the participation rate of older workers can yield significant budgetary savings.

In the second part of this paper, we presented results from an assessment of the impact of selected actual reform measures in Italy and Spain.[15] GDP effects are sizeable – they can add up to 0.2 percentage points to potential growth rates over five years. It has to be acknowledged that translating actual reform measures into quantified shocks is very challenging. For nearly half of the reforms, the information provided was overall insufficient, e.g. in terms of the quantitative elements and substantiation of the expected impacts or the description of the country-specific institutional details, timeframe and implementation strategies. In a few cases, appropriate methodologies and reform indicators were also missing. Therefore, these impact assessments are surrounded by a large range of uncertainties.

15 See European Commission: Market Reforms at Work in Italy, Spain, Portugal and Greece, European Economy 5/2014.

John Hassler

Experiences from the Swedish Crisis in the 1990s – An Opportunity for a Complete Makeover

The Great Recession that started in 2008 affected Sweden no less than most other OECD countries, and the fall in Swedish GDP between 2008 and 2009 was the largest recorded since 1931. The GDP gap was more negative in 2009 than under the recession in the early 1990s. Real GDP fell by six per cent during the crisis year of 2008 and 2009, which was nearly three per cent more than the OECD average. During the crisis in the early 1990s, it took three years for real GDP to fall by five per cent. Despite this fact, the negative effect of the latest recession on public finances has been contained. Automatic stabilisers have been functioning as intended, and there has been little domestic amplification of the negative consequences of the fall in foreign demand. Unemployment increased much less than in the 1990s. Employment fell initially but in 2010 began to increase again. Corrected for changes in the age composition of the labour force, employment is now back at pre-crisis levels, despite large inflows of immigrants and the fact that Sweden already has the highest employmentrate in the EU.

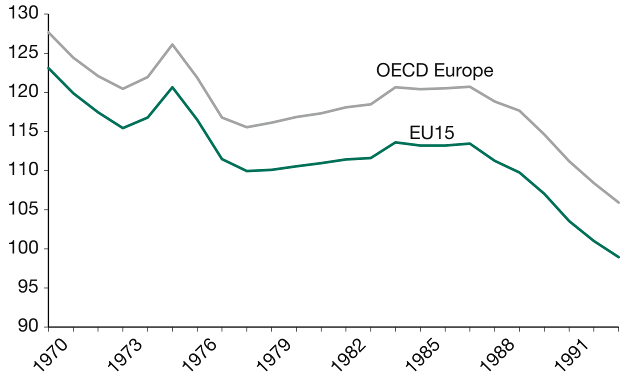
Sweden's experience during the Great Recession represents a textbook case of how a robust economy would be affected by an exogenous and temporary shock to foreign demand or productivity in the export sector. Automatic stabilisers could do their job in keeping up domestic demand and protecting individuals directly affected. Expectations did not deteriorate and firms did not lay off many workers. The fact that Sweden was robust enough to withstand the Great Recession without too much damage is strongly related to the reforms undertaken in the aftermath of the crisis in the early 1990s. In this paper, I will shortly describe these and the potential lessons for other countries.

Sweden before the reforms

Between 1870 and 1970, Sweden had among the highest growth rates in per capita GDP in the world. This transformed Sweden from a quite poor country with a very large level of economic emigration to one of the richest countries in the world. However, in the 1970s the trend started to reverse. This manifested itself in different ways, but the most important was arguably in GDP per capita relative to other developed countries. Figure 1 shows Swedish real GDP per capita (PPP) relative to the EU15 and OECD Europe average. In 1970 Sweden was 25 per cent ahead of the EU15, but this lead had disappeared some 20 years later. While it appears as though the 1980s were a good decade for Sweden, with hindsight it becomes clear that the development during this decade, which was driven by credit market deregulations that fuelled a property price bubble, was unsustainable. This served to mask the fundamental problems of Sweden.

