

The SNS Economic Policy Group 1986

Hans Tson Söderström (editor)

Getting Sweden Back to Work

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Foreword

The upturn in Swedish economic activity in 1983–84 has given rise to international comments about Sweden as a renewed economic success story after the gloomy 1970s, when the well-renowned Swedish model showed signs of collapse. Indeed, many facets of Swedish economic development have been considerably strengthened in the early 1980s; competitiveness has been restored, profitability is high, open unemployment is extremely low by international standards, inflation is falling, the budget deficit has been reduced significantly, and the external balance is moving from deficit to surplus.

On closer examination, however, it turns out that many of these improvements are strongly associated with the dramatic devaluations in 1981–82 and the ensuing upswing in international economic activity. These two factors have not created any fundamental change in the functioning of the Swedish economy. Structural problems and "systems errors" give serious cause for concern regarding the longer-term outlook for stability and growth. The problems are not insurmountable, but their solution requires major changes in economic policies and considerable adjustment in goods and factor markets. To some extent such changes are already under way.

This booklet is a survey of the current status of the Swedish economy in this perspective. It is a condensed and updated translation of the Swedish version of the SNS Economic Policy Group's report published in January 1986.

SNS has published annual reports on the Swedish economy since 1974. These reports have been written by the SNS Economic Policy Group comprised of four or five independent economists of high

academic standing on a rotating basis. The purpose of the reports is to provide an impartial assessment of the state of the economy, the medium-term economic outlook and the economic policy pursued. In order to substantiate its arguments the Group has regularly come up with its own policy programs in different areas.

The first condensed translation was entitled "Sweden – The Road to Stability" (SNS 1985). The present report has been written by the same group and can in many respects be regarded as an extension of the arguments set forth in last year's publication. Julie Sundquist has been responsible for the translation. Responsibility for all views contained in the report rests with the authors alone.

Stockholm, September 1986

Hans Tson Söderström

Executive director of SNS

Chairman of the SNS Economic Policy Group

Key data on the Swedish economy

Population	8.3 Million
Labor force	4.4 Millon
GDP	SEK 860 Billon (1985)

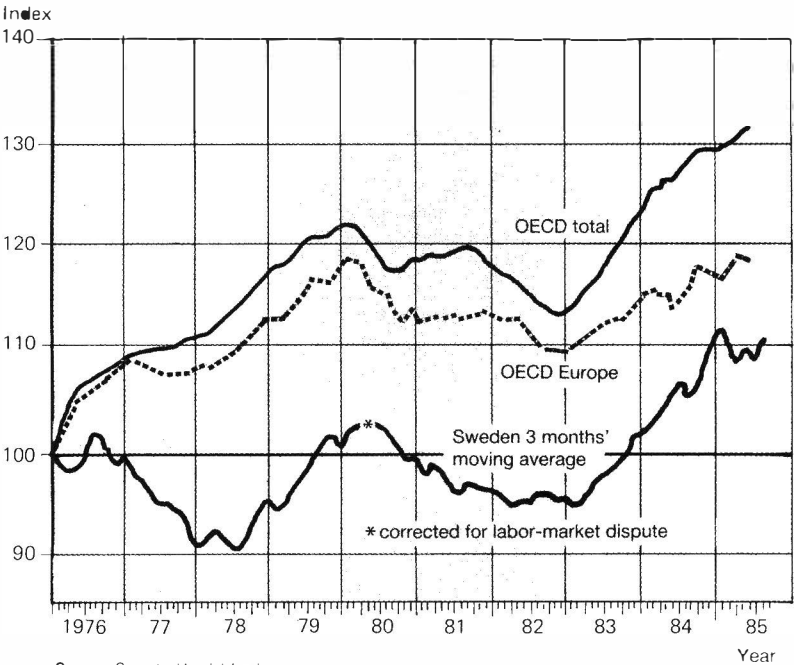
All values in this report are expressed in Swedish Kronor (SEK). The approximate exchange rate as of September 1986 was:

SEK 1 = USD 0.14	SEK 1 = GBP 0.10
SEK 1 = DEM 0.30	SEK 1 = JPY 22.42

The Present Economic Situation in Sweden

Between 1975 and 1982 Sweden underwent a period of slow economic growth. The gross domestic product (GDP) rose by an average of barely 2 percent per year and growth in industrial production remained more or less at a standstill; see Figure 1. Other

Figure 1. **Industrial production in OECD countries and Sweden;**
Index Dec. 1975 = 100.



countries in the OECD area also faced growth problems, but still seemed to perform better than Sweden.

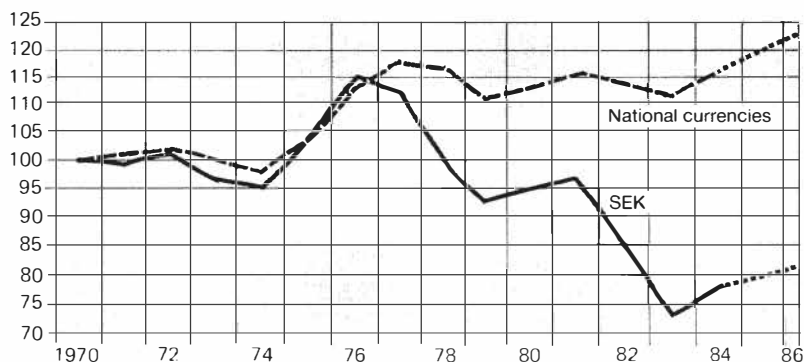
Along with the international upswing and after two devaluations, totaling 26 percent in 1981 and 1982, Swedish industrial production accelerated during 1983–1984. Since the end of 1984, however, industrial production has again exhibited a tendency towards stagnation.

1985 was the year when the positive effects of the recent devaluations began to fade and unsolved structural problems reappeared. The nature of the upswing had also changed. After having initially been dominated by exports, the upswing in 1985 was sustained by domestic demand, stimulated primarily by investments and to some extent by private consumption. As far as 1986 is concerned, investment growth has again stagnated and private consumption is expected to be the impetus behind an increase in domestic demand. This contributes to the impression that the export- and investment-led upswing, created by the devaluations in 1981–1982 and the simultaneous international upturn in economic activity, has now come to an end.

This is not to imply that the devaluations were not amazingly successful. Perhaps the most surprising aspect is the degree of cost stabilization achieved in the short run. The main reasons behind this are restraint on the part of labor and resistance on the part of employers, along with large productivity reserves at the outset, which mitigated the rise in relative costs due to those wage increases which did in fact occur. On the whole, Sweden has shown surprising real-wage flexibility throughout the past decade, achieved through rapid inflation. Thus far the effects of the devaluations in 1976–77 and 1981–82 on the relative cost level have only been expended to a small extent; see Figure 2.

On the debit side, the trend in relative costs has not been reduced to a lower level in any convincing way. Labor-market agreements arrived at since the devaluations in 1981–1982 have encroached on the relative cost advantage obtained initially. It is difficult to discern any fundamental improvement on this point. The latest central agreement on the private labor market (a wage cost increase of 7.5 percent for 1986) was not easy to convert into settlements at the union and plant levels. The situation in the public

Figure 2. **Relative wage costs in manufacturing industri.**



Source: National Institute of Economic Research

sector is even more complicated due to simultaneous demands for greater restraint and an increase in wage dispersion. As of August 1986 no agreement had yet been reached for public sector employees.

As analyzed in last year's report, developments in 1983–1984 substantially improved public sector finances. One important reason was in fact wage increases that resulted in a further sharp rise in public sector revenue. The improvement in the current account which had taken place since the devaluations was reversed during 1985; it deteriorated by SEK 15 billion or almost 2 percent of GDP.

The Outlook for 1986–1987

The latest domestic forecasts regarding development of the Swedish economy in 1986 and 1987 are shown in Table 1. Falling oil prices, a declining dollar and lower interest rates imply that the forecasts become more optimistic, the later they are produced – for Sweden as well as for other West European oil-importing countries. As compared to previous forecasts, growth is now expected to be higher, inflation and unemployment lower, and the current account improved.

Nevertheless, the main impression is that the upswing dominated

Table 1. **Economic development in Sweden, 1985 and some forecasts for 1986 and 1987¹⁾**

	1985 ²	1985	1986 (1987)							
			National Institute of Economic Research (March)	Ministry of Finance (April)	Swedish Confederation of Trade Unions (June)	Swedish Central Organiza- tion of Salaried Employees (June)	National Industrial Board (August)	PK Bank (June)	S-E Banken (June)	Handels- banken (August)
GDP	860	2.3	1.9	2.0	2.6 (2.6)	2.0 (1.4)	1.5 (2.5)	2.0 (0.8)	2.1 (1.2)	2.5 (1.7)
Imports	282	7.5	6.6	6.7	6.2 (6.2)	5.0 (5.5)	3.7 (5.9)	6.3 (3.5)	5.5 (4)	1.0 (1.0)
Gross investment	163	6.5	0.2	1.9	2.3 (4.2)	- 0.3 (1.9)	- 1.9 (4.6)	1.7 (- 0.2)	1.5 (1)	1.5 (1.0)
whereof industry	28	15.8	2.0	5.0	5.0 (10.0)	- 2.0 (5.0)	0.0 (10.0)	2 (- 3)	7 (5)	0.0 (0)
Inventory investment	-1	0.7	0.3	0.3	0.3 (0.5)	0.3 (0.3)	0.2 (0.1)	0.3 (- 0.2)	0.2 (- 0.2)	0.2 (0.2)
Private consumption	438	2.7	2.5	2.7	3.0 (2.5)	2.7 (1.5)	1.9 (2.5)	3.0 (1.2)	3 (2)	2.5 (2.0)
Public consumption	238	1.5	1.3	1.3	1.3 (1.0)	1.2 (1.2)	1.3 (0.8)	1.5 (2)	1.8 (1.5)	1.3 (1.5)
Exports	304	2.8	6.0	5.3	5.6 (5.2)	5.0 (4.0)	4.1 (5.4)	4.3 (2.8)	4 (3)	2.0 (0.5)
Consumer prices ³⁾		7.4	3.4	3.5	4.0 (3.0)	4.3 (4.0)	4.0 (4.5)	4.3 (3.7)	4.2 (3.7)	4.0 (4.0)
Current account ⁴⁾		-9.4	5.3	3.4	2.9 (10.0)	9 (7)	9.0 (6.0)	3.5 (4.5)	5 (7)	8.0 (10.0)
Unemployment ⁵⁾		2.8	2.7	2.7	2.6 (2.4)	2.7 (2.6)	2.8 (2.9)	- -	2.8 (3)	2.5 (2.7)
Industrial production		2.1	-	3.0	3.9 (-)	3.0 (2.0)	2.0 (4.0)	- -	2.5 (2)	2.0 (1.5)
Labor costs/hour ⁶⁾		7.0	5.5	6	7.0 (5.0)	- -	7.6 (5.8)	7.5 (5.0)	7.5 (5)	7.0 (6)

¹⁾ Percentage change unless otherwise indicated; Inventories are percent of GDP preceding year figures for 1987 in parentheses

²⁾ Billions of SEK

³⁾ Annual average

⁴⁾ Billions of SEK

⁵⁾ Percent

⁶⁾ Average for the total labor force, except for the National Industrial Board which projects the average for the industrial sector

by exports and investments is at an end, that consumption growth has become more important and that total growth will be low by international comparison. Increases in wage costs will also remain a cause for concern. No curtailment is expected between 1985 and 1986, and the weak letup which is expected during 1987 presupposes a more rapid rise in productivity in Sweden than the rest of the world, so as not to impair our international competitiveness even further.

