5 Labor Market Interventions

Policymakers in Sweden have long seen the shaping of labor market outcomes as critical to the pursuit of their equity objectives, using a range of instruments—both fiscal and nonfiscal—to secure high and stable levels of employment together with extensive participation. This chapter reviews experience with the principal devices used to these ends.

Background: A Brief History of Labor Market Outcomes

Centralized bargaining, a pivotal component of the Swedish model, aimed for full employment at high participation rates both as a means to income security within an egalitarian distribution of labor income and in order to broaden the tax base and hence help finance high budgetary expenditures. While these goals had largely been achieved through the mid-1980s, as welfare arrangements grew in size so the long-term disincentive effects of the Swedish model became more apparent. These effects stemmed from growing tax wedges, increasingly generous transfers, legislation raising the cost of firing and hiring, a high effective floor on the wage level, and growing uncertainty about the real value of future welfare entitlements as public debt grew rapidly. The result was a period of latent increases in unemployment (with the consensus estimate of the equilibrium unemployment rate steadily rising throughout the 1980–93 period) followed by a sudden quadrupling of the open unemployment rate during 1990–93 to 8 percent. The macroeconomic crisis hit employment and brought the public employment boom—which boosted public employment from 15 percent of the labor force in 1970 to one-third in the early 1990s—to an end. Awareness of these structural weaknesses was a key factor in the consensus underlying the 1991 tax reform summarized in Box 2 (in Chapter 2), with the restructuring of the labor income tax estimated by both Agell, Englund, and Södersten (1998)

and Blomquist, Elköf, and Newey (2001) to have led to an increase in labor supply on the order of 2 percent. Following the deep recession of the early 1990s, steady improvements have been registered in employment, unemployment, and participation rates. The levels of the late 1980s, however, have not been recovered. Participation rates, for example, remained 7 percent lower in 2000 than a decade earlier, with a drop of over one-fifth for workers under age 25.

Assessing the Impact of Government

A wide range of policy measures impact a variety of labor market outcomes. The state affects the labor market through the tax transfer system, through its influence on wage bargaining institutions and outcomes, and through spending on labor market programs. These potentially bear on all key dimensions of labor market performance, including hours worked, participation decisions, the duration of unemployment spells, the intensity of search effort, absenteeism, and the acquisition of human capital. These are areas, moreover, in which there has been substantial policy change over the past decade or so. Not surprisingly, the labor market impact of intervention in Sweden has been widely discussed and studied over this period. This section offers an overview of some of the principal issues and conclusions.

Incentives and the Tax Transfer System

The most direct (and readily quantified) effects are those of the tax transfer system on labor market incentives. Assessing these incentives, which bear on labor market outcomes, requires taking account of a wide range of features of the tax transfer system:

- Local income tax payable beyond a low basic allowance, at rates between 26 and 34 percent and averaging a little over 30 percent. Central income tax becomes payable at 20 percent on taxable income of SKr 273,800, and at 25 percent above SKr 414,200.[35] These latter thresholds are high, so that only about 9 percent of full-time employees pay central income tax.
- Social security contributions payable at 32.82 percent by employers, and at 7 percent (up to SKr 301,011) by employees themselves. To the extent that these are not perceived to carry actuarially fair benefits, the incentive effects of these will be akin to a tax. The ministry of finance estimates that over half of the average contribution could be regarded as a tax in this sense.

[35]There is no deduction or credit of either tax against the other.

- Indirect taxes—not least a standard VAT rate of 25 percent—affecting individuals' budget constraints in much the same way as taxes on their labor income, and so having, in principle, similar incentive effects.
- The withdrawal of means-tested benefits as income rises reduces disposable income just as would an explicit tax. As stressed in Chapter 2, Sweden has no general in-work benefit explicitly structured as a supplement to low incomes. Social assistance payments are available, however, to guarantee a minimum level of income to all, with an implicit tax (at a marginal rate of 100 percent) as income rises towards that level. Social assistance is paid by local governments, which have some discretion over its level. Moreover, housing allowances and the subsidy to childcare payments are means tested. So too is the repayment of student loans, again having an effect—once the benefits of the loan have already been enjoyed—similar to an explicit tax.
- Contingent benefit payments for unemployment, sickness, and parental duties, which potentially affect decisions on labor market status. These are typically related to prior earnings, and so may also affect the work effort of those likely to fall into these contingencies.

