

Sweden's Equalization Milk Cow

Transfers drag down the Stockholm economy while delaying regional reforms

Executive Summary

- In Sweden, the Stockholm region is the country's economic engine, with much higher average incomes. More government services are delivered at the local level than in most other countries.
- The country's complex system of equalization therefore imposes undue burdens on the capital region, whose citizens pay for most transfers to the rest of the country.
- The transfer payments encourage less successful areas to compound their relative disadvantage in order to maximize payments. They tend to impose higher tax levels, employ more citizens in the public sector and resist reforms in service delivery that have proven successful in the Stockholm area.
- Although intended to equalize economic conditions, the system has failed to prevent the migration of the young, entrepreneurial class to Stockholm. Social democratic support for the system is declining, especially since that party assumed power in the capital region in 2002.

Background

Located in northern Europe with only nine million inhabitants, Sweden has been known for blonde people and the social democratic welfare state that takes care of everybody and guarantees all Swedes a high standard of living. That picture needs some adjustment; not all Swedes are blonde and the golden days are over for the social democratic welfare state. Per Albin Hansson, Swedish prime minister during the 1940s, once said that: "Capitalism is a cow that should be milked, not slaughtered." That cow has indeed been milked, probably a little too hard. The analogy could also be applied to regional policy; the cow in this case is Stockholm, Sweden's capital.

Sweden has not always been wealthy. The rise to prosperity started in the late 1800s. Thanks to the foresight of entrepreneurs – and politicians who got out of their way, removed obstacles and embraced a free trade policy – Sweden managed to lift itself from poverty and become a developed, highly industrialized and economically successful nation. From the beginning of the 20th century until 1970, Sweden had the fastest-growing economy in the world (perhaps with the exception of Japan). During the last years of that period, however, Swedish politicians started to shift focus. Instead of being best at growth, they tried with great persistence to become world leaders in raising taxes, something they did very well. The result is evident today: Sweden has the highest taxes in the world and economic growth has declined.

Sweden and Denmark have the world's largest local government sector. It accounts for some 70 percent of general government expenditure, mainly for welfare services such as schools and health and care institutions. The model of local government has two levels, consisting of 21 county councils and 290 municipalities. The northern part of the country is sparsely populated. Half the Swedish population lives in regions around the three biggest cities, Stockholm, Göteborg and Malmö.

Economically, Stockholm is really in a league of its own. In 2001, the Swedish GNP per capita was 255,000 kronor (SEK), or approximately C\$45,000. For Stockholm County, it stood at 349,000 SEK (\$61,773). None of the other 20 counties have a per capita figure that exceeds 255,000, and if Stockholm were not part of Sweden, the GNP per capita would drop to 230,509 (\$40,800). The

Stockholm region¹ is also the part of the country where politicians have put most effort into positive reforms, such as voucher systems and privatizations of formerly government-run enterprises.

Stockholm is often described as “the economic engine of Sweden.” To a growing extent, the other regions could be described as cargo. Since the 1960s, a number of political measures have attempted to support less well-off regions through the use of transfers from the more prosperous ones. One of the policy’s intentions has been to stop the flow of young and educated people from moving out from sparsely populated regions and leaving mostly the elderly behind. Those steps have been taken in vain, since people are still leaving the countryside at a fast pace and moving to the larger cities.

The equalization system

The most obvious of the regional support policies is a system of government grants and intra-municipal equalization (in Swedish, *Systemet för statsbidrag och inomkommunal utjämning*). The system’s grandiose intention is to make sure that all municipalities and county councils have an equivalent economic standard, regardless of their particular structural circumstances.

The system was introduced in 1996 and has four different components:

1. Income equalization

Municipalities and county councils with a per capita taxable income below the national average receive equalization grants, and those exceeding the national average have to pay. After equalization, the tax base of all municipalities and county councils will vary only within a tight range, between 98 and 101 percent of the national average.

2. Cost equalization

This equalization is based on uncontrollable structural factors. If the per capita cost of those factors exceeds the national average, the municipality or the county council receives equalization grants from the state. If the costs are lower than the average, the municipality or county council pays an equalization charge to the state.

3. General government grants

The municipalities and county councils receive government grants calculated relative to the number of inhabitants. There is also a grant – which is paid only to municipalities – calculated in relation to the age structure.

4. Transitional regulation/Introduction grants

These grants are intended to mitigate the effect of recent political reforms and they have a marginal part in the over all picture. They will be removed next year.

In one sense, the equalization system more or less finances itself; some municipalities and county councils pay the money, other municipalities and county councils get it. But general government grants, layered on top of that, actually account for the largest sums of money transferred. Since 2003, some changes in the system have dropped general government grant levels considerably. Last year the system distributed 43.1 billion SEK in general government grants, compared to 66.6 billion SEK the year before.