The Official Scenario

The government's budget proposal for 1986 contains priorities and arguments which coincide to a large extent with the analysis of the SNS Economic Policy Group. The primary prerequisite for economic balance is said to be higher economic growth. Considerable emphasis is also placed on the necessity of maintaining and even improving the relative cost level in relation to the rest of the world. A norm for public foreign borrowing is said to be required in order to "discipline" economic policy. A restrictive fiscal policy – and thereby reduction of the government budget deficit – is specified as a necessary precondition for a less tight monetary policy and development towards economic balance.

The financial position of the consolidated public sector has improved a great deal since 1982; see Table 2. However, the rate of reduction of deficits has diminished. A major cut on the expenditure side was made in the beginning of the previous electoral period when pensions were depreciated and industrial support was discontinued. Further reductions have been achieved gradually through lower transfers to local governments, restrictive consideration of new budget appropriations, a lower degree of indexation of expenditures and rapid growth in the tax base. This method is also advocated for the future in order to bring about a continued reduction in the deficit. Further improvements should therefore be expected to occur at a relatively slow pace.

The emphasis on growth, relative cost level, fixed norms and restrictive fiscal policy is wholly compatible with earlier recommendations of the SNS Economic Policy Group and has our full sup-

Table 2. Public sector revenue, expenditures and deficit, 1982–1986, as a percentage of GDP

Fiscal year	1982/83	1983/84	1984/85	1985/86*	1986/87**
Calendar year	1983	1984	1985	1986*	
Central government					
Revenue	28.7	29.6	31.8	30.9	30.7
Expenditures, excl. interest on gvt debt	34,4	31,8	31,0	29,1	28,3
Interest on gvt debt	7,2	8,1	9,2	7,4	7,1
Total	– 13,0	– 10,3	– 8,4	– 5,6	– 4,7
Basic total***	– 12,2	– 8,9	– 7,1	– 5,4	– 4,8
Consolidated public sector					
Revenue	62,0	62,0	62,9	62,8	
Expenditures	67,0	64,4	65,1	63,9	
Financial saving	– 5,0	– 2,4	– 2,3	– 1,1	

* Forecast *Budget proposal ***Nonrecurrent cash items eliminated

Sources: Ministry of Finance and National Institute of Economic Research

port¹. But, so far, the government has made only a few specific proposals with respect to its growth objectives. The revised budget proposal presented in April 1986² did contain a number of suggestions similar to ours. Among them are deregulation on the labor market and in the housing and transportation sectors, liberalization of exchange controls, more growth-oriented labor-market policy and incentive schemes for timber supply and household saving. Many of these measures will be carried out or produce significant effects only after several years. For example, radical reform of our growth-inhibiting tax system has been postponed in favor of a welcome, but still very partial, simplification of the personal income tax system.

Without any extensive and rapidly effective *structural* measures to increase growth, demands for wage restraint will be exceedingly strong. Except for early specification of tax rates for 1987 and 1988, however the government has not presented any guidelines for wage formation. The outlook in the municipal sector is particularly disturbing. Despite some counteractive measures on the part

¹) See the 1985 SNS report entitled "Sweden – The Road to Stability".

²) Three months after publication of the Swedish version of this report.

of the government, strong financial development and a sharp increase in employment is expected in this area. There is an imminent risk that wage formation in the municipal sector will continue to create considerable cost impulses. The difficulties in reaching a wage agreement for public sector employees in 1986 substantiates our fears on this point.

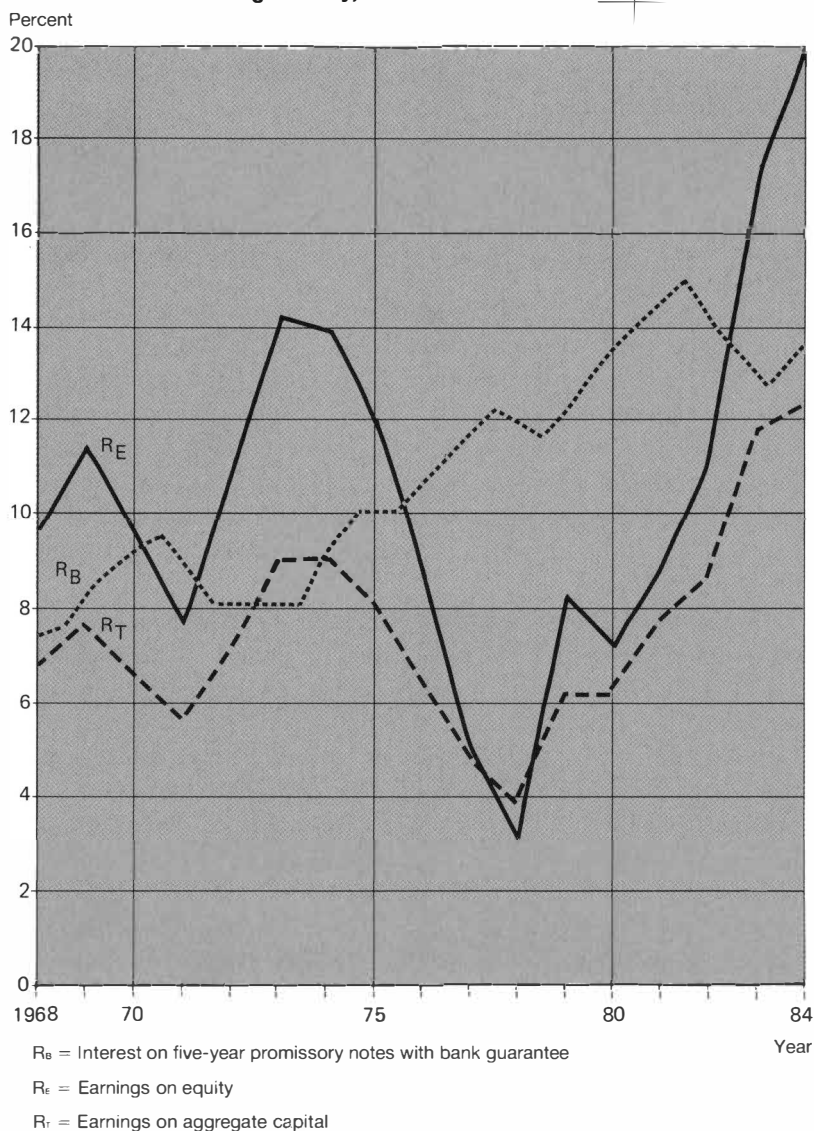
Sweden's Main Economic Policy Problems

The halt to growth in the Swedish economy which began in 1985 and is expected to continue during 1986–1987 is due mainly to the fact that export growth declined from a 6.5 percent increase in volume in 1984 to only 2 percent in 1985. During the same period, import growth rose from 4.7 to 8.5 percent in volume. In order to finance the resulting current account deficit by an inflow of private capital, interest rates had to be raised to levels which stifled investments. Hence, the upswing dominated by exports and investments has come to an end.

How could Swedish exports suffer such a setback during 1985? Of course, part of the explanation may be found in the decline in world trade. But a much more important factor is that since the second half of 1983, Sweden has continuously lost market shares on world markets. This is not because the effect of the devaluations on the relative cost level has been used up. Estimates from the National Institute of Economic Research indicate that the manufacturing industry still has a cost advantage of approximately 15 percent in relation to the period 1979–1981 (and 20 percent in relation to 1970–1972); see Figure 2. The relative price of Swedish exports of manufactured goods to the OECD countries is estimated to have remained unchanged since the first half of 1984, at a level which is about 7 percent lower than the average for the period 1979–1981.

It goes without saying that the relevance of relative cost in index comparisons which extend over relatively long periods of time may be regarded with scepticism. But other indicators also confirm that Sweden's relative cost level is still highly favorable. Figure 3 shows that profitability in the manufacturing industry was very high in

Figure 3. Rate of return and earnings on equity and aggregate capital in manufacturing industry, 1968–1984.



Sources: The Swedish Metal Trades Employers' Association and *Quarterly Review*, S-E-Banken, 1985:3.

1984 – much higher in 1983–1984 than during any other period since measurement began in 1963. S-E-Banken's profitability figures for all Swedish listed companies (excluding banks and insurance companies) also indicate that 1984 was an exceptionally good year in terms of profitability. In 1985, profitability remained at the 1984 level; further improvement is expected in 1986.

It may thus be established unequivocally that Sweden's current international competitiveness is still very good. It would probably be necessary to go back to the early 1950s to find profitability in the private sector equal to today's level.

However, there are indications that a favorable relative price level is obviously not enough to increase or even maintain market shares. The Swedish Board of Commerce recently published an analysis¹ in which the historical development of market shares for Swedish exports were described by a relation where a one percent reduction in the relative price of Swedish exports would result in a 1.2 percent increase in Sweden's market shares, whereas the market share shows a trendwise decline of 1.5 percent annually when relative prices are constant. If this relation remains in effect, then in a few years Swedish exports will have lost the market shares recaptured due to the devaluations in 1981–1982; see Figure 4.

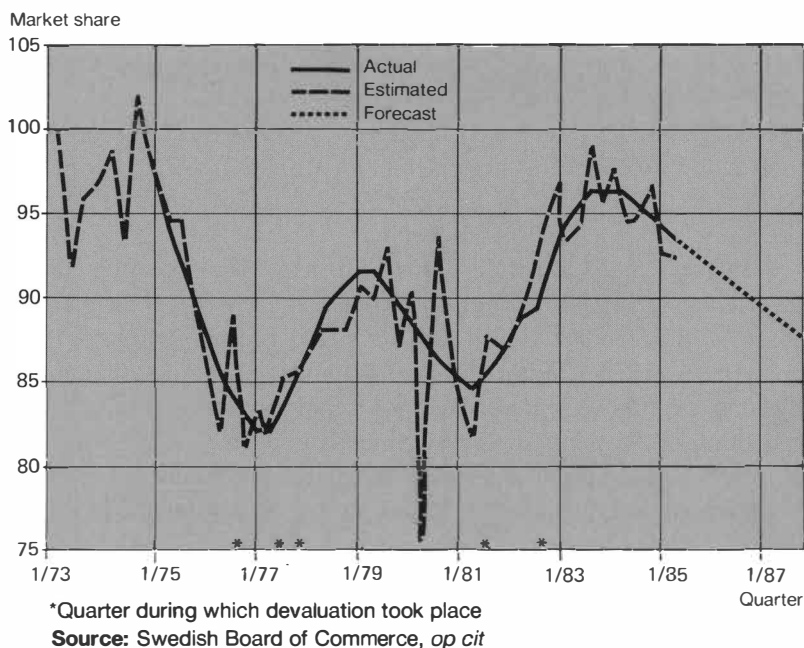
The Swedish Board of Commerce's study implies that continuous reductions in Swedish real wages in relation to the rest of the world would be necessary in order for the country to remain competitive on world markets. It will in all likelihood be extremely difficult for labor to accept the restraint in wage demands which would be required by continued slow productivity growth and structural change.