These taxes and transfers potentially distort labor market decisions by driving a wedge between the cost to the employer of expanding employment and the real value of the resources that the associated net earnings will buy the worker. When the former exceeds the latter, society loses from dissipation of the otherwise mutually beneficial expansion of employment that the tax transfer system frustrates. Such distortions operate on a variety of margins.

Hours Worked

Much attention traditionally focuses, in Sweden as elsewhere, on the impact of policy on workers' decisions as to the number of hours worked. In the short term, of course, many workers have relatively little control over the hours they work, especially given the existence of institutional limits on the number of hours of overtime that can be worked (some specified in national laws, others in central or firm-level agreements). Over the medium term, however, there is scope for variation in the renegotiation of labor agreements.

The impact of the tax transfer system on hours worked depends on both the average and the marginal rates of taxes and transfers combined, with the former critical for participation decisions and the latter for the level of effort chosen by those in work. Conditional on having chosen to participate in the labor market, the average tax rate—likely to be negative at low incomes, with benefits received exceeding taxes paid—determines the "income effect" of the

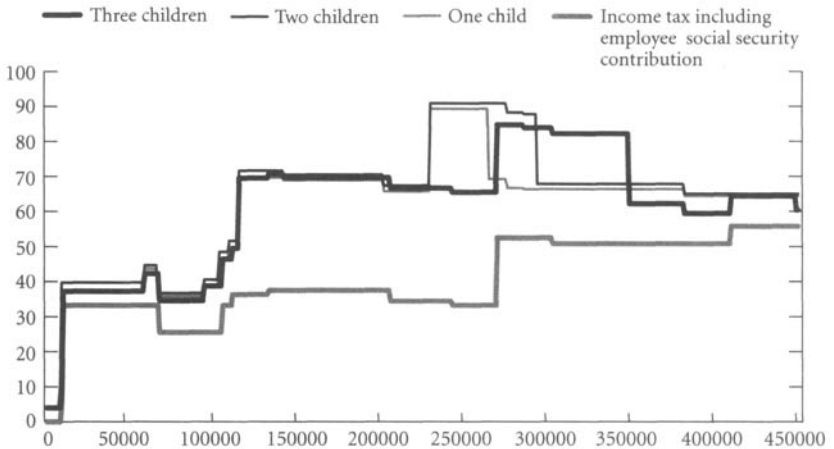
system. The higher the proportion of income taken in tax, the less the household can afford to take leisure, and so the greater on this account will be its labor supply. The average rate will also affect the discrete choices as to whether to work at all and of whether to migrate. The marginal tax rate, on the other hand, determines the "substitution effect": the higher it is, the less is the return from additional earnings, and so the lower labor supply will be. While the overall outcome depends on both marginal and average rates, the two differ crucially in their welfare significance. Since the income effect arises from the need to raise revenue, it is in a sense inescapable: even the least distorting tax system would generate an income effect. Thus, conditional on participation, it is only the marginal rate that generates efficiency losses; and it is with this that we begin.

The extent of the distortion to labor market incentives at the margin is conveniently described by the marginal effective labor income tax rate (MELT), defined as the proportion of one additional krona of earnings that is offset by increased tax payments and the withdrawal of benefit. Simple calculations show that this can be substantial in Sweden. For a worker paying at the top central marginal tax rate, the combined effect of income tax, the average VAT, and employer's social security contributions is a MELT on the order of 71 percent.[36] That is, SKr 100 additional expense by the employer buys the worker goods worth only SKr 29. For those lower down the income scale, the impact of the income tax will be less, but the withdrawal of means-tested benefits (particularly housing allowance and childcare support) will tend to raise the MELT.

MELTs on labor income in Sweden are high over some income ranges and for some household types. This is illustrated in Figure 20, which shows the MELT associated with social security contributions, central and local income taxes, housing allowances, and childcare support for single-earner households differing in the number of children. (Note that housing allowances and, of course, childcare support are not available to those without children.) The figure shows that the impact of these contributions and taxes is much less straightforward than might have been supposed. In particular, the MELT from these sources at some points actually falls with income, running counter to the

[36]Assuming all income to arise from wages, and that there is no savings, the consumer's budget constraint implies that $(1 + v)C = (1 - \tau_w)W$, where C denotes consumption, W wage income, v the uniform rate of consumption tax (taken to be 17.6 percent), and τ_w the rate of income taxation (55 percent). The gross cost to the employer of hiring this worker, G, is $(1 + \tau_s)W$, where τ_s is the rate of the employer's social security contribution (32.92 percent). Combining the two, the MELT, defined as unity minus the derivative of consumption with respect to the employer's wage cost, is $1 - (1 - 0.55)/[(1 + 0.3292)(1 + 0.176)]$. When, as in practice, taxes are nonlinear, the same algebra applies at the margin.