All municipalities and county councils receive general government grants, calculated in the fashion described above, and they are not taken into account in the description below. But considering that a third of total government tax revenues come from taxpayers in the Stockholm region – even though only a little more than a fifth of the population lives there – that area’s contribution to the general government grants is without a doubt disproportionately high. Some economists have brought that perspective into the calculation and made the region’s contribution to the rest of the country more transparent.

¹ The Stockholm County and its 26 municipalities.

The outcome

With some exceptions, the general picture is that the municipalities in Stockholm and the Stockholm county council are the contributors to the equalization system and the rest of the municipalities and county councils in the country, to a lesser or greater degree, are the receivers.

Table 1. The Stockholm region's net contributions to the equalization system 1996-2004, SEK

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Billions	5.7	4.6	5.3	5.8	7.7	10.0	13.2	16.9	16.4
Per Capita	3 268	2 609	2 972	3 216	4 223	5 439	7 133	9 133	8 813

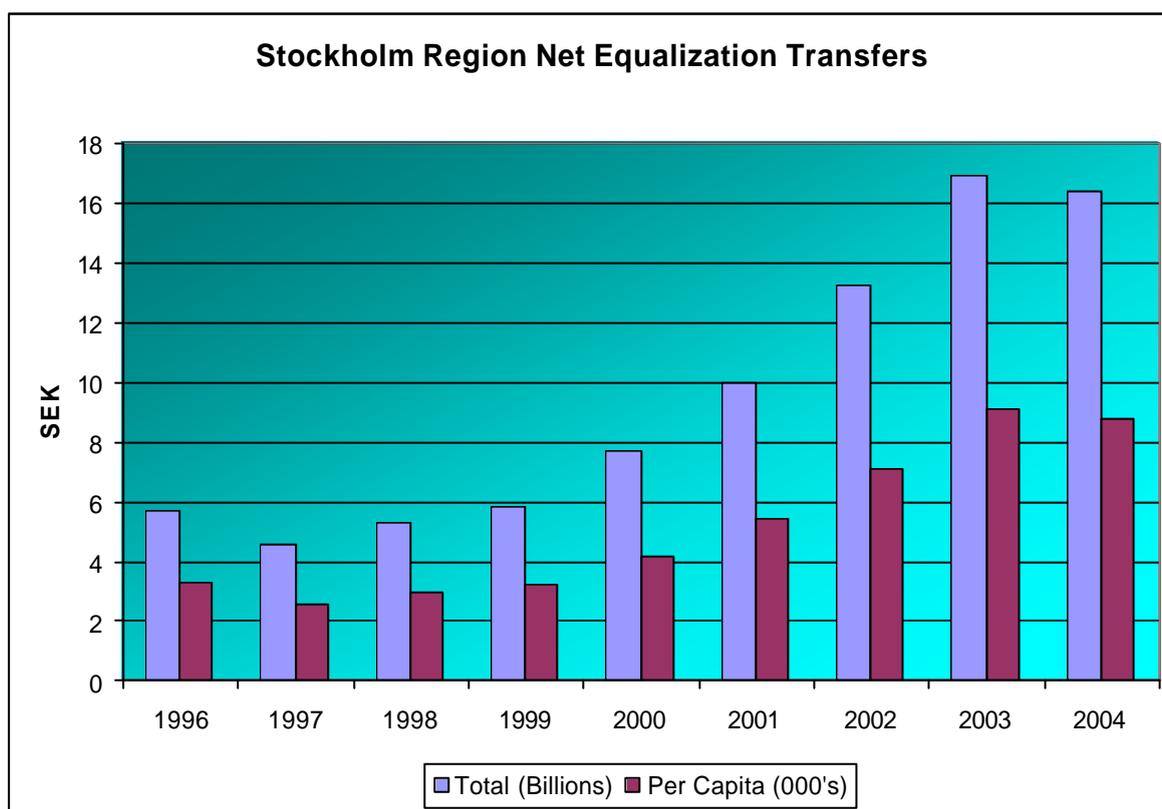


Table 1

Most of the municipalities that are net contributors to the equalization system are located in the Stockholm region, but there are a few net contributors among the municipalities in the Skåne region as well. But when counting the municipalities and county councils together as a region, there is only one net contributor in the country – the Stockholm region. The regions that receive the largest amounts of money per capita are the sparsely populated northern regions and the island of Gotland, which is located off the southeast coast of the mainland. But the biggest net receivers among the regions, in terms of sums of money, are Västra Götaland and Skåne, two areas surrounding the second and the third largest cities in Sweden.

For several years, the Stockholm county council and its area municipalities have had to make cutbacks in order to send money to other parts of the country. Last year, the Stockholm county council had to pay 5.4 billion SEK into the equalization system. That is nine percent of the county council's total revenues. Municipalities and county councils now spend money on local welfare

services that sometimes are not affordable in Stockholm. While the equalization system is complicated and is intended to compensate for several structural differences, it does not take into account that the general price level is higher in Stockholm than in the rest of the country. Costs for housing and salaries are much higher in Stockholm. The flip side of that coin is the naturally higher level of income, which dominates the calculations of transfers in the equalization system.