We believe that it is incongruous to try and establish durable growth in the Swedish economy solely by means of further real-wage adjustment. The parties on the labor market would be faced with excessive demands for restraint and we would risk getting caught in an inflationary economy with incessant new "offensive once-and-for-all devaluations".

Instead of a narrow approach involving real-wage adjustment, economic policy has to find other ways of exploiting the growth

¹) Swedish Board of Commerce (1985).

Figure 4. Sweden's market share for manufactured goods; actual, estimated and forecast; seasonally adjusted quarterly data at fixed prices; index series 1/1973 = 100.



potential of the economy. The recommendations set forth in last year's report are relevant in this context. The prerequisites for *persistent* growth are to a large extent the same as the preconditions for long-run stability: stable economic policy rules and well-functioning markets. Neither of these conditions are satisfied to any reasonable degree in Sweden today.

Last year's report focused on macroeconomic policies and contained recommendations with respect to stabilization policy rules. In this year's report the microeconomic prerequisites for efficiency and growth are analysed and a number of reforms are suggested. The two reports are hence complementary and comprise a coherent system of reform proposals for stability, efficiency and growth.

Accounting for Sweden's Poor Growth Performance

The most recent official Medium Term Survey (LU 84 – Swedish Government Official Report 1984:4) contained an assessment of economic growth in Sweden up until 1990; see Table 3. These estimates point to continuation of the low growth from the 1970s. The 1.0–1.9 percent GDP growth predicted in the report as the average for the 1980s is even lower than the average for the 1970s. The growth forecast is also 2–3 percent lower than average growth throughout the post-war period. Of course, these figures are subject to uncertainty as to the factors which really determine growth. Thus, it is questionable whether there is justification for the pessimistic growth perspective in the report.

Table 3. Total production capacity, 1970–1990; annual percentage change

	1970–1980	1980–1990
Employment, hours	– 0.6	0.1
Production/hour	2.9	1.6–1.9
Total production (value added at factor prices)	2.2	1.7–2.0
GDP at market prices	2.0	1.6–1.9

Source: Swedish Government Official Report 1984:4

The Swedish Medium Term Surveys and most other empirical studies of economic growth during the post-war period are based on the traditional model of growth accounting. Total growth is attributed to growth in volume and the quality of factors of production. After input of capital and labor have been assigned their shares, the remainder is usually called total factor productivity.

The growth in Swedish production has been divided into three six-year periods in Table 4. We can see that growth dropped dramatically between the "record years" 1963–1970 and the "stagflation years" 1976–1982. The table also provides a great deal of interesting information about the factors behind this decline. Generally speaking, all three base factors contributed to the decline: the investment rate fell, employment decreased and total factor productivity growth came to a halt.

Table 4. Swedish economic growth in a supply-side perspective

Volume of production and contribution	Periods		
	1963–1970	1970–1976	1976–1982
Volume of production	0.87	2.76	– 0.70
Contribution from:			
Volume of capital	1.39	1.23	0.79
Employment	0.40	– 0.15	– 0.31
Total factor productivity	2.08	1.68	0.22
Of which:			
Degree of utilization	– 0.05	– 0.64	0.48
Working time	– 0.45	– 0.57	– 0.62
Technical progress	2.58	2.90	0.36
Of which:			
Embodied technical change	0.73	0.75	0.54
Other technology	1.85	2.14	– 0.18

Source: Åberg (1985)

The breakdown of total factor productivity growth reveals some important observations. First, variations in capacity utilization are rather insignificant over such long periods as those listed here. This emphasizes the limited influence of short-run demand variations on economic growth in the longer run. Second, shorter working time – shorter work days, more part-time work and higher absenteeism – has had a continuous and increasingly negative effect on economic growth.

The most interesting observations are related to the rate of technical change. Technology embodied in new capital contributed less to growth during the last period, which is a natural result of the decline in investments. Other technology – the residual – shows a

dramatic reversal. After having made a positive contribution to growth of approximately 2 percent per year, this factor contributed to a *reduction* in economic growth during the last period!

Of course, technical change is not moving backwards. Obviously, we have very limited knowledge about the factors which determine this residual. However, a number of studies show that reallocation gains, i.e., the increase in production which arises when labor moves from low-efficiency to high-efficiency occupations, can often explain a large part of the residual in a growth-accounting framework. In other words, structural change is an important feature of the growth process.

The growth-accounting method lacks an analysis of the microeconomic conditions which create structural change and the institutional framework which is conducive to this process.

In order to induce education, innovation, mobility, exit and entry, economic rewards have to be large enough for such changes to be profitable. The price system has to be allowed to give signals for the transfer of resources through market prices which in some cases are much higher and in others much lower than production costs. Wages must provide information about the value of an extra work effort in different occupations, sectors and regions. Rates of return on the capital market have to give immediate signals in regard to changes in opportunities and risks associated with different investment alternatives. This requires, first and foremost, well-functioning markets with price and wage formation that reflect social costs and benefits. This, in turn, puts constraints on the nature and magnitude of government intervention in general and on the design and level of taxation in particular.

A well-functioning market economy is certainly highly dependent on a well-functioning public sector. Laws and ordinances are necessary to regulate the rights and obligations of different parties, to ensure that contracts are legally binding and that sanctions are carried out against those who do not live up to their contracts. Legislation is required to prevent harmful effects of monopolies, to ensure free competition, and to protect the environment. The public sector also has to be responsible for the provision of public goods such as defense, police, courts, transportation systems, etc.

Whereas some public-sector activities support the market

economy and promote economic growth, others obstruct growth. For instance, there is reason to question much intervention in the form of government regulation of industry and different kinds of so-called industrial policy. In a world characterized by uncertainty, government authorities usually do not have the information required for successful intervention in the private sector.

Public intervention runs a high risk of making matters worse rather than bringing about improvements. Regulation of prices or quantities places serious limitations on competition as a means of solving adjustment problems in the economy. Regulation often prevents process and product innovation. The result is inefficient use of economic resources. Furthermore, government regulation more often than not becomes a victim of firms' and pressure groups' attempts to limit their competition. Intervention may also increase uncertainty about the rules of the game in the economy and thus have an adverse effect on the business climate.

In short, higher growth cannot be regulated into the economy. The rate of economic growth which we observe is the result of individual decisions made by millions of households and firms.

Economic policy nevertheless has significant effects on the growth rate, even if they are indirect and difficult to measure. The design of stabilization policy certainly has a growth dimension. In a historical context, periods of strong economic growth have coincided with stabilization policy regimes with an emphasis on price stability. These periods are the days of the gold standard, 1876–1913, and the Bretton Woods era, 1950–1971.

Our reading of these experiences is that a credible and stable price level is a necessary condition for favorable economic growth. Long-run commitments such as material investment, education and innovation are incompatible with the uncertainty brought about by high and variable inflation. This is one reason why we advocated a stabilization policy which gives priority to price stability in last year's report.

But macroeconomic policies cannot make it alone. Laws and ordinances influence incentives for work, saving, business ventures, capital formation and, as a result, economic growth. Micro-economic policies can be designed to promote mechanisms which lead to economic growth. Important features include well-

defined property rights, a well-functioning price system with an emphasis on competition, a nondistortionary tax system, and stable long-run rules of the game in regard to the economic system. Some of these conditions as applied to the Swedish economy are analyzed in subsequent sections of this report.

The Swedish Economy: A Network of Regulation

Dramatic changes in the world economy during the 1970s and 1980s have intensified the need for economic adjustment and structural change. This has contributed to greater interest in the effects of regulation on competition and growth. Several industrial countries have initiated policies aimed at deregulation. So far, this international trend has not left many traces in Swedish economic policy – possibly with the exception of the capital market.

Free entry is the main prerequisite for competition and efficiency on a market. Today, many sectors of the Swedish economy are subject to regulation which prevents or limits new entry, with subsequent adverse effects on competition.

Regulation is least prevalent in markets for tradable goods. There is a certain amount of awareness that regulation in the tradables sector would seriously impair our international competitiveness. In the nontradables sector, however, regulatory control, and particularly obstacles towards new entry, continue to be a common feature of the Swedish economy.

Large parts of the housing sector are exposed to regulation, with strong elements of price control. The labor market is regulated through e.g. a public-sector monopoly on employment service and legislation on working time. The food and agricultural sector is protected by tariffs and quotas which exclude international competition. The capital market is constrained in many ways, particularly by exchange control. The insurance market and the bank sector are regulated through restricted entry and investigative agencies. Extensive price regulation on commodity markets has been in effect intermittently since 1970.

Special legislation contains far-reaching regulation in regard to acquisition and use of forests and land. The transportation sector is subjected to state and regional regulation of taxis, busses and air transportation; new entry is either prohibited or impeded. New stores, sports facilities, etc. are controlled by municipal planning where favoritism is shown to local monopoly interests. The service sector is highly regulated in regard to new entry, often in terms of official competency requirements. By supplying its services free of charge or at heavily subsidized prices, the public sector has in effect monopolized a number of areas such as health care, care of the elderly, education and day-care centers for children. In some cases private competition is explicitly prohibited.

Current Swedish regulation has many of its roots in the agricultural regulation of the 1930s and the control economy during World War II. Partial deregulation occurred during the early postwar period, although a great deal of wartime regulation is still in effect (e.g. in regard to housing, the capital market and exchange control). The most recent period of regulation with increasing government intervention on different markets occurred in the late 1960s and early 1970s.

Critical review and reform of government regulation in Sweden today would be instrumental in making the Swedish economy more flexible and efficient. Deregulation aimed at improving adjustment and growth would be particularly favorable in the following areas:

- Exchange controls should be abolished.
- Price regulation and price-control legislation should be discontinued immediately.
- Agricultural regulation along with legislation on acquisition and use of land should be gradually abolished.
- Review of other areas such as air traffic, housing, construction and employment services should lead to questions concerning existing regulation and reform proposals aimed at enhancing competition.
- In the long run, the production monopoly of the public sector in child care, education, health care and care of the elderly should be abolished. A first step towards this objective could be to increase user charges in public-sector services. The remaining

subsidy system should be extended to cover private alternatives.

- Freedom of entry in all trades should again be confirmed by legislation, as was the case up to 1968. This would make it difficult to introduce – even unintentionally – new obstacles to competition.
- The relevant regulatory agencies must also be dissolved in order to emphasize the permanence of deregulation.

Deregulation of the Swedish economy would have winners and losers. The losers would be employees in the regulatory agencies and both capital and labor in those areas of the private sector which have benefited from restricted competition. In some instances, deregulation should be combined with economic compensation, e.g. in the case of deregulation in the agricultural sector. But there is no reason to compensate other losers, e.g. in the case of abolishment of price controls. In any event, the winners are in the majority.