In the early 1990s, crisis hit Sweden. Unemployment increased from 2.3 per cent in 1990 to 10.1 per cent in 1993. Public sector savings went from a surplus of 4.1 per cent in 1990 to a deficit of 11.2 per cent in 1993. The Swedish government had made strong commitments to ensure that the Swedish devaluation cycle, in which problems with export competitiveness were solved temporarily by devaluations, would not be repeated. During the fall of 1992, the Riksbank raised its discount rate to 500 per

Figure 1
Swedish real GDP per capita (PPP) relative to the EU15 and OECD Europe
in %



Source: Data extracted on 12 Sep 2015 from OECD.Stat.

cent.[1] Fairly soon it became apparent that defending the fixed exchange rate was futile, and in November 1992 the fixed exchange rate was abandoned.

The crisis revealed a number of structural problems that had to be dealt with. For example:

- A long trend of increasing public expenditures had to be stopped and likely reversed.
- Wage setting was dysfunctional, leading to a low connection between productivity and wage increases.
- The competitiveness of the Swedish export industry could no longer depend on recurrent devaluations. Instead, large shares of important sectors needed to be restructured and many jobs permanently closed. The laid-off workers could not be absorbed by an expanding public sector.
- Many markets were regulated in an inefficient way.
- Incentives to work needed to be increased, and even if they were, the very low unemployment rate in the decades before the crises could likely not be maintained.
- Important transfer systems, including pensions, were unsustainable.

1 The rate was 500/365 = 1.37 per cent per day. The compounded yearly rate was therefore 100*(1.0137)365= 14,240 per cent! In his memoires, the Riksbank governor, Bengt Dennis, later stated that he was prepared to raise the discount rate to 4,000 per cent per year.

Table 1
Employment change

	2008Q1-2010Q1		1990Q1-1992Q1	
Industry	Persons	% of total	Persons	% of total
Agriculture, forestry and fishing	-7,200	-7.6%	-12,800	-8.6%
Manufacturing, extraction and energy	78,550	-11.8%	-135,400	-13.7%
Construction	-5,600	-1.9%	-28,600	-9.2%
Commerce	11,600	-2.1%	-36,600	-6.3%
Transport	-3,850	-1.6%	-11,800	-3.8%
Hotels and restaurants	-650	-0.5%	-3 ,100	-3.3%
Information and communication	10,700	-5.9%	-4,100	-3.7%
Financial services	18,000	2.6%	13,700	3.6%
Public administration	14,200	5.6%	8,800	3.8%
Education	5,050	1.0%	15,800	3.2%
Health care	26,950	-3.8%	-30,400	-4.3%
Personal and cultural services	13,850	6.6%	8,800	11.4%
No information	-800	-10.5%	-100	-1.8%
Total	94,900	-2.1%	-215,800	-4.95%

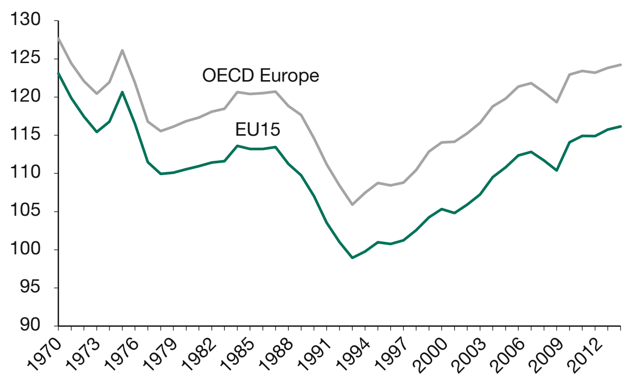
Source: Swedish Fiscal Policy – Report of the Swedish Fiscal Policy Council 2010.

The sudden understanding of the need for structural changes led to a drastic fall in consumer confidence, consumption and investments. This affected the whole economy, and employment fell in most sectors. Table 1 shows that employment in several important sectors not only fell in the beginning of the crisis but continued to fall for many quarters. This is in particular true for manufacturing, construction, commerce, and the sectors dominated by public employment, like healthcare and public administration. Assuming some foresight among employers, it is not difficult to understand that labour hoarding was not an option for a large share of employers during the crisis in the '90s. In contrast, although employment has fallen in many sectors during the current crisis, the bulk of the fall is accounted for by manufacturing. The total fall in employment between 2008Q1 and 2010Q1 was 94,900 individuals, while the loss of employment in manufacturing was 78,550 individuals. The fall in employment during the crisis in the 1990s was 215,800, of which 135,400 came from manufacturing.

