

Sweden's Economic Performance:
Recent Development, Current Priorities
Executive Summary

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In 1995, McKinsey & Company Sweden, in cooperation with McKinsey Global Institute (MGI), published a report on the Swedish economy. To understand how the economy has developed since then, and the driving forces behind that development, we have undertaken a second study of the Swedish economy. As in 1995, the study has been conducted in cooperation with MGI.

The study has three purposes. Firstly, we aim to analyze Swedish economic development from 1992 until the present, focusing on productivity and employment, using detailed analyses of selected sectors. Secondly, we aim to understand the challenges Sweden is facing, given the economy's recent development path and expected future changes. Thirdly, we set out priorities going forward that will improve conditions for future economic growth and development.

Sweden's relative decline in GDP per capita has been reversed by improving productivity in the private sector

From the 1960s and 1970s to the late 1990s Swedish GDP per capita fell relative to other countries. The McKinsey study published in 1995¹ showed that between 1980 and 1992, Sweden's GDP per capita fell from 115 percent of the OECD average and seventh place among OECD countries to only 106 percent and fourteenth place. Low competitive intensity and heavily regulated product markets were identified as the main causes of lower productivity and weaker job growth in several Swedish sectors, compared with the leading countries at that time. In a number of sectors, Swedish productivity was more than 20 percent lower than in the leading country. The result was lower prosperity, and lower economic growth overall.

1 "Sweden's Economic Performance" by McKinsey & Company Sweden and the McKinsey Global Institute, September 1995, at www.mckinsey.com/mgi/publications

From 1992 to 2004, however, GDP growth in Sweden has been at par with the OECD average. With GDP per capita at 112 percent of the OECD average, and lying in thirteenth place among OECD countries, Sweden has halted the relative decline in its GDP per capita. Sweden's GDP per capita continued to fall during the first part of this period, albeit slowly, to reach 104 percent of the OECD average, its lowest point, in 1998. Between 1998 and 2004, however, Sweden's GDP per capita growth was stronger than in other countries.

Strong productivity growth in the private sector explains this positive development. Productivity growth in Sweden's private sector, which employs about 70 percent of the workforce, has been the fourth strongest in the OECD. The sector's productivity has grown by 3.3 percent per year over the past decade, 1.5 times more than the OECD average. Total productivity growth in Sweden (including the public sector) was 2.4 percent per year between 1992 and 2004, in line with the OECD average, and considerably stronger than the average of the other countries in EU15 of 1.9 percent per year.

Strong aggregate improvement in private sector productivity has been matched by strong performance at the sector level in four of the five sectors we studied in detail. Automotive manufacturing, retail, retail banking, and processed food have all shown marked productivity improvements, both absolutely and in comparison with the same sectors in other countries. For instance, in 1995, productivity in Sweden's retail sector was 16 percent lower than the leading country (of the compared countries), in retail banking it was 20 percent lower, and in processed food it was 42 percent lower. Since then, however, productivity in Sweden's retail industry has increased at 4.6 percent a year, a similar annual rate as in the United States, the retail banking sector productivity has improved faster than in any of the countries we compared it with, and Sweden's processed food industry, with productivity growth of 3.1 percent a year, also takes first place just above Denmark in our productivity growth comparison.

The only sector we studied that did not show improvement was construction, where productivity has been growing by just 0.7 percent a year. Other countries' rates of productivity growth in construction were also low, but Sweden's sector came from a very poor starting point. In 1995, productivity in Sweden's construction

industry was 25 percent lower than in the United States, and its relative position has barely improved since then.

Deregulation has spurred more competition between private sector players

Extensive deregulation and regulatory reform over the past 10-15 years, both in the country as a whole and in individual sectors, explains the strong productivity improvements among Sweden's private sector companies. More appropriate regulation has intensified competition within each industry and enhanced companies' ability to respond, lifting productivity in the private sector generally. This finding is consistent with MGI's studies of other economies around the world².

Three regulatory changes have been critical. The first was Sweden's entry into the European Union in 1995. The resulting lowering of trade barriers between Sweden and other EU countries increased competition from abroad, prompting Swedish companies to boost their efficiency. For instance, imports of processed food into Sweden increased by 8 percent a year from 1993 to 2002, stimulating Swedish food processors to respond: food exports from Sweden rose at 15 percent a year over the same period. Second were stricter laws promoting fair competition. Earlier competition laws had been fairly toothless, for instance, allowing whole industries to adopt common pricing. Such practices are no longer permitted. Thirdly, there has been significant deregulation and regulatory reform at the sector level. Changes in zoning laws have introduced more competition in the retail sector, for example: in 1992, the law was changed to force local policy makers to consider effects on local competition when granting retail licenses to new entrants. Deregulation in retail banking has also led to new entrants being granted banking licenses, resulting in greater competition in the industry.

