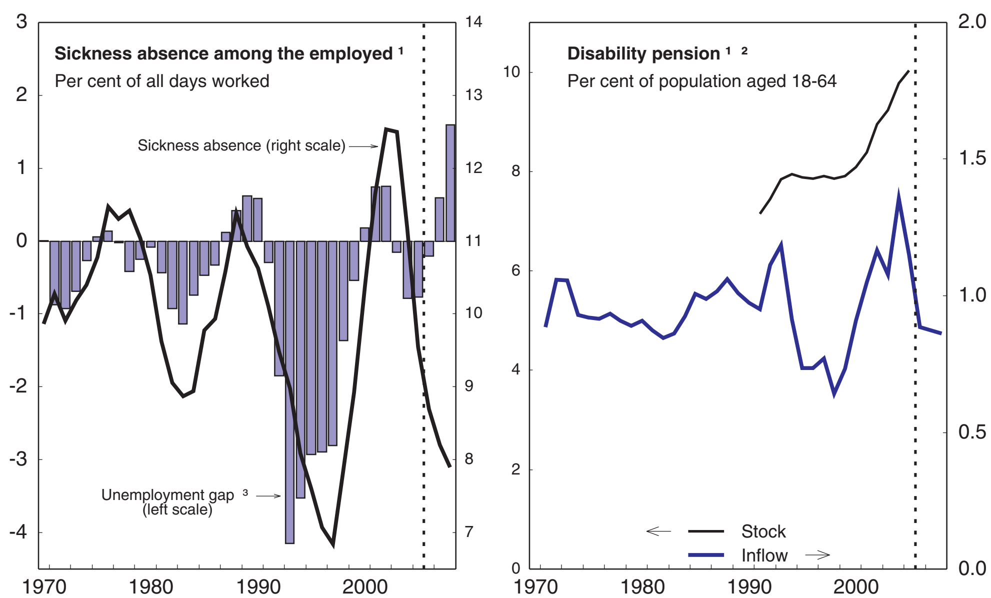
Box 3.4. **Seniority advantages have been made transferable in Austria**

Austria has recently transformed its severance pay legislation into a system of individual savings accounts. Previously, private sector employers paid severance when laying off staff having worked for the company for more than three years: starting with one month's salary and reaching one year's salary for someone having worked for the company for 25 years or more. Since 2003, employers have instead contributed 1½ per cent of payroll costs to individual savings accounts for each employee. If laid off after more than three years, the person can choose either to receive his/her severance payment from the account at once, or save it for a future pension. If the employee quits, the accumulated separation allowance will not be paid out. Instead it remains on the individual savings account which follows the person throughout her/his entire working life.

Sickness and disability

The number of working-age individuals receiving disability pension and in particular the extent of sickness absence among employees are exceptionally high compared to other countries. Avoiding prolonged sickness spells and disability and helping the persons concerned back to some form of employment would make a major contribution to reducing exclusion. The previous *Survey* dealt with this issue at some length (OECD, 2005c, Chapter 3). Since then, the situation has improved somewhat, partly reflecting policy reform. Following a steep increase starting in the late 1990s, sickness absence among employees has fallen continuously since 2003. Tighter administrative practice for social insurance coverage has contributed to this, making the fall larger than what the cyclical swings in the labour market can account for. This reflects a parallel decline in short- and long-term sickness absence since 2003, as fewer short spells have helped to stem the inflow to long-term sickness. Based on 2006 policies, however, the National Institute of Economic Research estimates that the improvement in sickness absence may now end. The ambitious target set by the previous government to halve the number of sickness absence days from 2002 to 2008 is therefore not likely to be met without further reform (Figure 3.9). Although the decline in sickness absence during 2003-04 was paralleled by a rising inflow to disability pension (*sjuk- och aktivitetsersättning*), that has not been the case recently; during the twelve months to October 2006, less than 50 000 persons entered disability pension, meaning that the inflow came down to its 1980-2005 average (Figure 3.9). Nevertheless, the stock of disability pensioners remains very high, growing by a quarter since the late 1990s, and also here the National Institute of Economic Research estimates that progress will stall without further reform (NIER, 2006b).

Figure 3.9. **Sickness absence and disability pension**



1. Numbers for 2006 – 8 are based on estimates by the National Institute of Economic Research.
2. *Förtidspension* before 2003; *sjuk- och aktivitetsersättning* since 2003. Total number of persons, of which about a quarter receive a part-time benefit.
3. Percentage point difference between NAIRU and actual unemployment.

Source: The Swedish Social Insurance Agency, the National Institute of Economic Research and OECD.

It is therefore most welcome that the 2007 Budget introduces a number of new measures. Already in January 2005, the 21 regional social insurance offices were merged into one state authority; this has helped to clarify procedures and strengthen compliance. Also, occupational healthcare and prevention in the workplace is being strengthened. The 2007 Budget sets as an objective for sickness and disability insurance that the person concerned should be helped back to work using and improving her or his remaining capacities. A number of measures will be introduced to combat over-use and social insurance fraud, increase the legal certainty and ensure that benefits are paid to the right person. Measures to ensure adequate treatment and rehabilitation will also be enhanced. The ceiling for sickness benefit will be lowered to the level applying prior to the recent rise, and the income on which sickness benefit is based will be redefined and calculated on a historic basis. Meanwhile the responsibility, introduced in January 2005, for each employer to finance 15% of the cost of sickness benefits to their staff after the second week of sickness absence will be abolished. These costs will instead be carried by employers collectively via slightly higher social contributions. In addition, the government intends soon to introduce more measures to strengthen medical assessments: employers will be able to demand a doctor's certificate from the first day of sickness; the panels of lay assessors will be abolished; and assessments of diffuse symptoms by the health and medical services will be improved. Efforts to revisit long-term sickness cases to activate the person, based on remaining work capacity, will also be stepped up. The budget estimate is that these measures will reduce annual sickness insurance expenditures by a total of SEK 1 billion.

Except for reducing individual employer co-financing, all these measures go in the direction advocated by the recent OECD *Survey* (Annex 1.A1). Abolishing the 15% co-financing may relieve small employers of some risk associated with sickness spells lasting for several years, but the other side of the coin is that employers striving to improve workplace health get less reward. Indeed, a preliminary evaluation of the 2005 measure published in the autumn found that a third of the employers being aware of the reform said they would be more attentive to sickness absence and a fifth that they would take a more active approach to rehabilitation and the working environment in response to the reform. However, two fifths said that they would tighten procedures for hiring in response to the reform so as to avoid candidates with existing health problems (Swedish Social Insurance Agency, 2006). Quantifying the effect of such claims is difficult, but it is likely that, in conjunction with the new measures to enhance medical assessment and responsibilities for the sick person, employer co-financing would be more effective. Alternatives to abolishing the 15% co-financing could therefore be considered, such as a higher up-front cost with a limited duration, for example full responsibility for the first month. However, in a situation where the main policy objective is to reduce labour market exclusion, it should be recognised that reduced employer responsibility is likely to raise the hiring prospects for individuals at risk of falling sick, such as those with chronic diseases.

The planned cross-party inquiry on sickness and social insurance is welcome. It should consider some of those recommendations given in the 2005 OECD *Survey* which have not yet been taken forward, and not least reconsider the role of partial disability benefits. Such partial benefits risk becoming an income top up for people who want to scale back their working hours. In the recent Dutch reform of disability policies, partial benefits were simply abolished. Another important issues is how to involve employers in vocational rehabilitation, and make advice and support easily available. It should be ensured that such rehabilitation starts early before the person has become too detached from the workplace. Research on the extent to which workplace management practice actually affects the incidence of sickness leave would also be valuable.

Conclusion

The 2007 Budget includes appreciable steps towards combating exclusion in the labour market. However, continued reform will be needed *inter alia* to cater for the wider diversity in the labour force resulting from immigration (Box 3.5).

Box 3.5. **Recommendations regarding employment and integration of immigrants**

General labour market and tax policies

- Enhance job search obligations for those receiving unemployment and similar benefits, and use moderate sanctions to support these requirements. Ensure adequate coaching and job-search assistance so that those at the margin of the labour market benefit fully from the current upswing.
- Continue to cut income taxes in ways that maximise the effect on employment rates and hours worked. Raise the threshold for where the state income tax applies or cut its rate. If expanding the in-work tax credit, it should be combined with benefit reform, like in the 2007 Budget, to ensure cost effectiveness.
- Make the welfare model and labour market institutions better adapted to increased diversity of the labour force, either *via* general reform or *via* targeted measures to avoid unemployment and inactivity traps. Adjust benefit withdrawal and maybe the level of benefits: social assistance and housing benefits for families with numerous children seem particularly problematic in creating such traps. Avoid under-financed benefit reforms as tax hikes would undermine efforts to raise employment.
- Ease job security rules for regular contracts, and consider in particular if the criteria for what is a fair dismissal are too strict in order to reduce the risks for employers hiring immigrants and others whose capabilities can be difficult to gauge. Abolish the last-in-first-out rule so employees risk less by taking another job.

Improving integration of immigrants

- Allow, in collective agreements, for lower initial wages followed by stronger progression during the first years of employment, thereby making it easier for immigrants to get established on the labour market while improving knowledge of Swedish language and other local conditions.
- Introduce a special benefit regime for youth without children, giving stronger incentives combined with enhanced training offers, similar to the Danish youth package. All, irrespective of origin, should be treated equally, but it would benefit immigrants and their offspring disproportionately.
- Improve the provision of language training for newly arrived migrants *inter alia* by improving the capabilities of the teachers and integrating language training on the workplace. Introduce early childhood action for migrants' children having language problems.
- Do more piloting to develop non-bureaucratic procedures for filling job vacancies in large as well as small firms in ways that avoid possible discrimination based on name or ethnicity.
- Shorten the time of reaching a final decision on asylum applications so that full economic integration can start earlier.

Sickness absence and disability pension

- Continue to improve administration in social insurance offices and the procedures for medical assessment. Limit the duration of sickness benefits to ensure early rehabilitation.
- Monitor carefully how partial disability benefits are being used to ensure they are not just an income top-up for people who wish to scale back their working hours. Revisit the many cases where disability pension has been granted during the past five years to assess options for rehabilitation to bring the person back to some form of work.

Notes

1. The calculations are based on Statistics Sweden's FASIT model with income data for 15 000 households in 2003. Only persons aged 20–64 are included and pensioners, students, self-employed and people migrating in or out of Sweden during the year are all excluded. In addition to net pay received now, the calculation also includes some elements of future gains like increased pension rights, and therefore the number is higher than what would be implied by the marginal tax schedule in Figure 3.2 paid on current income. More detailed calculations for persons out of work receiving sickness benefits, disability pension or social assistance will be published on 20 December.
2. Exactly to what extent gender and family models differ across cultures and thereby between immigrants and native Swedes is of course hard to quantify. Comparing the native populations across OECD countries, there is a wide variation in female employment rates from close to 75% in Sweden to 40-45% in several southern-European countries. This variation is matched by differences in institutional arrangements, such as childcare provision, that facilitate equal gender participation on the labour market. It would be strange if the development of such institutions over history did not to some extent reflect cultural preference. Unless the immigrants coming to Sweden are a self-selected group seeking a Swedish lifestyle, immigrants are therefore likely to add to the culturally diversity – including with respect to gender and family models. Some studies find that, when immigrant employment rates reach a steady differential *vis-à-vis* natives after 20-25 years of residence in Sweden, then the size of the employment gap between immigrants and natives is the same for women as for men (Nekby, 2003). Eventually, immigrants thereby seem to assimilate, but with continued net immigration adding ¼-½ percentage point to the Swedish population every year, the number of households preferring something slightly different from a Swedish family model can still be substantial.
3. Special job subsidies, however, will continue for those coming from long-term sick leave.
4. In addition to weakening the total labour supply effect, the negative income effect on above-average earners' labour supply implies a composition change with fewer high-productivity hours and more low-productivity hours. GDP therefore evolves less favourably than labour supply.
5. Survey by the public employment agency, reported by SVT 13 November 2006.
6. In 2000-02 efforts were made to reduce the number of tax payers concerned by the high marginal taxes, as the threshold for when the state tax was paid was raised more than the standard CPI-plus-two percentage points. As a result, from over 18% in 2000, the share of all tax payers paying state tax declined to around 16½ per cent in 2002-04, but this was then reversed by below-standard indexation bringing the share back to 18% in 2006.
7. Differentiated unemployment insurance fees may also be instrumental in promoting structural adjustment as increased fees for those working in sectors with high unemployment may encourage individuals to shift profession, adding to the incentives generated by sectoral wage differences. However, this effect could be achieved more directly via lower marginal taxes.
8. See column by Professor Lars Calmfors in Dagens Nyheter on 6 November 2006.
9. The number of persons granted residence permission as refugees based on UN quotas or conventions has been stable at a relatively low level around 2 000 a year since the mid 1990's. Over the latter two decades as a whole, only a fifth of those coming to Sweden for protection are found eligible for residence permission under UN conventions. The rest have been accepted based on wider humanitarian criteria, such as that sickness or the situation in their country of origin makes it difficult to return although they were not found eligible for refugee status in Sweden.
10. Each year 2000-05, about 23 000 permanent residence permissions were granted for family reasons, but only an average 3 500 of these were family of refugees or humanitarian immigrants. By contrast, Thailand has become the largest country of origin among female immigrants with 96% coming for family reasons. In 2005, only 451 men immigrated from Thailand when combining all reasons for migration, while 1603 women immigrated from Thailand due to family ties alone. A similar pattern can be observed for women from China, Russia, Philippines and Vietnam. Many of these marry men in Sweden.
11. Among the foreign born, 59% have acquired Swedish nationality.
12. Statistics Sweden press release No. 2006:285, November 14.
13. Before 2000, a decomposition cannot be made based on country of birth, but only on citizenship for which data go back to 1973. Based on country of birth, the other Nordics account for 24% of the 1.1 million foreign born living in Sweden in 2005.

14. The age-decomposition in the text is based on gross-immigration (65 229 persons in 2005). A decomposition of the net-immigration (27 111 persons in 2005) shows a roughly similar pattern with the overrepresentation of youths being even more pronounced: 59% of net-immigration was in the 18-34 age interval, 26% in the 0-17 age interval and 15% in the 35-64 age interval. For the age interval 65 and above, there was a small net outflow from Sweden.

15. Some countries allow entry only to those who already have a job, or who have been chosen through scoring and quota systems designed to meet the needs of the host country's labour market. This is one of the reasons why immigrants have higher employment rates in English speaking countries; and many migrants who come to these countries are not only selected but also have language fluency.

16. Interviewed about his results, Dan-Olof Rooth, said that "It is well established that discrimination exists, but there is no support for the idea that the whole of society is riddled with racism, as was claimed in the government inquiry 'Integration's black book'. Our results indicate that 70 per cent of employers don't actually discriminate." After interviewing many employers, the researchers identified the characteristics of those most likely to reject applicants with non-Swedish names. "They have workplaces where a large number of the employees are men, low staff turnover and fewer than 100 employees," Dan-Olof Rooth told Dagens Nyheter.

17. Since May 1999, a law on measures against ethnic discrimination in working life has been in force. It prohibits both direct and indirect discrimination on the basis of race, skin colour, national or ethnic origin or religious faith. The protection against discrimination covers the entire recruitment process from application to employment. The law prohibits unfair and irrational treatment with regard to promotion, salary, lay off or other intrusive measures against an employee based on the employees ethnic origin.

18. According to the Swedish Employment Protection Act, a termination of an employment contract may be deemed unlawful if it had been reasonable to require the employer to provide other work in his or her service for the employee. There is a very well developed case law from the Labour Court concerning this rule. In principle, an employer is not required to "create" work and/or make substantial changes in the organisation to meet this requirement. Nor is the employer required to offer work within the organisation that the employee does not have the right qualifications for. However, if the employee can gain the right qualifications through training within reasonable limits, based on the circumstances in the individual case, the employer must offer the work to the employee before termination of the contract.

19. Under 2006 rules, fixed-term contracts can be used without particular time limits under certain circumstances, for example contracts concerning a specified season or specified task, temporary substitute employment, and cases where the employee has attained the age of 67. Besides these cases, it is possible for an employer to, without stating any special grounds, conclude a fixed term contract with one and the same employee for at most a year within a three year period (so-called agreed fixed-term employment). The employer may never have more than five employees with agreed fixed time employment at the same time. In June 2006, Parliament passed a bill with changes in the rules concerning fixed-term contracts which, a bit simplified, would allow agreed fixed-term contracts for an unlimited number of employees, for at most 14 months within a five year period for one and the same employee. The new legislation was supposed to enter into force in July 2007, but the new government plans further changes to the legislation. Most likely, agreed fixed term contracts will be allowed for at most 24 months within a five year period, and possibly for an unspecified period if the contract concerns a specified season. Concerning temporary work agency, there are no rules in Swedish labour legislation that limit the period under which a business can hire a worker from a temporary work agency.

20. The rule does not guard outright incompetent workers, though, as these may be dismissed on personal grounds, in which case the last-in-first-out principle does not apply. Moreover, the last-in-first-out rule takes into account education and skills as an employee with longer employment time only has priority over other employees if he or she has satisfactory qualifications for continued work.