Figure 20. MELTs for a Single Earner in 2001



Source: Ministry of Finance.

usual notion that the marginal tax rate ought to increase with income.[37] The most striking downward dip reflects an unusual feature of the Swedish tax system—resulting from changes made in the 1991 tax reform—that, over a range of low incomes, the allowance (i.e., the standard deduction from taxable income) actually increases with income.[38] However, income tax and social security are not the only important determinants of the MELT. The withdrawal of means-tested housing and childcare benefits can give rise to very high MELTs at lower levels of income: well over 60 percent over quite a wide range, and in some cases even over 90 percent. Although the absence of means-tested income supplements means that these MELTs are, in a broad sense, lower than is sometimes found, they clearly have the potential to create significant disincentives to work among some groups of low-wage earners.

[37]There is in theory no reason to require the MELT to rise everywhere with income. Indeed, optimal tax schedules in some key cases imply that it should fall over high income ranges (Seade, 1977). More generally, although theory warns that optimal marginal effective rate schedules can have all kinds of shapes—see for instance the various cases in Boadway, Cuff, and Marchand (2000) for which closed-form solutions are obtained—there is no generally compelling rationale for having the MELT fall over a range of low incomes and then rise again.

[38]It then declines back to its initial level, implying a MELT initially below and then above the statutory tax rate. The purpose of this measure was to reduce marginal tax rates for those with very low incomes, especially students and part-time working mothers. However, this came at the cost of imposing particularly high marginal tax rates on those with somewhat higher incomes.

Table 7. Average Marginal Effective Labor Income Tax Rate (MELT) Across Households, 2001
(In percent)

Total	45.5
Of which	
Income tax	34.5
Childcare	0.2
Housing allowance	1.5
Social assistance	1.6
Maintenance advance	0.2
Unemployment insurance	7.6

Source: Ministry of Finance.

Averaged across all households—and in this calculation ignoring both the employers' social security contributions and indirect taxes—the marginal effective tax rate is about 46 percent. Table 7 shows the average MELT for a hypothetical increase of SKr 12,000 in the earnings of all households (and thus includes the effects of moving from unemployment back to work, an issue addressed below), together with a decomposition into its underlying components. Such an average clearly conceals important interhousehold variation in the MELT, and will tend to understate the effective distortion of the labor supply decisions.[39]

While the MELT provides a conceptually sharp quantification of the strength of disincentives to marginal labor effort, the key policy question is the extent of the welfare losses from these disincentives. It is these efficiency costs that need to be weighed against any distributional gains. The extent of these losses depends on both the size of the MELT and, for the reasons given above, the strength of substitution effects, as measured by the compensated wage elasticity[40] of the supply of labor. By way of illustration, Table 8 reports figures for the marginal excess burden of labor income taxes at various levels of the MELT and at various plausible levels of the compensated wage elasticity for primary earners in Sweden. Elasticities for secondary earners are generally found to be higher. As can be seen from Figure 20, the range of assumed values for the MELT is also within the experience of many workers in Sweden.

[39]Since the excess burden of a tax is a convex function of the tax rate, the associated inefficiency when MELTs vary around an average will be greater than it would be if all households faced that average MELT.

[40]This is the elasticity when the consumer's income from nonlabor sources is adjusted so as to leave their level of well-being unaffected by the change in the wage rate.

Table 8. Marginal Excess Burden of Taxation (MEB) per Additional SKr 100 of Revenue
(In percent)

MELT	Compensated Wage Elasticity of Labor Supply (ε)		
	0.05	0.11	0.25
35	2.7	6.2	15.4
46	4.4	10.1	26.5
60	7.9	19.1	57.3
70	12.5	32.5	125.9
80	22.7	68.8	1,250.0
90	61.6	521.0	−210[1]

Source: Authors' calculations.