Reforms in the 1990s

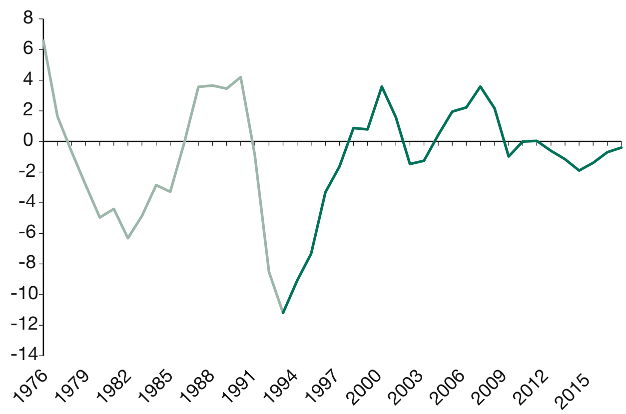
The crisis created a general awareness about reform needs. The Social Democrats as well as the centre-right

Figure 2
Swedish real GDP per capita (PPP) relative to EU15 and OECD Europe
in %



Source: Data extracted on 12 Sep 2015 from OECD.Stat.

Figure 3
Consolidated public sector financial savings
in % of GDP



Sources: Swedish National Institute of Economic Research; and Swedish Government Budget Bill 2015.

bloc agreed that Sweden needed to undergo a radical transformation. In December 1992, the liberal finance minister Anne Wibble asked the economist Assar Lindbeck to head an academic commission with the assignment to identify the weaknesses of the Swedish economy and to propose solutions. Already in March 1993, the commission had finished its work, proposing 113 changes and reforms.[2] A key theme in the report was to reduce tendencies for political myopia. The report was quite influential and laid the foundation for the extensive reform process. Despite alterations of governments in power between the Social Democrats and the centre-right, a consistent reform agenda was implemented. Among the changes in the Swedish economy that were undertaken during the 1990s were:

- fiscal consolidation, aiming for a long-run surplus
- takeover of insolvent banks without compensation to previous owners, the threat of which induced private capitalisation of other insolvent banks
- an increase from three to four years between parliamentary elections
- a fiscal framework with a top-down budget process, a surplus target and expenditure ceilings
- an independent central bank with an inflation target
- a new tax system that cut corporate taxes in half, reduced marginal top income taxes from 90 per cent to 50 per cent and broadened the VAT tax base
- new structure for wage bargaining with the export industry leading
- a new contribution-defined pension system immune to variation in growth and demographics
- large privatisations of rail, telecom, taxis, schools, post and electricity.

Most of these reforms were on the list of the 113 reforms proposed by the Lindbeck commission.

Sweden after the reforms

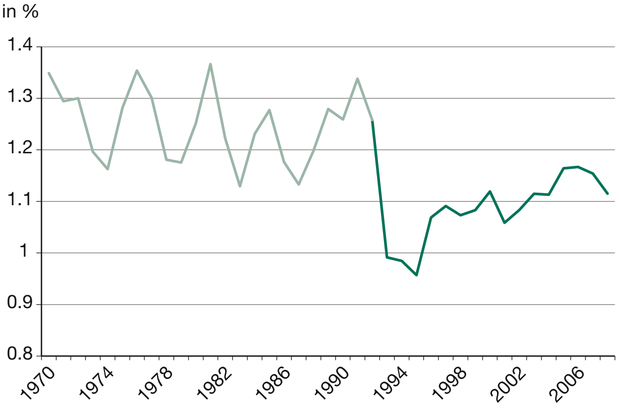
It is not possible to make an exact account of the effects of particular reforms, but it is clear that the negative trends Sweden was experiencing were broken or reversed. Figure 2 shows a continuation of Figure 1, i.e. Swedish real GDP per capita relative to EU15 and OECD Europe. As we see, Swedish growth rates have been substantially higher than those of its European counterparts since 1994.

The new fiscal framework was also successful, with much less volatile public sector financial savings and achieving on average a surplus, as seen in Figure 3. In particular, expenditures came down to tolerable levels.