Our Complicated, Distortionary and Unfair Tax System

In the Swedish tax system, the marginal effect for labor and capital income usually amounts to 50–90 percent. Most of the compensation for extra efforts is thus taxed away. There are also very large variations in effective rates of taxation among different activities. As a result, actual resource utilization does not reflect social benefits and costs.

The tax system is also perceived as unfair in many respects. Large variations in taxation of different kinds of income permit well-informed and financially strong individuals and firms to lower their taxes through tax avoidance and tax evasion. The ethics of tax avoidance condoned by legislation became the subject of lively debate after the mass media observed that high public officials had lowered their taxes in this way. However, the mass media's examples must be regarded as only the tip of the iceberg.

In particular, taxation of income from capital provides many opportunities for manipulation. When shares are used as collateral for borrowing, for example, an immediate deduction can be made for interest expenses, while capital gains on the shares are taxed at a lower rate on a later occasion. Corporate taxation also contains many loopholes for avoiding tax through depreciation, reserve funds, etc. Owners of farms and small businesses are thus able to report a low taxable income even when they make relatively high withdrawals from their operations.

In the case of labor income, tax avoidance and tax evasion take place by means of untaxed fringe benefits such as subsidized meals, pension insurance, subsistence allowances, other cost remunerations and scholarships. In other words, opportunities for manipula-

tion are relatively extensive, even within the limits of tax legislation or normal practice. A flagrant example of pure tax evasion which has been accepted in practice is that those who provide private day care for children do not as a rule pay income tax and the parents in question do not normally pay any payroll taxes.

In addition to the problems associated with distortions and fairness, the tax system is highly complex. Total corporate taxation, for instance, is so complicated that those liable to tax and tax authorities alike find it difficult to master the system.

There are two conflicting tendencies in current development of the tax system in Sweden. The first represents efforts to simplify the system and eliminate distortions. One result is a simplified personal income tax with fewer and standardized deductions. Corporate taxation has also been simplified and rendered less distortive by means of a lower tax rate and an extended tax base through e.g. reduced allowances for research, investments and inventory depreciation. A further example is that local government taxation of corporate bodies has been abolished.

The second tendency is that other political ambitions have led to new complications. The introduction of wage-earners' funds, for example, has necessitated an additional tax base for computing a new "profit-sharing tax". Housing policy objectives regarding redistribution of housing expenses have resulted in a special apartment-house tax and later a real-estate tax. In order to hold back wage increases, liquidity was withdrawn from the private sector through appropriation to special "renewal funds". A currently real interest rate tax is currently under investigation in the Ministry of Finance. As part of the tax reform in 1982–1985, deduction for deficits was limited to 50 percent. This made tax computations more complicated and increased the importance of determining how income and deductions are distributed among different types of income.

As a result of dissatisfaction, particularly in regard to income taxation, a number of commissions have been set up to study alternative forms of direct taxation. Several comprehensive reforms have already been proposed, although the changes which have actually occurred, such as the tax reform in 1982–1985, have been much less drastic.

Swedish *taxes on labor earnings* discriminate against taxed labor as compared to different kinds of household work, unreported labor income, hobbies and other leisure activities. The nature and effects of these distortions were discussed in detail in last year's report. It was found that the total marginal effect for all taxes on labor earnings amounted to approximately 71 percent in 1985. We also showed that the marginal effect in Sweden exceeds the average for the OECD countries by about 20–25 percentage points.

Another conclusion presented in our report last year was that increased taxation of labor earnings has given rise to high economic costs to society. According to various studies, if government transfer payments are increased by SEK 1, financed by raising payroll taxes, the indirect economic costs to society will correspond to approximately SEK 0.5–1.3. A rise in public spending of SEK 1 must therefore have a social value of at least SEK 1.5–2.3 in order to compensate for the direct *and* indirect costs of this type of tax hike.

As shown in Table 5, total *taxation of capital* in Sweden is low as compared to total taxation of labor. If real income from capital is estimated at 10 percent of GDP, total taxation of capital in Table 5 implies an average tax rate of 22 percent. This may be compared to an average tax of 58 percent on labor earnings when total compensation for work is estimated at 78 percent of GDP. (The remaining 12 percent is capital depreciation.) Such a low average tax rate on capital income indicates that capital taxation probably has a moderate effect on the size of *total* saving.

However, the tax system does bring about large variations in effective tax rates on different types of investment. Some investments are highly taxed, whereas others are strongly subsidized. An international study¹ has examined total taxation of corporate investments for three different types of capital, three sectors, three sources of finance and three owner categories. When all parts of the Swedish tax system are taken into account, the effective marginal effect estimated with respect to the 81 different investment categories varies between –166 and +144 percent. This implies that gross earnings of 10 percent resulted in real after-tax earnings

¹) King and Fullerton (1984)

Table 5. **Classification of taxes and tax revenue as a share of GDP, 1985**
(SEK 850.8 billion), in percent

Taxes on income from capital	2.2	Taxes on labor earnings	45.1
Personal income tax on income from capital	- 0.4	Personal income tax on labor earnings	21.5
Corporate income tax	1.7	Payroll taxes	11.2
Wealth tax	0.3	Value added tax	6.6
Inheritance and gift tax	0.1	Other taxes on goods and services, e.g. liquor, tobacco, gas, lotteries, etc.	5.8
Other property taxes, e.g. stamp tax, real estate tax, etc.	0.5		

Note: Income tax in business and agriculture is distributed between labor and capital on the basis of a standard estimate of capital income. Payroll taxes have been reduced by 3.3 percent of GDP to account for the fact that these charges are only partial taxes.

Sources: National Audit Bureau and own calculations

of between 21.6 and -4.4 percent for different investments. Thus, the tax system produces excessive and socially destructive distortions in the pattern and financing of investments.

Table 6 shows further results from this study. The first line reveals that the marginal effect as an average for all corporate investments in Sweden amounts to 35.6 percent. By way of comparison, the marginal effect for the U.S. was 37.2 percent, for West Germany 48.1 percent and for Great Britain 3.7 percent. Thus, on average, Swedish taxation of corporate capital is not conspicuously high in an international perspective. However, the table does indicate far-reaching fiscal discrimination of investments.

According to estimates for the U.S., tax distortions between different investments result in a loss of economic efficiency equivalent to 1-2 percent of GDP. Since Sweden has higher taxes and larger variations in effective tax rates, the corresponding loss is likely to be even greater. These studies thus indicate that the loss to the Swedish economy due to tax distortions of investments is on an order of magnitude of at least SEK 10-20 billion per year. Elimination of these distortions is therefore an important feature of fiscal policy for growth.

The *distributive* effects of *personal* taxation of income from capital do not fulfill redistributive ambitions. In Figure 5 households are divided into deciles based on households' gross income cor-

Table 6. **Marginal effect (in percent) for different corporate investments based on before-tax real earnings of 10 percent**

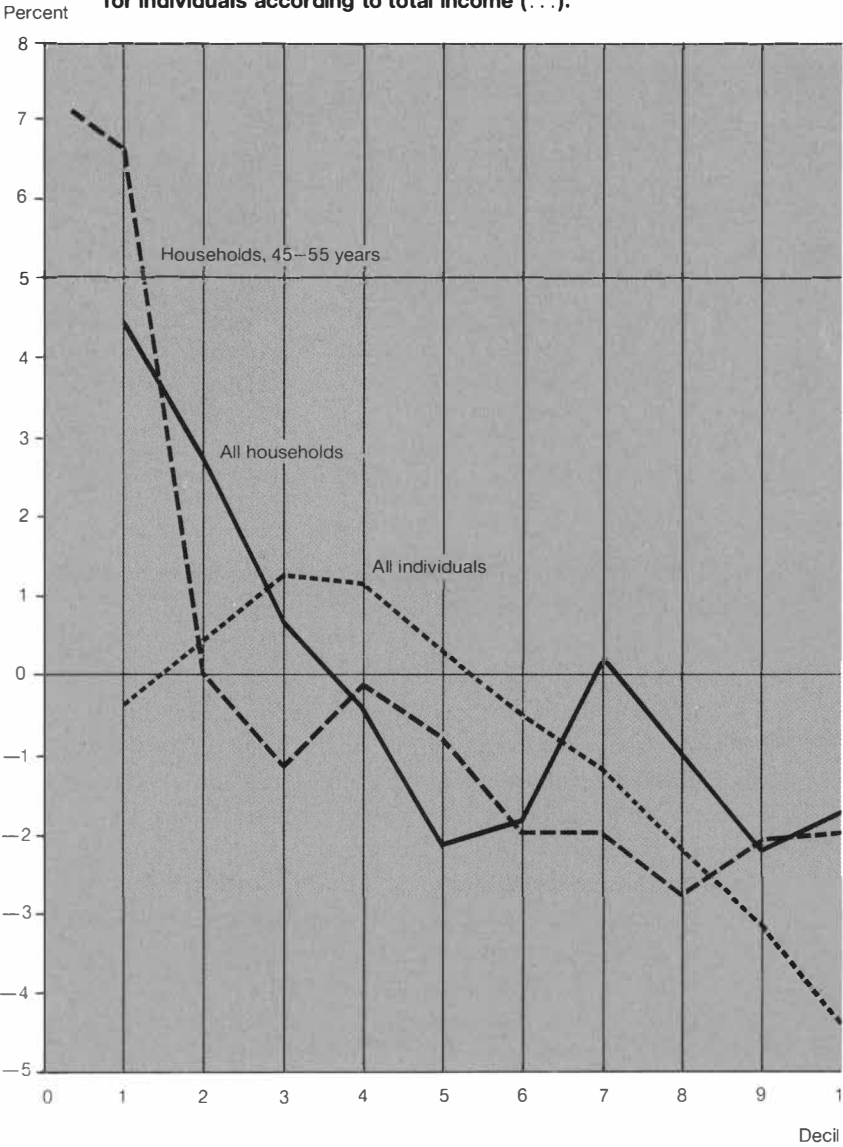
Total		35.6
Type of capital	Machines	0.2
	Buildings	36.6
	Inventory	68.8
Line of business	Manufacturing industry	27.1
	Other industry	60.5
	Trade	39.2
Financing	Loans	5.0
	Issue of new shares	90.4
	Retained earnings	68.2
Owner	Houeholds	105.1
	Tax-exempt institution	- 51.8
	Insurance company	18.9

Sources: King and Fullerton, *op cit*, and Södersten and Lindberg (1983)

rected with respect to household size. The solid curve in the figure shows the tax which arises due to personal taxation of income from capital as a share of gross income for the ten deciles. This part of the tax system produces some net average tax for low-income households. On the other hand, households with high income have on average a negative tax share, i.e., this part of the tax system gives high-income households a tax cut. The main explanation for this fact is that deficit deductions for private homes are concentrated in households with high income.