Note: Marginal excess burden is calculated as $[t/(1-t)]\varepsilon/\{1-[t/(1-t)](\varepsilon+\alpha\eta)\}$, where t is the marginal effective tax rate, ε the compensated wage elasticity, and η the income elasticity of labor supply (taken to be −0.05—in line with estimates for Sweden reported by Agell, Englund, and Södersten (1998)—and to be independent of the net wage) and α is the ratio of hours worked to the time endowment (assumed to be 0.4). Excess burden is defined as in Kay (1980). Nonlabor income is assumed to be zero, and there are no taxes other than on earned income.

[1]In this case, an increase in the tax rate actually reduces revenue, so that revenue can be increased while reducing excess burden.

At high MELTs, the efficiency loss is considerable even when compensated labor supply is relatively unresponsive. At a marginal effective rate of 80 percent, for example, even with a compensated elasticity as low as 0.05, the additional excess burden created by raising an additional SKr 1 of revenue is over SKr 0.2. In this context it should be emphasized that the 1991 tax reform, although to some degree reversed since (by, for instance, the introduction of the 7 percent employee's social security contribution), has greatly reduced the distortionary cost. Agell, Englund, and Södersten (1998) report, for example, that the MELT on the average blue collar worker was reduced from about 73 percent to about 63 percent by the reform, nearly halving the marginal excess burden per krona of revenue even at low levels of responsiveness. Nevertheless, the persistence of high MELTs means that there would still be a potentially worthwhile gain from further reducing MELTs. Even at the average current MELT of 46 percent, the marginal loss per krona of tax revenue may plausibly be as high as SKr 0.1–0.2.

The question of how to significantly reduce MELTs without unduly jeopardizing revenue or wider social objectives raises distinct issues at the top and bottom of the income distribution. It is here that incentive concerns are commonly greatest: in the former case reflecting a presumption that high earning power reflects an especially strong productive capacity; in the latter case in order to ensure that incentives for the poorest to improve their position by their own efforts are not blunted. Indeed, theory suggests—subject to

many caveats—that the MELT should be zero at both extremes of the earnings distribution.[41]

Action at the top of the distribution is relatively easy. Simply eliminating the top central marginal rate of tax—establishing a uniform rate of 20 percent—would cost only about SKr 3 billion, roughly 0.3 percent of general government revenues. Going further and reducing the uniform central rate to 17 percent would only cost an additional SKr 5 billion.

It is more difficult to reduce the high MELTs at the lower end of the distribution, associated with the withdrawal of means-tested benefits and the relatively high starting rate of income tax. Simply adopting a slower phaseout for means-tested benefits in itself raises the cost of the benefit (the limiting case being that in which the benefits are paid to all, irrespective of income). Extending the range over which the benefit applies also raises MELTs above the income level at which the benefit would previously have been extinguished, making the problem of MELTs less marked but more widespread (although, since excess burden rises more than proportionately with the tax, this is likely to reduce the aggregate efficiency cost).[42] Offsetting these effects requires reducing the basic level of the benefit, and so reducing its distributional effectiveness at the lowest levels of income. Attention thus focuses naturally on the purpose of the means-tested benefits, and whether they might be better served by other instruments. The aim of providing acceptable housing for all, for example, might be better served by freeing up the housing market to allow for the expansion of affordable housing.

Since a key purpose of many of these means-tested benefits is to support households with children, a more efficient way of achieving the same end might be by increasing the flat-rate child benefit. This too would be costly in so far as these are paid to all with children, but some of the cost could be recouped by making the benefit taxable. For most households taxability would make little difference, since it would be possible to pay the same net amount at the same cost to the budget simply by grossing up the payment. In the higher reaches of the income distribution, however, where the income tax schedule is progressive, the net amount received would be lower, implying a more effective targeting of the benefit.

There may also be scope for moderating the impact of the income tax on low earners. The basic deduction from the income tax is very low, and the starting tax rate of 30 percent is relatively high by international standards (see

[41]This is shown in Edwards, Keen, and Tuomala (1994).

[42]MELTs may also need to rise to finance any increase in the costs of the benefit.

Table 3 in Chapter 2). Changes in these dimensions are liable to be costly, since an increased allowance or reduced starting rate would benefit all taxpayers. Indeed, the gain from increasing the allowance would be greatest for the highest earners, since it reduces the amount of income taxable at their highest marginal rate, and they are able to take maximum advantage of a reduced starting rate. Both effects could be limited, however, by transforming the basic allowance into a credit, the same for all. The state of the public finances is healthy enough to suggest that a start in this direction could be made in the foreseeable future.

