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Highlights in this issue:

- Swedish labour market arrangements are designed to deliver equity and jobs. The social partners take care of labour conditions, the government manages unemployment
- Performance is good relative to the EU as a whole but competitive pressures requires an open mind where reform proposals should be set in a comprehensive medium-term strategy

The Swedish labour market model: performance under outside pressures

By Jonas Fischer*

A key element in any "social model" is the institutional framework of the labour market. The Swedish set-up still builds on the Rehn-Meidner model which aims to simultaneously achieve low inflation, low unemployment, high economic growth and an equitable distribution of income. Openness and acceptance of structural change to keep competitiveness is compensated by income security. There is a clear division of roles, with the social partners responsible for wage-setting and the government responsible for helping the unemployed back into work. While Sweden continues to perform well relative to the EU as a whole, there has been an intensifying domestic debate on its labour market arrangements, related partly to the issues of EU enlargement and globalisation. The labour market arrangements do seem to have contributed to the achievement of social objectives such as an even income distribution, relatively peaceful labour market conditions, relatively low unemployment and, since the crisis of the early 1990s, wage behaviour compatible with competitiveness requirements and the low inflation regime. However, there is a high rate of absence from work and recently a low rate of employment growth, both features partially linked to the lack of incentives to work or to recruit under the tax and benefit system. In a model like Sweden's, where ambitious social objectives have to be squared with the need for a competitive and strong private sector, the trade-offs between equity and efficiency concerns must be well balanced, preferably within a comprehensive medium-term strategy.

Introduction

The introduction of reforms that enhance the efficiency of the European social model is an ongoing project. The Nordic countries have attracted increasing attention as a result of their current favourable economic performance and comprehensive social security systems (see Fischer and Matthiessen, 2005). A key element in any social model is the institutional framework of the labour market. In the EU, how this framework is structured is entirely a matter for national policy provided that the fundamental rights of free movement of labour, capital, goods and services are respected. Recently, the domestic debate on the Swedish model, in which collective agreements play a fundamental role, has intensified. A number of current issues have galvanised the debate, raising questions on the status and application of Swedish labour market rules – and especially the role of the collective agreements – in relation to the rules in application in other countries. In the light of both the interest in the Swedish model from outside the country and the vigorous domestic debate, this Country Focus explains the institutional framework of the Swedish labour market, presents some data on its performance and tries to reflect on its implications for the EU as a whole.

The labour market arrangements are a key element in the "Swedish model"

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The Swedish model and the role of collective agreements

The principles of the Rehn-Meidner model are still central where...

The main driving force behind the Swedish labour market model is the labour movement, made up of the Social Democratic Party (which has effectively been in government for most of the post-war period) and the umbrella blue collar worker trade union, Landsorganisationen (LO). A landmark in the development of the model was the famous 1938 "Saltsjöbad-agreement" between the social partners, concluded in response to a government threat to introduce labour market legislation. The agreement contained rules on collective bargaining, industrial action, disputes threatening the public interest and dismissals (though the rules on dismissals are now covered by legislation and have been since the 1970s). It can be argued that the agreement encompassed a common view on the need for industrial rationalisation/restructuring and egalitarian wage policies. Since then Sweden has developed a corporatist model characterised by strong co-operative links between social partners. The design of the labour market model was further developed by the LO economists Gösta Rehn (1913-1996) and Rudolf Meidner (1914-2005). The resulting "Rehn-Meidner model" aims to simultaneously achieve low inflation, low unemployment, high growth and equal distribution of income (Fregert and Jonung, 2005). Active labour market policies and welfare policies, centralised wage-setting and an egalitarian wage policy are the main elements of this model.

...the social partners agree on labour market conditions and the government is responsible for managing unemployment..

The Rehn-Meidner Model

The so-called "Rehn-Meidner model" is designed as a way to promote structural change and growth without abandoning egalitarian goals while achieving price stability in a small open economy (see Fregert and Jonung, 2005). In this model there is a clear division of roles with the social partners responsible for wage-setting within a framework of centralised wage negotiations and the government responsible through fiscal, labour market and monetary policies for the management of unemployment and inflation. Rehn and Meidner proposed that restrictive economic policy keep inflation under control. Government intervention should keep aggregate demand below equilibrium while compensating for the demand slack in regions, sectors or categories of workers, with selective labour market policies. In addition to the egalitarian wage structure, restrictive general government policies "push" unprofitable firms out of the market while more profitable firms pay lower wages than what they can actually afford. The excess profits give room for accumulation of physical capital. This "creative destruction" generates short-term unemployment, countered by intense active labour market policies channelling the unemployed back into work. A guiding principle in the approach to labour market policies is the "work line". This involves protecting income levels rather than jobs: openness to structural change is the trade-off for income security. In the centre of this system stand the collective agreements negotiated by the key umbrella trade unions (LO for blue collar workers, SACO for academics and TCO for white collar workers) and the central private sector employers' organisation (Swedish Industry).

