Panel 1
Keynote Address by

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Ladies and Gentlemen,

I am a little more optimistic about Europe's future than Professor Hans-Werner Sinn. To be sure, Sweden used to have the highest government share of GDP in Europe. As mentioned in the previous contribution, Denmark scores now higher, with 56 percent of GDP, followed by France (55 percent), Belgium, Finland and Sweden (all at 53 percent). In addition Sweden has a balanced budget. According to the latest forecast, the country will have this year a budget surplus of, at least, 1 to 2 percent. The reason I am more optimistic is that the European social model – the social market economy – is efficient and can adapt to the challenges of the future. I argue that if we introduce more labour market reforms and perform stringent fiscal policy in Europe, there is a good potential for the entire society to be endowed with economic growth, low unemployment and a decent degree of social cohesion.

Why is the Nordic model superior?

There are many different social models – not just one European one. The Nordic model is based on a well-functioning labour market with a high degree of unionization, but also very strong work ethics. This model is equipped with fairly high taxes accompanied by efficient tax systems. The Continental model is similar with respect to work ethics and also to fairly strong unions, but has a stronger corporate system. Thirdly, there is the Anglo-Saxon model, with a low level of tax but also a means-tested welfare system. Nevertheless, it has a very flexible labour market and weak unions. Finally the Mediterranean countries have a system with rather strong employment protection, a more rigid labour market and also a fairly large welfare state, which is, however, basically focused on retirement and pensions rather than what we have in the Nordic countries. Looking at the results, I would argue that the Nordic model has been successful, when it comes to combining high employment, favourable growth and good social cohesion: the Nordic countries have rather low poverty rates and a low degree of income inequality.

There are three reasons for the success of the Nordic countries in achieving a high labour participation ratio combined with a low unemployment rate, while in the Mediterranean countries the opposite is true. The first is that the Nordics have a strong growth culture: they are open to trade, technology and change. But they include a strong belief in rational engineering, not only with respect to manufacturing companies but also to social engineering of their welfare states. They are also societies that are based on a high degree of trust: if someone enters a business deal, it is believed that they will adhere to what they say. If people are required to pay taxes, they *will* pay taxes. And they assume that the people who collect the tax revenues will use them in a decent and efficient way. These countries have also been able to achieve a high degree of price stability and low deficits, which is important for a society's sense of stability. In addition, they also strive to uphold employment through demand policy. This is the reason why safeguarding low deficits and debt levels has always been crucial in these countries. Furthermore, their labour markets are also quite flexible, with strong but responsible unions, where wage increases are matched to productivity. And there is also a strong employment record. I would argue that there are some general lessons to be learned from the Nordics that could be applied to all countries.

Reasons for Swedish success

Why has Sweden been successful? My point is *not* that we have to abandon the social market economy in Europe. I emphasize that with limited adjustments we can make it work much more efficiently. First and foremost is the commitment to sound public finances. Flexibility is required in a crisis to restore the frame-

work for fiscal policy. The Swedish debt amounted 46 percent of GDP when I became the Minister of Finance in 2006, and is expected to reach 36 percent this year. Such a significant reduction is not only due to good policies in the short term, but also to policies in the past instituted by the previous Social Democratic government. There has been a dramatic change in the fiscal policy framework within the last twenty years: in the early 1990s Sweden had, along with Greece, the weakest budget situation in Europe.

A particular aspect of the welfare state is that there is a strong incentive for people to leave the labour market, since a decent income is guaranteed even if they are unemployed. That means that the driving forces to re-enter the labour market are weaker. This is particularly dangerous for low-income workers: in general they do not have a promising wage career, do not love their job and so on. For them it is extremely important to have strong economic incentives. That is why Sweden has introduced an earned-income tax credit. This system is based on earned income with the purpose of reducing the wedge between being on welfare benefits and working.

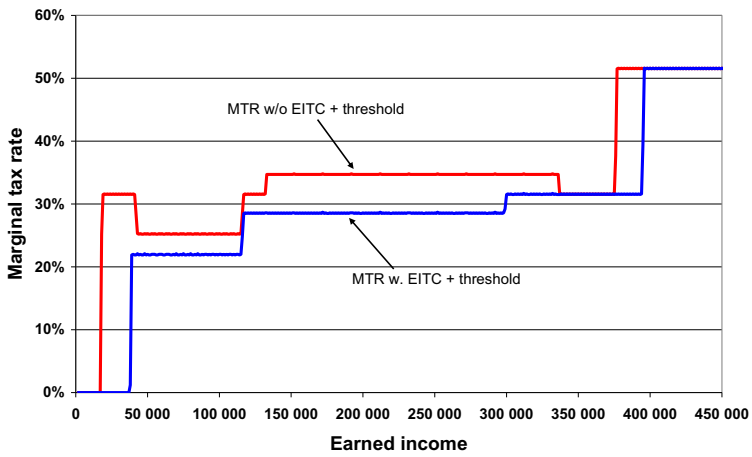
Sweden has also implemented a substantial amount of pro-growth reforms. Ownership, as we all know, is important for entrepreneurship. The wealth tax has been scrapped and the previous Social Democratic government also eliminated the inheritance tax. In addition, Sweden reduced the corporate tax rate, cut social insurance fees, and deregulated large sectors of the economy. According to the latest employment forecasts, the country expects 3-percent employment growth in the next few years. A large part of that is now coming from the social services provided by the private sector, such as private schools and private health care. Moreover, education is a cornerstone of the reform: it is essential to encourage students to move into the more sophisticated subjects as well as to improve the training of teachers and to raise their salary. Better students and better teachers in maths and in the natural sciences are two important factors that are likely to bring positive results.