Participation and Search Incentives

Public policy has been instrumental in attaining and maintaining high participation rates in Sweden. Participation rates are especially high for women and in the 50–64 age bracket, with participation rates for the latter being 12 percentage points above the OECD average. While the quite high average effective tax rates in Sweden—documented in discussing labor mobility in Chapter 8—would tend to discourage participation, a range of other measures act in the opposite direction. The elaborate and effective social support system for working parents and elderly workers, as well as the wide availability of part-time work, especially in the public sector, have played a key role. High marginal tax rates on the first earner and the direct link between wages and many social benefits also strongly encourage the labor force participation of the second earner in each family.

The unemployment benefit regime was made significantly more conducive to participation in early 2001. Prior to this, benefit duration spells could effectively be extended indefinitely by participation in labor market programs. This is no longer the case. Under the new "Activity Guarantee" scheme, at the end of a 300-day spell claimants who have not worked enough within that period to qualify for another 300-day benefit spell[43]—an extension that is available only once—are required to enter a full-time activity.[44]

At its current level of 80 percent—which was increased from 75 percent on September 1, 1997—however, the statutory replacement ratio remains high. While the effect of this has been mitigated by the SKr 580 ceiling on payments—which has remained unchanged for several years, and now constrains payments to about 45 percent of claimants—the increase in the ceiling to SKr 680 from July 2001 marks a significant increase in generosity. Past

[43]At least 70 hours per month for six months.

[44]Such activities may be offered during the benefit spell, with sanctions in the form of reduced benefit payment if not accepted.

experience suggests that this and other reforms to the unemployment benefit regime can have substantial behavioral effects: Carling, Holmlund, and Vejsiu (2001) find that the reduction in the replacement rate from 80 to 75 percent on January 1, 1996 increased transitions out of unemployment by around 10 percent.

Figure 21 compares the replacement rates for relatively low-paid workers across the EU, as of 1997, showing Sweden to have among the highest. This is especially so for households with children, reflecting a relatively high level of the child benefit.[45] Replacement rates are generally lower for higher-paid workers, reflecting the operation of the benefit ceiling, but those in Sweden again rank among the highest.

Disincentives to work are especially high among the low-paid with children. Calculations of replacement rates for representative workers of the kind reported in Figure 21 mask the considerable cross-household variation that can arise from the diversity of households' situations and the corresponding complexity of benefit arrangements. Table 9 shows not the replacement rate, but—a related quantity—the MELT (per krona of additional income) faced by workers moving into employment. This is over 90 percent for a low-paid worker with two children in daycare, reflecting a sharp withdrawal rate for the housing allowance and a marked increase in childcare costs. The MELT tends to be lower at higher incomes, reflecting the cap on the absolute amount of unemployment benefit paid. This creates an important disincentive to work by elevating the economic value of domestic work, general maintenance, and repairs that a household can perform for itself, as well as of taking paid work in the informal sector.