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ANNEX 3.A1

Taxes, social contributions and benefit withdrawal, 2006 rules

Employers pay contributions equal to 32¼ per cent of the total wage sum, meaning SEK 100 000 annually for a person with average full-time wage. A third of this is for retirement pension, another third for health insurance while the rest is for various labour market programmes and a general pay-roll tax. Uniform rates are applied for all, except for those aged 65 or more, for whom lower rate of 24¼-26¼ per cent are applied. Moreover, there is a small basic discount of up to SEK 37 000 which means that self-employed and small firms have slightly lower average contributions.

Employees and self-employed pay a general pension contribution of 7%, though maximum SEK 25 100 a year, but this is pension contribution is fully offset by a tax credit, implying a zero net payment for employees and self-employed alike. State income taxes are only paid of incomes above 106% of full-time average wage earnings. The rate is 20%, which rises to 25% for income above 152% of average earnings. Local government income taxes are paid at a uniform rate of all income above a basic allowance of SEK 11 700-30 600; the rate varies by municipality from 28.89% to 34.24%, with the average being 31.60%.

Benefits add to the effective taxation of income from work by being contingent on not working (unemployment benefits) or by being withdrawn when income grows (housing benefits and social assistance). Unemployment insurance benefits with a gross replacement rate of 80% are available for 20 weeks at a daily maximum of SEK 730 and thereafter for 40 weeks at a daily maximum of SEK 680 (58% and 54% of average full-time earnings, meaning that the maximum is binding for incomes above 72% and 67% of average full-time earnings). For uninsured persons above 20, there is a lower unemployment benefit for 60 weeks at a flat daily rate of SEK 320 (26% of average full-time earnings).

Housing benefits are available for households with dependent children, but if annual gross income exceeds SEK 117 000, the benefit is withdrawn at a rate is similar to adding 20 percentage points to marginal income taxes. Housing benefits are also available for young persons below 29 without children, for whom it is withdrawn at a higher rate similar to adding 33 percentage points to marginal income taxes. For those with neither income nor assets, social assistance can be claimed at a monthly rate of SEK 2 650 per for a single person and SEK 4 840 for a couple plus 1 200-2 400 per child and other supplements. Social assistance is withdrawn one-to-one for any income the person has, implying marginal effective tax rates of 100%. There is also a child benefit, but the level is independent of parental income.

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Child care fees are calculated as 3% of gross income for the first child, and an additional 2% and 1% for the second and third child with a ceiling reached at household income of 170% of average full-time earnings. However, as these fees are not tax deductible, their effect on average and marginal effective taxes is higher than what the percentages would indicate at first glance.

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Chapter 4

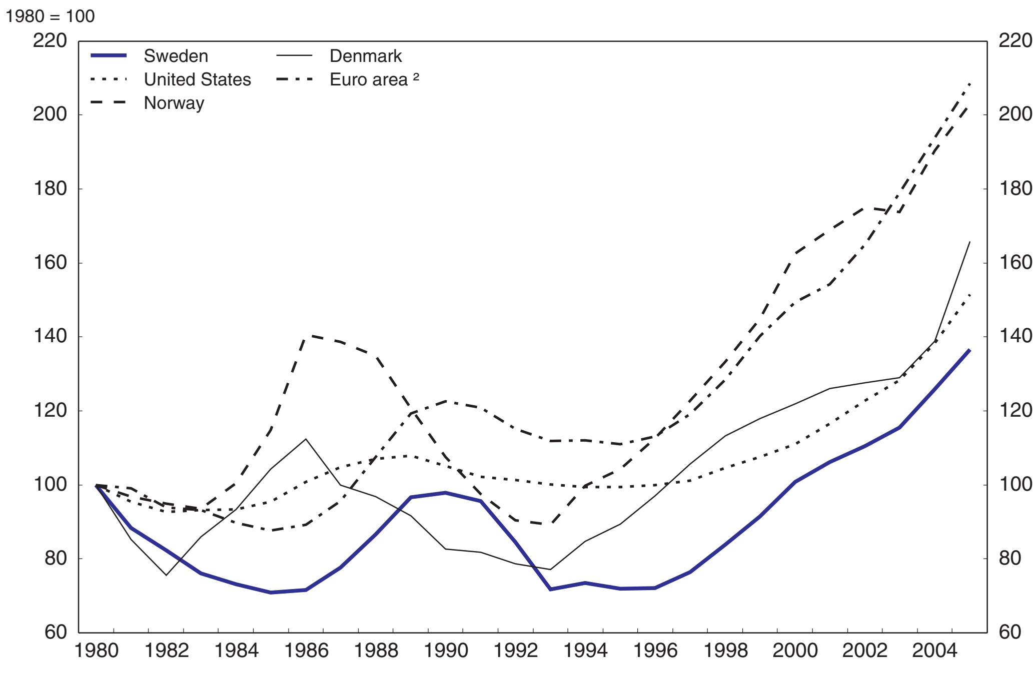
The housing market – better allocation via less regulation

While several sectors in the economy have been deregulated, the Swedish housing market remains distorted, hindering an optimal matching of supply and demand. In the rental market the rent setting framework with its focus on cost-based rents in the public sector prevents a price response, leading to long queues in some regions and vacancies in others. Many Swedes that would have preferred otherwise are driven into the owner-occupied segment, where prices are increasing strongly, and rising above an estimated fundamental value. The supply of new dwellings is made more difficult by an uncompetitive construction industry, coupled with cumbersome planning regulations and few incentives for municipalities to issue more land. On the fiscal side, real estate taxes are below neutral levels, implying an indirect subsidy to housing. This chapter presents a critical review of the recent steps to abolish real estate taxes and also proposes comprehensive reform of regulations in the rental housing sector.

After rebounding from the serious crisis in the early 1990s (when real prices fell by 30%), house prices in Sweden rose continuously over the past decade, enjoying the longest unbroken upturn in recent history as in several other industrial countries (Figure 4.1). This benign development, however, masks structural problems in the housing market, as is visible foremost in the rental market, where rents are effectively regulated and long waiting queues for new tenants in the metropolitan areas coexist with vacancies in other regions. As has been summarized recently: "If one were to design a legal framework for the [Swedish] housing market, it is inconceivable that one would end up with the system we see today" (Ellingsen and Englund, 2003, p. 3). Making the housing market function better would help overall economic performance by facilitating labour market mobility, encouraging economic activity and giving citizens more freedom to choose a place to live and the type of tenure most suitable to their individual needs.

The main challenge going forward is to better match demand and supply, which is hampered by regulations as well as a lack of adequate incentives in several areas. The rent regulation framework is one of the strictest among OECD countries, effectively preventing people from making a free choice of tenure, and the lack of substitutability between owner-

Figure 4.1. **Real house prices in an international perspective**[1]



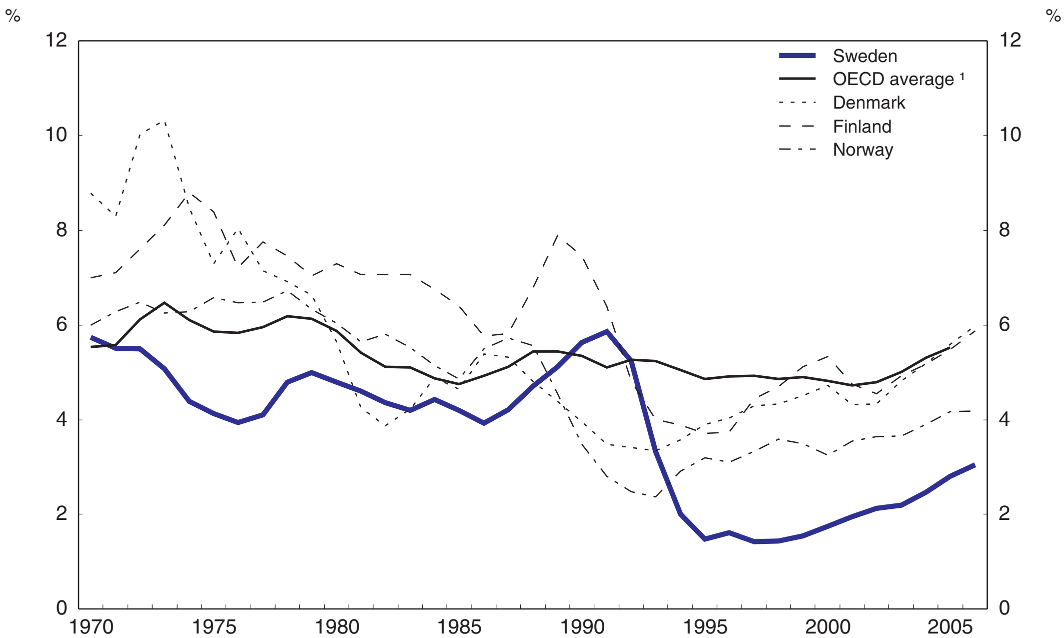
1. Nominal house price indices deflated by CPI.
2. Average index of Finland, France, Germany, Ireland, Italy, the Netherlands and Spain.

Source: OECD Analytical database and OECD calculations.

occupation and renting drives many to become owner-occupiers who would have had other preferences. It benefits those tenants inside the market at the expense of those outsiders waiting in queues. In addition, an adequate supply response to growing demand is hindered by a planning system that lacks incentives and a construction sector with one of the highest costs in Europe due to weak competition. These factors show up in residential construction activity, which historically has been – and still is despite recent rapid growth – markedly lower than in the average OECD country and in particular when compared with other Nordic countries (Figure 4.2). And the investment that takes place does not seem to occur where it is most needed. On the demand side, the tax and subsidisation system – despite extensive previous reforms – is distorting consumer choice towards more housing consumption. Government plans now envisage that housing taxation should be reduced and eventually abolished, which would stimulate demand further.

Figure 4.2. **Residential investment**

As percentage of GDP, current prices



1. Excluding Luxembourg, Hungary, Portugal and Slovak Republic. Including Switzerland as from 1990, Poland as from 1991, and Czech Republic as from 1992.

Source: OECD Economic Outlook database.

House prices and household indebtedness

Apart from the *welfare* aspect of better allocation, the current situation of the housing market also raises *cyclical* and *financial stability* aspects, related to the continuous increase in house prices and rising household indebtedness. Both have an impact on Sweden's growth perspective and are present in contemporary discussions in Sweden.

Econometric evidence (Box 4.1) suggests that Swedish house prices can be explained over the long run by developments in disposable income, interest rates adjusted for taxes, construction of new housing and population trends. Rising household income, falling

Box 4.1. **Determinants of real house prices**

House prices tend to follow long cyclical patterns which can be related to underlying fundamental factors. One way to model long-run or equilibrium prices is to relate real house prices to real after-tax user costs, real disposable per-capita income and the dwelling stock in relation to demographic developments (OECD, 2006a; Hort, 1998):

$$p_t = \alpha + \beta y_t + \gamma r_t + \theta (hs_t - pop_t^{25-44}) + \varepsilon_t$$

p is the price index for one-/two-dwelling buildings for permanent living (quality-adjusted) deflated by the consumer price index, *y* is real per capita income, *r* is a measure of the real user costs, *hs* is the stock (number) of dwellings and $pop^{25\text{-}44}$ is the population being 25 to 44 years old (as a proxy for the share of first-time buyers).[1] In addition, a supply equation was estimated, relating residential investment (*ihv*) to construction costs (*cc*), house prices and the same demographic variable as in the price equation.

All variables, except user costs, are in logarithms and standard unit root tests indicate non-stationarity for all of them. Both long-run relationships are estimated jointly (using the seemingly unrelated regression (SUR) estimator) with annual data from 1975 onwards and stationarity tests of the residuals suggest the existence of a cointegration relationship. Results for this relationship show that actual developments can be explained fairly well with those variables (t-values in brackets).[2]

$$p_t = \underset{(-3.9)}{-18.6} + \underset{(4.6)}{1.9} y_t - \underset{(-3.5)}{2.3} r_t - \underset{(-3.2)}{4.0} (hs_t - pop_t^{25-44})$$

$$ihv_t = \underset{(-4.8)}{-340.1} - \underset{(-6.8)}{1.5} cc_t + \underset{(4.3)}{1.4} p_t + \underset{(5.2)}{24.3} pop^{25-44}$$

The adjustment of deviations of actual house prices from their long-run fundamental level can be explained by a short-run relationship of the following form (t-values in brackets).[3]

$$\Delta p_t = \underset{(6.6)}{0.79} \Delta p_{t-1} - \underset{(-3.5)}{0.40} ECM_{t-1} - \underset{(-2.8)}{0.09} dum^{1992/93}$$

$$Adj.R^2 = 0.75; s.e. = 0.04; LM\,test\,pvalue = 0.96$$

$$\Delta ihv_t = \underset{(4.0)}{0.50} \Delta ihv_{t-1} + \underset{(2.2)}{0.52} \Delta p - \underset{(-3.1)}{0.22} ECM_{t-1}$$

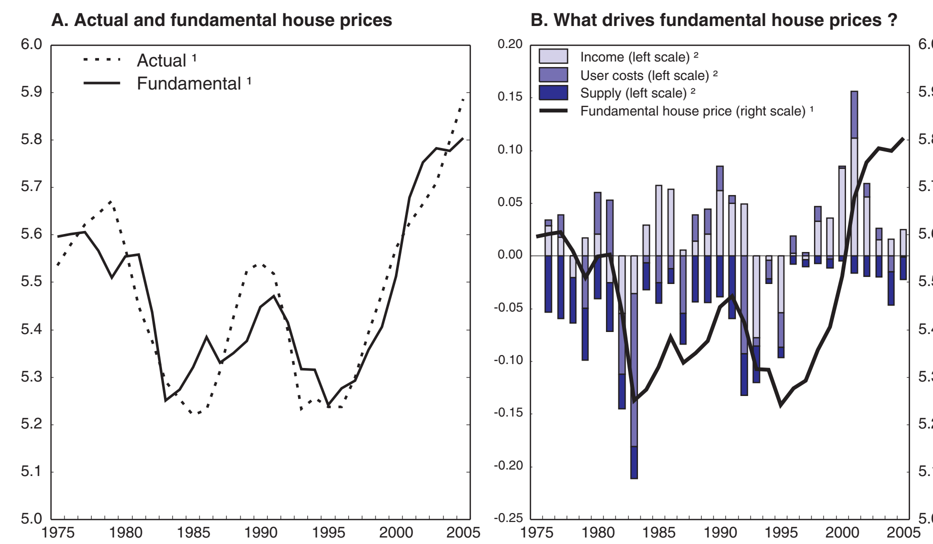
$$Adj.R^2 = 0.66; s.e. = 0.1; LM\,test\,pvalue = 0.42$$

Both error correction terms (ECM) enter negatively, showing that differences between actual and fundamental levels are corrected over time (over a third of the over-/undervaluation is corrected within one year in the price equation). The estimated coefficients for the long-run price equation, in particular the strong income elasticity and the moderate elasticity regarding user costs are similar to other studies. The response of house prices to changes in supply is fairly high (Ireland: -1.7 *vs.* -4.0 for Sweden). At the end of 2005, actual house prices were estimated from this relationship to be about 8% above their fundamental value (Figure 4.3) and updating with preliminary annual data for 2006 shows that this overvaluation has increased to around 15%.[4] Residential investment in the supply equation is positively related to house prices and demographic developments and developments in construction costs are found to dampen the growth of investment. Since the mid-1990s actual construction has been significantly below the estimated fundamental level, but strong growth in residential investment over the most recent period has led to a closing of the gap.

Box 4.1. **Determinants of real house prices** *(cont.)*

Figure 4.3. **Actual and fundamental house prices**

1975-2005



1. Log of actual and estimated house price index.
2. Graph shows each component's contributions to changes in the estimated fundamental house price over time in log differences.

Sources: Statistics Sweden, OECD Analytical database, OECD Labour force statistics database and OECD calculations.

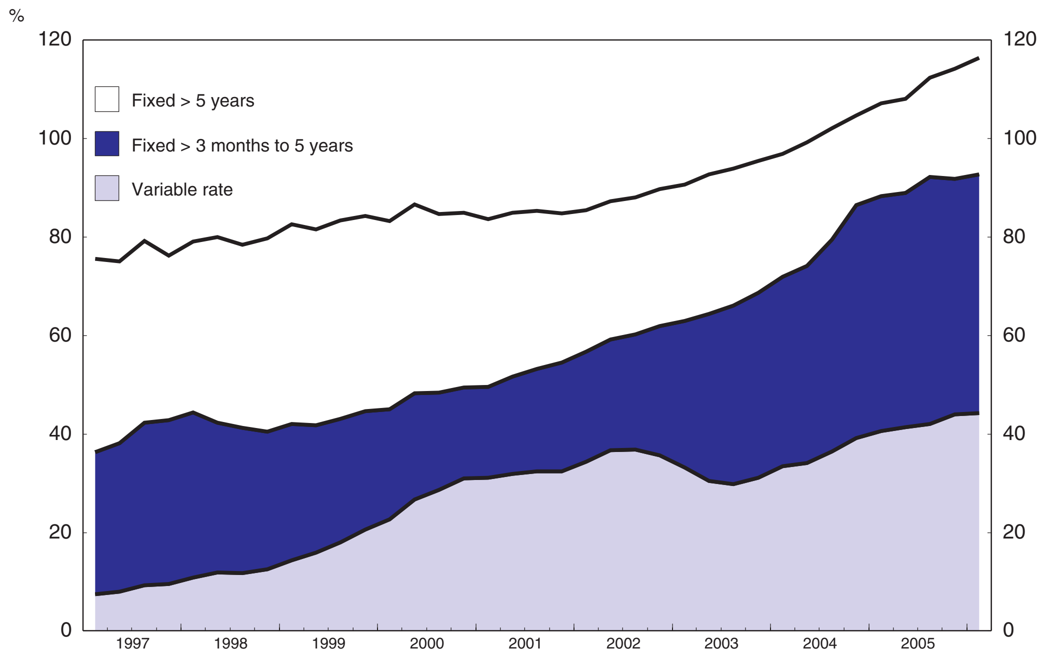
It is important to keep in mind that econometric models of house prices are surrounded by considerable uncertainty, but comparing different approaches can serve as a robustness check. In OECD (2006b) valuation of house prices is analyzed by comparing the house price to rent ratio across countries. While these results might be of limited explanatory power for Sweden as rents cannot adjust to market conditions, it is nevertheless interesting to note that this approach yields a similar overvaluation of 2% and 17% at the end of 2005 and the second quarter of 2006, respectively. However, the user cost elasticity is higher: a 1 percentage point increase in user costs leads to a 10% decline in house prices (compared with 2.3% in the above equation).

