Comment on the 2006 SNS-NBER report:

To Reform the Welfare State

By Lars Calmfors

I take it that we are expected to deliver a mix of both positive and critical comments, so I shall try to do that.

PICTURE 1

I shall ask three questions:

1. Is this the right kind of report to write?
2. Does it ask the right questions?
3. Does it give the right answers?

PICTURE 2

Let me start with the first question. I think it is a real achievement for the second time to get nine top US economists to participate in a report like this. As one should expect, the result is a high-quality product, which just as last time will help raise the level of policy discussion. I say this even though the project has the peculiarity that one has in effect written up the summary of it – which is this report – already before most of the research has been done.

Having said this, I should add that there could be diminishing marginal returns on these types of comparisons with the US: many of the points were already made in the previous report from 1995. In some respects, there might be more to learn from comparisons with other European countries, where there are both success stories and failures. I shall come back to this.

In my view, the report is also a little bit too retrospective: it might have been better to start out from the most important issues today than to try to squeeze everything into the same format as last time and to spend effort on evaluating the conclusions of the earlier report.

One could also question the *exclusive* focus on welfare state problems: I agree that they are crucial, but one cannot fully understand Swedish developments since the early 1990s without also analysing the changes in the macroeconomic policy framework (in fiscal and monetary policies) and how they have interacted with for example wage setting.

Let me then turn to my second issue: Does the report ask the right questions? In 1995, the main question was simple: what was wrong with the Swedish economy? Today the economic situation is much more diverse.

PICTURE 3

In terms of GDP growth, the question should rather be why we have performed so well over the last decade. Perhaps you don't want to hear it, but in a European perspective, Sweden has been fairly successful when it comes to growth. Growth has been lower than in the US, but not very much lower. It has been much higher than in the large continental EU countries, although this does not say so much.

If one looks at the pattern of Swedish growth, it has is in some respects been very similar to the US. Growth of IT capital has made a significant contribution to output growth and has been more important than growth of conventional capital in both countries, as you can see. Total factor productivity (TFP) – the efficiency with which we use all our productive factors – has grown fast, in fact even faster in Sweden than in the US. The largest difference to the US concerns total hours worked, which have developed more weakly in Sweden, particularly in the late 1990s.

PICTURE 4

If one compares with the UK, another European country with relatively high growth, total labour input in Sweden has developed more weakly. But we have had faster growth in total factor productivity. If one compares with Germany, there are, of course, huge differences Germany has done badly on all counts: low contribution from IT investment, negative growth of labour input, and low productivity growth, as you can see.

PICTURE 5

What I miss the most in the report is a *comprehensive* discussion of the factors behind Swedish output growth over the last decade and of the chances for it to continue in a situation where major labour market reforms are very unlikely. The report does not try to answer the key question of how much of growth has been a recovery from the crisis in the 1990s and how much is due to a other factors. How much of productivity growth can be explained by restructuring during the economic crisis? Or were we just lucky because we had Swedish firms well disposed to take advantage of the IT revolution? A prime candidate for why potential growth is likely to have increased is product market deregulations, where Sweden has done much more than most other European countries (as this table which tries to give a summary picture of the extent of product market regulations indicates).

PICTURE 6

The most convincing analysis in the report – where I think both questions and answers are correct – concern the weak development of employment. Several of the contributions point to the employment problems of particularly low-skilled workers associated with high benefit levels, wage compression, tax wedges and a small service sector compared to the US.

I agree very much with the conclusion that there are large employment benefits to be had from accepting *small* increases in income inequality that would strengthen work incentives. But, as we all know, the problem is that it is so hard to convince many people of that. Here one could do much more than the report by studying the effects of the more limited differences among European countries rather than the huge differences to the US system (which will never be politically acceptable in Sweden, whereas minor reforms as those carried out in other European countries might be).

One could also do much more out of the comparisons with the US, for example by explicitly comparing the effects of Swedish labour market policies (which build mainly on employment subsidies to employers) with US policies that focus instead on income tax credits to low-income employees.

What is the main conclusion from the Swedish experiences of the last decade? I think it is very simple. *With product market deregulations*, one can get reasonable output growth also *without labour market reform*. But one does not solve the unemployment problem. To get both high employment and high output growth, one needs deregulation not only of product markets, but also of labour markets. There we still have a long way to go. I think this is the main message of the report, which I fully agree with. Thank you.