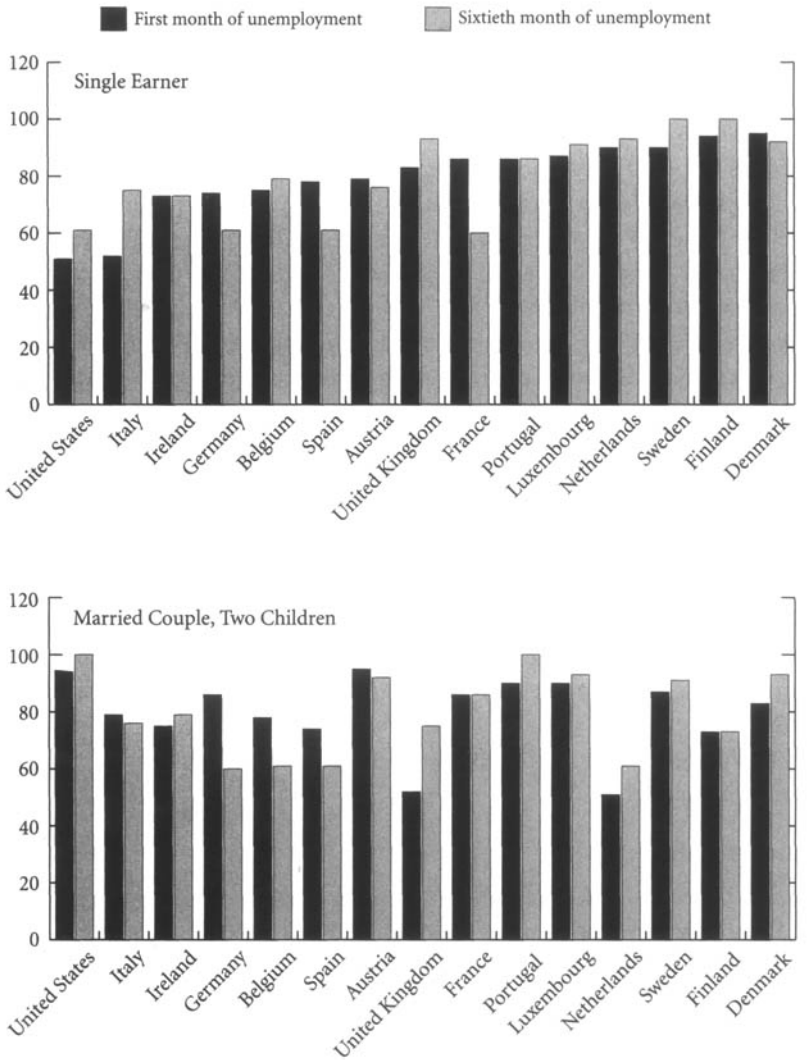
Sickness Benefits

Absences through sickness have increased substantially in recent years. The increase amounted to an average of 20,000[46] in 2000 compared with 1999, or 0.5 percent of total employment. There has been a strong procyclical movement in sickness absence in Sweden since the late 1960s (Aronsson and Walker, 1997), suggestive of work-related stress, compositional effects in the labor force (with those last employed having a higher propensity to be sick), or intertemporal smoothing of labor supply. But there is also evidence that, in Sweden as elsewhere, sickness absence is responsive to the incentive effects of the

[45]Payments received both in and out of work, such as child benefit, increase the replacement ratio (since they appear in both the numerator and denominator).

[46]Absent for the entire week owing to sickness.

Figure 21. Net Replacement Rates of the Unemployed at Average Wage Level, 1997



Source: OECD, *Benefit Systems and Work Incentives* (Paris, 1999).

benefit system (Johansson and Palme, 1993). Henrekson and Persson (2002) estimate that the 1998 increase in the sickness benefit replacement rate, from 75 to 80 percent, increased sick leave by about 30 percent.

Table 9. MELTs on Returning to Employment, 1999

Unemployment Benefit	Wage on Return to Employment	MELT	
		One child in daycare	Two children in daycare
96,000	120,000	64.1	92.7
150,800	192,000	63.4	70.1
150,800	300,000	54.8	57.6

Source: Ministry of Finance.

In this setting, the sickness benefit system is rightly coming under scrutiny. The restriction of unemployment benefit rules described above will increase the importance of guarding against an inappropriate expansion of sickness payments. In both the effectively unlimited duration of benefits and the level of compensation, however, the Swedish scheme is, by international standards, very generous (see, for instance, Mehrez, 2002). Not least, with employers bearing none of the cost after the first 14 days of a sickness spell, it may be difficult to guard against abuse. A natural strategy would be to improve employers' incentives to monitor absences more closely, either by increasing the periods for which they bear the cost of the benefit (from the present two weeks to, say, one month) or by introducing a system of experience rating (under which social security contributions would increase with the extent of their employees' claims).

Collective Bargaining and the Effects of the Tax Transfer System

The effective incidence of the tax transfer system can be much harder to gauge than is often supposed. Much discussion of the labor market impact of the tax transfer system—including that above—focuses on the effects on the incentives faced by individual workers, taking as given the wider labor market setting they face, their wage rates, the level of unemployment benefit, and so on. But that wider context is also liable to be affected by the tax transfer system, making it important to consider issues concerning its effective incidence. Part of the benefit of housing allowances, for instance, may accrue to landlords in the form of increased price of housing services; and employment subsidies may in part go to the benefit of employers, enabling them to pay reduced gross wages in the knowledge that they will be topped up by the state. Assessing effective incidence is difficult, and in many respects this remains an area of considerable ignorance.

Table 10. Average Direct Tax Rates by Income Group
(In percent)

	1989	1998
0–50,000	14	23
100,000–150,000	33	31
200,000–250,000	36	35
500,000–	58	43

Source: National Tax Board (2000).