The automotive sector provides a good example of how the absence of regulatory product market barriers drives competition and therefore productivity growth. Competition between global players in the automotive sector is intense. With no regulatory barriers protecting them from overseas competitors, Swedish automakers constantly need to improve their productivity to stay ahead. The

2 See, for instance, Diana Farrell, "The Real New Economy", Harvard Business Review October 2003; and Martin Baily and Diana Farrell, "A road map for European economic reform," The McKinsey Quarterly, September 2005.

Swedish automotive sector has been remarkably successful in this regard. By 2003, it was jointly with the Japanese the most productive of all the automotive sectors we compared. It also had the highest productivity growth rate, and was creating the most new jobs.

In contrast, the example of Sweden's construction sector shows how inappropriate regulation holds back productivity improvements. The construction sector was the only one of the five we analyzed to remain comprehensively regulated, with few changes to its rules occurring during the period of our study. Rigid zoning laws, a bureaucratic planning process, and over-detailed construction codes continue to limit innovation in the industry and make it inefficient. There has been no significant improvement in productivity in construction in recent years, and employment in the sector has been falling. This is important not only because Sweden's construction industry employs 3.5 percent of the labor force and accounts for 4.4 percent of GDP, but also because inefficiencies in construction have ripple effects in other sectors, raising the cost of offices, factories, housing, and hospital buildings alike.

Productivity growth in the public sector has most likely been less impressive

Sweden has a large public sector, employing 30 percent of the country's workforce. Productivity in the public sector is therefore critical to the prosperity of the economy as a whole. However, productivity in the public sector is not measured in the national accounts because of difficulties in quantifying its many outputs, like national defense, environmental protection, healthcare and education. As a replacement, the value added is measured based on the cost. This leads to Sweden's annual increase in overall productivity over the past ten years, at 2.4 percent, being almost 1 percent lower than the increase in its private sector productivity.

However, since productivity improvement in public as in other sectors is closely linked to competitive intensity and the regulatory framework³, and government services in Sweden face little competition and are heavily regulated, it is reasonable to assume that productivity in Sweden's public sector has improved much more slowly than in the private sector. Earlier academic attempts to

3 See Thomas Dohrmann and Lenny Mendonca, "Boosting government productivity", The McKinsey Quarterly, 2004 Number 4, available online at www.mckinseyquarterly.com.

measure Sweden's public sector productivity support this assumption.

Sweden has failed to create new jobs, especially in the private service sector

Despite its recent improvements in productivity and income growth, Sweden's economy is significantly worse than others at creating new jobs. From 1992 to 2003 the share of people of working age (15-64 years) in employment declined by 3.1 percent. In contrast, the same measure of employment in Great Britain, France and Norway increased by approximately 4 percent during the same period. The difference in Sweden's employment performance is equal to between 400,000 and 500,000 jobs.

Sweden's failure to create jobs is most apparent in the private service sector, where Sweden has been the worst at creating jobs of the 11 countries we chose for comparison. From 1992 to 2003, the Swedish private service sector created new jobs equal to only 4 percent of the working age population, compared with 5.7 percent in Japan, 8.1 percent in Germany and 13.5 percent in the Netherlands. Sweden's weakness in creating new private service jobs has added to the problem of high de facto-unemployment. This failing is especially grave given the long term trend in all industrialized countries for employment to shift from manufacturing industry to services, and the fact that about 40 percent of Sweden's workforce is already employed in the private service sector.

High taxes and counterproductive regulations explain the private service sector's failure to create new jobs

High taxes on employment raise the cost of labor for all employers and potential customers. They also make low value-add services, like food preparation, retail services, or household services, very expensive. For instance, someone on a salary of 26,000 SEK per month (around one third of all full-time employees in Sweden have a salary at this level or higher) would need to work for six hours to afford just one hour of labor on this kind of service. As a consequence, many Swedish consumers choose either to do these services themselves, or purchase them on the informal labor market. Indeed, formal employment in such services is low in Sweden compared with other countries.

In addition, sector-specific regulations limit the creation of new jobs in individual sectors. For example, high statutory overtime payments in the retail sector make it much more expensive for stores to be open at the times most convenient to

customers. Costs for retail labor rise by 70 percent on late weekday evenings, and 100 percent at weekends. These cost hikes result in shorter opening hours, reducing both the service provided to consumers, and retail employment. Overall employment in retail is much lower than in the United Kingdom, for example, where retail overtime rates are less costly. The difference in employment rates in retail between the two countries corresponds to 180,000 jobs in Sweden.

Likewise, rigid labor market regulations in the construction sector contribute to lower productivity, which drives up costs. This reduces demand, leading to lower employment in the industry. Examples of these barriers include the complex and inefficient piecework system for calculating wages, and the rigid division of tasks between different categories of construction workers.