1. The real estate price index is calculated by Statistics Sweden using information from tax assessments as well as sold property and refers to the value of the house (not the square metre size). User costs are a broad measure which take into account that housing costs for households encompass more than the monthly nominal interest payment. They are computed for this analysis using 5-yr mortgage bond yields after tax (*i.e.* taking into account the value of interest deductibility), deflated by the average of the current and past inflation rate and adding the real estate tax rate $r_t = [(1-t)i - \pi^e + \tau_h]$ (Hort, 1998).
2. The house price equation also includes a time-trend.
3. A dummy variable that takes the value of 1 in 1992 and 1993 was included to account for the real estate crisis.
4. This calculation assumes supply growth in 2006 at average historical rates.

mortgage costs and a low level of construction have contributed to the large upswing over the last ten years. This has been supported by an increase in mortgage lending and the increased use of more flexible mortgage loan products (Box 4.2; Nyberg, 2006).[1] Mortgage credit is usually granted against pledging property for up to 70-80% of its value as collateral (no legal limit for the loan-to-value ratio exists). Additional credit is often provided by the bank that owns the mortgage institution. Outstanding household mortgage debt in 2005 was at around 53% of GDP, somewhat higher than the EU15 average of 46%.[2] Similar to developments in neighbouring Denmark, the share of variable rate loans has increased significantly over the last decade (Figure 4.4). Variable rate loans (duration < 3 months) now account for more than a third of the total stock (up from around 10% in 1997) and more fixed rate loans (duration > 3 months to 5 years) around 40% (up from around 30%).[3] Ten years ago, more than half of outstanding loans had a duration of over 5 years; now they account for only around 20%.

Figure 4.4. **Stock of household mortgage loans by duration of fixed interest periods**[1]

As percentage of household disposable income



1. Excluding loans to non profit institutions serving households.

Source: Riksbank and OECD Analytical database.

Due to this change in the structure of mortgage loans, households today are likely to be more exposed to fluctuations in short-term interest rates.[4] As in other countries with comparable developments in mortgage markets, monetary policy thus has a more direct influence on household consumption expenditures and the lags of transmission are probably shorter today than previously (OECD, 2006c).

At their current level house prices are estimated to be somewhat higher than warranted by fundamental factors. Compared internationally, this is not particularly worrisome. However, it has to be kept in mind that interest rates are still at very low levels

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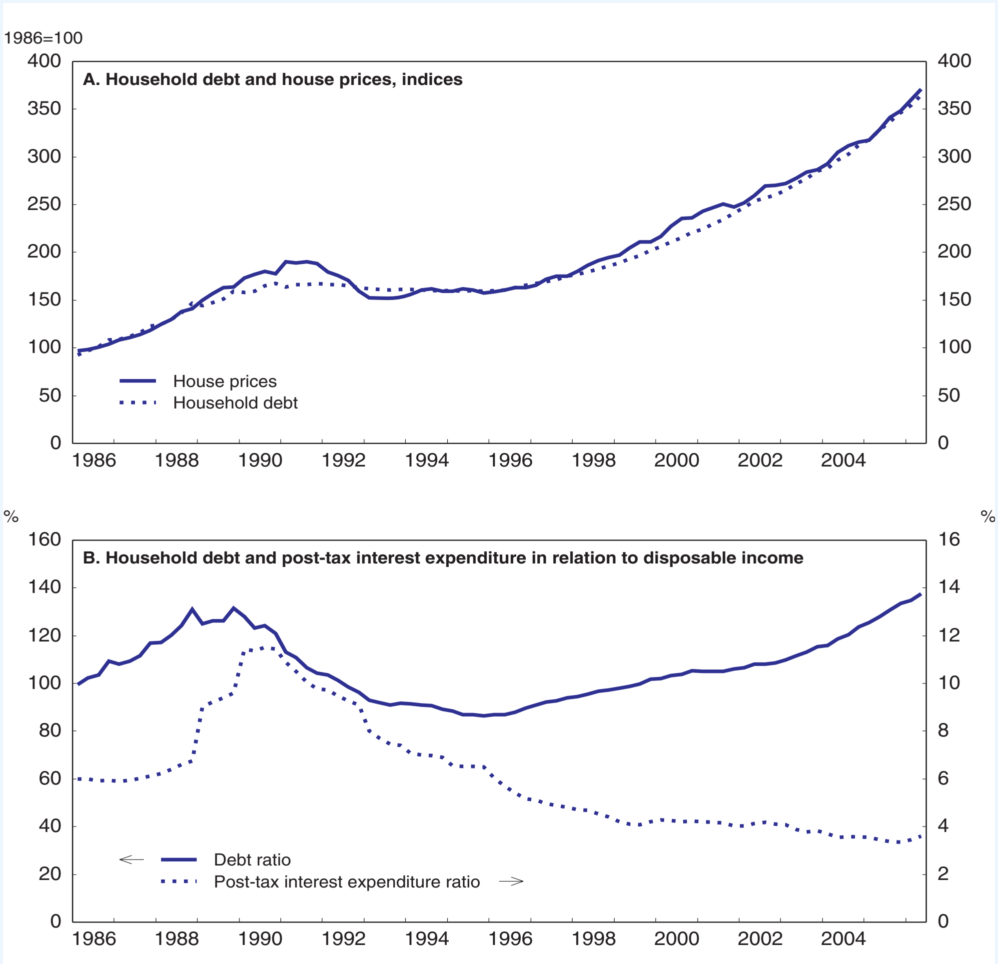
Box 4.2. **Financial position of the household sector**

Along with the increase in house prices, household mortgage debt has increased strongly in recent years (Figure 4.5). For the sector as a whole, the overall debt burden in relation to disposable income has reached over 130% – the highest ratio since the beginning of the 1990s. At the same time, the interest burden has declined to historical lows – a development akin to other countries that have seen their interest rate levels coming down since the 1990s (and also supported by the increasing share of variable rate loans). Notwithstanding the debt dynamics, an even bigger increase in assets has actually led to an improvement in the overall net financial position of the household sector (from 105% of disposable income in 1995 to 180% in 2005). This is mainly due to increases in the value of their holdings of shares and other equity as well as in their pension fund assets. Apart from financial assets, the housing assets of households have significantly gained in value, amounting to approximately SEK 3 300 billion (250% of disposable income) in 2005.

Figure 4.5. **Household debt**



Source: Statistics Sweden and the Riksbank.

Box 4.2. **Financial position of the household sector** *(cont.)*

At the micro-level, analyses by the Riksbank suggest that households with a high debt burden are typically those in the higher income brackets.[1] Nevertheless, more than a third of borrowers in the lowest income brackets are below a financial margin that would allow them to cope with negative shocks (such as high interest rates).[2] Looking at indebted households only, the debt burden differs not only across income groups but also on a regional basis, with the debt ratio being highest in Stockholm (average debt burden of indebted households 210% of disposable income *vs.* national average of 169%). This is supported by the housing affordability indicator (*Boindex*) published by Swedbank which measures the purchasing power of households after housing expenditures. While for the country as a whole, households on average spend less than 15% of their gross income on housing, households in Stockholm, Gothenburg and Malmö spend significantly more.

1. The analysis is based on the annual cross-sectional survey of the economy of 20 000 households (HEK survey) by Statistics Sweden. See Riksbank (2006b).
2. The financial margin calculated by the Riksbank equals household's disposable income after interest expenditure, other housing expenditure and expenditure for a reasonable standard of living (Riksbank, 2006b).

and incomes have grown significantly due to the favourable cyclical position. Going forward, both factors are likely to return to more normal levels with a slowing effect on house price growth. Prices in the past have also shown a high elasticity to changes in supply and higher house prices have thus also reflected restrained construction activity.

Structure of the housing market

The Swedish housing market has a particular structure somewhat different from comparable countries with owner-occupied housing (mostly single family houses) representing only 38% of the total stock – at first glance considerably less than in other countries (Table 4.1). However, tenant-owner dwellings (housing cooperatives or *bostadsrätter*), which basically represent the segment of owner-occupied apartments, cover another 17% of the stock, thereby putting Sweden's effective owner-occupation rate at

Table 4.1. **Structure of the housing market by tenure**

% of total

	Private rental	Public rental	Tenant-owner/cooperative[1]	Owner-occupation
1945	52	6	4	38
1960	43	14	9	34
1970	30	23	13	34
1980	21	24	14	41
1990	20	25	15	40
2000	24	23	15	38
2005	**23**	**22**	**17**	**38**
Denmark	**17**	**20**	**11**	**52**
Finland	**15**	**17**	**10**	**58**
Norway	**18**	**5**	**16**	**61**
Other Europeans	**19**	**13**	**8**	**60**

1. Includes employer-provided housing for countries other than Sweden.

Note: The last census in Sweden was done in 1990. Data for 2005 represent unpublished calculations by Statistics Sweden. Data are 2004 for the other Nordic countries and 2001 for the other Europeans average.

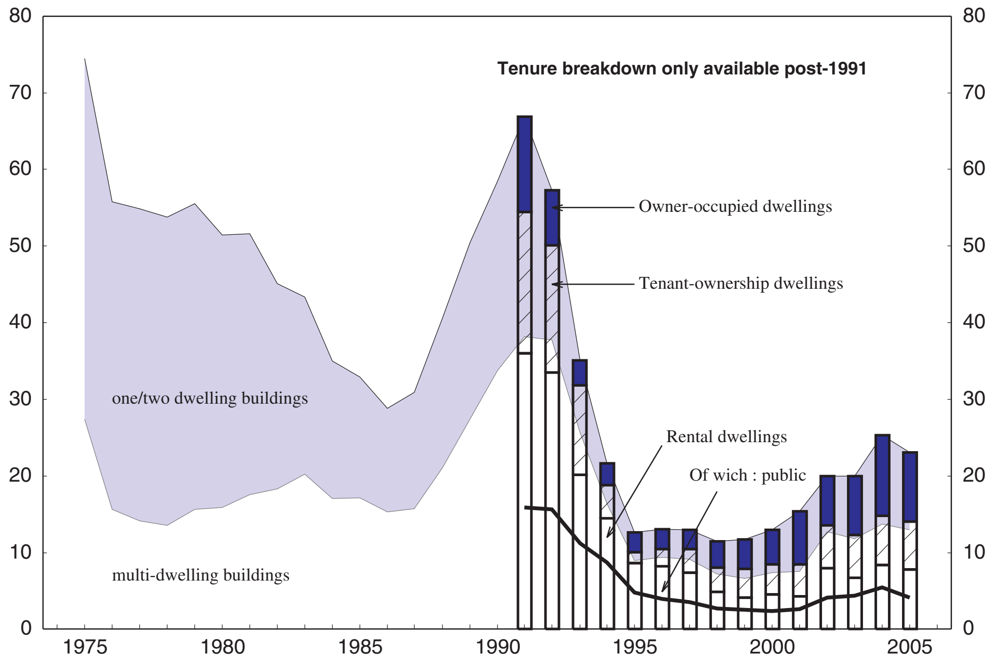
Source: Englund *et al.* (1995), Ministry of Finance, OECD (2006c).

55% – closer but still somewhat below the average of Nordic and other European countries of just under 70%.

Tenant-owners are members in a cooperative association that owns a multi-dwelling building. They do not own their apartment but can trade the "right to live" in it relatively freely (Box 4.3). Tenant-owner dwellings are currently the fastest growing tenure (partly due to conversion from rental flats but also encouraged by the tax system – see below). The importance of tenant-owner dwellings is partly explained by the fact that Swedish law does not allow outright ownership of an apartment.[5] The reasons for this regulation are unclear and the government should consider abolishing it so as also to allow the establishment of a buy-to-let market as in other countries which would help individuals to better spread the risk of their capital investments.

Figure 4.6. **New construction of dwellings by tenure**

Thousand units



Source: Statistics Sweden.

The rental sector is somewhat larger than in many other European countries, and is characterized in particular by a high share of public housing of 22% (of the total housing stock). This is high even among Nordic countries and in Europe only surpassed by the Netherlands. Its importance has been increasing significantly in the post-war decades at the expense of the share of the private rental sector. Public housing companies are owned by municipalities and, in contrast to social housing in most other countries (except for Denmark), they are open to all (no means-testing). The specific tenure of municipally owned housing was intended to play an important role in achieving the goals of housing policy after the war, namely to raise the average housing standard, to equalise the distribution of housing consumption, to restrict wealth transfers to private property

Box 4.3. **Tenant-owner (co-operative) housing**

Tenant-owner housing provides an alternative to both renting and owning and is closest to cooperative housing as it exists in other countries. This vehicle constitutes an indirect form of ownership which is essentially the only possibility in Sweden to "own" an apartment outright. It differs from direct ownership in that the building is collectively owned by a legal entity – the cooperative association – of which the tenants are members. Usually there exists a separate association for each apartment building. The tenant acquires a share of the entity that represents his right to live in the apartment. This share can be used as a security for mortgage loans and can also be freely traded (although the association may reserve the right to be asked for permission). However, the ownership right is limited in the sense that it cannot be used purely as a capital investment by renting the apartment to someone else (mostly this can be done, however, for shorter time periods after permission from the cooperative). Tenants pay a monthly fee to the association to cover running costs including the financing costs for mortgage loans taken up by the association as well as real estate taxes. Another variation of the co-operative form of ownership is so-called "cooperative rental housing" where members rent the apartment from the association of which they are a member. The shares in such entities cannot be sold on the free market and trading always takes place with the association.

owners and to counter housing segregation. Of these goals, only the first was clearly achieved: the stock of dwellings per inhabitant as well as their size is one of the highest among European countries.[6] The housing stock is also comparably young and has been mostly built in the post-war decades. This is clearly an effect of the substantial production subsidies that were given to new construction as well as public efforts to increase construction activity such as the "Million dwellings programme" started in the 1960s.[7]

Thus, Sweden does not have a shortage of housing supply – quite the contrary. However, supply is not located where it is most needed in terms of demand: rents differ very little across the country, thereby not reflecting different demand situations (unlike house price developments which significantly diverge across regions). Queues for new tenants in the rental sector coexist with vacancy rates for apartments, which still are about twice as high as in the end of the 1980s.

Having a sufficiently large rental market is important as it provides the public with an alternative tenure choice that is more flexible that owner-occupation. Mobility is facilitated by renting and financial flexibility is enhanced as citizens can make a free choice whether to invest their money in a home or in other assets. However, in order to fulfil its important role, the rental market must be able to match demand and supply for this tenure form. The Swedish rental market model fails to do so, not least due to its unique rent setting system.

The rent regulation system

Historically, rent regulation was introduced in Sweden during the 1940s as a control framework to avoid unjust rent increases. Discussion about reforms started in the 1960s, but changes were enacted only in the 1970s, gradually moving to a softer form of rent regulation. However, rent setting still remains *de facto* highly regulated.[8] Today's system is a collective bargaining system (analogous to the labour market, see Lind, 2005) with a price determining role being played by non-profit municipal housing companies which in effect establish a ceiling for rents for the whole rental market. The yearly rent setting process starts in September with negotiations between local tenants' unions and the respective municipal housing companies. The basis for the rent determination is a historical cost approach, reflecting the age composition of the housing stock of each individual housing company. The latter can set rents differently among its dwellings with the overall aim that rents more or less reflect the total costs of the company (Box 4.4). However, as each municipality has its own housing company, such rent differentiation is restricted to the region the company is responsible for.

Following an agreement in the public housing sector, rents in the private rental sector are set through negotiations between local tenants' unions and local landlord associations and are based on the use value principle (which specifies that rents should be the same for similar apartments in the same area with equal general value to the occupant). In practice this means that private rents can be agreed individually, but tenants have the right to let the appropriateness of their rent be determined by a public rent tribunal (rent committee). The committee decides on the basis of comparable rent levels in public housing (within the same municipality) and usually slight deviations (up to 6%) are deemed acceptable. Thus, although there are no normative rules for setting the rent level, the result of the system is that private rents are essentially tied to the rents in the public sector (which thereby set a ceiling for the national rent level).[9] It is becoming increasingly difficult to find comparable public housing dwellings within the same municipality that can serve as a comparison group for private dwellings. As public rental construction on average accounts for more than half of total rental construction, this reflects that new construction is distributed fairly equal across regions rather than taking the regionally diverging demand situation into account. Also for this reason, the regulations concerning comparison of public and private rents have been applied somewhat more flexibly in recent years.[10]

Due to the cost-based rent determination in public housing, rents in attractive city locations are significantly below a market-clearing level. Rents in the Greater Stockholm region, for example, were about 10% higher than the national average in 2005. By contrast, prices of owner-occupied houses in Stockholm county as well as of tenant-owner flats in central parts of Stockholm were more than twice as expensive as the national average suggesting a significant underpricing of rental housing.

