Will High Unemployment
in Sweden Become Persistent?
An Introduction

Lars Calmfors*

Summary

■ This paper summarises the main findings in the volume. These can be formulated as follows:

- There appears to be some evidence that equilibrium unemployment has increased in Sweden, although the alternative interpretation that the rise in unemployment has been mainly cyclical is also possible.
- The volume seems to add to earlier material casting doubts on the effectiveness of Swedish active labour market policy.
- There is support for the hypothesis that employment protection legislation has adverse employment effects for teenagers.
- A higher degree of central bank independence is found to be associated with lower inflation among OECD countries also when other institutional factors are taken into account. ■

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It is a common judgement that unemployment may turn out to be Sweden's most difficult macroeconomic problem. Persistence of high unemployment in itself means not only serious welfare and output losses, but also means that it will become much harder to deal with other issues of economic policy. For instance, fiscal consolidation will require much tougher expenditure cuts – and perhaps also tax increases – if employment is not restored to more normal levels.

In view of these considerations the Economic Council of Sweden has decided to devote the first two issues of *Swedish Economic Policy Review* to unemployment. The first issue represented an attempt to survey the Western European experiences of high unemployment and draw appropriate lessons for Sweden. The main focus of this second issue is on various aspects of the Swedish unemployment situation. The material helps illuminate the risk that present unemployment will become persistent.

1. Equilibrium unemployment

According to received macroeconomic theory there is a crucial distinction between *equilibrium* and *actual* unemployment. Conventional wisdom suggests that equilibrium unemployment (the natural rate or the NAIRU) depends on structural labour-market variables, such as wage-bargaining institutions, the level and duration of unemployment benefits,

the extent of active labour-market programmes and perhaps also employment regulations and tax rates. Cyclical variations in demand can, however, produce substantial deviations of actual from equilibrium unemployment in the short run. The aim of **Anders Forslund's** contribution entitled "Unemployment – Is Sweden Still Different?" is to estimate the Swedish equilibrium rate of unemployment and to find out the extent to which the recent rise in unemployment reflects an increase in this equilibrium rate or a cyclical deviation from it.

Forslund estimates a small-scale macro model containing equations for wage setting, price setting (labour demand) and the current account as well as an Okun's-law relationship between employment and output. This type of model was originally developed by Layard and Nickell (1986) and has become a standard tool in macroeconomic analysis (see also Layard *et al.*, 1991). The equilibrium rate of unemployment is obtained by imposing the restrictions that inflation is constant and the current account in balance: the idea is to rule out cyclical variations in unemployment. These could arise either because of expectational errors with respect to inflation on the part of wage setters (with the result that actual real wages deviate from the target ones) or because of variations in aggregate demand that result in current-account disequilibria.[1]

If Forslund's estimates are taken at face value, they suggest a rise in the equilibrium rate of unemployment of somewhere between one and four percentage points between 1990 and 1993. If one assumes an initial level of 3–3.5 percent, this would imply an equilibrium rate of 4.5–7.5 percent in 1993. The results are, however, open to many interpretations. One issue concerns the treatment of foreign demand in the computation of Swedish equilibrium unemployment. The rise in the equilibrium rate when actual foreign demand is taken as given is estimated to be 3–4 percentage points, but it is only 1–1.5 percentage points if the estimates are corrected for the fall in foreign demand (higher foreign demand would permit higher domestic demand without a deterioration of the current account). One might perhaps argue that it is more reasonable to calculate equilibrium unemployment in Sweden at a "normal" level of foreign de-

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[1] See e.g. Calmfors (1994a), Minford (1994) or Holmlund (1994). This way of taking account of the current-account situation can be seen as a rough way of imposing an intertemporal solvency constraint on unemployment. If lower unemployment today is achieved at the expense of a current-account deficit, this may require higher unemployment in the future when current-account surpluses may have to be run, since in the long run income and expenditure must match for a country (see Bean, 1994).

mand rather than at the depressed level that prevailed during the recent recession.

Another question concerns the main domestic driving force behind the rise in equilibrium unemployment found by Forslund. It is a rise in government subsidies to private business -- mainly reflecting the subsidies to save the banks from bankruptcy – which according to Forslund's estimates increases the mark-up of prices on wage costs (which is equivalent to a reduction in labour demand at given real wages). It is not clear how this finding should be interpreted. It may be the case that government subsidies to private business serve simply as an indicator of cyclical demand in Forslund's regression.

Thus, Forslund's analysis can also be given an optimistic interpretation according to which equilibrium unemployment has hardly risen at all. However, such a conclusion may not be warranted. As pointed out in the paper, the method used does not permit any interaction between the cyclical shortfall in demand and structural labour-market parameters that could result in *hysteresis* (persistence) phenomena because of, for instance, reduced competitiveness of the long-term unemployed or insider–outsider mechanisms (see Wyplosz, 1994). This is tantamount to saying that it may still be too early to evaluate the long-term consequences of the recent recession.