...while low productivity plants are replaced by high productivity plants...

Although the key features of the Rehn-Meidner model remain in place today, changes have taken place since the crisis in the early 1990s, which was accompanied by negative economic growth, rising unemployment and public deficits. Besides, being a small open economy with a high export share, Sweden was exposed to fiercer international competition than other EU states, intensified by competitive pressures stemming from its late EU membership. A key argument against Sweden joining EMU in the first wave in 1999 (SOU, 1996) was the risk of continued high unemployment in the absence of a flexible or adjustable exchange rate should wages not develop in line with productivity (as had frequently been the case in previous years, leading to a number of devaluations of the Swedish krona). An important concern has therefore been how to ensure that the wage formation process is consistent with the new stability-oriented setting in a rule-based fiscal framework (see Fischer, 2005) and the low inflation environment which came with central bank independence and inflation-targeting.

...and the Industrial Agreement of 1997 aims to ensure responsible wage-setting and industrial peace.

The Industrial Agreement of 1997 responded to this concern. This agreement, basically covering the whole industrial sector, responded to employers' need to decentralise bargaining in order to arrive at more flexible pay schemes. It introduced a reformed model for collective bargaining and conflict resolution whereby collective agreements provide the broad framework, while wage-setting is more decentralised. There is a developed preventive framework to handle disagreement in order to avoid conflict. Wage bargaining should start well before previous agreements end, and the "National Mediation Office" (Medlingsinstitutet), set up by the government, is responsible for mediating labour conflicts before industrial action is called. Once an agreement has been negotiated and signed, the "peace" obligation prohibits industrial action during the lifetime of the agreement.

The collective agreements remain central, and the vast majority of employees are covered by collective agreements, as is the case in most EU Member States. However, in Sweden the degree of unionisation is also high (LO, 2006). A key feature worth underlining is that the collective agreements between the social

partners are voluntary and not based on statutory rules as in other countries where collective agreements, once agreed, are legally binding. In Sweden, it is still the case that relatively few areas are regulated by law (dismissals being one of the exceptions), though government intervention has increased over time.

The debate on labour market arrangements is being fuelled by outside pressures...

Enlargement has stimulated a broad debate on the regulation of the employer-employee relationship. Sweden from the outset chose not to put any restrictions on labour immigration from new Member States, and recent studies indicate that the influx of workers from the new Member States to Sweden has indeed been marginal (EU Commission, 2006a), perhaps because of Sweden's weak labour market in recent years. The fears of *welfare shopping* or "social tourism", raised by the Swedish government ahead of enlargement, have not come true (Doyle et al., 2006).

The labour market debate has been fed by issues surrounding enlargement, the services directive and globalisation...

However, there are other pressures on the regulatory framework coming from lower cost providers undercutting Swedish wage agreements. Some instances of this have attracted a great deal of publicity. For example, in one case a Latvian firm (Swedish-owned) used Latvian employees under Latvian collective agreements to build a school. Demanding that Swedish collective agreements be applied, Swedish unions put the construction under blockade. The European Court has been asked to give an opinion on whether the blockade complies with the free movement of workers and the posted workers directive. Another case is that of Polish self-employed dentists supplying dental services in Stockholm, on a short-term basis, and charging distinctly lower fees than Swedish dentists. Linked to this is the debate on the EU services directive. Sweden has been positive towards the opening of services markets but concerns have been raised regarding the risks of underbidding in the labour market. A key issue for the Swedish government in these discussions has been to ensure the status of national labour law including the collective agreements.

In addition, the discussion is taking place in an overall environment where the impact of globalisation and increased international competition on industry shows in many ways. Low-technology labour-intensive production is increasingly being shifted towards locations with lower labour costs. The same trends are also visible in areas such as banking and marketing where part of the production chain, helped by new technologies, is shifted towards lower labour cost locations (Konkurrensverket, 2005).

...despite a bright labour market performance by EU standards...

...though the labour market performance is satisfactory by EU standards...