As noted above, Sweden abandoned its fixed exchange rate in 1992. This led to a depreciation of the currency that clearly was helpful for the recovery. However, Sweden did not repeat the previous pattern of unsustainably large nominal wage increases eventually leading to a lack of competitiveness. The combination of an inflation-targeting independent central bank and a changed pattern of wage negotiations, whereby the export sector took the lead and provided a "mark" for the other sectors based on the development of unit labour costs in competing countries, led to the much more stable development of

2 The report is published in English as A. Lindbeck, P. Molander, T. Persson, O. Pettersson, A. Sandmo, B. Swedenbor, N. Thygesen: Turning Sweden Around, Cambridge MA 1994, MIT Press.

Figure 4
Swedish consumer prices relative to German in common currency



Source: Data extracted on 12 Sep 2015 from OECD.Stat.

the Swedish relative price level. An indication of this is given in Figure 4, which shows the Swedish price level relative to that of Germany.

Before the reforms in the 1990s, Sweden tended to have higher inflation than Germany, and this created the devaluation cycle pattern visible in the peaks and valleys in Figure 4 prior to 1992. During such a cycle, devaluation restored competitiveness but led to wage and price inflation, which, after a few years, induced a new devaluation. Since the depreciation in 1992, which likely overshot its long-run equilibrium value, the development has been much less cyclical.

How Sweden managed to reform

A key question is how Sweden managed to undertake such an extensive reform plan. Certainly, such a question is difficult to answer rigorously, and we are still awaiting scientific work on this. I will therefore only give a number of, to my mind, reasonable factors that perhaps could serve as hypotheses for future work.

First, the crisis was obvious to everyone – it was an *eye opener* to politicians, union leaders and the general public. Unemployment skyrocketed, and the government budget collapsed. The central bank raised interest rates to levels unheard of, and households and firms also faced extremely high interest rates. The depth and abruptness of the crisis created an almost war-like atmosphere in which it was not beneficial to try to exploit short-run political opportunities at the expense of the long-run recovery of the economy. Therefore, the political discussion became quite constructive.

Second, Swedes understood that there was no one else to save Sweden. Sweden joined the EU in 1995 after a fairly close referendum in November 1994. The crisis likely affected the popular support for EU membership positively, perhaps due to the hope that membership would be beneficial in a crisis situation. However, when the crisis erupted, Sweden was not a member of the EU and support from abroad was not expected. Instead, the Swedish Finance Minister Göran Persson had to go Wall Street to explain the Swedish situation and what was being done about it and ask for money from the market.[3] Everyone understood that borrowing had to be done at market interest rates that Sweden largely had to take as given. That no support was to be expected from abroad fostered a feeling of *being in the same boat*.

Third, the need for a complete makeover implied that structural reforms had to be quite *comprehensive*. That meant that people were to be affected in many different ways by a large number of changes. This made it less interesting to focus on the distributional consequences of particular reform elements. Likely, the sheer width of the reform package also made it more difficult to identify winners and losers. In politics, there is generally a status quo bias, since it is often easy to identify specific losers of reforms that have more general gains that are more spread out and difficult to evaluate. In Sweden in the early 1990s, it was pretty clear to everyone that the status quo was not an option.

Fourth, the Swedish society had a substantial stock of social capital in the form of *trust*. Swedish politicians were not seen as corrupt, and compared to many other countries, the level of popular trust in politicians was high. I also believe that trust among politicians was at a comparatively high levels, and thus the political discussion had little of the "blame game" character. Also, trust in academics was high, as indicated by the importance of the Lindbeck commission, as noted above.

Fifth, the Social Democrats seem to have perceived that structural reform was not only, perhaps not even primarily, about rolling back the welfare state. Certainly, the Social Democratic leadership understood that major cuts in marginal tax rates, reductions in corporate tax rates, reduced government spending and market liberalisations were necessary. Although this was not in line with previous strategies, social democratic ambitions of a fair and equal society did not have to be given up. Fiscal rules and

3 Later, when Göran Persson became Prime Minister and Sweden was on a recovery track, he said, "I do not want coming finance ministers to have to go to New York, Washington or London and explain the Swedish welfare system to grinning 25-year-old stock brokers." See Dagens Nyheter, 27 April 27, author's translation. Persson also wrote the book with the telling title "The one in debt is not free". In Swedish, Göran Persson: Den som är satt i skuld är icke fri: min berättelse om hur Sverige återfick sunda statsfinanser, Stockholm 1997, Atlas.