In order to eliminate life-cycle effects, corresponding calculations were made for the age group 45–55 years (broken curve in Figure 5). A more conventional – but from a distributive viewpoint less relevant – calculation was also carried out on the individual level (dotted curve). The results are unambiguous, regardless of which classification is applied. Personal taxation of positive and negative reported income from capital results on average in net taxation of households and individuals with relatively low income and net tax relief for those with relatively high income. The conclusion is that the efficiency costs of the highly complicated personal

Figure 5. Tax as a share of gross income for households divided up into deciles according to gross income per consumption unit (—), correspondingly for households in age group 45–55 years (---) and for individuals according to total income (...).



taxation of income from capital is not outweighed by any positive redistributive effects.

The Swedish tax system systematically discriminates against work effort and capital investment in the taxed sector and encourages people to use their time, energy and capital in other ways. Tax hikes counteract growth in the taxed economy by transferring resources from the taxed sector to different kinds of untaxed activities. According to a simple simulation model of the Swedish economy, tax increases between 1965 and 1979 have reduced the annual growth rate of the taxed sector by approximately 1 percentage point over the period in question. Such estimates are relatively uncertain, however, and should be interpreted to indicate the order of magnitude of the social cost.

Tax Reforms for Growth and Welfare

Earlier and suggested reforms for *taxation of labor income* were analyzed in detail in last year's report. The marginal income tax in some income brackets was lowered substantially during the period 1982–1985, but the relevant marginal effect was still only reduced from an average of approximately 74 percent in 1982 to 71 percent in 1985. This relatively moderate effect is partly due to the fact that other taxes were raised to finance the reduction in income tax.

A reasonable objective for tax reform in regard to labor income is that the marginal effect should be reduced – for instance, by limiting marginal income tax to 50 percent – even in income brackets which apply to most lawyers, physicians and other professions where the economic value to society of an extra work effort is often very high. A marginal tax ceiling at 50 percent would reduce tax revenue by 0.6 percent of GDP (SEK 4.8 billion in 1985). The effect on the government budget would thus be limited.

The distortionary effects of taxes can generally be reduced by a switch to congruent taxation of different activities. In terms of taxation of labor earnings, this calls for broad-based taxes such as the payroll tax and the value added tax. The tax bases for income taxes and, in some instances, payroll taxes, can be extended by eliminating deductions and taxation of different types of fringe benefits. Value added tax is currently levied on approximately 70 percent of all private consumption; this proportion could be extended to 100 percent. The extension would imply that value added tax would be levied on rent and imputed rent in owner-occupied housing.

Personal taxation of income from capital represents, as demon-

strated above, a complex aspect of the tax system which distorts investments, reduces tax revenue and has undesired distributional effects. The effects are obviously not the result of deliberate priorities on the part of political decision-makers. This implies strong reasons for considering radical reform of this part of the tax system.

The basic reason why current taxation of income from capital is beset with so many problems is that different principles are applied to taxation of various types of income. A consistent solution to such problems would be to base a new tax system on a single general principle, so as to ensure similar treatment of all types of capital income. Since a consistent nominal principle would obviously have unreasonable consequences in many respects, a choice should be made between a consistent real principle and a consistent principle for tax exemption. The latter can in effect be achieved by a switch to an expenditure tax or by outright elimination of personal taxation of capital income.

When *real taxation* is applied, the effective tax rates are obtained which would have arisen in the absence of inflation. A consistent transition to real taxation would eliminate most of the reported deficits for e.g. private homes and increase tax revenue by SEK 9–13 billion in 1982 prices. Such a reform would drastically reduce the distortive effects of the tax system on investments.

The largest disadvantage of real taxation is that the tax system would become even more complicated. Furthermore, in practice, it is extremely difficult to achieve equivalent taxation of capital gains as compared to current income from capital, as well as of retirement pension assets and consumer durables as compared to saving in bank accounts and bonds. Some distortions between different types of investments would remain.

A switch to *expenditure tax* means that households would be allowed to deduct all types of saving, whereas all dissaving would be taxed. A household's tax base would thus coincide with its consumption expenditures. This may appear attractive from a distribution policy point of view.

But expenditure taxation is highly complicated, mainly because different types of saving must be accounted for and verified. Difficult problems would arise when wealth is transferred between

individuals in connection with divorce, inheritance and gifts, or emigration. Tax collection would become more complex in the sense that withholding tax would deviate sharply from final tax due in many cases.

A consistent tax-exemption principle could also be achieved by simply *abolishing personal taxation of income from capital*. As we have shown earlier, this would raise tax revenue, alleviate distortions and produce a redistribution in favor of low-income groups. Income taxation would be drastically simplified. All capital gains taxes would be eliminated, and the rules which now limit tax relief for deficit deductions would become superfluous. Most wage-earners would find that their withholding tax coincided exactly with their final tax.

However, elimination of personal taxation of income from capital would, at least in the short run, lead to large gains for some wealthy households. This contradicts accepted principles in regard to taxation according to ability to pay. Such a reform would have to be supplemented by changes in *net wealth taxation*.

Today's net wealth tax gives rise to distortions because it is only levied on some assets, and some of the assets covered are systematically undervalued. It is progressive and amounts to 1.5 percent of net wealth in the interval SEK 400 000–600 000 and 3 percent in excess of SEK 1 800 000. A comprehensive progressive net wealth tax would e.g. require that the value of retirement insurance and consumer durables be computed for each household. But a proportional net wealth tax would lead to important simplifications. The tax on pension wealth could be paid directly by insurance companies, thereby avoiding assessment and verification of individual pension wealth. Such a tax would be similar to the interest tax which is under consideration by the Swedish Ministry of Finance.

The assessment and verification requirements linked to a progressive net wealth tax would, in practice, also make it difficult to include consumer durables in the tax base. In the case of a proportional net wealth tax, an imputed combined property tax could be imposed at the time of sale, in analogy with the current excise tax on cars.

If the real pretax yield on capital amounts on average to 3 percent, a tax rate of 1.5 percent on net wealth would correspond to an

income tax rate of 50 percent. With a basic deduction of SEK 100 000, such a comprehensive net wealth tax would yield tax revenue of almost 2 percent of GDP, as compared to current revenue from personal taxation of income from capital of -0.4 percent of GDP.

Corporate taxation also gives rise to distortions between different investments. According to Table 5, however, the corporate income tax in Sweden results in positive tax revenue. On the other hand, *net* income from this tax is much less because corporate taxes reduce revenue from e.g. income, wealth and payroll taxes. Gross revenue amounting to 1.7 percent of GDP for 1985 thus corresponds to net revenue of perhaps 0.5–0.8 percent of GDP.

One alternative under discussion is replacement of the corporate income tax by a general *tax on production factors*. In contrast to other alternatives, this is in principle an income tax which involves taxation of capital income. Neutrality among different investments would therefore require the system to be applied not only to corporate capital, but also to privately-owned firms, real estate and consumer durables. A well-functioning tax on productive resources would have to be based on real return on capital. This would create the same complications as in regard to real taxation. A tax on production factors would be levied on capital that is used in Sweden. In a small open economy such a tax is borne primarily by wage-earners in the form of lower real wages in the long run. Consequently, this tax does not seem very attractive from a distributional viewpoint.

Of course, the simplest solution would be to *abolish corporate income taxes* altogether. The reform of personal taxation of income from capital discussed above would raise revenue to compensate for the loss of tax revenue.

Elimination of the corporate income tax would mean that state and local government could write off the tax claim created earlier by generous tax rules for depreciation and appropriations to reserve funds. If this is to be avoided, the simplest alternative would be to tax corporate net cash flow to its holders, i.e., to *tax dividends minus equity capital acquired through new issues*. Given the current tax rate of 52 percent, corporate taxes are approximately equal to dividends for many firms. An unchanged tax

amount on available capital would thus require a dividend tax of about 100 percent. A new issue for SEK 1 would then result in a tax cut of SEK 1, while a dividend of SEK 1 would mean a tax of SEK 1; i.e., the state would in principle participate as a sleeping partner in joint-stock companies. If earnings on equity exceed the public-sector borrowing rate, this participation would be profitable for the public sector. The consequences of this form of taxation may be described as taxation of "excess profits", i.e., of earnings in excess of the interest on financial assets.

Corporate income taxes are levied on capital used in Sweden, regardless of who owns it. If effective corporate income taxation were eliminated for new investment by the suggested "cash-flow tax", pretax earnings requirements on investments in Sweden would be lowered; Swedish and foreign companies would find it more attractive to invest in Sweden. This could be expected to increase investments and growth in the Swedish economy.

The suggested reforms of capital income taxation would eliminate most distortions in the choice among different investments. Investments would compete under equal conditions so that the socially preferable alternative would also be best in private economic terms. The reforms would thus not only sharply reduce the distortionary effects of the tax system, but also improve the precision of distribution policy, simplify the tax system and increase tax revenue.

For example, the locking-in effects of the present tax system on capital in historically profitable firms would be eliminated completely. If a cash-flow tax were in effect, the tax on dividends in a company would be neutralized by a corresponding tax cut when capital is transferred to another firm through a new issue.

A tax policy for growth and welfare presupposes elimination of the distortions which are so costly to society. The arguments presented here are based on an unchanged tax level, but speak in favor of sweeping tax reforms. Our proposals are characterized by simplicity and neutrality; they are not in conflict with distribution policy objectives. In addition, they would satisfy important social interests by making the entire tax system and its effects more transparent. These reforms would also make the tax system more robust against inflationary disturbances and thereby increase confidence

in the stability of economic policy rules.

The tax reforms discussed in this report would create transitional problems in the sense that the price of assets which had been taxed at low rates, such as owner-occupied housing, would drop. As in any far-reaching reform of capital-income taxation, these reforms should therefore be preceded by advance information and a long transition period in order to facilitate adjustment and reduce losses for households and firms which had to a large extent based their economic planning on current tax rules.

A Capital Market in Transition

A number of changes on the economic scene have resulted in new conditions for the Swedish capital market in the last decade. Sizeable budget deficits, a series of devaluations and high corporate profits have created an entirely new situation, where new actors appear in new roles.

The Swedish capital market has moved away from the extensive regulation system which prevailed during the 1950s and 1960s. New financial instruments and techniques have evolved. Finance companies and large corporations have penetrated markets which used to be dominated by commercial banks. The ban on international banks has been lifted. In these respects, Sweden has joined the international trend towards deregulation and higher financial sophistication.

The first steps towards liberalizing the capital market took place in the late 1970s and were sharply intensified during the 1980s. The deregulation process consists of two parallel developments: i) existing regulation of interest rates and credit flows has been relaxed or abolished; ii) new instruments, financial markets and institutions have emerged.

The National Debt Office has participated in the liberalization process by issuing treasury bills and government bonds with market-determined yields. The Central Bank has contributed to the process by relying more on open market operations. Forward trade in treasury bills and government bonds has begun to evolve. Most of the financial innovations have occurred on the money market, although the bond market has also exhibited a trend towards liberalization.