The main theoretical argument put forward in favour of some form of rent control is that landlords have more bargaining power than sitting tenants, who face costs of moving as well as search costs for a new place and thus are more willing to accept a landlord's demands.[11] Conclusive empirical evidence on the efficiency of rent control to deal with this asymmetry is, however, scarce (Turner and Malpezzi, 2003). The major negative effects of rent regulation are seen as low private housing construction, black market activities, inefficient use of the dwelling stock and segregation effects; many of these apply to the Swedish case (Lind, 2005, Ellingsen and Englund, 2003). However, they are all more or less symptoms of the general failure to match demand and supply at the level of individuals, which is visible in increasing regional house price variation in combination with little rent differentiation, long queues for new tenants as well as illegal side payments for rental contracts. In addition, the rent setting framework benefits insiders already in the market but makes it increasingly difficult for an outsider to enter it. It is a common practice to accept a rental apartment which may not serve your purposes right now, since, once in the rental market, it becomes easier to move around.

Box 4.4. **Municipal housing companies**

In the post-war period Sweden decided against the creation of a "poor-housing" sector and instead established public not-for-profit competitors on the rental market providing housing to a wide range of households. These public institutions were expected to make up for any construction shortfalls by private competitors and eventually were aimed at competing on the open market. While in the 1970s and 80s, public construction was responsible for more than 75% of new rental dwellings, its importance has declined somewhat but still remains at around one half. The public rental housing sector today consists of around 300 municipal housing companies (MHCs) which are owned by their respective municipalities. The rent level they aim to set is used to cover direct costs, but they are not managed on a strict non-profit-making objective as they provide a return for the capital invested by the municipalities (the share of the initial municipal equity capital, though, has declined significantly over time since many MHCs were created in the 1960s and have grown since then). There is a cap on what dividends a MHC should pay to the owner and the government decides what an appropriate rate of dividend is.[1] Until further notice this has been defined as the average interest on government bonds during the preceding year, plus one per cent, calculated on the part of the owner's equity. MHCs aim for cost-covering for the company as a whole and thus they can set varying rents in different dwellings within their municipality. If a MHC has a rental income in excess of costs and dividends, these funds are reinvested in new construction. In addition, mortgage loans are taken up for which the municipality may provide a guarantee (against a fee).

The extent to which the state is subsidizing MHCs and whether this constitutes a case of state aid is currently the content of a complaint filed by the European Property Federation (on behalf of the Swedish Property Federation – an interest organisation for property owners and tenant-owner associations) to the European Commission. It is argued that apart from some direct payments of the state, the guarantees were not given at normal conditions and that the return the municipalities receive for their equity stakes is lower than a comparable market return. The estimated amount of state support (and whether it constitutes a breach of European state aid rules) is controversial, however.[2] Also, the government argues that there is an important social element involved in the provision of public housing. While the outcome of the complaint is still uncertain, its existence might lead to a general rethinking of the role of MHCs in the housing market and generate some reform momentum.

1. See SFS 2002:102, Public Utility Housing Companies Act, and SFS 2003:348, Ordinance on reasonable dividends from Public Utility Housing Companies.
2. In the complaint it is estimated that state support given to municipalities amounted to around SEK 12 billion in 2002 (0.5% of GDP), most of this related to an *allegedly* too low return on capital requirement for the municipalities' equity stake in MHCs. The government (apart from questioning the assumptions for the calculations) in response argued that the prime cost principle for rent determination in MHCs effectively limits their earnings capacity in comparison with private housing companies. Overall, therefore, they deem Swedish housing policy to be neutral and non-discriminatory.

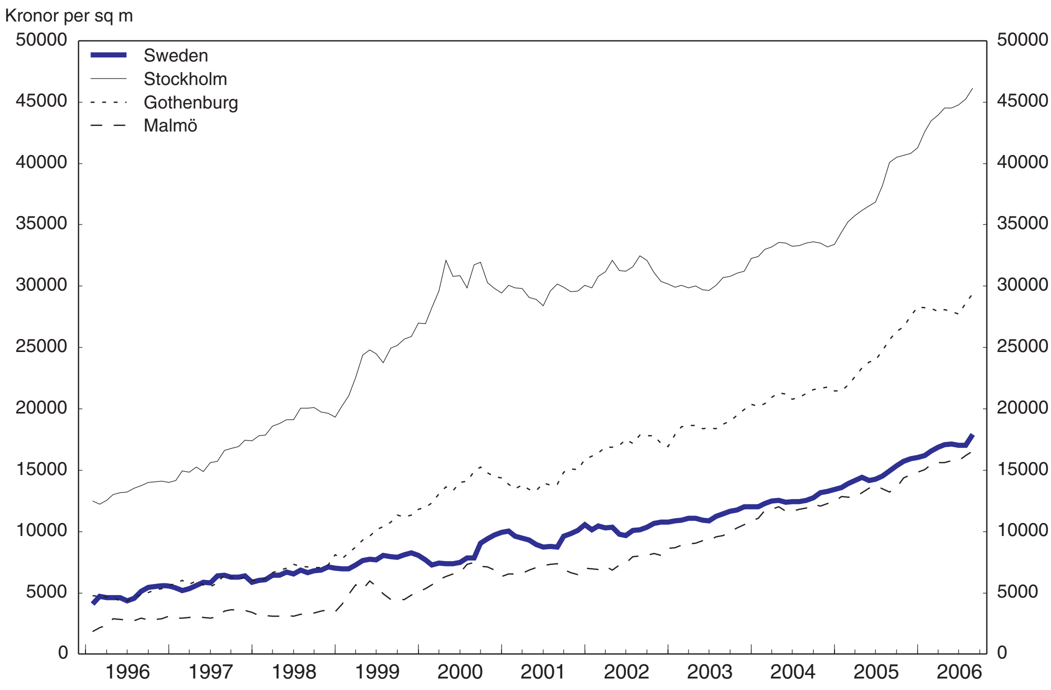
Rent regulation lowers construction activity,...

While construction of owner-occupied dwellings has increased over the past decade, in line with increasing house prices, the number of newly built rental dwellings remains muted and below the levels seen in the early 1990s. This holds in particular for the construction activity of private rental dwellings. Rent regulation is often mentioned as a damping factor for construction (Lind, 2003) as owners cannot charge a market-clearing rent and face the risk that regulations might change over time. In addition, the property owner carries the risk of being asymmetrically hit in case of a recession as demand for housing might fall in particular in newly constructed private rentals (which have higher cost-based rents than older apartments) rather than spread over the whole housing stock. Hence attention should be paid as to whether the recent step towards liberalisation of rents for newly constructed dwellings leads to major construction activity as long as rents are kept down in other parts of the rental sector. One way to circumvent this problem is to allow flexible rent setting for apartments that become vacant when the previous tenant moves out (Finansdepartement, 2003). This would still protect sitting tenants, but would reduce the risk of constructing new rental dwellings. On the other hand, lock-in effects would almost certainly be aggravated.

One way to capitalize the difference between market and regulated rents is to convert a rental building into a tenant-owner dwelling whose price is not regulated and can be sold on the free market (Figure 4.7). If a majority of tenants can agree to form an association they can buy the property and convert it. They have to agree on a purchase price with the owner which allows both sides to retain some of the gain. As tenant-owner dwellings are the fastest growing form of tenure, such incentives clearly seem to work. In particular, conversions into tenant-owner housing are so far mostly a phenomenon of metropolitan areas where the difference between market and regulated rents is large. Since 1990 around 6% (90 000 dwellings) of the stock of rental apartments has been converted into tenant-owner dwellings and 80% of those took place in the Stockholm region. Over time, therefore, the share of rental flats has decreased, making the visible shortages even more acute – particularly when taking into account the low rate of construction of rental dwellings.

Figure 4.7. **Prices of tenant-owner dwellings across Sweden**

January 1996 to August 2006



Source: Maklarstatistik.se.

Meanwhile, in Stockholm, due to legislation making the selling of MHC property more difficult and to political considerations, the conversion of public rental housing into tenant-owner dwellings has been heavily restricted in the last years by the local government, making private rental conversions more frequent (they account for around 75% of all conversions since 1990). However, the new local government in Stockholm is advocating conversion of municipal rental housing to tenant-ownership and the national government has announced that the legal restrictions against conversions will be removed.

... creates inefficiencies in the use of existing housing stock,...

Inefficiencies in the use of the housing stock can take several forms, such as tenants being locked into cheap apartments that do not fit their preferences anymore or, on the contrary, tenants renting much larger places than they actually need (or could afford at market rents). The most striking example of the inefficient allocation of the housing stock is the existence of queues for the allocation of apartments. In the Greater Stockholm region 8% of the population was registered with the Municipal Housing Allocation Agency in 2005.[12] 70% of those had a permanent dwelling but were obviously willing to switch to another form of tenure. Due to the cost-based rent determination, which does not take location into account, attractively located city dwellings might rent for a similar or even lower price than apartments located in more remote areas, and therefore become much more sought-after. In order to be allocated an apartment in the inner city of Stockholm the waiting time is more than 10 years. Even for a place in the outer suburbs and neighbouring municipalities one has to wait around 4 years. This should have negative effects on tenancy and labour mobility, as empirical evidence for other countries suggests (Munch and Svarer, 2002 and Svarer *et al.*, 2005).

... leads to black market activity,...

Lind (2005) reports that around 50% of apartment exchanges in Stockholm involve some kind of side-payment with prices of around 150 000 SEK (€ 16 300) per room for a rental contract. This can take the form of direct payments or can be hidden, *e.g.* the new tenant takes over the old furniture from the old tenant at a high price. While it can be argued that such payments introduce a market element into the rental market “through the back door”, this is clearly not a preferred way of making the housing sector more efficient.

... and might even increase segregation

Magnusson and Turner (2005) find that vulnerable households are overrepresented in public housing and moreover that they are more concentrated within this sector in areas where there is a smaller share of public housing.[13] Such households clearly have more problems getting a foothold in the private rental market. This is somewhat ironic, as one of the pillars of Swedish housing policy was to not create a public housing sector for the poor but rather to attenuate housing segregation (Nesslein, 2003). However, in 2002, half of all people living in areas with employment levels below 50% had an immigrant background, an indication that this policy has not been successful in preventing spatial segregation between households with different cultural and socio-economic background. There are many causes behind housing segregation. One structural factor is that municipal housing companies have a relatively large share of rental dwellings in the outer suburbs, while private rental dwellings are more frequent in the cities and inner suburbs. Also,

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municipalities are responsible for providing housing to asylum seekers, who to a large part have been housed in public housing dwellings. However, segregation can also occur or be reinforced, for example, because black market activity underlying the rental market has the effect of pricing poorer people out of the attractive locations (and into the public housing sector). Also, better off households can afford to wait in the queue for attractive apartments for many years as they probably have good housing already. For these reasons it is not necessarily to be expected that segregation will increase if rent regulation is phased out. In Malmö, where rents were gradually being adjusted closer to market levels, no significant change in the segregation situation took place relative to cities where no adjustment took place, such as Stockholm (Lind and Hellström, 2006). Furthermore, evidence for Denmark suggests that the gains from rent regulation are poorly targeted, with those in the higher income deciles benefiting most (in contrast to the intended effect) (OECD, 2006c).

Gradually let rents reflect market demand

The above mentioned distortions that the current system creates call for a gradual phasing out of rent regulation. However, the system can be improved without a major overhaul, as the example of Malmö shows.[14] Since the beginning of the 1990s, rents in Malmö have moved to more market-oriented levels – with the agreement of the local tenants' union. The process was carried out gradually, but by now, rents differ by around 25% between the most and least attractive areas (Lind and Hellström, 2006) and the length of queues has been reduced.[15] In Stockholm, by contrast, there are no visible differences between locations. What would happen if rent regulation were to be lifted? Berger, Jonsson, and Turner (1994) estimated that the "undervaluation" of rent levels was around 40% in the metropolitan areas of Stockholm and Gothenburg, but not so in other regions. Anecdotal evidence suggests that this is still a reasonable measure.

A small step towards more liberal rent setting came into force in July 2006. Since then the rule is that if rents for new dwellings have been negotiated and accepted by a local, established Tenant's Association these rents shall be presumed to be reasonable and not liable to be contested in a Rent Tribunal or to be compared with other, similar dwellings for a period of ten years. After that time rents shall be determined according to the ordinary utility value rules (comparison with similar flats in the public housing sector). But reforms could be more far-reaching, in particular as a gradual process of change risks significantly increasing lock-in effects of existing tenants.

Increase flexibility of public housing companies

The setup rather than the existence of the public housing companies is part of the problem: rents can be adjusted *within* a housing company (which, according to the Municipal Act, only can operate within the municipality or municipalities owning the MHC) to better reflect the demand situation, but not *between* companies. In other words, cross-subsidisation is possible within a company but not within regions made up of several municipalities. The example of reforms in Malmö shows that problems can be solved within the current system by introducing more rent differentiation through increased cooperation among municipalities. Stockholm should seek inspiration from this example. One part of a possible reform could thus be to allow MHCs to operate out of the limits of their own municipality, thereby putting them on a more equal footing with private investors. This would at the same time allow them more differentiation within their stock of dwellings.

Fiscal issues

In previous decades, fiscal support for housing consumption was abundant. Including interest subsidies for rental housing, housing allowances and favourable tax treatment of owner-occupied housing, etc., expenditures increased from around 1.7% of GDP in 1970 to close to 4% of GDP in 1990 (Englund *et al.*, 1995). These direct and indirect subsidies were drastically reduced with the 1990/91 tax reform, which cut interest subsidies, increased the real estate tax rate to 1.5% and reduced the tax value of interest deductibility to 30% from previously up to 50% for persons in the highest income tax brackets. Finally, value added tax rates for building material, heating and other housing services were almost doubled to match the standard VAT rate. Since the 1990/91 tax reform, the real estate tax rate has been altered quite frequently: it was raised to 1.7% in 1996, between 1997 and 2000 the assessment values were frozen, and when un-frozen in 2001, the rate was lowered to 1.0% for owner-occupied houses and 0.5% for apartments.

Housing taxation as of 2006 is below neutrality

As of 2006, housing taxation is based on a wide set of instruments: a real estate tax, imputed rent taxation, interest deductibility as well as capital gains and wealth taxes (Table 4.2). The effective taxes, however, are weakened by several factors. First, the

Table 4.2. **Housing taxation in Sweden, 2006**

	Owner-occupied houses	Tenant-owned cooperative apartments	Rental housing
Real estate tax *(fastighetsskat)*	1% of assessment value[1]	0.5% of assessment value[1, 2]	0.5% of assessment value[1]
Imputed rent tax *(schablonintäkt)*	none	The corporate tax rate of 28% is paid exclusively on imputed rent income being 3% of assessment value (this corresponds to a 0.84% tax of assessment value)[2]	none
Interest deductibility	Interest expenditures of any kind are deductible at a rate of 30%. If this leads to net capital income being negative and exceeding SEK 100 000 annually (SEK 200 000 for couples), then a lower rate of 21% is applied for the part of negative net capital income exceeding this ceiling.[3]	Interest expenditures paid within the cooperative are deductible against imputed rent income. Interest expenditures paid individually for debt taken up to finance purchase of a share in a tenant-owned cooperative are deductible as described for owner-occupied housing.	For rental apartments owned by a corporation: As for other expenditure, interest can be deducted from rental income before paying corporate taxes of 28%.
Capital gains tax *(kapitalvinstskat)*	⅔ of capital gains are counted as capital income and taxed at 30%, but this can be deferred[4]		
Wealth tax *(förmögenhetsskat)*	1.5% of wealth above SEK 1.5 million (3 million for couples)[2]		

1. New housing is exempted for 5 years, afterwards only half of it is paid for another 5 years. Full tax is paid after 10 years. For owner-occupied housing, a limitation rule prevents real estate tax payments to amount to more than 4% of disposable household income.
2. For tenant-owned cooperatives, the property assessment value is based on the comparable market value of the apartment block if used for private rentals. Due to rent regulation, this may be only a small fraction of the sum of individual apartments' market value. This lowers effective real estate tax, imputed rent tax and wealth tax.
3. If net capital income is negative, tax deductibility of interest expenses only matters if the person has sufficient earned income against which to deduct. As all pensions, sickness and unemployment benefits etc. are taxed as earned income, this is usually the case. Only social assistance, child benefits and housing benefits are not taxed as earned income.
4. For housing capital gains, taxation can be deferred indefinitely as long as the gain is re-invested in another owner-occupied house or tenant-owned apartment. Deferral can even extend across generations when a person dies and a house is transferred to the heirs.

Source: Taxes in Sweden, *www.skatteverket.se*.