2. Active labour market programmes, unemployment benefits and employment regulations

The next three papers by Susanne Ackum Agell, by Susanne Ackum Agell, Anders Björklund and Anders Harkman, and by Per Skedinger deal with various structural labour-market variables likely to influence equilibrium unemployment. The hope in Sweden has been that the strong emphasis on active labour market programmes (henceforth denoted ALMPs) should be an efficient way of reducing the risk that unemployment will become persistent. Whether this is actually the case is the theme of **Susanne Ackum Agell's** paper on "Swedish Labor Market Programs: Efficiency and Timing". She analyses the effects of various ALMPs on the participating individuals' labour market performance by using data from the National Labour Market Board and controlling for a number of (mostly individual) background factors.

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One important result is that participants in ALMPs appear to find regular jobs at a lower rate than unemployed non-participants. This may be an indication of low effectiveness of ALMPs similar to the findings of Regnér (1993). However, the comparison here is between openly unemployed who *have not* participated in programmes prior to unemployment and openly unemployed who *have* participated in such programmes (and hence are likely to have been openly unemployed before entering programmes). If so, the results could reflect negative duration dependence (that exit rates to regular employment may decrease with duration of unemployment, as found e.g. in AMS, 1994) and give too negative a picture of ALMPs.[2] There may also be selection bias that has been inadequately controlled for: the population of participants in programmes is perhaps made up of a larger fraction of "difficult cases" than the population of openly unemployed. Still the results provide an additional warning about low effectiveness of ALMPs.

When comparing different ALMPs, it is found that temporary replacement schemes (*utbildningsvikariat*) seem to produce the best results in terms of returning the participants to work. The cheaper and lower-paid job introduction projects (*arbetslivsutveckling*) did not perform worse than traditional relief work (*beredskapsarbeten*). Finally, the study finds support for the hypothesis that (higher) unemployment benefits do reduce the rate at which the unemployed find jobs.

A common explanation as to why ALMPs in Sweden may be less effective today than earlier is that they have increasingly come to be used as a means of prolonging the duration of unemployment benefits: there is a formal right to placement in programmes when benefits expire. It is also well known that there is a positive correlation between unemployment and benefit duration across countries (e.g. Burda, 1988; Layard *et al.*, 1991; Heylen, 1993). This appears to have been one of the reasons why the liberal-conservative majority in the Swedish Parliament enacted stricter rules in 1994. The maximum duration of a benefit-programme-benefit spell was in effect set at 33 months (14 months of unemployment compensation, 5 months in programmes and then no more than 14 additional months of benefits unless eligibility was renewed through regular work), although it was not clear whether there could (or should) be new

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[2] However, a full analysis wold also take into account that the search activity and exit rates to regular employment appear lower for participants *during* programmes than for the openly unemployed (Edin and Holmlund, 1991; Ackum Agell, 1995).

placements in programmes after that. This reform was immediately cancelled, mainly on equity grounds, by the social democratic government that come to power in October 1994.

The paper by **Susanne Ackum Agell**, **Anders Björklund** and **Anders Harkman** on "Unemployment Insurance, Labour Market Programmes and Repeated Unemployment in Sweden" uses data from both the Swedish Level of Living Surveys and the National Labour Market Board to try to estimate the number of unemployed who would be affected by a limitation of benefit duration of the type introduced in 1994. It is found that around 8 percent of the population of unemployed and participants in ALMPs (approximately 0.6 percent of the labour force) belonged to that category in October 1994. An additional 0.5 percent of the labour force was either openly unemployed or in programmes with only half a year before benefits would expire according to the limitation imposed by the liberal-conservative government.

It is not clear what conclusions may be drawn from the figures quoted, however. The incentives to search efficiently for a new job and to lower the reservation wage are likely to be substantially strengthened for a large number of unemployed. But as highlighted in the paper, the reforms also involve – not very surprisingly – a serious equity-efficiency trade-off: the lower quartiles of the income distribution are overrepresented among those with a long period of open unemployment and/or participation in ALMPs and so are non-Nordic citizens, the handicapped and the low-skilled (although the authors express surprise that the overrepresentation of the latter groups is fairly small).

In his paper on "Employment Policies and Displacement in the Youth Labour Market", **Per Skedinger** focuses on the consequences of employment protection legislation and job creation programmes for the regular employment of young people. As regards employment protection legislation, the conventional wisdom is that the net effect on employment is theoretically ambiguous. On the one hand such regulation adds to employment adjustment costs, which tends to reduce the flow into employment. But on the other hand the inflow to unemployment from employment is also reduced (Edin and Holmlund, 1993). There is a stronger theoretical case for the hypothesis that employment regulation redistributes work in favour of insiders in the labour market and puts entrants (mostly young people) at a disadvantage. Skedinger tests this proposition for six countries by distinguishing between periods of strict and liberal employment regulation regimes. He finds empirical support for the hy-

pothesis that more stringent employment regulations increase youth unemployment mainly for teenagers, but not for young adults (20–24 years) in most countries.[3]