Despite some degree of deregulation, the Swedish capital market is still governed by considerable regulation. Exchange control prevents private Swedish citizens, firms and institutions from freely choosing the composition of their portfolios and likewise prohibits foreigners from freely investing in Sweden. Other remaining regulation has the character of taxation on the activities of different financial institutions, such as requirements on insurance companies and the General Pension Fund regarding gross investment in low-yield government bonds. Various kinds of trade-licensing are still in effect, although this has been relaxed to some extent during the 1980s. A new regulation has arisen through legislation which stipulates that since year-end 1984, the government has to approve the election of chairmen of commercial banks.

Along with the emergence of new instruments and techniques, large institutional changes have taken place on the credit market. A characteristic feature of this process is that commercial banks have lost market shares in the organized credit market because they have been subjected to relatively stringent regulation on lending operations. This in turn has prompted rapid expansion of finance companies since the mid-1970s. Finance companies originally concentrated on leasing, factoring and credit cards as their special niche on the credit market. Their activities have gradually expanded to cover a broad spectrum of financial services. In particular, they satisfy small and medium-sized firms' financing requirements.

Large industrial corporations have also expanded their activities on the credit market. Owing to high profits and modest domestic investments in recent years, these corporations have substantial liquid assets. New credit-market instruments such as treasury bills and commercial certificates have increased their opportunities for engaging in financial activities. Finance divisions have been enlarged and many corporations report large net interest income. Some corporations, such as Volvo and ASEA, have even set up their own finance companies.

Concurrent with rapid development on the credit market, the Swedish stock market has undergone a dramatic transformation. Since September 1980 share prices have risen almost continuously by a total of more than 500 percent. The average value of daily stock-market transactions rose from less than SEK 8 million in 1979

to more than SEK 600 million in the first half of 1986. The number of listed companies increased from 101 in 1980 to 166 in 1985. In addition, the rapidly growing OTC list now covers approximately 100 quotations. New stock-related financial instruments have also been introduced: convertible bonds, convertible participating debentures, warrants and call options. Foreign investment has quickly become an influential factor on the Stockholm Stock Exchange.

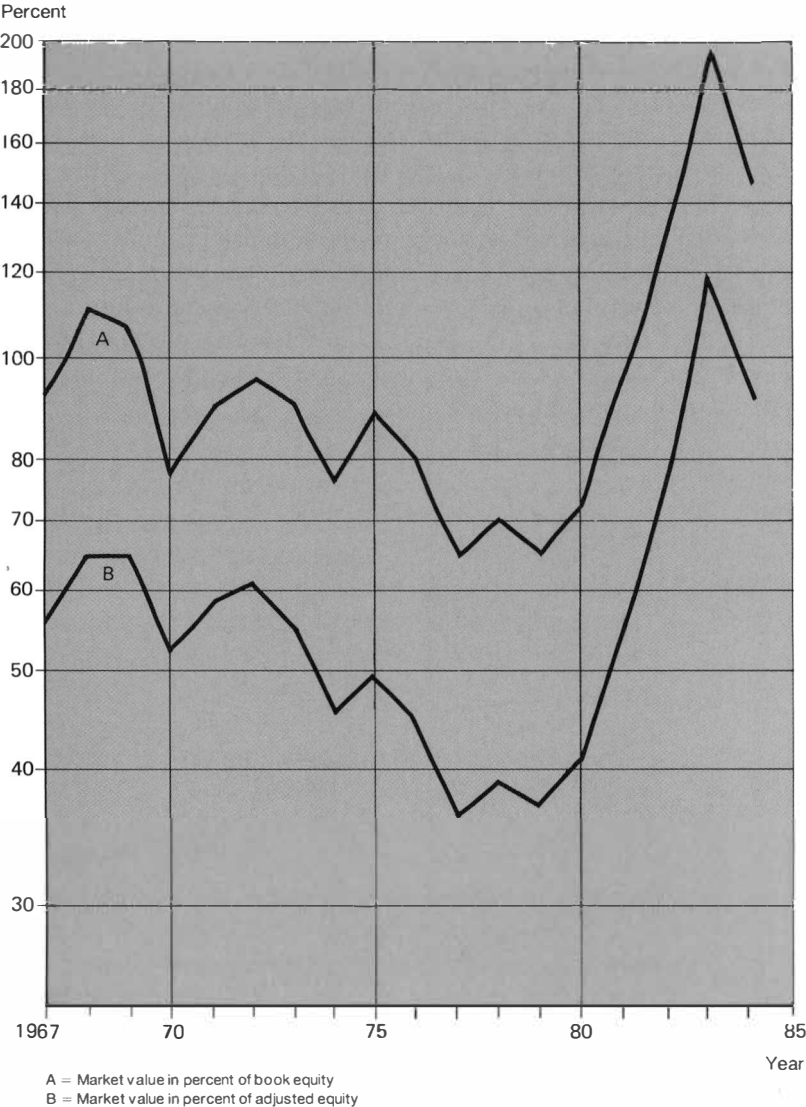
Due to the stock-market upswing, the net worth of listed companies is approximately equivalent to the market value of their net assets; see Figure 6. As could be expected, this gave rise to extensive new issues and new introductions on the Stock Exchange. The question of supply of risk capital, which was debated so widely during the 1970s, has been made irrelevant by this process. Instead, there are new problems: institutionalization of the stock market and a decline in household ownership of shares, foreign ownership and differentiated voting rights, cross ownership and superimposed ownership, treatment of minority shareholders in power struggles and takeover bids, stock-market ethics, etc.

This rapid development of the capital market has rendered current legislation and regulation obsolete and poorly adapted to present conditions. Much attention is now focused on a suitable legal framework for the capital market and regulation of the financial sector. The decisions to be made are of the utmost significance not only for the financial sector, but also for the future development and growth potential of the overall economy.

The problem inherent in the reforms proposed thus far is that they refer to single institutions (e.g. finance companies), individual sectors (e.g. exchange controls) or isolated objectives (e.g. placement of the national debt). There is considerable risk that different reforms will counteract each others' objectives and have unintended side-effects. What is lacking is a comprehensive legal approach based on the vital importance of the capital market in regard to the ability of the market system to allocate resources.

We see little reason to impose regulation on corporations and other institutions on the capital market except in the case of commercial banks. The ability of the market and competition to create institutions and mechanisms for supervision and control – and thereby also confidence – should not be underestimated. The capi-

Figure 6. Net worth of all Swedish listed companies (except banks and insurance companies).



Source: *Quarterly Review*, S-E-Banken, 1985:3

tal market is in the midst of rapid transformation. Extensive regulation of various agents could well become a strait-jacket which obstructs the transformation process.

The greatest threat to public confidence in the banking system does not originate from ownership or management of the banks and other financial institutions. Instead, it comes from large macroeconomic disturbances in the surrounding world and the way these disturbances are handled by domestic stabilization policy. The effects of such disturbances on the Swedish economy and the capital market cannot be neutralized by detailed regulation of domestic banks, but only by a stable and credible stabilization policy regime. Ultimately, the Bank of Sweden and the government have to guarantee public confidence in the Swedish currency and the Swedish payments system.

Relative Wages and the Efficiency of the Labor Market

Wage relations in Sweden have often been discussed solely on the basis of distributional and equity aspects, while their significance in terms of employment and growth has been neglected. But in a market economy, changes in relative wages are important because they signal how manpower should be distributed among firms, sectors, regions and occupations. Wage differences create incentives for individuals to invest in education or make their career in a firm. They also enable labor to be recruited to jobs with low status or inconvenient working hours.

If wages are not allowed to adjust to market conditions, the labor market will be characterized by imbalances. This is what has taken place on the Swedish labor market. Unemployment is concentrated to youth and older people; see Figure 7. This has occurred in spite of extended high-school education and “youth teams” (the sharp decline in unemployment for 16–19 year-olds in 1983–1984 reflects the introduction of such work teams) and widespread early retirement. There are sizeable regional differences in regard to regular employment. A chronic shortage of skilled labor in industry has prevailed throughout the postwar period. More recently, scarcity of engineers has also arisen; see Figure 8. Salaries of college-educated personnel are much higher in the private than in the public sector, resulting in a disquieting outflow of competent people from the public sector. A further indicator of imbalances on the labor market is decreasing mobility. This can be measured in various ways, although alternative measurements unanimously show a significant decline; see Figure 9.