In a well-functioning labour market, increasing flows of employment and participation should be absorbed in such a way that the level of unemployment consistent with a stable inflation rate is reduced. The literature on wage bargaining indicates that systems that are either highly centralised or highly decentralised perform better than intermediate ones (Arpaia and Mourre, 2005). In Sweden wage bargaining is traditionally centralised, though the Industrial Agreement has led to more decentralisation in wage determination. In general, the broad framework and common rules including minimum salaries are decided at central level while individual salaries are set locally. This coordinated decentralisation seems to have paid off in terms of labour market performance.

...evidenced by high labour productivity, participation rates, lower unemployment and an even income distribution...

This positive performance has a number of facets. Firstly, the labour market participation is high, for both men and women, though lower than in the 1980s. The extensive social security system allows family planning since it enables women to enter and remain in the labour market (OECD, 2005). Secondly, unemployment rates have come down since the crisis of the early 1990s, though not to pre-crisis levels. The government has set a target of reaching 4% unemployment (using the national definition (6% in 2005) which, in contrast to the Eurostat definition (7.8% 2005) does not record students looking for a job as unemployed). Thirdly, the 2% inflation target has gained in credibility over time. Overall, labour productivity growth has been relatively high while nominal wage increase developments have been cautious, helping to safeguard competitiveness. The real effective exchange rate has improved in relation to the euro area. And finally, as witnessed by the Industrial Agreement, there is a general awareness of the gains from structural change and of the importance of an adaptable and competitive industry. An indicator of this is that

the number of strike days in Sweden today is lower than in the 1980s and 1990s and is clearly below the EU average. For example, in 2004 Sweden lost 3.7 working days to industrial disputes while in the EU15 the comparable figure was on average 57 days (source: Eurostat).

Table 1. Selected indicators

	1985		1995		2005	
	Euro area	Sweden	Euro area	Sweden	Euro area	Sweden
Inflation, HICP (1985:CPI)	n.a.	7.4	2.6	2.7	2.2	0.8
GDP, constant prices (2000=100)	n.a.	72.9	87.4	85.3	107.1	111.7
REER (ULCM), 1999=100	87	143	117	114	108	92
Unemployment rate	9.3	2.9	10.5	8.8	8.6	7.8
Employment rate	58.6	80.4	60.4	72.8	65.9	73.6
Income equality index (Gini)	n.a.	n.a.	31	21	30	23

Source: Commission services

This successful performance has not required the key policy objective of high income equality to be given up. In the 1990s income dispersion across households increased, but in comparative terms Sweden still ranks among the most equal countries in the world. It is, however, interesting to note that the main driver behind this relative decrease in equality is in fact an increase in the distribution of hours worked. This in turn reflects the relative decline in labour market participation rates. Thus, the most important factor in inequality today is whether a person has a job or not. Wage compression remains high (Björklund and Freeman, 2006).

....but still: all that glisters is not gold

...however, absence from work remains a problem...

The labour market performance described above is positive in comparison with the rest of the EU (although the trend clearly indicates that the euro area is catching up) but there are still some weaknesses that are worth mentioning. Unemployment rates are still particularly high among certain groups, namely the young and immigrants (EU Commission, 2006b). A large part of the working-age population is not active. Employment rates are, as seen above, high by EU standards, but distinctly lower than in the 1980s and at the start of the 1990s. In 2005, on top of the 7.8% open unemployment (Eurostat definition), 2.7% of the workforce was occupied in different labour market programmes. Account should also be taken to the high absence from work due to illness, parental leave or vacation (see Eckefeldt and Cech 2004). Overall, hours worked per year are far below the OECD average (OECD, 2005). However, Swedes appear to work as much as anyone else when they are at work but they are often absent because of illness (despite having one of the healthiest populations in the EU). The high rate of absence due to illness has led to a policy response from the authorities and recent figures do indicate that it is starting to come down – though some of the effect is simply due to people being shifted between long- and short-term schemes: early retirement due to illness is not coming down in the same way.

...raising the question of what the "real unemployment rate" is...

Accordingly, doubts have been raised as to what the 'real' unemployment rate is. Ljungqvist and Sargent (2006) argue that if an adjustment is made for the currently abnormally high absence rate for illness as compared to historical values, the unemployment rate could be closer to 15%. Aware of the importance for public finances not only of reducing unemployment but also of having enough people in regular work, the government has set a target that 80% of the working age population should be in regular employment (that is, excluding active labour market measures), an objective that is currently not met (77.4% in May 2006).

...while the rate of employment growth has been low given GDP growth figures...

Another concern has been the low employment growth of the last few years. Average yearly GDP growth over 1995-2005 was 2.8% while the average employment growth was meagre at 0.7%. In 2004, GDP growth was 3.7% but employment growth -0.5%. The other side of the coin is that productivity growth has been high. Over the 1994-2004 period manufacturing industry was the key driver behind Sweden's strong GDP growth performance, increasing its value added by 87%. At the same time employment in manufacturing industry was reduced by 0.5%.