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property value assessment set by the tax authorities is required to be 75% of the actual market value. Second, no tax is paid for the first 5 years after a new house is build, and only half is paid for the next five years. Third, a limitation rule prevents real estate taxes from rising above 4% of disposable household income.[16] Around 200 000 individuals are affected by this rule. Consequently, the effective real estate tax rate for owner-occupier homes amounts to around 0.94%, or 0.71% when taking the below-market value assessment into account.

For tenant-owned apartments, the combination of real estate tax and imputed rent taxation is comparable to a 1.34% real estate tax rate, and at first glance, it could therefore seem as if tenant-owned apartments were taxed more than owner-occupied houses. However, tenant-owned apartments benefit from a somewhat artificial value assessment. As the real estate tax and imputed rent tax is paid by the cooperative rather than the tenant-owners, the property value assessment used as tax base is derived from the market value of the apartment block if used for private rentals. In the metropolitan areas where the negotiated rents are well below what tenants would be willing to pay, the sum of market values of the shares in a tenant-owned cooperative may be several times higher than the market value of the apartment block sold as a whole. On a national average, probably the effective real estate and imputed rent taxes of tenant-owned cooperatives are comparable to that of owner-occupied housing.[17] Consequently, the arguments made for owner-occupied housing below could be made with similar conclusions for tenant-owned apartments.

The ideal housing tax system would be to give deductibility for interest expenses while mirroring it by imputed rent taxation, thereby taxing the benefit associated with living in the house. Such imputed rent taxation would come in addition to VAT paid on building materials etc. when constructing the house. In principle, the VAT ought not be paid before housing services are consumed, but charging it up-front at the time of construction is a reasonable practical arrangement which does not disadvantage the average home owner (Box 4.5). In principle, the imputed rent could vary with the interest level in capital markets, thereby mirroring the fact that a higher (lower) interest rate leads to higher (lower) tax reductions when borrowing costs are deducted. However, if abstracting from this by applying a constant imputed rent factor to the assessed house value, then an imputed rent tax becomes mathematically identical to a real estate tax as they are applied to the same tax base.

To assess whether the system of housing taxation is appropriate, the first question is, therefore, whether the real estate tax as of 2006 is neutral *vis-à-vis* the taxation of other assets. It appears that the real estate taxes applied to owner-occupied as well as tenant-owned housing are too low, but the answer is complicated by two factors. First, it depends on the level of interest rates. Second, it depends on what is the relevant alternative when the person considers investing in owner-occupied housing or financial assets. Someone who owns a debt-free house with a SEK 1 million market value, would under 2006 rules pay real estate tax equal to 1% of the property assessment value of SEK 750 000, *i.e.* SEK 7 500 a year. If the person sold the house, moved into rental housing and invested the money in bonds with a 5% nominal yield, she/he would pay capital income tax equal to 30% of 5% of SEK 1 million, *i.e.* SEK 15 000 a year. For the investment return that remains after tax, *i.e.* SEK 35 000 a year, the person would not be able to rent a house similar to the one sold. In fact, the real estate tax rate should be twice as high as in 2006 in order to avoid that different tax treatment skews the choice between owner-occupied and rental housing. A

Box 4.5. **The relation between value-added taxation and imputed-rent/real-estate taxation**

When an owner-occupied house is constructed, valued-added tax (VAT) is paid on building materials as well as construction services, etc. With consumption taxes paid up front in this way, it could be asked whether imputed rent (or alternatively real estate) taxation implies unwarranted double taxation. This is not the case, though, because imputed rent is not supposed to mimic consumption taxes, but rather capital income taxes. When living in her house, the owner-occupier both receives a return on investment and consumes this return. It is instructive to draw a parallel to what happens if, instead of buying a home, the capital is invested in bonds with the interest income being spent on consumption. In that case, the person would first pay capital income tax on the interest receipts and then VAT when the money is spent. For neutrality, housing taxation must therefore include both imputed rent and value added taxation.

Another issue relates to the timing of the VAT payment. Considering an owner-occupied house as an investment good, it could be argued that VAT on construction materials and services should be refunded when the house is being built. Thereafter VAT should be charged when the consumption of housing services takes place. In a system with imputed rent taxation, the net present value of tax payments would then be as follows, where *A* is the initial house price, π is annual house price inflation, *i* is the imputation factor, $t_{capital}$ is the capital income tax rate, t_{VAT} is the valued added tax rate and δ is the discount rate:

$$NPV\ tax\ payments = \sum_{t=1}^{\infty} \frac{1}{(1+\delta)^t} \left[A(1+\pi)^t\, i\, t_{capital} + A(1+\pi)^t\, i\,(1-t_{capital})t_{VAT} \right] \tag{1}$$

In practice, however, VAT is charged on the physical transactions occurring when the house is constructed, implying an initial house price $B = (1 + t_{VAT})A$. The net present value of tax payments is as follows:

$$NPV\ tax\ payments = \frac{B}{1+t_{VAT}} t_{VAT} + \sum_{t=1}^{\infty} \frac{1}{(1+\delta)^t} B(1+\pi)^t\, i\, t_{capital} \tag{2}$$

One difference between the two regimes is that a larger investment is needed when constructing a house when VAT has to be paid up front. In equilibrium, however, house prices will be higher, so VAT related to the remaining value of a house is recuperated when selling. An intuitive argument then goes as follows: If keeping the house fully maintained, so that it can be sold for the same price as it was constructed, the VAT on construction will in some sense not be paid by the owner, because it will forever remain as a constant markup on the house price. Effectively, VAT is only paid on the maintenance work, and thereby the time profile of the owner's VAT payments is not much different between the two regimes (1) and (2).

Nevertheless, paying VAT up front entails a financing cost which tends to make the net present value of tax payments larger in (2). On the other hand, if house prices increase substantially, then up-front VAT is advantageous for the owner. If, for example, urban development makes the location of an existing house more attractive, then only imputed rent taxation would rise, while no VAT would be paid on the additional consumption associated with the rising location value. The opposite applies if the value of a particular house falls. For assets that can be reproduced (buildings), prices should be expected to grow in line with general inflation, albeit slow productivity growth in the construction sector would imply that the real price of newly constructed housing (with given characteristics) should trend upwards. For assets that cannot be reproduced (land), prices should grow faster than general inflation – at the rate of the nominal interest rate in a

Box 4.5. **The relation between value-added taxation and imputed-rent/real-estate taxation** *(cont.)*

world with a constant population and Cobb-Douglas preferences. In dynamic general equilibrium, prices are in each period determined by an adjustment of the housing stock to the point where marginal utility equals the resource cost (shadow price) of newly constructed housing. Rational agents foresee this price development, and via the user-cost of housing capital, it will have a level effect on the housing stock, but no effect on the house price trend. Considering 1976-2005, for which data are available, national average house price inflation exceeded CPI inflation by 1.5%. Looking ahead, with this real house price increase coming on top of CPI targeted at 2%, nominal house price increases could be $\pi = 3.5\%$. Assuming a (nominal) discount rate equal to the net-of-tax (nominal) interest rate, $\delta = \textit{interest rate}\ (1\text{-}t_{capital})$, and applying a benchmark interest rate of 5% together with the Swedish $t_{capital}$ =30%, it appears that $\pi = \delta$. Thereby the discount and price increase terms cancel each other out, making (1) and (2) identical. So for the average house there is no difference between the two tax regimes if indeed nominal house price increases continue at a 3.5% long-run average.

Strictly speaking, the relevant price trend would not be the one for a house having given characteristics, because repair is needed to maintain the house's characteristics. The equations could therefore be solved under the alternative assumption that house prices – net of repair – remain flat $\pi = 0\%$. If full imputed rent taxes (with i equal to the capital markets' nominal interest rate) had been applied in Sweden, then the up-front application of VAT would entail over-taxation with net present value of 8.6% of the price of the house, given t_{VAT} = 25%. In conclusion, the up-front application of VAT may in practice imply a bit of over-taxation of net present value, somewhere in the range of 0-8% of the price of the house. However, this is offset by the discount implied by value assessments being set at only 75% of the market value.

similar non-neutrality is created for a first-time buyer borrowing all the money needed to buy the house. She/he would save SEK 15 000 a year in income tax payments when deducting mortgage interest expenses. Effectively, the difference of SEK 7 500 *vis-à-vis* the real estate tax is an indirect tax subsidy. It has a fiscal cost, and it encourages people to buy bigger houses than they would have preferred to do in the absence of the indirect tax subsidy. Consequently, with a benchmark nominal interest rate of 5% (2% inflation and 3% real interest rate), a neutral real estate tax rate for owner-occupied housing would be 1.5% of the market value, or in fact 2.0% to compensate for the property assessment values being systematically below market values (Table 4.3). A parallel argument can be made for tenant-owned apartments.

Some caveats apply for first-time buyers in very expensive areas and those contributing to voluntary pension savings plans. For people with very large interest expenditure and negative net capital income (typically first-time buyers), the value of interest rate deductibility decreases to 21%, implying that the neutral real estate tax rate would be lower. But at a mortgage interest rate around 5%, this applies only to the part of household debt exceeding SEK 2 million (4 million for a couple) and thus concerns only a small minority of urban households.[18] More importantly, it should be noted that if the alternative to buying a house is to invest via a pension saving scheme, then the current 1% real estate tax rate is exactly neutral, as investment returns are taxed by only 15% while they accrue inside pension saving schemes.[19] About 40% of the 25-64 year olds make

Table 4.3. **The real estate tax rate for owner-occupied housing that would be neutral *vis-à-vis* alternative financial investment**

Per cent

Capital tax considered for neutrality	Nominal tax rate	Real tax rate[1]	Nominal interest rate[2]					
			1990-99 average 9.2		Benchmark 5.0		2000-06 average 4.6	
Tax on positive capital income from investment held outside pension funds Tax deductibility of interest expenses	30	50	2.8	(3.7)	1.5	(2.0)	1.4	(1.8)
Tax deductibility of interest expenses if negative net capital income exceeds SEK 100 000	21	35	1.9	(2.6)	1.1	(1.4)	1.0	(1.3)
Pension saving schemes	15	25	1.4	(1.8)	0.8	(1.0)	0.7	(0.9)
Average across all current home owners								
Marginal capital tax rate[3]	25.1	41.9			1.3	(1.7)		
Average capital tax rate[4]	26.2	43.6			1.3	(1.7)		

Note: Numbers in brackets indicate what the real estate tax rate needs to be in order to imply full neutrality when taking into account that property assessment values are systematically 25% below market values.

1. Because part of the return on an investment is simply compensation for inflation, a capital tax applied to the nominal return implies heavier taxation than what appears at first glance. The real tax rate is what can meaningfully be compared to tax rates for earned income. It measures the effective tax on real investment returns as (1+nominal return)/(1+inflation), here using the benchmark nominal interest rate being 5% and inflation being 2%.
2. Based on quarterly averages of 5-year mortgage bonds.
3. Based on the following stylised characteristics and assumptions: For the 40% 25-64 year olds contributing to private pension saving schemes, this is, at the margin, the relevant alternative investment for three quarters, while debt repayment or assets held outside pension schemes is the relevant alternative for the remaining quarter. When moving into retirement, the speed of pension payments from private schemes can be adjusted thereby giving the recipient roughly the same flexibility to choose net saving flows on the favourable tax conditions as for those in working age contributing. Presumably, one in twenty has interest expenditure exceeding the SEK 100 000 threshold. Consequently, 30% face a *marginal* capital tax rate of 15%, 4% face a marginal rate of 21% and 66% face a marginal rate of 30%.
4. Based on the following stylised characteristics and assumptions: Half of the housing stock value is financed by debt. Presumably only a fiftieth of this debt mass is subject to the lower 21% interest deductibility. Had savings not been placed in mortgage equity, those contributing to private pension saving schemes might have placed half of the mortgage equity in their pension scheme. All other mortgage equity would have been placed in assets outside pension schemes. Consequently, the relevant *average* capital tax rate is 30% with a weight of 0.49, 21% with a weight of 0.01, 15% with a weight of 0.25 and 30% with a weight of 0.25.

Source: OECD calculations.

contributions to voluntary private pension schemes. The maximum annual contribution is SEK 20 000 for most, but rising to SEK 39 700 for high-income individuals. On average the 25-64 year olds contribute SEK 6 000 a year, meaning that most have remaining flexibility to increase their contributions if they wish.[20]

Under the current personal capital tax system, the real estate tax rate for owner-occupied housing would need to be raised to 1.3% to be neutral *vis-à-vis* how other capital assets are taxed (Table 4.3). This holds if considering the marginal capital tax rate, which is relevant when individuals and families decide where to place savings surpluses: building up mortgage equity by repaying debt, or placing it in financial assets. It also holds for the average capital tax rate which matters for assessing whether there is an implicit housing subsidy via the tax system.If adjusting for low assessment values, in fact, the neutral real estate tax rate would be 1.7%.

Independent of the level of real estate taxes, a tension is evolving between tax-favoured pension savings and interest deductibility. It is closely entangled with the issue of housing taxation, because of the still-easier access to flexible mortgage equity withdrawal and deferred amortisation, whereby the house is used as collateral to obtain cheap borrowing. The gap between the low 15% tax on investment returns in voluntary pension savings and the 30% tax value of interest deductibility invites tax planning by giving incentives for homeowners to shift to interest-only loans while increasing pension savings. With house prices now being far above what anybody had imagined when the 1990/91 tax reform was made, the net-present value of the tax revenue loss from such an arrangement may easily exceed SEK 100 000 in a typical example, part of which accrues to financial intermediaries (Box 4.6). Financial market development and flexible mortgage are beneficial, but may require renewed attention to skewed tax incentives. The only effective way to address this is to raise the very low tax rate on investment returns in voluntary pension savings or reduce the tax value of interest deductibility.

Box 4.6. **Low taxes on pension investments invite tax planning to benefit from interest deductibility**

Consider a couple aged 45 buying a house worth SEK 2½ million. They use their liquid savings and need mortgage finance for the remaining SEK 1½ million. One option is to take a loan with linear repayment over 30 years, meaning SEK 50 000 annually. Their income is sufficient to pay such a mortgage, and following common practice, the mortgage credit institute is therefore willing to offer them an interest-only loan as an alternative. Using this loan, they can channel the SEK 50 000 into their individual pension schemes. If (for simplicity of illustration) they buy the very same bond in the pension scheme as is issued for their mortgage loans, they will earn the same interest rate as they pay, say 5%. With interest expenditure of 5% * 50 000 = 2 500, their income tax payments will be reduced by 30% * 2 500 = 750, whereas the pension savings tax on the interest income is only 15% * 2 500 = 375. The net result is a tax subsidy of SEK 375 in the first year, and with another SEK 50 000 being moved into pension savings every year, the tax subsidy grows above SEK 15 000 in the year they are 65. From thereon it gradually declines when they retire and start repaying the mortgage with the extra pension income. In net-present-value terms, the couple saves tax payments in the order of magnitude of SEK 100 000-200 000, depending *inter alia* on how they liquidate the pension savings and the mortgage in old age. It is close to the equivalent of one year's earnings net of social contributions, income and consumption taxes for one average worker. Fees from financial institutions will absorb some but not all of the taxes saved: if additional mortgage borrowing costs are 0.5% of the increase in outstanding debt, then it is about half of the taxes saved at nominal interest rates of 5%; holding the bond in the pension savings plan is not expensive. For simplicity, this calculation abstracts from the fact that pension contributions are deductible from income taxes when made while pension receipts are taxed as income, since this is neutral as long as the person faces the same marginal tax rate when working and when on pension. In practice, many face a lower marginal rate when retired, in which case the reduction in tax payments from the described arrangement is larger.

Capital gains on housing are generally liable for taxation in Sweden unlike in most other countries where gains on an individual's principal residence are exempt in order to avoid lock-in effects and thus potential obstacles to mobility it could create (OECD, 2006d).[21] However, in the Swedish framework both owner-occupied housing and tenant-owned cooperative housing have preferential treatment via a discount on the tax base. When such a dwelling (which has been the owner's primary residence) is sold, two-thirds of the capital gain is counted as taxable income and taxed at the standard capital income tax rate of 30% (thus, the effective tax rate is 20% of the nominal gain). Moreover, taxation can be deferred for the part of the sale proceeds that is reinvested in another house or apartment and deferred taxes can be transferred at death to heirs who inherit a house.[22] Deferral of capital gains taxes amounts to a quite sizeable interest-free credit granted and the total stock of deferrals outstanding in 2005 was equal to 4.7% of GDP. Deferral reduces lock-in effects and thereby facilitates mobility, but by allowing a deferral of capital gains taxes only when buying another house or an apartment, people who sell their house to move into a rental flat have to pay the tax. Thereby, the incentives given by deferral favour tenant-owned and owner-occupied housing and distort the choice of tenure (Finansdepartement, 2003) – notably so when real estate prices have risen significantly as in the recent past. A general disadvantage of a capital gains tax is that it may increase house price volatility (Fuest *et al.*, 2004). The argument goes as follows: when house prices are above their equilibrium value, home buyers are less cautious, because the tax deductibility for capital losses softens the consequence if having to sell some day at a lower price. *Vice versa*, prices may go further below equilibrium because potential buyers will value houses less when knowing that they would be taxed of any capital gain. Consequently, prices may become more volatile, but how large a role this has played in Sweden is hard to quantify.