changes in parliamentary procedures were *not forced upon* the Swedish politicians from abroad. The Social Democrats and the parties to the right of them organically worked out new rules that both sides saw as useful for their own respective political agendas. Jens Henriksson, a long-time state secretary at the finance ministry, argues that successful consolidation requires that the government must challenge its own constituency. Therefore, a left-wing government needs the expenditure ceiling to cut expenditures and a liberal/conservative one needs the surplus target to increase taxes.[4]

Lessons for other times and countries

It is close to tautology to say that a crisis reveals structural weakness in an economy. Clearly, a crisis almost by definition implies that transfer systems and other welfare state policies will undergo a significant test. Such stress tests are unwelcome but nevertheless have the positive side effect of revealing structural weaknesses. By being real, rather than theoretical, calculations of fiscal sustainability can work as eye openers for policy makers and the general public. Therefore, they create windows of opportunity for necessary structural change. However, such opportunities are not always seized.

Some of the factors that were identified above as key for the Swedish reform success are not easy to replicate in other countries. Trust is very valuable for an economy, not least when it comes to making use of a crisis as a reform catalyst. However, trust is a social capital that is not easy to build, and the accumulation process is slow. When the crisis has already arrived, it is too late to attempt to build much new trust.

Other key factors are arguably more transferable. Foreign help from other countries or institutions can of course be useful. However, it is key that negotiations over such help do not work against the notion that a country must solve its own problems. If such a feeling is instead replaced by the view that what is needed is a tough negotiator in Brussels to secure the best possible deal, the reform window is easily closed. It is certainly not obvious how foreign assistance should be constructed in order to be beneficial in this sense. However, once-and-for-all debt relief combined with a commitment not to lend more is arguably better than repeated negotiations over continuous budget support. Similarly, pressure in the form of market signals like higher rates on government borrowing is likely to be better than punishment decided by foreign political leaders. This argument is not only about money. If structural reform is forced upon a country, it is much less likely to be successful than if it had been devised by domestic policy makers.

Along the same line of argumentation is the recommendation that structural reform implementation is much more likely to work if reforms are perceived as non-partisan. That both Social Democrats and the conservative-liberal parties in Sweden believed that their respective political visions were compatible with the reforms was key for reform success. When the political power shifted during the 1990s and 2000s, polices shifted, but the structural reforms were not rolled back. The fact that structural reform often involves measures that have or may be perceived as having regressive redistributional consequences makes it extra valuable to include political groups with more egalitarian ambitions into the coalition that decides on the reforms. Full redistributional neutrality may be impossible, but making "the rich" also contribute to the reform efforts certainly has an important value. Having left-wing politicians taking responsibility for reforms may increase the credibility of reform. Paraphrasing Cuikerman and Tommasi, it took a Swedish socialist to reduce top marginal taxes and corporate taxes by half.[5]

Another lesson is to aim for broad reform packages to overcome a situation in which reform costs are borne by small and easily identified groups while gains are distributed broadly to "the general public", a problem described by Olson.[6] This should not be seen as a way to hide the distributional effects of structural reform. Rather, by combining reforms with different and partly offsetting distributional consequences, it becomes less relevant to identify losers of particular reform items. This enables the more aggregate consequences to become salient. However, one should not overestimate the ability of people to look beyond their own short-run budget.

Finally, the window of opportunity for reform should not only be used to resolve the acute crisis and get the country back on track. Instead, the opportunity should be taken for creating an institutional memory that helps the society remember the lessons from the crisis after it is over. Independent fiscal councils consisting of academics without government career ambitions, fiscal frameworks with targets and ceilings, top-down budget decision-making, and systems for automatic budget consolidation under constant law through imperfect indexation of transfers and taxes are all examples of reforms that can make the gains of reform more long-lived.

4 J. Henriksson: 10 lessons about budget consolidation, Bruegel, 2007.

5 A. Cuikerman, M. Tommasi: When Does It Take a Nixon to Go to China?, in: The American Economic Review, Vol. 88, No. 1, 1998, pp. 180-197.

6 M. Olson: The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities, New Haven and London 1982, Yale University Press.