The second part of Skedinger's contribution deals with displacement effects of job creation schemes for young people on the regular job market for the same category. Such displacement effects may occur either because of direct substitution in labour demand at given real wages or because ALMPs raise wage pressure (Calmfors, 1994b). Skedinger performs a VAR (vector autoregressions) analysis on quarterly data for 1970–1991 and comes to the conclusion that there is "complete substitution", i.e. that "for every programme place created by the government, approximately one job is displaced" with the result that there is no net effect on open unemployment.[4]

Taken as a whole, Skedinger's analysis raises some interesting issues about the consistency of employment regulations and active labour market policies. On the one hand employment protection legislation appears to redistribute employment away from young people. On the other hand ALMPs seem to aim explicitly at improving the relative employment performance of this group. This may be both an ineffective method – as suggested by Skedinger's analysis – and an expensive one. There would seem to be obvious gains to be had from better co-ordination of employment regulations and active labour market policies.

3. Inflation and unemployment

In the public debate there is much concern that low inflation can be bought only at the price of permanently high unemployment. The last paper by **Gunnar Jonsson** on "Institutions and Macroeconomic Outcomes – The Empirical Evidence" brings this and related issues into the

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[3] For Germany, however, the effect is larger for young adults than for teenagers. Skedinger attributes this to the apprenticeship system for the latter group, which may cause spillover effects.

[4] This result is consistent with Calmfors and Skedinger (1995) who found aggregate displacement effects of job creation schemes of a similar magnitude on pooled time-series and regional data for Sweden and little evidence that the results are affected by the degree of targeting on young people. It is also consistent with the Swedish wage-setting studies suggesting that more emphasis on ALMPs contribute to wage pressure (see Forslund's article in this issue and Calmfors, 1993). The result squares somewhat less well with the analyses of aggregate job-creation schemes by Ohlsson (1993) and Forslund and Krueger (1994).

picture. The starting point is the literature on the time-inconsistency problem of monetary policy initiated by Barro and Gordon (1983), according to which governments concerned with unemployment and pursuing discretionary monetary policy are likely to end up in an equilibrium with inefficiently high inflation (without being able to reduce unemployment below the equilibrium rate).

Jonsson is interested in the remedy that has been suggested for this problem, namely to delegate monetary policy to a "conservative" central banker (with a lower weight for unemployment relative to inflation in his/her preference function than in that of the government – and the electorate). Earlier research has pointed to a negative correlation across countries between central-bank independence and inflation. Jonsson extends this very rudimentary analysis by exploiting a panel data set – pooled cross-section and time-series observations for the OECD countries – and by taking also a number of other institutional variables (as well as possible variations in the natural rate of unemployment) into account. The conclusion is that the negative relationship between central-bank independence and inflation appears to be robust. It is found to be stronger under floating than fixed exchange rates. Lower inflation also appears to be associated with more conservative governments (and probably also with systems with less flexible exchange rates). Jonsson does not, however, find much support for the positive association between the natural (equilibrium) rate of unemployment and inflation suggested by the theoretical framework.

Jonsson also confirms the results of earlier empirical studies suggesting that there is no association between central-bank independence and the level or variability (variance) of unemployment. If these results are taken at face value, the upshot is that institutional reform strengthening the independence of the central bank can reduce inflation without causing either permanent unemployment losses or more short-run employment variations. However, such an interpretation presupposes that the degree of central bank independence can be regarded as a decision variable that is independent of the preferences of the government and the public: in his comment to Jonsson, Vredin argues that *both* low inflation *and* a high degree of central bank independence in some countries may be explained by a strong public aversion against inflation.

4. Conclusions

What are the conclusions regarding the question posed at the outset: How great is the risk that high unemployment in Sweden will become persistent? I would summarise the findings in this issue of *Swedish Economic Policy Review* as follows:

(i) The evidence in Forslund's contribution can be interpreted in two ways. His interpretation is that the equilibrium unemployment rate has increased. An alternative conclusion is that the rise in unemployment up until 1993 is mainly cyclical, but that it has not yet been possible to capture possibly adverse interaction effects on equilibrium unemployment between the shortfall of demand and existing labour-market institutions (wage-bargaining practices, unemployment insurance, active labour market programmes resulting in an indefinite duration of benefits, etc.).

(ii) The evidence in Ackum Agell's and Skedinger's articles seems to add to earlier material which casts doubts on the effectiveness of Swedish active labour market policy. This is ominous since one of the main differences between Sweden in the 1991–93 recession and Western Europe in the early 1980s was the strong Swedish emphasis on active labour market policy.

(iii) A possible – but not the only – reading of Jonsson's contribution is that a higher degree of central bank independence can contribute to lower inflation, without further costs in terms of higher and more variable unemployment.

As should be clear from my introduction, the results in the individual papers are often amenable to different interpretations. It is up to each individual reader to make an own overall judgement. The papers are therefore recommended for careful reading.

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