For the wealth tax there is no explicit preferential treatment of housing assets, but effectively there is, as the property assessment value is below market value, thereby implying lighter taxation than for financial assets. For those in tenant-owned housing, this is magnified by the fact that their share of cooperative equity, which is the basis for personal wealth taxation, is calculated based on the property assessment value of the apartment block if used for private rental housing, as described above.

In sum, there are good arguments for increasing housing taxation, for example by increasing the real estate tax. In addition to the concern for neutrality underlying the discussion above, it should be noted that globalisation will make it increasingly important to focus taxation on less mobile factors such as land and housing. Consequently, the optimal real estate tax rate would be higher than indicated in Table 4.3.

Housing taxation initiatives in the 2007 Budget and the new government's programme

In the 2007 Budget, the government declares that it will abolish the real estate tax in two steps.[23] In 2007, the property value assessments would be frozen at the level applied for taxation in 2006. This would apply to all housing categories, including one-family houses and holiday homes as well as multi-family houses (apartment buildings). For one-family houses and holiday-homes, the real estate tax associated with the land value would be capped at SEK 2 per square metre or SEK 5 000 per property if that is lower. For multi-dwelling houses, the real estate tax rate would be reduced from 0.5% to 0.4% and imputed rent taxation would be abolished. The wealth tax, which is paid by many homeowners following the strong house price increases of recent years, would be halved in 2007, as a prelude to later abolition, but the halving in 2007 will only apply to financial wealth, not to housing wealth.[24] In a second step, a commission would be established to prepare the abolition of the state real estate tax from 2008 and the introduction of a municipal real estate fee that would not be based on the property value assessment. This might be coupled with adjustments of the municipal financial equalisation scheme and other measures to address distributional effects across income groups as well as regions. The key concern stated as the reason for these changes is that the dependence on current property value assessments makes the real estate tax go up in ways that are unpredictable and felt as unfair by households. Another argument made is that the automatic adjustment of the

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property value assessments makes real estate taxes go up without an active political decision being made. Changes made in the second step will be fully financed within the housing sector. But currently there is no commitment to finance the cuts made with the 2007 Budget. In one step, Swedish housing taxation is being reduced by almost ¼ per cent of GDP – close to what the nominal tax freeze in neighbouring Denmark has produced over five years.

Implementing such a strong reduction of housing taxation is most unfortunate seen from a macroeconomic perspective. It would worsen the non-neutrality described above with housing taxation already being below what would be neutral *vis-à-vis* other parts of personal capital taxation and would also risk overheating the housing market and construction sector (Chapter 1). It is a legitimate concern that movements in real estate taxes resulting from rising house prices can create liquidity problems notably for older persons, but this can be solved in other ways than by abolishing the real estate tax (Box 4.7).

It is true that a number of vehicles are used for taxing immovable property in Sweden: stamp duties, real estate tax, wealth tax and capital gains tax. But the combined revenue from these taxes is not large compared to other countries (Figure 4.8) – even if capital gains taxes from housing are included (which in 2003 amounted to an additional 0.3% of GDP).[25]

The preferred policy option

The first-best solution would be to replace the 2006 housing taxes with an imputed rent tax at a rate that ensures neutrality *vis-à-vis* interest deductibility. A second-best would be to maintain the mix of real estate and imputed rent taxes applying in 2006 while raising the tax rates to neutral levels, thereby mimicking a pure imputed rent tax system. It should also be recommended to let the taxation of tenant-owned housing be based on property value assessments that reflect the value of each individual apartment.

Alternative policy options

If, nevertheless, abolition of the state imputed rent and real estate taxes is pursued, a number of measures should be recommended:

- Introducing a local land or real estate fee, as announced by the government would have a number of positive effects including encouraging municipalities to issue more land for construction, thereby helping to meet the rising demand for housing. To fully reap these benefits, however, it is important that such a fee reflects actual valuations and that municipalities decide to set the fee at a level that is not too low. Development of mortgage instruments as described in Box 4.7 should handle any liquidity problems for home owners.
- Strengthen the taxation of housing capital gains. The effective tax rate could be increased by simply applying the standard 30% tax rate on the full housing capital gain rather than on merely two thirds of the gain as is the case currently. Adjustments to diminish the effective tax rebate associated with deferral should also be pursued, but without creating lock-in effects. One option is not to grant deferral when the owner dies and the house or apartment is transferred to the heirs. It would even have the appeal of reducing lock-in effects, as older persons would then not disadvantage their heirs if selling their house or apartment to move into a rented special living facility adapted to the functional limitations older persons may have. To reduce possibilities to circumvent

Box 4.7. **New mortgage products could relieve homeowners of tax-generated liquidity problems**

When house prices go up in an area, all homeowners become richer. Some realise the gain by selling the house. But also those remaining where they are become richer as the difference between the market value of their house and their remaining mortgage debt, *i.e.* their so-called mortgage equity, grows. Under the current system where real estate taxes follow updated property value assessments, they therefore get to pay more taxes. The tax increase is small, however, compared to the growth of mortgage equity: the average homeowner in Stockholm has experienced a price increase of 15% in the last year, worth around SEK 375 000 of mortgage equity.* At the same time, his real estate tax dues have increased by around SEK 2 800 and some households may find it difficult or simply inconvenient to find the money for paying this – in particular pensioners arguing that "my pension is small, and you cannot eat bricks and mortar".

If the problem with real estate taxes in an environment of rising prices is actually more about financing and liquidity, instead of wealth, cutting real estate taxes is not the best solution. Instead, the stream of yearly tax payments can simply be transformed for cash-constrained tax payers by mortgage financing of the tax liability. When house prices increase 15%, mortgage credit institutions would have no worry lending an additional 0.1%. A natural solution would therefore be that payment of the real estate tax becomes part of the standard financial package offered by the mortgage credit institution or bank financing the purchase of the house. It can be made in a way so the person or family buying a home will know exactly how much they will have to pay each month. If house prices then grow, a bit of the rise in house value will be matched by additional debt to finance the increasing real estate tax, leaving the homeowner with a slightly lower increase in mortgage equity than otherwise. Conversely, if house prices fall, mortgage debt will be reduced more rapidly, as the lower real estate tax is matched by more debt repayment. In any case, the homeowner's monthly payment is completely foreseeable. And for the lending institution the risk of loss associated with default would be smaller than today, as falling house prices are slightly less likely to lead to negative mortgage equity and thereby an inability to recover debt when repossessing the house as collateral. Both parties gain and should see an interest in developing such instruments. The current limitation rule implying that no one can pay more than 4% of their disposable income for real estate tax, could be maintained, but there would be less need for it, were the financial products describe above to develop.

Regulations may need to be adjusted to allow credit institutions to offer taking over the administrative task of automatically paying the home owner's real estate tax bill, and to allow mortgage institutions to increase lending slightly without initiating special procedures such as re-assessment of the house value.

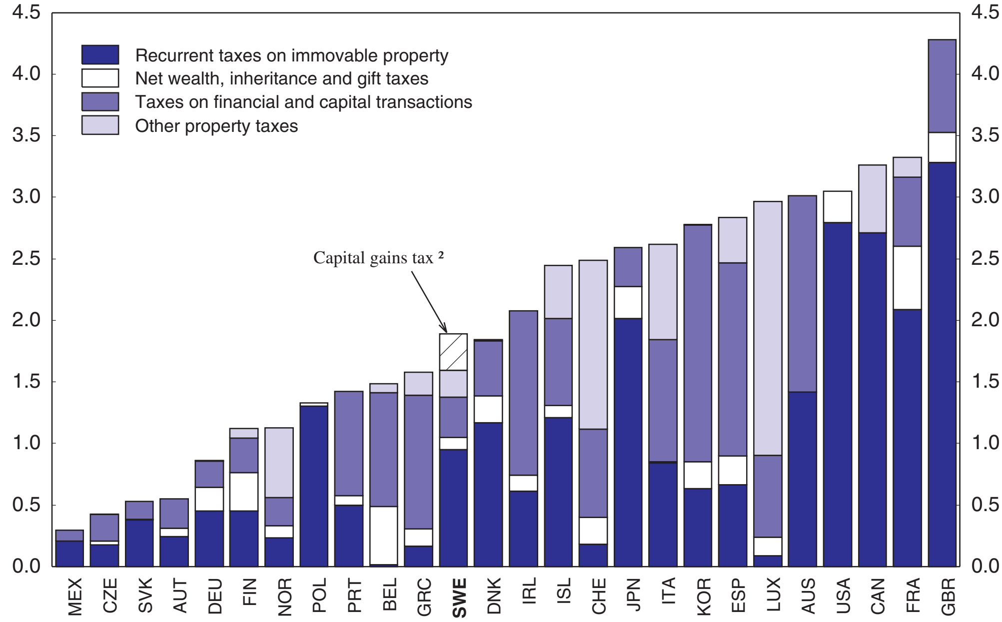
* This calculation is based on the average house price of around 2.5 million SEK in Stockholm county and the price increase from 2005Q2 to 2006Q2.

the tax payment, deferral should not be granted if the property is donated as a gift. Another option is to charge interest when capital gains taxation is deferred while moving to a system based on accrual rather than realised housing capital gains. If designed appropriately, such a system would generate substantial revenue without increasing lock-in effects (Box 4.8).

- Reduce the tax deductibility of interest expenses. One option is to move the threshold for the 21% rate, so that it applies for all negative net capital income. The 30% rate for

Figure 4.8. **Property tax revenue**

As percentage of GDP, 2004[1]



1. 2003 for Australia, Belgium, Greece, Mexico, Poland and Portugal.
2. Only available for Sweden.

Source: OECD, *Revenue Statistics*, 1965-2004, 2005 edition.

positive capital income should be maintained in order to avoid increasing tension with respect to the already complicated rules about how entrepreneurial income should be divided up as capital income and income from work. Although reduced interest deductibility would thereby introduce an asymmetry between positive and negative net capital income, this does not invite tax planning as such, but rather reduces the scope for such tax planning via pension savings (Box 4.6).

When assessing these policy options it should be stressed that by far the best would be to maintain the system as it applied in 2006. Imputed rent or real estate taxes based on updated value assessments are unpopular in all OECD countries, but neither a capped local land fee as envisaged by the government, nor a higher capital gains tax or lower interest deductibility would deliver results that match the 2006 system. The experience of other countries shows that, in practice, taxation of housing capital gains can be difficult to maintain in a way that generates significant revenue. And reducing interest deductibility can only re-establish tax neutrality for those (young generations) financing the house with debt, but not for those (mid-aged and older generations) with large housing equity. By far the best solution would therefore be to maintain housing taxation as of 2006 – possibly shifting some of the revenue to municipalities – while letting mortgage products be developed to relieve home-owners of the liquidity problem, as discussed above (Box 4.7). If, however, reforms are undertaken, they should at a minimum be fully financed, including the 2007 cut in housing taxes.

Box 4.8. **How can capital gains tax deferral be adjusted without lock-in effects?**

Taxation of housing capital gains needs careful design to avoid lock-in effects that would hamper labour mobility and thereby economic growth, but also distort housing consumption by hindering adjustment in size, location, tenure etc. when needs and preferences change. Lock-in effects can arise if, following a house price increase, the associated capital gain is taxed more lightly if the owner remains in the house compared to moving. By deferring the taxation of housing capital gains that are re-invested in another home, the current Swedish system avoids such lock-in. However, interest-free deferral – typically lasting for several decades – weakens the effective taxation. A key question is therefore whether effective housing capital gains taxation could be strengthened by charging interest on deferral.

In the current system where capital gains are taxed when realised (*i.e.* when a house is sold), it would not work, because it would bring back lock-in effects: If moving following a house price increase, interests would start to accrue on the capital gain, but not so if remaining in the same house.

This problem is solved, however, if personal capital gains would be taxed on an accrual basis (*i.e.* when they are generated, even if not realised). In a pure form, accrual capital gains taxation would imply that housing capital gains are calculated each year based on assessed values while allowing the home owner to defer payment to when the property is sold – or even later. Capital losses would entail a tax refund. In such a system there would be no lock-in, as capital gains are taxed continuously whether moving or staying.

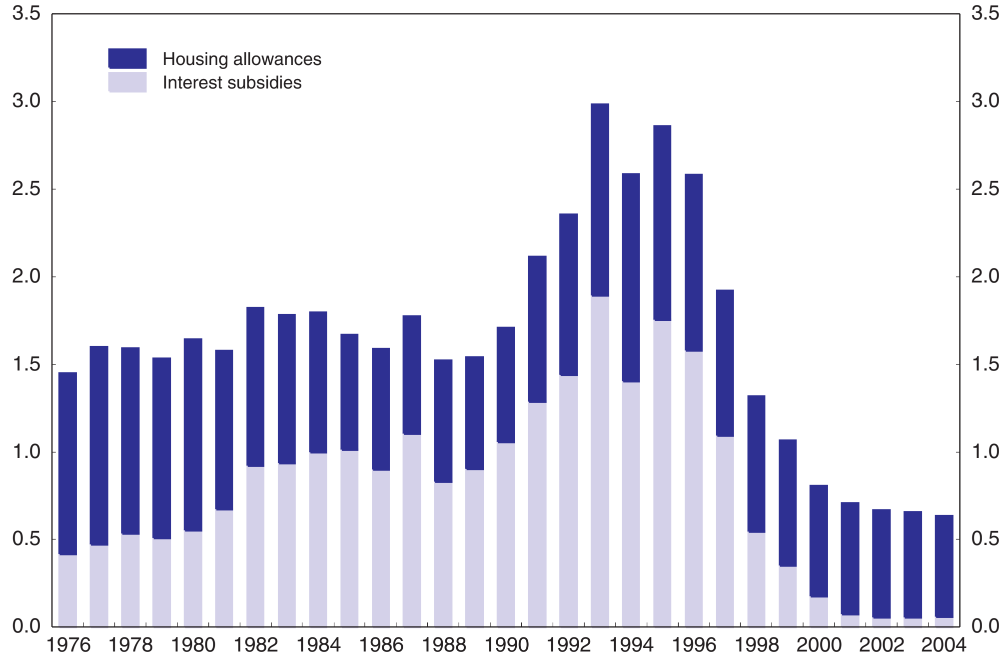
In practice, the most interesting might be hybrid models relying on the prices at which each property has actually been traded, thereby reducing the uncertainties associated with relying on assessed values. One possible hybrid would be as follows: When a house is sold, an implicit path is generated between the price at which it was originally bought and the final sales price, while mirroring the average price trend of the geographical area. Based on this price path, annual capital gains and cumulated interest can be calculated. Alternative price interpolations could also be used, and in some sense such hybrid models could be thought of as variation of realised capital gains taxation where the tax rate grows with the length of home ownership. The popular tractability of such arrangements would be that home owners only face a tax bill when realising their housing capital gain, thus having a cash flow to pay with.

Housing allowances and direct subsidies

Apart from different forms of real estate taxation housing allowances and direct subsidies have an influence on the tenure decisions of households. They need to be seen in the context of what changes may happen with regard to housing taxation, so as to ensure neutrality between owner-occupied, tenant-owned and rental housing. At the current juncture, although the size of the subsidies has been reduced by over two-thirds since the early 1990s (Figure 4.9), the design of the schemes is continuing to give incentives for more housing consumption, thereby distorting the household's choice.

Housing allowances are given as a consumption support for families with children and low incomes as well as to pensioners. Those benefits are open to households in all tenure types and are determined by the level of housing expenditures (up to a certain cap) and the size of the household (including the number of children). The actual amount paid takes the

Figure 4.9. **Direct housing subsidies**
as percentage of GDP



Source: Statistics Sweden and OECD Analytical database.

household's income level into account by subtracting a certain share of the income from the calculated benefit.[26]

The share of the rent (or the cost of housing for owner-occupiers) paid by the housing allowance for families varies between 20% and 33% and around a fifth of total households receive them (Åhrén, 2004).[27] It is mostly directed towards the rental sector: 31% of all households who rent a dwelling receive housing allowances, compared with 10% of households in the tenant-owner sector and 7% in owner-occupied homes. This generous scheme benefits a large share of poorer households (82% of lone parent households and 23% of pensioner households), but arguably sets questionable incentives as it increases with the level of housing expenditures up to a cap of SEK 63 600 for a family with one child (a four-room apartment of 80 square metres in Stockholm has an annual rent of about SEK 100 000). In addition, granting housing allowances also risks creating poverty traps in so far as individuals might have low incentives to move from unemployment to full-time work or to extend the numbers of hours worked when the income-tested benefits are taken away and tax payments increase (Chapter 3).

On a very general level, it may be asked what purpose a housing benefit serves at all in a system which provides for income support – which people are free to spend on housing or other goods as they wish to. Arguments for a more paternalistic approach would run along the lines that people tend to spend less on housing than would be optimal and that the state therefore needs to act in a corrective manner. Even if one subscribes to this view, however, the design of the Swedish system does even more than to ensure that a sufficient share of income is spent on housing: by linking it proportionately to housing expenditures it encourages more expensive housing. Ideally, an allowance should depend on the income, not the housing situation of the individual and give the freedom of choice regarding the level of housing expenditures. A flat-rate system as has been introduced in the UK recently ("Local Housing Allowance") would be one alternative. This pays out a certain amount depending on the region the person lives in and the tenant has the choice whether to spend it all on housing or to pay less and retain the difference.