Figure 7. **Relative unemployment figures for different age groups.**

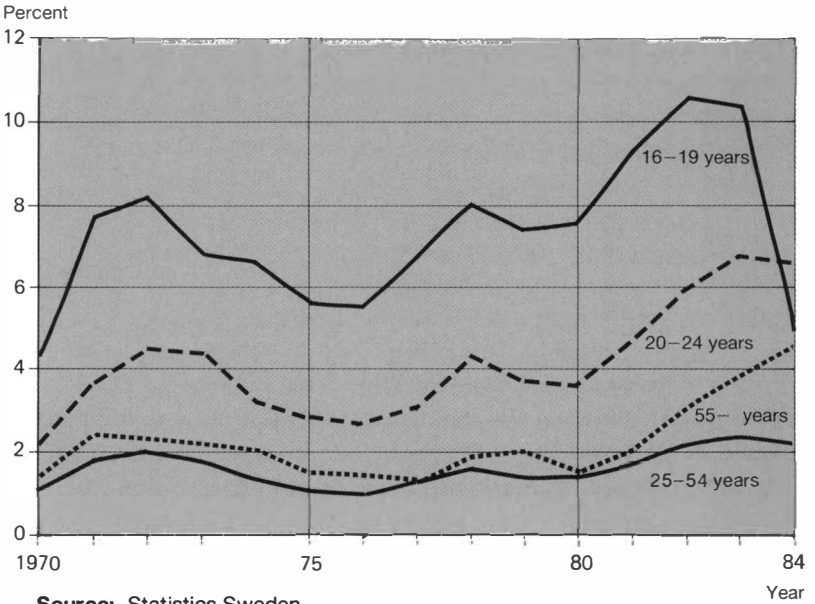


Figure 8. **No. of firms with a shortage of manpower.**

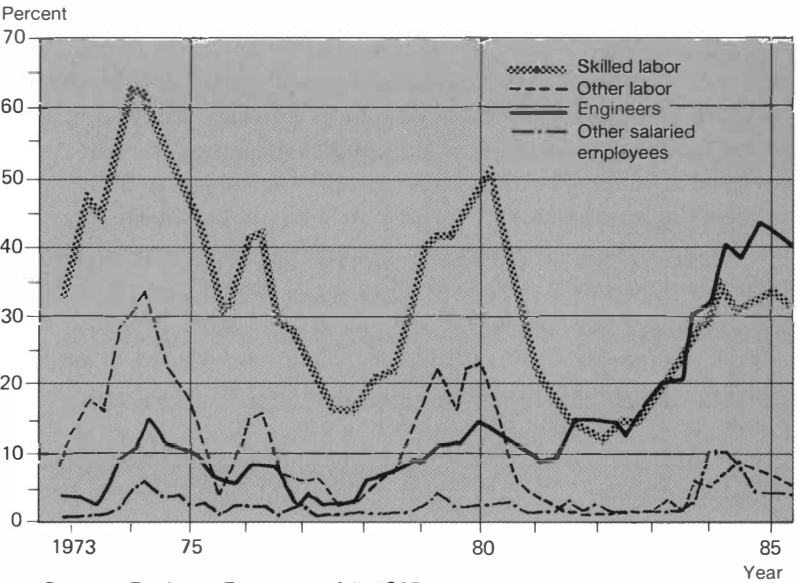
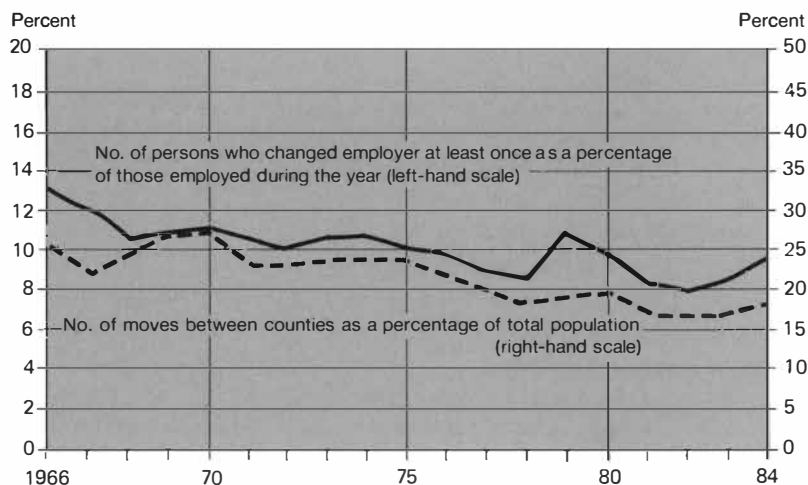


figure 9. **Mobility on the Swedish labor market.**

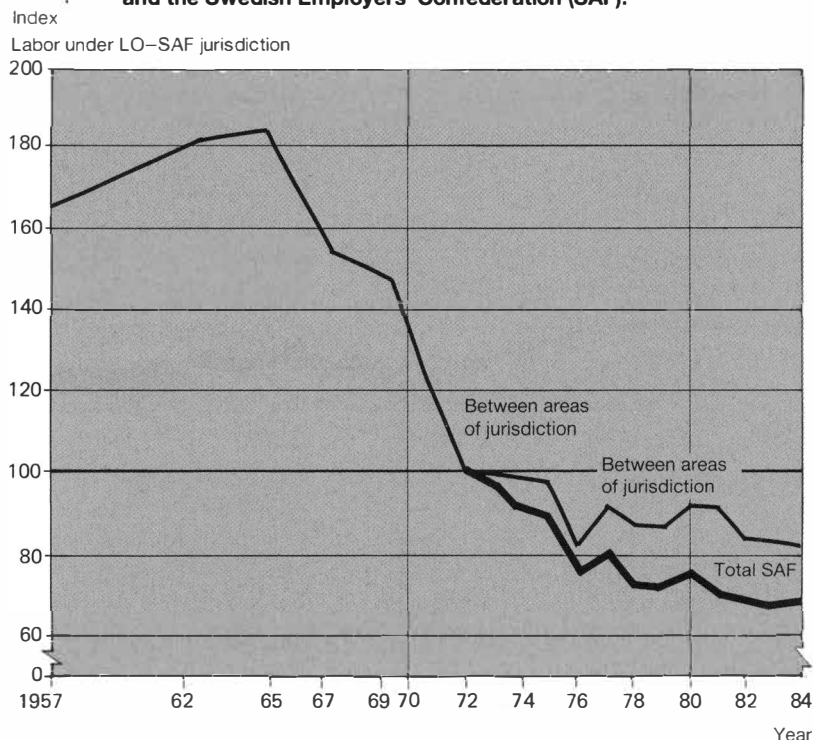


Source: Statistics Sweden

Different measures of wage differences all indicate a sizeable reduction in wage differentials in Sweden since the mid-1960s. Figure 10 shows that a substantial decrease in wage differentials *between different sectors* included in the central agreements of the Swedish Confederation of Trade Unions (LO) and the Swedish Employers' Confederation (SAF) took place after 1965. For the period beginning in 1972, there are also figures on *total wage differentials* between labor in the LO-SAF area which confirm a further heavy decline. The situation is similar for salaried employees. One consequence of these decreases in wage differentials *within* the skilled and unskilled labor collectives is that wage relations *between* low-paid salaried employees and high-paid skilled labor have shifted in favor of the former.

Another dimension is the distribution over age categories, where the wage curves have become considerably flatter. The most striking aspect is the sizeable increase in wages for young labor in relation to average wages; see Figure 11. The increase persists even after rising educational levels for youth have been taken into account.

Figure 10. **Wage differentiation (coefficient of variation) for labor under the jurisdiction of the Swedish Confederation of Trade Unions (LO) and the Swedish Employers' Confederation (SAF).**



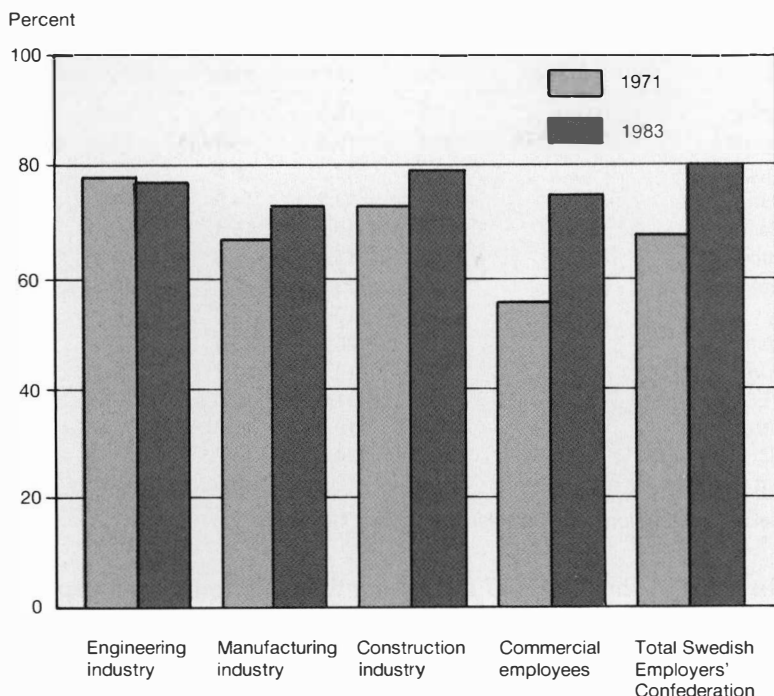
Note: Coefficient of variation indicates the standard deviation (square of the sum of all deviations from the average wage) divided by the average wage.

Source: Jonsson and Siven (1985).

The wages of female labor as compared to those for males have also increased substantially (between the early 1960s and the beginning of the 1980s, average wages for female industrial workers rose from approximately 70 to 90 percent of average wages for men). Relative wages for well-educated skilled labor have fallen sharply.

It is difficult to make international comparisons of wage differentials due to a lack of data. Table 7 shows the wage distribution between industrial sectors in a number of countries. The relative size of the sectors has not been taken into account, so the measures

Figure 11. **Wages for labor under age 18 as a percentage of average wages for adult labor.**



are poor indicators of total wage differentiation. However, they can be used to discuss the function of wages as a signal for determining how manpower should be distributed.

Even if the number of sectors varies among countries, so that the figures should be interpreted with caution, the overall impression is about the same as in other studies. The U.S., Canada and Japan exhibit much higher wage differentials than European countries. In addition, wage differentiation in the former has shown a tendency to increase, whereas there is no clear-cut tendency for Western Europe. Sweden has the lowest wage differentials of all the countries listed and the further contraction which occurred during the 1970s is plainly observable. It should be kept in mind that these figures refer to wages *before* tax. The additional contracting effect of the sharp increase in the progressivity of the Swedish tax and transfer system during the 1960s and 1970s has not been taken into consideration.

Table 7. **Wage dispersion for industrial labor among sectors in different countries (unweighted coefficients of variation)**

Country	No. of sectors	1972	1977	1982	Average 1972–1982
Austria	11	14.3	18.0	18.9	17.5
Belgium	15	16.6	15.3	16.1	14.2
Canada	15	23.2	23.3	25.5	23.5
Denmark	11	12.8	13.9	14.9	14.2
Finland	15	16.6	15.2	15.4	16.4
France	15	14.6	13.0	12.3	13.3
Great Britain	15	14.7	12.5	17.1	14.6
Italy	15	18.3	10.9	10.5	13.8
Japan	13	23.1	26.0	26.4	25.0
Norway	14	14.4	14.5	14.7	14.4
SWEDEN	15	11.2	11.6	10.0	11.0
Switzerland	13	11.5	12.6	13.7	12.6
U.S.	15	23.9	24.5	25.2	24.5
West Germany	15	12.8	12.8	12.8	12.8

Source: Lennart Jonsson, Swedish Employers' Confederation

In general, the effects of decreasing wage differentiation depend on market preconditions. Higher wages for women have not created any problems in Sweden – unemployment has not been concentrated to women. The large share of part-time female labor appears to be determined by household supply.¹ Market preconditions in this context have been created by expansion of the public service sector. The decrease in relative wages for college-educated personnel has probably also conformed to the market by reflecting the increase in supply due to expansion of higher education. In the case of youth, however, increased relative wages have been contrary to market forces, as evidenced by weak employment trends.

The major trade unions' ambitions in regard to equalization are the main reason for the sharp decrease in wage differentiation. These ambitions have been manifested in central agreements by sizeable increases in the lowest wages, wage-adjustment guarantees

¹⁾ According to recent surveys, the share of women who work part time and would like to increase their working time is approximately the same as the share of those who work full time and would like to decrease their working time – about 25 percent.

and extra allocations to low-wage groups. The importance of these ambitions have been confirmed by e.g. Jonsson and Siven¹, who have shown that wage differentiation decreases when central agreements are carried out at the firm level, after which wage differentiation tends to increase again between these occasions.

Union wage policy in Sweden during most of the post-war period has dissociated itself from wage differences as a means of achieving mobility on the labor market. According to the original ideas about "solidary wage policy", the goal was formulated as "equal wage for equal work", regardless of the ability to pay of an individual firm or sector. In other words, wage differences should not arise as a result of expansion or stagnation in different sectors. Instead, the result would be sharp increases in vacancies in expanding sectors and unemployment in stagnating sectors. These push mechanisms would force labor to become mobile. In order to limit the duration of unemployment on an individual level, solidary wage policy would be supported by active labor-market policy including retraining and generous allowances for moving expenses.

Solidary wage policy in this sense was aimed at wage relations which, in the long run, would still be governed by market forces. This policy may thus be regarded as conforming to the market in the long run. The difference in relation to models of the market economy has to do with the adjustment process when faced with disturbances. Whereas these models use temporary wage differences as a means of achieving mobility through pull mechanisms, solidary wage policy was aimed at establishing long-run wage relations immediately. Thus the burden of adjustment was placed on those who became unemployed and were forced to move.

