"The Rock Star of the Recovery": Explaining Sweden's Strong Economic Performance

Johan Berggren
Political Advisor to the Swedish Ministry of Finance

Europe is beset by economic and financial risks: uneven and in many cases slow growth, high unemployment, weak public finances, jittery financial markets, and popular dissatisfaction with consolidation schemes. The sovereign debt crisis afflicting several southern and peripheral Euro-economies exemplifies Europe's current travails.

Amidst these dark clouds of uncertainty over Europe, the Swedish economy is powering ahead. GDP grew by 5.5 percent in 2010—among the highest in the entire Organization for Economic Cooperation and Development (OECD)—and is projected to increase by well over three percent this year. Employment is set to grow by over two percent in 2011 and while unemployment is still too high at over seven percent, it is falling. While other countries struggle with deficits of five to ten percent of GDP and debt levels approaching 100 percent, Sweden will achieve a budget surplus this year and debt will fall below 40 percent.

Though significant challenges remain, these economic data have led to Sweden recently being described as Europe's "north star"[1] and "tiger economy"[2] as well as "the rock star of the recovery."[3] At the World Economic Forum discussions in Davos in January this year, the Nordic model was lauded for combining efficiency and equality. This renewed attention for the Nordic or Swedish economic model is reminiscent of the interest that it first generated in the 1960s, but given the passage of time and structural changes, it is now more fitting to speak—in the words of Swedish Minister for Finance Anders Borg—of a *Swedish model 2.0*.

What explains the success of the Swedish economy? At least four main factors can be identified.

First, a strong commitment to sound public finances, including a robust fiscal policy framework, has been crucial for Sweden's economic fortunes. A responsible fiscal policy in the good years before the crisis, including a surplus of over three percent in 2007, placed Sweden, in contrast to most other countries, in a strong position, entering the downturn. The government could therefore pursue an expansive—but still responsible—fiscal policy during the crisis, and let extensive automatic stabilizers work.

---

[1] "The Swedish Economy: North Star," *The Economist*, 9 June 2011.

[2] From Ecofin Council discussions, January 2011.

[3] "Five Economic Lessons from Sweden, The Rock Star of the Recovery," *The Washington Post*, 24 June 2011.

The fiscal policy framework, with a surplus target of one percent of GDP over the business cycle, a multi-annual expenditure ceiling, a statutory balanced budget requirement for local government, and a centralized, top-down budget process, remains a cornerstone of economic policy. The framework was introduced after the deep economic recession of the early 1990s, which in part reflected the weak fiscal institutions previously in place.

The surplus, in fact, has been on average just over one percent since 2000, and the expenditure ceiling has never been breached. Given the credibility of government fiscal policy, households and firms have not had to adjust investment and consumption decisions. Most importantly, Sweden has avoided the tax increases and the cuts to public services, which are now occurring across the OECD and which almost always harm the poor the most.

Equally important has been the goal of moving people from social exclusion into work by making work pay again, which is at the heart of the current center-right government's economic agenda. When elected in 2006, nearly a fifth of the working age population was outside the labor market and faced very high marginal tax rates. To help this group back into employment, benefit systems have been reformed and income taxes have been reduced substantially, particularly for low- and middle-income earners—through the introduction of earned income tax credits—thus making it more worthwhile to work.

These and other changes have helped people escape poverty traps and make the labor market function more effectively. The time lost due to sick leave has fallen by nearly two weeks per year. Moreover, employment is now growing faster than in many other OECD countries and total employment is nearing an all-time high, despite the financial crisis. Labor force participation is rising steadily, while unemployment is declining.

Third, a number of pro-growth structural reforms since the early 1990s have contributed to a more efficient economy. Markets have been deregulated, state-owned companies sold, competition introduced in health care and education—through school vouchers—and the pension system has been made demographically sustainable. The wealth and inheritance taxes have been abolished, while entrepreneurship as well as research and development have been stimulated.

Fourth, the government has focused on improving the educational system and the plight of groups with weak employment prospects. Reforming education has been an obvious priority given declining results and the importance of high quality schooling and vocational training in equipping individuals for the modern economy. Major changes to primary and secondary schools have been introduced, including report cards for younger students, improved curricula and teacher training, and more teaching hours. Employer costs have been cut, both in general and specifically for those companies that hire workers who have been unemployed for long periods, thus making those workers more attractive. Other labor tax wedges have also been addressed.

These reforms, targeting both the demand and supply side of the economy, in conjunction with active labor market policies, have served to help long-term unemployed and other marginalized groups establish themselves in the labor market, which has been the central goal of government policy. Social exclusion, defined as the share of population in various social welfare programs, has already fallen to the lowest levels since the early 1990s and is projected to continue declining.

The accomplishments of the *Swedish model 2.0* to a considerable extent also reflect various socio-economic and cultural traits inherent to Sweden and Scandinavia. Tolerance and economic openness are two values that have underpinned our long and staunch support for free trade, which has allowed Swedish companies to grow and prosper and, even in some cases, become world-leading.