Similar to the housing allowance scheme, interest subsidies are given proportionately to the actual or implied interest cost for building new rental dwellings as well as tenant-ownership dwellings.[28] The benefit is calculated on standard costs and is independent of whether loans have actually been taken up or not (Box 4.9).[29] Since this right is not limited in time, interest subsidies, once granted, will be paid out for ever, or at least as long as the buildings are still there (unlike interest deductibility). Thus, interest expenditure grants grow every year for every new vintage of dwellings that are granted interest subsidies. The Spring Fiscal Bill 2006 declared that, with the approval of the Swedish parliament, housing finance would be reformed and a new system introduced from 1 July 2008. At the same time, interest grants will be abolished: no new interest subsidies will be given from this date, and interest subsidies decided on before this date will be phased out over a period of time. However, as proposed by the new government, the Riksdag has decided that all production subsidies will be abolished already from 1 January 2007 and that already granted subsidies be phased out during a five-year period. No new production subsidies are envisaged. The focus has been shifted towards the situation of the households rather than support to "brick and mortars".

Box 4.9. **Calculation of interest subsidies**

Interest subsidies are granted only for a dwelling area below 120 square metres (no subsidies for exceeding areas) according to the following formula:

Grant base * subsidy interest rate * 30% = Interest grant.

The grant base depends on the number of dwellings (for multi-dwelling buildings) as well as the size of the dwellings. The grant per square metre is decreasing with the size of the dwelling. The maximum amount per dwelling is SEK 963 000 for a 120 square metre dwelling. For a 70 square metre dwelling the grant base is SEK 684 250. The subsidy interest rate is determined by the National Board for Housing, Building and Planning on a weekly basis, depending on the interest level in general (the prevailing rate in 2006Q3 is around 4%). For each project that has been granted interest subsidies, the rate is fixed for five years, after which time the subsidy interest is changed according to the prevailing rate at that time. The last part in the formula reflects the fact that 30% of the interest on loans is tax deductible.

For a 70 square metre dwelling the interest grant thus amounts to:

SEK 684 250 * 4% * 30 % = SEK 8 211.

An increase in interest rates and apartment building activity leads to increased government expenditures. Sensitivity analysis on the budget effects show that an increase in the long term interest rate (5-year mortgage bonds) of 1 percentage point compared to the present interest rate forecast for 2006-08 will lead to higher cumulative government expenditures of around SEK 700 million (0.03% of GDP) until 2008. And with the current rate of construction of dwellings at around 30 000 per year, the level of expenses due to interest subsidies will rise by approximately SEK 225 million (0.01% of GDP) each year.

Housing credit guarantees play only a small role today. The system was introduced in 1992, as the state moved from a regulated state lending system involving subsidized loans to a guarantee system administered by the National Housing Credit Guarantee Board (BKN). Now, government credit guarantees can be provided for loans advanced by financial institutions in Sweden against a fee (0.25-0.6% of the guaranteed amount).[30] While the government is fully responsible for BKN's debt, guarantees issued after 1997 must be fully financed by fee income. Only guarantees from 1992-96 are still financed by the government budget and amounted to SEK 160 million (0.006% of GDP) in 2005.

The existence of the state-operated credit guarantee scheme has to be seen in relation to the transition from a system of state loans for housing production that existed prior to 1993 to a system with no state loans. However, from today's point of view maintaining such a scheme is questionable. It is true that asymmetric information problems can lead to market failure in financial markets.[31] In this regard, a credit guarantee system can help to make the market function again. However, in practice other approaches are more common, such as taking collateral – a mortgage on the financed house for example. A guarantee system provided by the state, in contrast, runs the risk that it encourages risky lending by banks, even more so as the pricing for these guarantees is probably perceived as being below what private insurance markets would charge. It is difficult to see a reason why the Swedish mortgage loan market should not function well without this scheme and hence consideration should be given to abolishing it.

Planning and construction

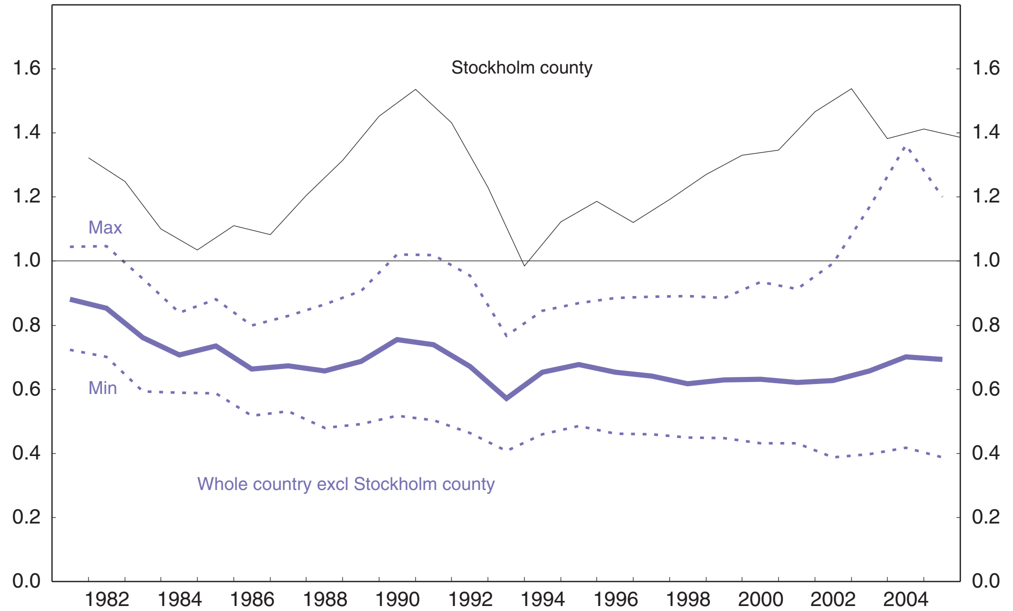
A key factor in dealing with changes in demand for housing is to ensure a swift and targeted supply response in regions where it is most needed. In this regard it is remarkable to see that the average Q ratio (of house prices to construction costs) for the country as a whole has been below one for the past two decades, *i.e.* construction has just not been profitable (Figure 4.10). At the end of 2005, the Q ratio had been above one only in a quarter of municipalities, including Stockholm.[32] One reason is the exceptionally high level of construction costs relative to other countries which has damped residential investment for the most part of the last decade (see Box 4.1).

Lack of competition in the construction sector

Lack of competition in the construction sector – in contrast to many other highly liberalised parts of the economy – has been repeatedly pointed out in previous *Surveys* (OECD, 1999, 2004). The high housing subsidies of the past have apparently led to market structures with informal cartels and little incentive for cost-containment. In a recent survey of 600 managers in the construction sector, 50% of respondents stated that cartels exist, with half of them saying they were quite frequent. And a recent study found that 30% of construction costs are due to a lack of efficiency.[33] The four largest developers, which account for a large share of the market, do not normally purchase construction services in the market as 75% of apartments are built in-house. This results in higher building costs than for smaller developers, who procure projects to a much greater extent (Konkurrensverket, 2006). The large construction companies are vertically integrated in terms of access to the requisite building material and the three biggest construction companies together have a share of two thirds of the Swedish market.[34] Barriers to entry for new enterprises are high and smaller companies already operating usually cannot compete on major construction projects. Also, growth in companies is inhibited by the fact

Figure 4.10. **Tobin's Q ratio across Sweden**[1]

1981-2005



1. Based on sales prices of single-family houses and regional construction costs. A value above (below) one is defined as house prices being above (below) construction costs in a county. Min and Max show the lowest and highest Q-ratio among all counties (except Stockholm).

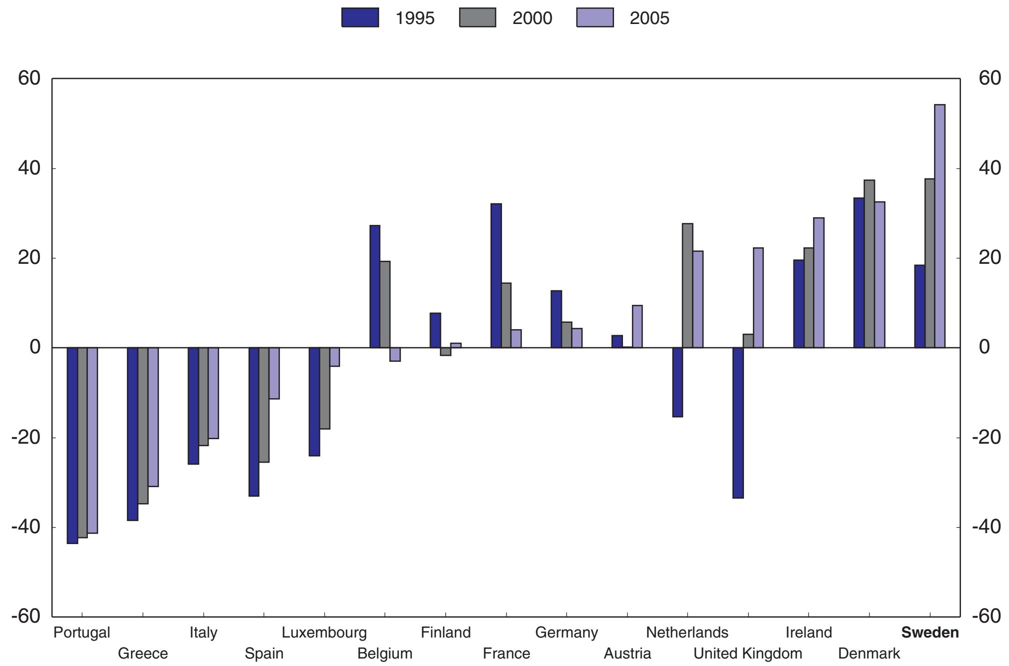
Source: Institute for Housing and Urban Research, Uppsala University.

that the informal sector represents up to 12% of the entire building sector (reflecting the high tax wedges on labour). Concentration is also strong in sub-sectors for building materials and prices for construction material have been rising more in Sweden than in most other comparable countries (McKinsey, 2006). Further along the supply chain, competition is particularly limited when it comes to larger projects as this segment is dominated by the existing few large companies. This overall lack of competition shows up in prices: among European countries Sweden has the highest level of construction costs (Figure 4.11).

Regulations regarding input materials and a lack of internationally (and EU-wide) harmonized construction codes are preventing new entries into the market, in particular from abroad, although the national standards for building methods have been harmonized somewhat (the work under the EU's Construction Products Directive has been underway for over ten years and is due to be completed in 2007).[35] The wage setting also contributes to making construction expensive as unit labour costs in Sweden over the past decade rose significantly more than in other European countries. Growth in labour productivity in the construction sector has significantly lagged economy-wide developments (OECD, 2007). The somewhat sheltered position of the construction sector is protected by the powerful construction workers' union Byggnads (representing 85% of construction workers), as exemplified by the recent conflict surrounding a Latvian construction company trying to enter the Swedish market (Box 4.10). There is evidence that the union's influence affects building costs directly, as Byggnads collects charges from non-member firms (in addition to membership fees for member firms) which further increases wage costs. Examples are "inspection fees" (1.5% of the payroll) to enable the union the check whether workers get

Figure 4.11. **Relative price levels for housing investment**[1]

Difference with EU 15, per cent



1. Percentage difference in relative price level indices between each country and the European Union (EU15). Housing investment refers to gross fixed capital formation in construction (SNA 1995).

Source: Eurostat PRC_PPP_IND table, January 2007.

Box 4.10. **The Vaxholm conflict**

The conflict surrounding the Latvian construction firm Laval un Partneri Ltd (L&P) provides some insight into the potential problems of the Swedish construction sector and the role of labour unions. The company was starting to build a school in Vaxholm in 2004, sending their workers to Sweden and paying them below the Swedish collective bargaining wage (but about twice their Latvian wages). When L&P turned down the demand from the Swedish building workers' union Byggnads to sign a collective agreement under Swedish terms, the trade union blockaded the construction site. At that point, L&P filed a suit against Byggnads, arguing the conflict actions were contrary to EU law. The union's point of view was that industrial action conflict rules are dealt with in national but not EU law.* The Swedish Labour Court decided to send the file on to the European Court of Justice for a decision of whether such hindrance of free movement of services is in line with the EU treaty. The European Court is due to decide in 2007 whether unlawful discrimination has taken place. In the meantime, however, L&P's Swedish subsidiary went bankrupt.

* Industrial action against a company is unlawful as long as there is a collective agreement between the concerned parties in force. However, there is a specific amendment to the Swedish legislation, the so-called Lex Britannia which states that this does not apply to foreign companies not connected to the Swedish labour market. Under this law, trade unions thus have the right to take industrial action against foreign companies even if such companies are bound by collective agreements from other countries.

the right pay or a "measuring fee" (2% of the payroll) in case workers are paid at a piece rate (Zaremba, 2005).

Looking ahead, while competitive pressures in the construction sector might change, for example in anticipation of a decision on the Vaxholm conflict and further EU harmonisation efforts for construction codes and building materials, a number of regulatory shortcomings exist and there is substantial scope at the national level for more reforms to foster competition (Konkurrensverket, 2005 and 2006; OECD, 2007). The public developers' way of purchasing contracts should take small enterprises into account by reducing costs for producing tenders and conducting the tendering process in a way that allows more companies to join the bidding. In addition, municipalities should allocate land on a competitive basis, rather than selling land through a direct transfer combined with counter-demands as is often practised today. There is also some evidence that land is allocated depending on the construction company which will build the real estate, possibly benefiting local companies for employment policy considerations and hindering competition.

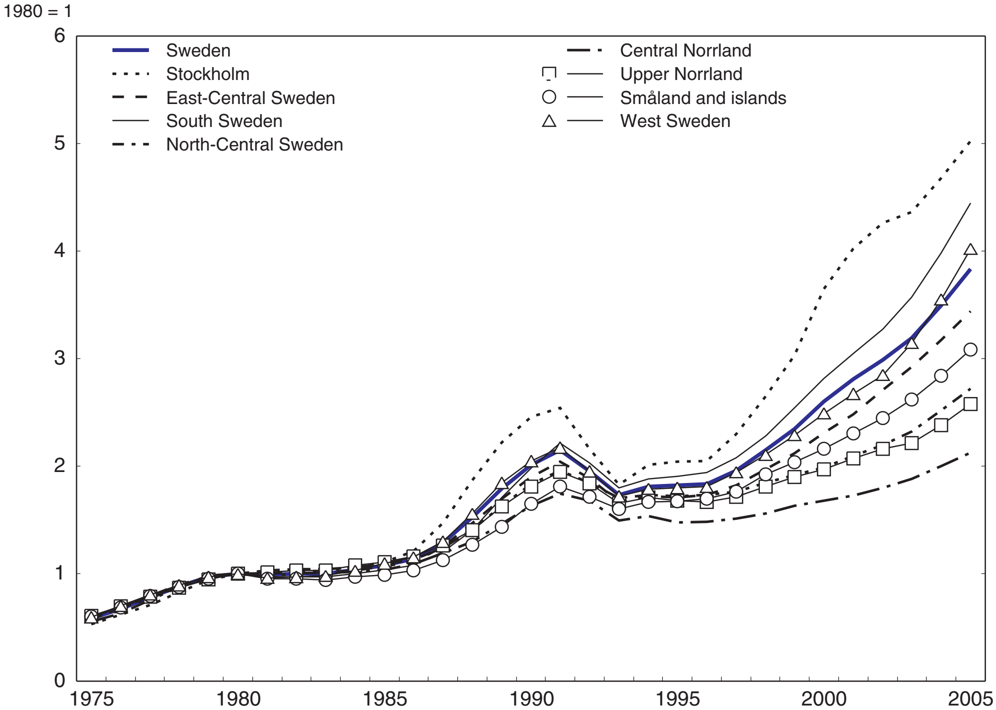
Zoning regulations still hamper housing investment

Further hindrances for supply to react swiftly lie in the length of time of the planning process and its unpredictability as well as in a lack of incentives to issue new land for construction. As a large majority of new apartment construction requires changing the local development plan before building can commence, municipalities play an essential role in the building process (Konkurrensverket, 2006). Prior to granting the building license, the municipality must set up a general plan (designating residential, commercial and industrial areas) and a detailed plan (defining the type of building). The process of developing or changing a detailed plan can be long and tedious. In addition, appealing against detailed building plans can take up to 3½ years and thus makes a swift supply response to changes in demand quite difficult (McKinsey, 2006).

In terms of incentives to build, one potentially negative factor is the municipal tax equalisation scheme. By operating to redistribute revenue between local authorities it means that a municipality reaps little benefit from expanding its population base (OECD, 2001). At the same time, the new equalisation system introduced in 2005 also takes structural cost differences into account, such as public transport expenses. However, Sweden is unusual in not having a municipal real estate tax which could strengthen incentives to parcel out land sites, even if the tax base were integrated to some extent in the equalisation scheme (OECD, 2002).

Development and volatility of house prices and granting of building permits differs across the country. While in an ideal world supply would react flexibly to differing demand situations, in reality the response is sluggish and thus an upward sloping curve is to be expected (this could also be due to physical constraints to construction). However, Swedish housing prices are characterized by diverging developments, with the metropolitan areas registering the strongest increases and the rural areas (apart from the seaside) somewhat falling behind (Figure 4.12). Apparently, the supply response works better in some areas than in others, granting more building permits in relation to the house price increase than in others (Figure 4.13). The metropolitan areas Stockholm, Malmö and Gothenburg, have all had fewer building permits relative to the house price increases they experienced when compared to other parts of the country, though only slightly so.