During the 1970s, the content of solidary wage policy changed in the sense that ambitions in regard to equalization were intensified. The objective shifted, from attempts to reach long-run equilibrium wages as quickly as possible, to permanent contraction of the entire wage structure. Special allocations to low-wage groups, increases in the wages paid to youth and shrinking wage differences between skilled and other labor should all be perceived in this context.

It should be apparent today that wage equalization has become

¹) Jonsson and Siven (1985).

too far-reaching. This view is shared by a wide body of opinion, even in the Swedish Confederation of Trade Unions. A first step would be to revert to the original objectives of solidary wage policy. A second – and more controversial – step would be to use relative wage flexibility to a larger extent as an instrument for redistributing labor among firms and sectors. We believe that this second step also should be taken.

In order for increased wage differentiation to dissolve the imbalances on the labor market, two prerequisites have to be met: i) relative wages should affect the *demand* for different kinds of manpower, and ii) changed wage relations should increase *mobility* of labor among firms and sectors. There is some empirical evidence on these two conditions.

The increase in relative youth unemployment which began in the early 1970s is an international phenomenon. An OECD study has shown that higher relative youth unemployment in four out of six countries studied (Australia, France, Great Britain and Sweden) coincides with sharp increases in relative wages for youth as a result of union wage policy and/or minimum-wage legislation. In the U.S., on the other hand, where relative wages for youth have declined, relative youth unemployment has fallen.

The above-mentioned OECD study also contains a survey of a number of econometric analyses of labor demand for different categories, grouped according to age and sex. Most of the studies refer to the U.S., although a few cover England, Canada and Australia. Even if the results vary, they widely support the notion that the relative youth employment level depends on the relative wage and that demand is sensitive to the wage level. There appears to be a consensus that the elasticity of demand with respect to youth is on the order of magnitude of 0.5–1.5, i.e., a reduction in youth wages of 1 percentage point would increase youth employment by about 1 percentage point. As far as Sweden is concerned, the data are still rather unsatisfactory and to some extent contradictory.

Empirical studies for the U.S. have established that mobility is affected by wage and income differences. This is supported by studies based on sectoral and individual data, as well as by analyses of migration between different geographical areas.

In the case of Sweden, data is much less abundant. The most extensive studies have been carried out by Holmlund,¹ who found that both actual and planned quit rates are highly affected by relative wages. Estimated elasticities are on the order of magnitude of 0.5–1.0, i.e., a change in relative wage of 1 percentage point increases the quit rate by between 0.5 and 1.0 percentage points. Sensitivity to changes in relative wages seems to be about the same as in the U.S. studies. According to Holmlund's results, this sensitivity has not decreased over time – if any change has occurred, it has been in the opposite direction.

Holmlund has also shown that migration between regions in fact leads to higher wages, although the returns on geographical mobility have declined over time. Another Swedish study by Nilsson² confirms the significance of relative wages.

It may thus be concluded that wage differences do affect mobility on the labor market. There is no evidence that conditions in Sweden deviate to any large extent from those in other countries.

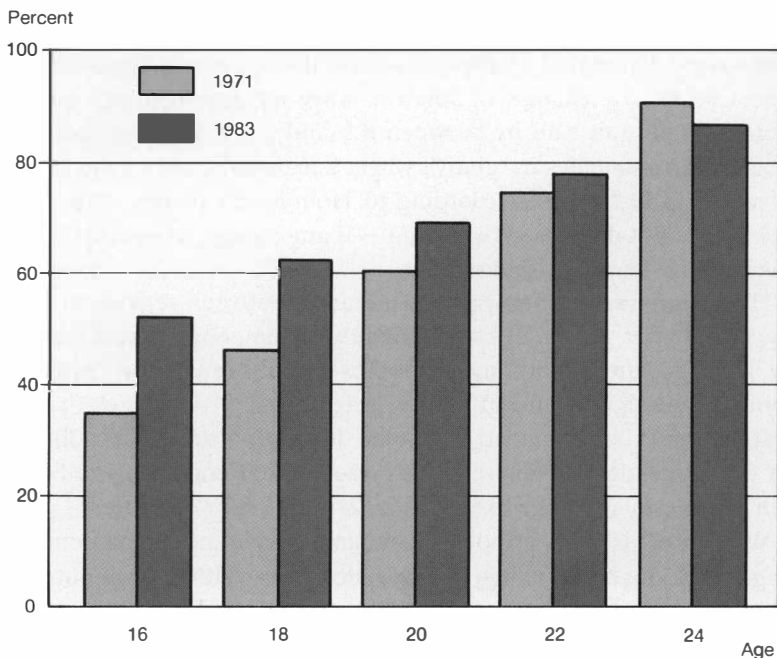
What then is the outlook for enhancing market adjustment of wage relations? A change in attitude, both within and outside labor-market organizations, is obviously evolving. Wage negotiations in Sweden are becoming more decentralized and thereby more closely adjusted to the market. As of 1983, wage equalization has also diminished; cf. Figure 12.

A crucial organizational change has occurred in that the Swedish Confederation of Trade Unions is under the threat of losing members to salaried employees' unions if current wage relations between skilled workers and low-income salaried employees persist. A fundamental problem is that wage equalization has taken place over such a long period of time and has gone so far that the process of regaining balance may be extremely time-consuming. But there are a number of measures which can be undertaken to increase the flexibility of relative wages more rapidly and improve the overall function of the labor market.

¹⁾ Holmlund (1985).

²⁾ Nilsson (1985).

Figure 12. **Salaries of young employees as a percentage of average for all salaried employees.**



Note: Refers to mid-level employees

Source: Jonsson and Siven (1985)

- Profit-sharing and earnings-based bonus systems can be expanded. If a larger share of wages would become flexible in this way, wages would automatically be linked to the profitability of individual firms.
- State contributions to unemployment benefits can be reduced and member fees raised correspondingly. Since unemployment benefit societies are organized sectorally, an employee's wage after deduction for fees to unemployment insurance in a sector would then be directly tied to unemployment in that sector. This would also increase incentives to move out of a stagnating sector. If unemployment benefit societies also became responsible for the costs of youth unemployment, labor unions would have an incentive to reduce wages for youth.

- In order to stimulate youth employment, contributions to the national supplementary pension scheme (ATP) could also be dispensed with for this group. In Sweden, the size of pensions is usually not affected by the first years of work, so that ATP contributions for youth could be regarded as a pure tax on youth employment. However, ATP contributions for youth should be removed only on the condition that a concurrent reduction in youth wages occurs. If wage costs for regular employment are reduced in this way, youth teams can be abolished.
- The trend towards higher growth and market adjustment in labor-market policy should continue. The policy changes which have already taken place should also be pursued when economic conditions deteriorate. Retraining, severance pay and moving allowances should be used instead of sheltered employment and new supports to industry. Retraining and education can be purchased from private producers on a wider scale. Firms can also be given tax cuts if they pay the moving costs and bonuses of new employees.
- Significant efficiency gains can probably be achieved by breaking up the National Labor Market Board's monopoly on employment services and allowing competition.

Finally, demands for flexibility in the labor market should be perceived in a larger economic and social context. There is a direct relation between tax policy and mobility on the labor market. Reductions in marginal tax rates – which are also desirable for other reasons – decrease the need for greater differentiation of gross wages in order to achieve a sufficiently high degree of labor mobility. The better capital and credit markets function, the lower the demands on labor mobility. Changes in tax policy which reduce the locking-in of profits in existing firms and facilitate new business ventures can thus lessen the demands for labor mobility.

Getting Sweden Back to Work

In spite of a continuously excellent profitability level, the export- and investment-led upswing in the Swedish economy in 1983–84 came to an end in 1985–86, and growth prospects for the coming years are low by international standards. We do not share the passive approach to economic growth which has had such an impact on recent gloomy forecasts of slow growth in Sweden during the next few years. In our opinion economic policy has an important task to perform by creating prerequisites for growth in the Swedish economy.

The *macroeconomic* preconditions for stability and growth were investigated in last year's report of the SNS Economic Policy Group, where a reorientation of Swedish stabilization policy towards a norm-based nonaccommodation policy stance with an emphasis on price stability was suggested. In this year's report we have focused on *microeconomic* conditions for efficiency and growth, where present conditions in Sweden leave a lot to be desired. Our analysis leads up to concrete proposals for reform in a number of areas, where strong impediments to growth can now be observed.

Specifically, we suggest

- a policy of *deregulation*, not only with respect to the domestic capital market (where it has already been initiated), but also in regard to exchange controls, price controls, agricultural protection and land use, transport, housing, construction, employment service, and including abolishment of effective government production monopolies for many personal services such as child care, education, health care and care of the elderly;

- comprehensive *tax reform*, comprising personal taxation of income from labor and capital, the corporate income tax and a tax on net wealth, aiming at lower and less progressive (and therefore less distortionary) tax rates on broader tax bases;
- modernized *capital market legislation* without detailed regulation of individual financial institutions and instruments;
- a marked increase in *relative wage flexibility*, aiming at higher occupational, sectoral and geographical labor mobility and achieved via negotiated profit-sharing and earnings-based bonus systems, a reduction of public subsidies to unemployment benefit societies, special measures to lower total youth labor costs, and continued market orientation of labor market policy.

In some cases, the suggested changes in policy can (and should) be carried out immediately (such as reorientation of stabilization policy and deregulation); in other cases, it will take a long time for measures to be prepared and carried out (such as reforms of capital taxation and larger wage differentials). It is urgent, however, that these endeavors begin before the optimism in the private sector promoted by the recent devaluations and the upturn in international economic activity has evaporated. It is time to start the process of getting Sweden back to work.

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Presentation of the members of The SNS Economic Policy Group

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Along with the international upswing and after two of devaluations totaling 26 percent in 1981 and 1982, Swedish industrial production accelerated during 1983–1984. Since the end of 1984, however, the Swedish economy has again exhibited a tendency towards stagnation. The export- and investment-led upswing has come to an end in spite of favorable external conditions, good international competitiveness and high profitability in Swedish industry. Unsolved structural problems – temporarily concealed by the large devaluations – are beginning to reappear.

In this year's report the SNS Economic Policy Group focuses on economic growth – the mechanisms behind growth and impediments to growth. A norm-based stabilization policy regime, which was advocated in last year's report, is a necessary but not sufficient condition for growth. At the microeconomic level the vigor of the Swedish economy is hampered by serious growth impediments: a network of regulation, a distortionary tax system, public monopolies and an extremely compressed wage structure. The group presents a program for reform designed to set Sweden on a stable growth path.

The SNS Economic Policy Group has been expanded this year to include *Lars Calmfors* of the Institute for International Economic Studies at the University of Stockholm. The remaining participants are as last year Professors *Ingemar Hansson* and *Lars Jonung*, Lund University, *Johan Myhrman*, Stockholm School of Economics, and *Hans Tson Söderström*, executive director of SNS, who also serves as chairman of the group. The SNS Economic Policy Group works under the auspices of SNS with full academic freedom, independently of interest groups, political parties and government agencies.