Another significant feature is the value placed on social cohesion, which is illustrated by Sweden having very small income inequalities and a generous welfare state, which provides citizens with high-quality health care, education, pensions, and many other services. However, the social benefit systems are designed to protect people, not jobs, and hence help individuals to transition into new industries in the wake of globalization and economic changes.

Swedish society also values gender equality highly. While complete equality still eludes us, with women earning less than men and doing more of the household work, Swedish women are more active politically, economically, and socially than in most other countries. Both the Swedish parliament and government typically have nearly equal representation of men and women. The female employment rate, though lower than the male rate, is among the highest in the European Union at over 70 percent, and higher than the average male rate in the Union. Affordable and readily available child care is part of the explanation as are public attitudes favoring female participation in the work place.

In spite of the progress made, Sweden cannot afford to rest on its laurels. Challenges abound, both domestically and internationally. For the Swedish economy, two of the most pressing concern the labor market and the educational system. Far too many people, particularly among young workers, immigrants, and those without a high school diploma, lack jobs. Additional reforms to increase participation and employment rates, including further tax cuts for low-income earners, are therefore warranted, as indicated in the government's 2010 re-election manifesto.

With years of falling educational outcomes and high drop-out rates, the government will remain focused on strengthening the school system. Given the increased importance of human capital in driving growth, productivity, and innovation in the 21st century economy, the speedy and effective implementation of the aforementioned educational reforms is a priority. Further changes may also be necessary. Moreover, higher education needs to improve, in order to support world-class research and development.

Europe's finance ministers have identified the precarious state of Europe's public finances, often referred to as the sovereign debt crisis, as perhaps the most serious international challenge to economic stability. Large deficits and debts are worrying for several reasons. As debt accumulates, risk premiums on government bonds rise, and countries have to spend ever-larger amounts servicing debt repayments, thus crowding out welfare services and growth-generating investments. More generally, the uncertainty associated with massive debt complicates economic policy making. Third, with deficits set to persist well into the future, many countries risk being unable to pursue expansionary fiscal policies or let automatic stabilizers work in the next down-turn. Fourth, Europe's aging populations, driven by low birth rates and rising life expectancy, will add further fiscal pressure in the years to come.

Policymakers generally agree on the solution: serious, substantial, and sustained fiscal consolidation, using all means available, including tax increases, expenditure reductions, and pension reforms, such as increased retirement ages and limiting early retirement. Economists also point to the importance of strengthened fiscal frameworks. Credible and robust frameworks play a crucial role in safeguarding sound public finances, as in the case of Sweden. Empirical evidence shows that countries with stronger fiscal institutions achieve better outcomes, in terms of lower deficit and debt.

A second international challenge relates to European labor markets, which have suffered greatly in the past few years, with tens of millions unemployed across the continent.

Member states, seeking to improve the prospects of the jobless by making work more attractive, have several tools at their disposal. One option is to cut income taxes, particularly for low-income groups, for example through the use of an Earned Income Tax Credit, as in Sweden. Another option is to reform benefit systems, especially unemployment insurance as well as sick leave and early retirement benefits, so as to reward returning to work. Well-designed active labor market policies can also help improve the functioning of labor markets. It is worth remembering, of course, that in many countries the room for action is constrained by weak public finances.

Most economists would agree that increasing female participation and employment is especially important—because it is good for the economy, individuals, and gender equality. Data show that too many women are absent from the labor market: female employment is 12 percentage points lower than male employment in Europe, and in some countries below 50 percent. If women worked as much as men, GDP in the European Union would be about 25 percent greater. Key factors in helping reduce the gender gap in employment include better and more affordable child care and stronger economic incentives to work, which involves reducing the marginal tax rates facing women in the work place and eliminating unfair pay differences between men and women.

A third international challenge concerns the financial system, a system whose health and efficiency is crucial for economic growth and stability. It is well known that the financial crisis grew out of an insufficient, incomplete and uneven regulatory landscape as well as unsustainable and reckless behavior among actors in the financial system. The need for new, stronger rules and institutions has therefore been a cornerstone in strengthening crisis prevention mechanisms in Europe.

The European Union has worked for greater regulation and the creation of powerful new European financial market supervisors to minimize the likelihood of costly public interventions and to secure financial stability. New common rules that promote a sound and sustainable long-term development of banks and prevent unhealthy compensation schemes were therefore introduced, yet more remains to be done.

In conclusion, Sweden is currently an outlier in the European economic landscape, with strong growth, improving labor markets, and sound public finances. The success of the *Swedish model 2.0* reflects a number of factors, including a commitment to strong public finances, most clearly exemplified by a responsible fiscal policy and a robust fiscal policy framework; an economic policy centered on making work pay and reducing social exclusion; pro-growth structural reforms; and measures designed to improve education and the employment prospects of disadvantaged groups. Underpinning these reforms is a set of values allowing Sweden to embrace globalization and the modern economy, namely a proclivity for social cohesion, free trade, tolerance, gender equality, and a welfare state protecting people, not jobs.[*]

[*] *Editor's Note: This piece is based on a presentation given by the author in June 2011.*