Taxes

The income equalization system has evolved in such an extreme way that a municipality barely benefits when taxpayers make more money or wage earners move in from other areas. Stockholm is the fastest-growing region and people who move there should be considered assets for economic development. Instead, they become a burden. If a municipality with a tax level below the average increases its base for taxation in those ways, the net outcome of the equalization system will be negative. In many cases, local politicians are forced to raise taxes to compensate for the loss. Moreover, tax cuts among the receiving municipalities and county councils are very rare.

The equalization system has been nicknamed after Robin Hood. Stockholm taxpayers are said to pay a "Robin Hood tax." This is an odd choice of metaphor, since the legendary English rebel was busy stealing from the taxman to give back to the taxpayer, not the other way around.

By looking only at GNP figures and general income levels, one might forget that a lot of people in Stockholm are not that rich. One way of looking at it is that the equalization system forces poor people in Stockholm to pay high taxes to support rich people in other regions. Even from a social democratic, redistribution perspective, this is problematic since these kinds of transfers put regional needs before individual needs.

Prevents reforms

Perhaps the most harmful effect of the equalization system is that it hampers efficient management of the municipal and county economies. That goes both for successful municipalities as well as ones ridden with problems. There is simply no incentive to improve the situation and pursue economic reforms at the municipal or county level. If you are doing well, you lose your surplus to less fortunate county councils and municipalities. And if your economic performance is bad, well, then you get money.

Some local politicians in the Stockholm region – mainly from the Conservative Party and their coalition partners – have since the early nineties been pioneers in reforming the welfare state at the local level. Privatizations and voucher systems has been implemented and these reforms has been proven quite successful. The Social Democrats are in general more skeptical about such policies. With an equalization system that guarantees them "an equivalent economic basis" no matter what, why should they really care?

Especially in the northern regions, Social Democratic Party dominance at the local level is very strong. If public sector reforms are needed anywhere, they are needed there. In those regions, between 40 and 50 percent of the workforce is employed in the public sector and the young and well-educated are moving out.

Unconstitutional

Some critics claim that the equalization system violates the principle of local self-government stated in the Instrument of Government (*Regeringsformen*), which is one of four separate documents forming the Swedish constitution. A prerequisite for the concept of local self-government is the concept of self-finance. The equalization system completely disregards that concept. According to the law, municipalities and county council have the right to impose taxes to finance *their own* public expenses, not other municipalities and county councils expenses.

The equalization system can be seen as a cunning way for the Social Democrats to impose their policies even on a local level, regardless of the principle of local governance and whoever is in charge in the different municipalities and county councils in the country. Many of the municipalities in the Stockholm region just happen to be run by conservative-led coalitions.

The Conservative Party (*Moderaterna*) in Stockholm in particular has criticized the system for a long time. Sometimes this criticism has been delivered in a very hands-on manner. Despite the equalization system, the former conservative-led coalition in the Stockholm county council actually cut taxes, and handed over a 4.1 billion SEK deficit in the budget to the Social Democratic-led coalition which replaced them after the 2002 election. Ironically, the conservative politicians responsible for those actions were accused of violating the law. The local government act stipulates that the budgets of local government must be balanced. But then again, being a lawbreaker is common in this system.

The system under review

A recent governmental inquiry has proposed several changes in the way the equalization system operates. Nothing is definite yet and the effects remain to be seen. Reviews of this kind are not new; the system has been up for review several times before. Every time, Stockholm seems to end up in a worse situation than before. There might be some grounds for hope, though. Even Social Democratic politicians, especially the ones who currently are in charge of the Stockholm municipality and the Stockholm county council, are growing increasingly critical of the system.

Perhaps the newly awakened social democratic criticism is due to a fact that becomes more and more obvious – Stockholm is declining partly because of the equalization system. Looking at table 1, one can see that Stockholm's net contribution has declined since last year. The reason - the region's tax base decreased. Social Democrats now in charge, both in the Stockholm municipality and in the Stockholm county council, are now forced to face this fact. But everything depends on the politicians at the national level and especially the Social Democratic government.

The system itself is so complicated that few people really know how it works. This complexity seems to explain the system's survival. Not enough people are knowledgeable enough to offer qualified criticism.

Further equalization

As mentioned before, the equalization system and the figures above do not represent the complete picture. How much Stockholm's net loss is with respect to the general government grants is not calculated, neither are the less obvious parts of the regional transfers. NUTEK, the Swedish Business Development Agency, has calculated that the taxpayers in Stockholm every year pay about 230 billion SEK in taxes to the government, but the sum coming back to the region is 115 billion SEK. That means an average 65 000 SEK (\$11,505) net loss per capita for Stockholm.

When one counts in this manner, there are three other regions who are net contributors as well, but only on the margin. The big milk cow is as always Stockholm.

An increasingly tired cow.



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