...feeding a national debate on the existence of "jobless growth".

Overall, most of the employment growth contribution came from the services sector (Davis and Henrekson, 2006). Recent studies have focussed on issues linked to the supply of jobs. While the growth rate of new companies has been good the share of entrepreneurs in the labour force is low by EU standards and has been declining (NUTEK, 2006). One reason for this may be that there is an imbalance between risk and return when changing from employment to self-employment: while the self-employed are still covered in terms of payments and rights by the social insurance system, the costs of absence from work are so much higher that the systems can not be effectively used (Företagarna, 2006). Whatever the reason, the evidence suggests (NUTEK, 2006) that older companies and micro companies are more dynamic than small and medium-sized firms. The way company structure is evolving therefore arguably presents a problem in the medium to long term.

What is causing this "jobless growth", however, is the subject of heated domestic debate. Some argue that the high productivity growth rates seen are normal in a phase of corporate restructuring and free resources. With higher capacity utilisation and at a better stage in the cycle, employment growth will pick up. Others contend that the low employment growth is a structural problem due to high relative prices on labour, tax wedges and an overregulated labour market. This increases the capital intensity in production and hinders the growth of small enterprises and low-productivity service sectors.

High productivity growth cannot be bad but requires flexibility and training to be exploited to the full

The truth probably lies somewhere in between, with both cyclical and structural factors explaining the relatively low growth in jobs. The high productivity growth may work as a substitute for low-skilled labour in the short term, but in the longer term it should be a complement to high-skilled labour (Andersson and Kainelainen, 2006). In a period of rapid technological change, labour force skills need to adapt to changing demands. The academic literature has pointed to a possible trade-off between unemployment benefit generosity and strictness of labour market regulation. In particular, it has been claimed that the degree of employment protection and the level of unemployment benefits can be substitutes: Sweden would seem to be on the average to high side in both dimensions. Denmark, by contrast, manages to combine generous benefits with distinctly less employment protection, overall providing for a flexible labour market with high labour market turnover (see Fischer and Matthiesen, 2005).

Concluding remarks

The trade-offs between equity and efficiency must be well balanced...

In Sweden, while the labour market performance remains good in comparison to a "catching-up" euro area, the requirements are also large given the high welfare ambitions. In a model like Sweden's, where very ambitious social objectives have to square with the imperative need for a competitive and strong private sector, the trade-offs between equity and efficiency concerns must be well balanced. It is reasonable to continuously monitor whether there is an appropriate balance so that there is a proper delivery of growth and jobs while workers' rights and social objectives are also ensured. Inequality is a two-sided coin. One side shows that it may enhance incentives to work, train, innovate and produce. The other side is that it creates disparities that may be socially undesirable. Economists tend to focus on the former (SNS 2005). In a recent report on the reform of EU social models (Sapir, 2005), the "Nordics" were classified as strong on both efficiency and equity while the "Mediterraneans" were weak on both accounts. Concerns have been raised that in Sweden, there has been too much emphasis on income equality, possibly at the expense of efficiency-enhancing reforms that would be available at a low marginal cost in terms of social objectives (OECD, 2005). To this extent, there may consequently be room for additional reforms increasing Sweden's labour market performance and job creation capacity without scaling back its social ambitions.

...and a successful reform agenda should form a comprehensive package to allow agents to balance losses and gains

However, there is a fine line between economics and politics and it is difficult to avoid party political position taking and consequently blockages. Therefore, it is important that any reform agenda is formulated as a complete, fully sequenced whole. This was already argued in the 1996 Swedish EMU report (SOU, 1996), which called for a complete and comprehensive strategy for labour market reforms to avoid individual policy proposals getting bogged in an "either/or" debate instead of being assessed on their individual merits. Else, for example, a debate on proposals for supply-side reforms may get stuck in a countervailing argument for more demand policies, rather than a discussion on the proposals' inherent usefulness. In the same vein, proposals for reforms in education and active labour market measures are set

against changes in social security systems and labour laws. And, likewise, subsidies on private services face arguments against changes in public employment. Such blockages could be overcome by a longer-term comprehensive strategy including all different elements. This would allow for different interest groups to make an overall assessment of risks and balance losses and gains across proposals. Specifically, a successful formulation and implementation of the Lisbon strategy at national level (see EU Commission, 2006b) could, by means of its broad coverage across policies and medium-term focus, help the EU reform agenda.

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