One important determinant of that incidence, however, is the existence and nature of collective bargaining arrangements in the labor market. In particular:

- Under centralized wage bargaining, negotiators are more likely to be conscious of and hence internalize in their negotiating positions more of the macroeconomic risks—in terms of both unemployment and inflation—of high wage settlements.
- Progressivity of the tax transfer system is itself conducive to wage settlements that imply relatively low unemployment. The reason for this—an effect shown by Koskela and Vilmunen (1996) to apply in a range of bargaining models—is that a high marginal tax rate raises the before-tax cost to the employer of meeting any increase in after-tax wages, also raising the cost to the union, in terms of induced unemployment, of seeking such net wage increases. This tilts negotiations toward agreement involving relatively low wages and high employment. Empirical support for this effect has now been found in a range of countries, with Holmlund and Kolm (1995) finding such an effect for Sweden. As they note, this may be one reason why the positive correlation between labor taxes and unemployment found in an influential study by Daveri and Tabellini (2000) is not apparent in Sweden and the other Nordic countries.

Both of these effects, which mitigate the adverse employment consequences of the tax transfer system, have become less marked in recent years, with the bargaining system having become significantly less centralized since the 1970s (Friberg and Uddén-Sonnegård, 2001). The tax transfer system has also become less progressive since the 1991 reform: Table 10 shows a significant increase in the average direct taxes paid by the least well-off between 1989 and 1998, and a reduction in the average tax rate on the most well-off. Although it is hard to quantify the significance of these developments, their direction is fairly clear: the employment effects of the tax transfer system have become, through these routes, more adverse.

Wage Compression

Centralized bargaining in Sweden gave rise to a substantial compression of the wage scale, an implicit progressive tax on labor income akin to the explicit one. As shown in Figure 22,[47] wage compression in Sweden—as measured by the university wage premium—was at a level comparable to that in the United States in 1969, but it rose markedly in the 1980s, severely diminishing the private financial payoff to education. There has since been some decompression, but only enough to return to the level of 1969 and far below the current U.S. level.

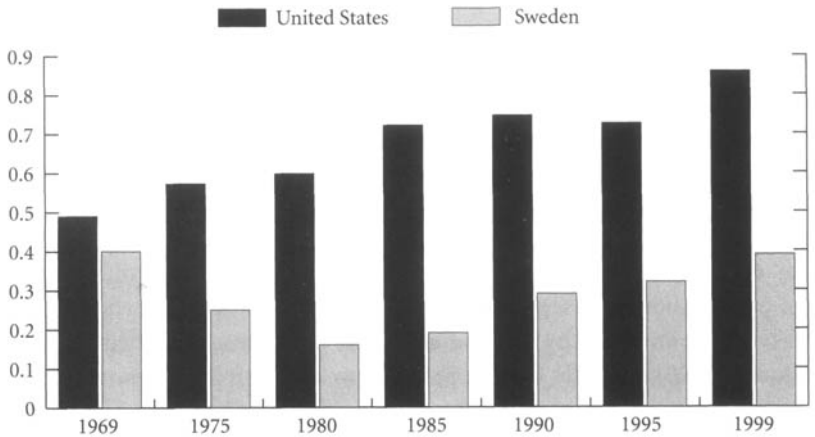
By driving a wedge between relative wages and productivity differentials, wage compression generates distortions and consequent efficiency losses that are likely to be amplified by the progressivity of the tax transfer system. Indeed, Lindquist (2000) estimates that the potential welfare gain from removing wage compression would be around 4 percent of GDP, mainly due to higher employment of low-skill workers, and the resulting broader tax base and reduced need for transfers. The substitution effect of a wage scale compressed across skill levels reduces work intensity and hours worked by high-skill labor, and induces low-skill workers to work too much, impairing average productivity levels. Exacerbated by high and progressive labor taxation, it reduces the returns to education, and hence the incentives for acquiring education, lowering the average skill level. While the subsidization of education can counter this effect, it leads to inefficient resource utilization unless the positive externalities associated with higher education levels are commensurate. Wage compression also diminishes incentives for creating jobs for low-skilled workers, or for retaining them. A significantly compressed wage structure is invariably associated with a relatively high effective minimum wage (even when, as in Sweden, there is no legislated minimum wage), which hampers the entry of low-productivity workers, especially the young. Finally, the response of migration patterns to wage compression may result in a net loss of human capital.