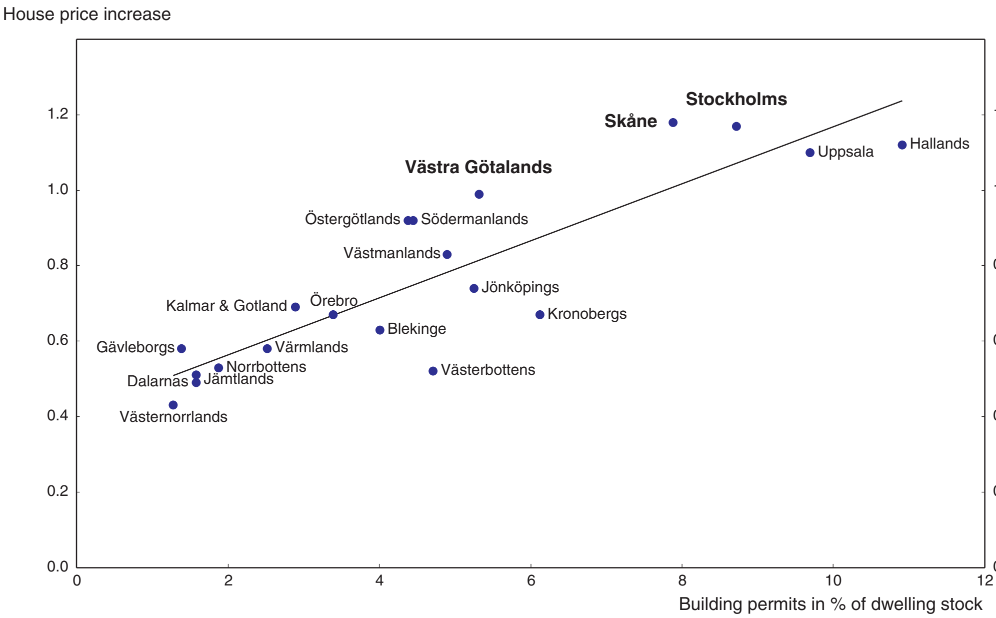
Figure 4.12. **Regional house prices**



Source: Statistics Sweden.

Figure 4.13. **Building permits and house price increases by county**[1]

1997-2005



1. Percentage increases of house prices from 1997-2005 and cumulative number of building permits 1997-2005 in % of dwelling stock in 1996.

Source: Statistics Sweden.

One reason why some urban (and high-income) municipalities provide fewer permits might be that current residents do not have an interest in construction, as it could have a damping effect on the prices on the existing housing stock (Finansdepartement, 2003).[36] To avoid such a thing happening, private developers should be allowed to go to court to challenge a negative municipal decision (which is currently not possible). At the same time, availability of land is restricted and might explain low construction activity in some regions. Even so, Sweden being one of the least densely populated countries in the OECD, there is sufficiently land available. A 30 minute train drive from Stockholm to Uppsala runs mostly through scarcely populated areas.

In general it is essential that reforms are introduced that lead to a level playing field between those wanting to develop land and those wanting to leave it unchanged (Finansdepartement, 2003). One possibility could be to consider setting up an independent Planning Commission, as recently proposed in the United Kingdom (Barker, 2006). Some of the issues involved in reforming the planning process in Sweden have been identified and proposals have been presented by a committee (Box 4.11). However, it remains to be seen how much of this will find its way into legislation. In general, municipalities should increase the speed with which cases are processed and the introduction of time limits and a simplification of the process would help in this direction. Swifter planning decisions would help to dampen volatility of regional house prices and make the market work better. The introduction of a local real estate tax akin to the tax levied by local authorities in

Box 4.11. **Current proposals for reform of the Planning and Building Act of 1987**

In order to improve various aspects of the planning system a "Committee of Inquiry regarding the Planning and Building Act (PBL-kommittén)" was set up and given a large mandate to propose improvements in the current Planning and Building Act of 1987. The final report,* submitted to the Ministry of Sustainable Development in September 2005, contains a multitude of detailed proposals, such as:

- regulations should be clarified in order to improve the implementation of national interests in the planning procedure;
- cooperation in planning between municipalities should be improved;
- procedural rules should be simplified and municipalities should be given greater leverage in determining the procedure in individual cases;
- regulations on building permits should be altered so that the same rules apply to everybody regardless of where the proposed construction is being considered;
- joint procedures should be aimed for when it comes to the planning procedure and parallel procedures in accordance with the Environmental Code;
- the right to appeal decisions should be clarified and the number of appellate levels should be reduced;
- the municipalities' supervision regarding the fulfilling of building regulations needs to be improved and independent quality control should be considered.

The proposals of the Committee are currently being analyzed and considered by the Ministry of Sustainable Development.

* "Får jag lov? Om planering och byggande" ("Am I allowed to? On Planning and Building"), Swedish Government Official Reports Series No. 2005:77.

Denmark would probably help to set the right incentives. However, the design of such a tax is essential: rather than being a property-related charge as envisaged by the government's plans, it should take land size and value into account.

Conclusion

To sum up, even though housing policy has been reformed significantly, particularly in the area of taxation in the 1990s, further reforms are essential (Box 4.12). The overall objective should be to significantly improve the mechanism to better match demand and supply. The current favourable economic environment provides a golden opportunity to put reforms in place which will enhance overall welfare over the long term.

Box 4.12. **Recommendations regarding housing policy**

Housing tenure composition

- Introduce legislation to allow owner-occupied apartments as an alternative to the current tenant-ownership.

Rents reflecting market demand

- Rent regulation should be phased out to make the market function better.
- To facilitate rent differentiation to better reflect differences in market demand across municipalities, regulation of rents in municipal housing companies should be reformed, and closer cooperation between concerned parties should be encouraged. Malmö's example of gradually introducing rent differentiation according to demand and supply should be considered as a model for Stockholm.

Taxation

Preferred policy option

- Introduce the ideal imputed-rent taxation. Alternatively, the housing taxation framework should be maintained as of 2006, but base the taxation of tenant-owned housing on property value assessments that reflect the value of each individual apartment. Raise the real-estate tax rates for owner-occupied and tenant-owned housing to levels that are neutral *vis-à-vis* other asset classes. Review capital market regulations to facilitate the development of mortgage products that finance increasing taxes when house prices and thereby mortgage equity grow thereby relieving owners of tax liquidity problems.

Alternative policy options if state housing taxes are abolished

- As a minimum, fully finance the 2007 cuts in housing taxation. Introduce a local property tax based on value assessments and let municipalities set the local tax rate above a minimum threshold. Strengthen capital gains taxation: an interest liability on accrued (but not realised) capital gains could be considered, or the effective tax rate on realised capital gains could be increased, *e.g.* by basing the tax on the full capital gain, rather than two thirds as currently. Moreover, deferral should not be granted when the owners die and the house or apartment is inherited. To prevent circumvention of this tax payment, deferral should also not be granted if real estate is donated as a gift. Reduce the value of interest deductibility, *e.g.* by lowering the threshold for the 21% rate so that it applies for all negative net capital income.

Box 4.12. **Recommendations regarding housing policy** *(cont.)*

Subsidisation

- Make housing allowances dependent on income and other personal and family characteristics rather than the level of housing expenditures.
- Carry on with the phasing out of the interest subsidy scheme.
- Abolish the credit guarantee scheme as it might encourage risky lending by the banking sector.

Construction and land planning

- Enhance competition in the construction sector: Change the public procurement process to reduce participation costs and thereby increase the number of companies bidding. Municipalities should allocate land on a competitive basis, rather than selling land through a direct transfer combined with counter-demands.
- Make the land planning process more efficient: Municipalities should increase the speed with which cases are processed. Allow private developers to go to court to challenge a negative municipal planning decision. Introduce the proposals submitted by the "Committee of Inquiry regarding the Planning and Building Act". Consider the introduction of a local property tax that takes land value into account.

Notes

1. In addition, mortgage banks' lending rates have declined in anticipation of the new Basel II capital adequacy rules in 2007 that will entail a lower capital requirement for house mortgage loans, thereby reducing refinancing costs for mortgage institutes.
2. Source: European Mortgage Federation, *www.hypo.org*.
3. The statistics refers to the duration of loans at the time when they were taken up, *i.e.* a loan with a 10 year fixed duration that becomes due in a few weeks is still classified as being a 10 year fixed rate loan. With regard to new loans, more than half were on variable rate terms in 2006 (Riksbank, 2006a). No official data exist for the use of loans with deferred amortisation (interest-only loans), but news reports suggest that their share can be up to 60% of outstanding loans (depending on mortgage institute).
4. Variable rate loans that switch into a fixed rate loan once the short-term interest rate rises above a certain threshold (capped loans) are not very common in Sweden (unlike in neighbouring Denmark).
5. Until 2004 it was impossible under Swedish law to own an individual apartment outright. Legislation was introduced in 2003 allowing buildings to be divided into more than one estate ("three-dimensional property registration"), but it is still not possible to get legal title for individual flats.
6. There were 483 dwellings per 1 000 inhabitants in 2002, a number only surpassed in Europe by Finland, Spain and Greece (European average 422); see Regular National Report on Housing Developments in European countries 2004, Synthesis Report.
7. A growing shortage of rental dwellings led the government to initiate the "Million Dwellings Programme", designed to build 100 000 dwellings per year from 1965-74.
8. On a scale from A (weakest regulation) to E (strongest regulation), Lind (2003) describes Swedish rent regulation as being of type E as it intends to also keep new rental contracts below the market level in certain areas. Recent legislation has softened this somewhat by allowing market rents in newly constructed dwellings.
9. Lind (2005) argues that the advantage of orienting private market rents at the municipal housing rent level as seen at that time was that the government was no longer directly responsible for the rent setting, yet rents would be set in a "socially responsible way".

10. A court ruling in 1998 determined that rent levels in municipal housing companies can not be used if they reflected an explicit subsidy element. The background was the case of a public housing project in the St Erik area of Stockholm for which the housing board apparently decided to lower the appropriate rent level in order to make it affordable for lower income households (see Lind, 2003). According to Lind (2003), this reduced the role of municipal housing rents for comparison and moved more towards rents being determined at 'reasonable costs'.
11. Rent control is just one method of dealing with this a potential asymmetry; most countries protect the tenant through the legal system without interfering with the pricing mechanism (apart from regulating the allowed annual rent increases).
12. This is already a major improvement compared to the past: Nesslein (2003) reports that in 1963 about 40% of Stockholm's population was registered in the queue.
13. Vulnerable household groups in their study include poor families, single parents, elderly families and immigrants. All of these groups, except elderly families, were found to be overrepresented in public housing, in particular in the metropolitan cities.
14. A government commission on modernizing rent legislation was initiated in mid-2006 and proposals should be expected in 2008. However, a chairperson as well as other officials of this commission have yet to be appointed.
15. The attractiveness was determined by the housing company based on consumer demand.
16. The limitation rule was introduced in 2001 with the background that house prices in attractive coastal areas have been rising fast and thus causing an increasing tax burden for permanent residents in those areas (whose average income is below that of second-home owners). Originally the limit was 5% of disposable income, but from 2006 it was reduced to 4%.
17. In principle, the separation of the cooperative's interest deductibility, imputed rent taxation and real estate taxes on the one side, and the tenant-owner's interest deductibility on the other side, could be a disadvantage if cooperative interest expenses exceed imputed rent, as there would then only be partial interest deductibility. But as shares in tenant-owned cooperatives can be used as collateral for mortgage finance, this tax disadvantage can be circumvented by shifting debt to the tenant-owners. This is effectively what happens when over time cooperative debt is being repaid.
18. The average purchase price of houses in 2005 was SEK 1 066 428 for the country as a whole. Only in 12% of municipalities the average purchase price was above SEK 2 000 000 (SEK 3 218 000 for Stockholm, SEK 2 689 000 for Gothenburg and SEK 2 611 000 for Malmö).
19. Unlike most OECD-countries, but like Denmark and Italy, Sweden allows for income-tax deductibility of voluntary contributions to pension savings schemes. Subsequently, when pensions are paid out from the scheme, they are taxed as income (Yoo and de Serres, 2004). Aside from any differences in the marginal income tax rate faced by the person while contributing *versus* receiving pensions, this means that capital income is taxed at 15%, being only half of the tax rate for capital income earned outside a pension scheme. In practice, the tax on pension fund earnings is paid by insurance companies as 15% of an estimated yield of the fund capital calculated by multiplying the fund capital by the so-called state lending rate.
20. See "Privat pensionssparande 2004" at *www.scb.se*.
21. Most countries exempt capital gains on a primary residence if it has been owned for a certain minimum period (mostly 2 years) and if it is not used for business purposes. In Spain, an exemption exists for persons above 65 years of age. Hungary provides tax exemption if the proceeds from selling the property are reinvested within a certain period and Portugal (like Sweden) grants a rollover in case of reinvestment. Only Japan and the United States tax capital gains on principal residence. However, tax rates in Japan decrease with the holding period and the US system grants exempt amounts (USD 250 000/USD 500 000 for couples) as well as lower tax rates than for other capital gains (OECD, 2006d).
22. Previously, capital gains tax had to be paid if the proceeds where reinvested outside of the country. But this regulation has been abolished as it was out of line with the non-discrimination principle in the EU.
23. See 2007 Autumn Budget Bill: "Putting Sweden to work – a good deal for all", Ministry of Finance, 16 October 2006.
24. It is positive that the exemption of housing wealth from the reduction in wealth tax will limit the overall housing tax reduction, but it is symptomatic that this move will open up further for tax planning, as persons shifting out equity from housing by increasing mortgage debt and investing

in financial assets will benefit from the halved wealth tax, thereby reinforcing the incentive discussed in Box 4.6.

25. It should be noted that in Sweden the relationship between the tax base and the actual market value and its development have been rather close compared to the situation in most other countries where real estate taxes sometimes are levied on bases determined far back in history. Any effect of this is, however, captured by Figure 4.8 which compares revenues rather than statutory tax rates.

26. The formula for calculating allowances is (Åhrén, 2004): Housing allowance = a*housing expenditure - b*income with 0.5 < a < 0.75 for families depending on their level of housing expenditure (0.91 for pensioners) and 0.2 < b < 0.33 (0.5 < b < 0.62 for pensioners) for income in excess of SEK 117 000 for lone parents and SEK 58 000 per person for parents. In addition, families with children receive a flat rate supplement. The benefit amount is capped and does not increase further for yearly expenditures over SEK 63 600 (for a family with one child).

27. Housing allowances were reduced significantly from 1996 on by raising the eligibility qualifications (childless households older than 29 years were excluded and a limit to the qualifying floor space was introduced) (Chen and Enström, 2004).

28. The present system has been in force since 1993 and when it was introduced one argument was that the system should be seen as a parallel to the right to interest deductions of owner-occupiers and tenant-owners (a view that has since been largely abandoned). Subsidies to owner-occupied homes were completely phased out in 2000.

29. Before 1993 there was a "real" interest grant that took into account actual productions costs and actual interest rates, a system that step by step had been adapted to the high inflation during the 1970's and 1980's, and thus tended to make way for continuing cost increases. The present system, based on standard costs that have been unchanged since 1993, has been intended to make builders more cost conscious. Another difference is that the previous interest grant system (before 1993) was a time limited support for the receiver. The subsidy interest rate that the property owners had to pay was increased every year until it met the market interest rate, then the grant ceased (*i.e.* it was the difference between the subsidy interest rate and the market interest rate that was subsidised to a decreasing degree).

30. The guarantee covers any losses the bank incurs. When the borrower defaults, the bank sells the property and will be reimbursed by BKN for any remaining credit amount. In this case, BKN takes over the right to demand repayment of the losses from the borrower.

31. In case of a loan contract that allows for bankruptcy, the lender takes the risk that the borrower does not pay back his money. If he raises interest rates to compensate for this risk, more risk averse borrowers would chose not to take up the loan. As the downside is limited by the debt contract, the remaining borrowers simply chose to take up even more risk if the interest rate is higher. In this situation, the lender will react by rationing credit rather than increasing interest rates, leaving a share of willing borrowers without access to funds (Stiglitz and Weiss, 1981).

32. The Q ratio data is calculated by the Institute for Housing and Urban Research at Uppsala University as the mean for every municipality using the sales prices of single-family houses and six regional construction costs.

33. Based on the following articles in the newspaper *Dagens Nyheter*: "Jakt på olagliga karteller i byggbranschen i host" (Hunt for illegal cartels in the construction sector this autumn), 22 July 2005 and "Byggbranschen slösar bort miljarder" (The construction sector is wasting billions), 23 February 2006.

34. Measured as cumulated Swedish revenue of the three biggest companies relative to the combined Swedish revenue of the 60 largest construction companies in 2003. See Konkurrensverket (2005).

35. The old specific regulations have been replaced by more functional codes, basically allowing for more flexibility in the use of construction methods. However, if the contractor does not follow the advised building method, he must prove that it has the same lasting functionality. This is more burdensome than following just the older regulations and many companies thus want to remain on the safe side and apply the earlier strict codes.

36. Alternatively, consideration could also be given to the protection of green areas or a preference for low population density.

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