During the crisis, all of the Nordic countries expanded active labour market policy measures. But the Swedish system comprises a lot of tax-based incentives. If a company hires someone who has been unemployed for over a year, it receives a double deduction in social insurance contributions: they are waived for the new employee, and the government subsidizes an additional contribution for as long as the individual has been unemployed. The social insurance contributions have also been cut in half for individuals. For household services and repairs, the tax wedge has been reduced significantly, because in those areas a wedge is particularly costly in a high-tax society such as ours. These are not huge shifts at all. But Sweden has shifted the balance towards dynamism and stronger incentives for the employable to join the labour market. This can obviously be done in any country.

Let me point out that we used to have much higher taxes in Sweden, as shown in Figure 1. If we go back ten years, the tax rate was almost 40 percent. The red line is the tax rate when I became Minister of Finance in 2006, and the blue line is the current rate. The country has cut taxes substantially at the lower end in order to provide stronger incentives to join the labour market. With a good welfare system there is a huge threshold effect. If a poor person joins the labour market, welfare benefits, as well as unemployment and housing benefits, are reduced. Thus, for rather large groups of individuals there is very little return if they decide to work. By reducing the taxes at the lower end such a system lowers the threshold effect, with very strong employment effects. According to the calculations of the Swedish National Institute of Research, the impact would be equal to a 10-percent increase in income for a female employee working

Figure 1

Reduced Marginal and Average Tax Rates in Sweden



Source: Ministry of Finance, Sweden.

part-time. This is a substantial shift in Swedish tax policy. Obviously the country needs to do more: for example, the state income tax brackets rise very steeply, a problem that needs to be tackled in the future.

Sweden has also achieved a major reform of its early retirement and health care systems. Despite having one of the healthiest populations in Europe, with one of the highest average life expectancies and excellent conditions in the working environment, it also had a fairly high degree of illness. When the relevant reform measures related to labour supply were implemented, the number of working hours developed substantially better than expected. So over the last two to three years the tax revenues have considerably exceeded expectations. And the country has not cut benefits, although the OECD has always argued that Sweden needs to reduce them. Instead, it implemented much tougher administrative procedures.

What should be done in Europe?

What does Europe have to do to meet the challenge of Asian competition as well as of demographic and public finance crises? We need to make our tax system more competitive, while spending more money on infrastructure, education, research and development. How can this be done? The only solution is that more people work, while at the same time reducing transfers to the people outside the labour market. By doing so, we can strengthen public finances, introduce better conditions in the labour market and also reduce unemployment levels.

In the past, German unemployment was stuck at a high level, whenever there was a crisis. This time, however, unemployment has come down. That is the payoff from implementing substantial labour market reforms. So a stringent fiscal policy, combined with labour market reforms, is crucial. But if we want to preserve social cohesion, it is also necessary to invest in education, implement active labour market policies, and safeguard people in the labour market. This can be achieved in any European country.

The second challenge for Europe is obviously Asia's increasing strength. For me this is not a problem but a challenge. For Swedish and German companies with high productivity levels, this represents an opportunity. We can sell more trucks, more cars, and we can work more efficiently together because we have a different corporate advantage. On the other hand, it is also clear that almost all Swedish and German companies will have to adjust to efficient Asian competition. At the same time, these are countries that are spending large amounts on education, training people and providing them with high-quality academic degrees, and learning to run companies in an efficient manner.

We can choose to see this as a threat, as it is perceived in the United States, or as an opportunity. There will be 2 billion people entering the modern economy; 70 million Chinese are entering the consumer market every year. Nowadays Asia comprises 70 percent of world demand. Europe needs Asia, but in order to face the challenge we have to implement proper policies – strong public finances, labour market reforms, investment in education, and an economy based on openness. In my opinion, the conclusions are very clear: we do not have to abandon the social market economy, and we do not have to follow the US model with very low taxes and no social protection. What we need to do is to reform the way the welfare state functions today: Europe should:

- reinforce the incentives for people to stay in the labour market, especially for those with low earnings;
- encourage more entrepreneurship and dynamism in our industries, change the tax system so we do not tax ownership and corporate profits, in the same way as Sweden has done; and
- revitalize the educational system and give priority to knowledge across the entire society, as low knowledge inequality can reduce income disparity.