A related problem is that relative wage adjustment is very sluggish in the present low-inflation environment, exacerbating the effect of the compressed wage structure. Nominal wages remain sticky in Sweden, with downward adjustments extremely rare even in a crisis.[48] The only exceptions are sector or individual specific. Nominal salary cuts have occurred in the ICT sector recently as a result of the worsening of the outlook in the sector. In addition, individuals may choose to trade off a higher but volatile income stream for a

[47]See also Table 19 in Chapter 8.

[48]Agell and Lundborg (1999).

Figure 22. University Wage Premium: Percentage Difference in Average Wage Between Workers with 16 and 12 Years of Education



Source: IDC (2001).

lower, but steady source of income. With relative wages broadly stable for a long period, the incentive effects of wage compression on effective labor supply acquire a great deal of permanence.

Active Labor Market Programs

Sweden supplements passive labor market measures with a wide array of active labor market programs (ALMPs) that provide support conditional on some labor activity by the recipient. Programs of this kind in Sweden consist of self-employment grants, subsidized on-the-job training, wage and employment subsidies, and training courses. About 4.5 percent of the labor force participated in ALMPs in 1997. Sweden led the OECD rankings in the proportion of total labor market program spending allocated to ALMPs in the 1980s, and has remained among the top three since then. By specifically aiming to enhance employment rather than finance spells of unemployment, ALMPs, if well-designed, tend to alleviate structural rigidities, and help maintain attachment to the labor market, factors generally deemed crucial in bringing about a rebound in participation rates following major deteriorations in labor market conditions.[49] ALMPs do

[49]See, for instance, Forslund and Kolm (2000).

have costs for the budget, however, and may have an adverse effect on search behavior (since participants are likely to stop searching upon entering a program). In addition, with spending on ALMPs being less countercyclical than passive spending (OECD, 2000), they tend to reduce the automatic stabilizing effect associated with spending on unemployment. ALMPs also favorably affect the measured unemployment rate, because participants in ALMPs—other than in education programs—are not considered unemployed in official Swedish statistics.

Recent research points to the need for refinements to enhance the efficiency of ALMPs.[50] Measures to improve the intensity and efficiency of job searches hold the promise of raising employment in a cost-effective manner. Youths, the most mobile group in the labor force and with the greatest capacity to absorb risk, might often be better off if encouraged to keep searching for a job, especially because they have the most to lose from a prolonged cutoff from active employment. The most effective training programs are those that are close substitutes for regular employment. While this would argue for employment subsidies, the negative externality (crowding out) on others can be large. A sensible middle ground would be to target employment subsidies at the long-term unemployed, who are readily identified and would have little chance at reentering employment otherwise. Direct measures to support regional mobility have been found generally to be ineffective.

Temporary and Part-Time Employment

The rapid spread of temporary and part-time work helped the Swedish labor market attain much-needed flexibility and contributed to high participation rates. Part-time workers account for one-fifth of the labor force; the share of those on temporary contracts is approaching one-sixth. The availability of part-time jobs helps by tapping a supply of individuals who are unable or unwilling to work full time. Temporary workers, on the other hand, are the first to be hired in an upswing and released in a downturn. The high level of cyclicality in their employment may be an important source of aggregate labor market flexibility.

Conclusions

The Swedish labor market has proven to be fairly efficient in the upswing following the crisis of the early 1990s, and resilient in the slowdown during

[50]Much of the work in this area is by the Office for Labor Market Policy Evaluation (IFAU). See also Calmfors, Forslung, and Henström (2001).

2001–02. Participation rates and employment have increased, and are high relative to those in other OECD countries, although not compared with Swedish levels in the 1980s. Centralized bargaining, complemented by considerable local autonomy in setting relative wages, managed to constrain wage increases to a rate commensurate with productivity gains until the slowdown from mid-2001. However, the recent cyclical downturn in productivity is likely to pose a challenge to the ability of Swedish wage bargaining to deliver wage restraint on a macroeconomic level. The compressed wage scale, together with the tax transfer system, is likely to impair labor market efficiency and flexibility. On the other hand, extensive active labor market programs, the growing share of temporary and part-time work, and some reforms in the transfer system appear to largely offset these effects, as demonstrated by Sweden's consistently high employment and participation rates.