Certain employment practices in Sweden also make employees reluctant to move to a new job, even one with a more productive company with better growth prospects. The resulting inertia in the labor market puts a brake on overall productivity improvement in the economy, which also, ultimately, means that fewer new jobs are created.

Sweden's economy has reached a pivotal point

Strong productivity improvement in the private sector has driven Sweden's economic growth over the past decade. However, Sweden cannot rely on this factor alone to drive future growth and employment, for three reasons.

First, private sector productivity improvements since the early 1990s have been generated to a large extent by deregulation, which has enabled some sectors to catch up with more productive foreign peers. Impressive as this performance has been, however, it represents a "one time only" change. It is unlikely that productivity will continue to improve at the same rapid pace without further deregulation in the private sector.

Second, demographic change will put Sweden's public sector under intolerable pressure unless its productivity improves rapidly. The aging population will require more welfare services, paid for by taxes levied on a declining share of people of working age. Technical developments in healthcare mean that demand for healthcare is constantly increasing. If nothing else changes, the resulting increase in welfare costs will become too large to finance through the current

tax system in only 10-20 years time. Even our base case scenario indicates that the combined state and municipality income tax rate would need to increase to roughly 50 percent over the coming 20-30 years, from about 30 percent today. Taxpayers are unlikely to accept such an increase: the quality of public welfare and healthcare services is more likely to decline.

Thirdly, Sweden's de facto unemployment is serious in itself, but is even more troubling in the light of accelerating globalization. As it becomes increasingly feasible for companies to produce goods and services in lower-cost countries, and pressures grow on Swedish companies to improve their productivity, we estimate that they will move between 100,000 and 200,000 jobs offshore in the coming 10 years. That makes it imperative for Sweden's economy to become more dynamic and create new jobs to replace those that go abroad. Then the economy as a whole will benefit from offshoring, rather than just the firms that move jobs offshore.

At present, because of Sweden's low rate of re-employment, there is a net loss to the economy each time a service job is moved to another country. In contrast, the US economy makes a net gain from each such move, largely because it re-employs the displaced workers much faster. Denmark also has a higher re-employment rate than Sweden, which is why the negative effect on Denmark's economy when a service job is moved offshore is much less severe than the corresponding effect on Sweden's economy..

Sweden must act now to sustain economic improvement

Sweden's macroeconomic situation and the findings from our sector studies point to three priorities for increasing GDP growth and employment in Sweden by accelerating productivity growth.

Firstly, the government should remove remaining barriers to competition and productivity improvement throughout the private sector. Strong growth in labor productivity over the past 10 years has resulted partly from the deregulation of sectors that were very highly regulated at the outset, the effects of which will lessen over time. In order to maintain its positive growth trajectory, Sweden needs to remove any remaining barriers to productivity growth and strive to continue intensifying competition in every sector.

Secondly, productivity in the public sector must improve rapidly. Demographic development and the tendency for public sector labor costs to rise in line with labor costs in the overall economy, with no proportionate increase in public sector output, mean that Sweden will soon struggle to finance its current level of welfare services. At that point, either their quantity and/or their quality will have to be reduced. To avoid that risk, productivity growth in the public sector must match the pace of private sector productivity growth. Increasing competition and measuring productivity improvement have proved effective means accelerating productivity growth in the private sector. They should therefore be applied to the public sector as well, as far as possible.

Thirdly, the rate of job creation must increase, especially in the private service sector. Given that services provide a growing proportion of all employment in developed economies and that the private service sector already employs 40 percent of Sweden's workforce, the failure to generate more jobs here is worrying. To tackle this problem, total labor costs must be lowered, for example, by reducing direct and indirect taxes on labor. Furthermore, other regulations that limit the creation of new jobs or create inertia in the labor market should be reconsidered and revised. Despite their good intentions, such regulations are often counterproductive for the overall economy.

Success in these three areas would significantly improve prosperity in Sweden. If private sector productivity continues to improve at 1 percent above the OECD average and the economy creates 500,000 new jobs, Sweden will reach the same level of GDP per head as Switzerland, adjusted for purchasing power. Switzerland today lies in fifth place in the OECD welfare ranking, the position that Sweden held in 1970. With a simultaneous increase in productivity growth in the public sector, Sweden will be able to make the improvements in public services that it needs, and the outlook for the Swedish economy will be significantly stronger than it is today.

Policy makers, companies and labor unions all need to contribute to making the necessary changes. Given the challenges the Swedish economy faces, all three should communicate the need for change to their respective constituents, and create realistic expectations. The experience of Sweden's automotive industry demonstrates that effective change comes about when all three parties understand what is required from them, and contribute the best they can.

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