

SWEDEN'S ECONOMY: DISTORTED BY TAXES

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Introduction

Sweden's marginal tax rate, near 60 percent for moderate-income households, is higher than that of any other developed country in the world. (Swedish Institute) In order to fund the social welfare state, Sweden places an unusually heavy burden of taxation upon its residents. In exchange for their high tax contributions, Swedes receive perhaps the most extensive benefits package offered by industrialized nations. Health care, pensions, child care, elder care, education, social services, and various other types of economic and social security systems are all covered under this system. Traditionally, Swedes have shown great reluctance to change their lifestyles in favor of a more Americanized system, where fewer services are provided by the government but more disposable income is available to each household. However, there is reason to believe that Swedes may be reconsidering the trading of taxes for benefits. An underground sector is rapidly emerging where residents are both

avoiding and evading the potential burden of taxation.¹ The high level of taxes in Sweden may very well be causing the economy to grow in directions uncommon to most developed nations.

The disincentives created by taxation can promote behavioral responses in two major economic sectors: the personal or self-service sector and the underground economy. The personal service sector is comprised of unpaid work performed by the individual or household. These services include home and car maintenance, construction, landscaping, and other household work. Swedes often attempt to avoid the labor tax and value added tax by performing tasks themselves that would otherwise be performed by professionals. The illegal side, the underground economy, is comprised of all unrecorded activity that should be, but is not, included in the gross domestic product. Both the legal and illegal distortions are caused by

¹Tax *avoidance* refers to the legal methods of relieving one's tax burden, whereas tax *evasion* refers to illegal methods of the same intent.

the extreme tax burden. This article will show how Sweden's high taxes stifle the service sector and create one of the most interesting underground economies in the developed world.

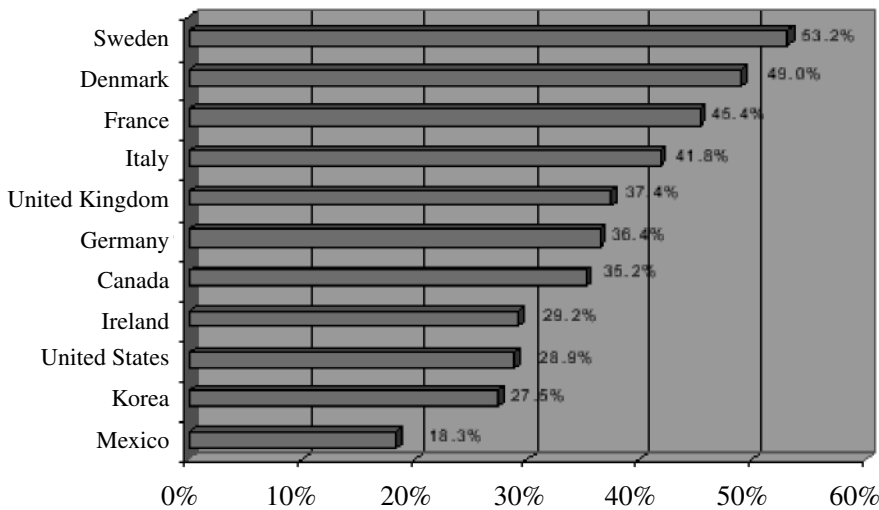
The Swedish Public Sector

The size and scope of public services offered in Sweden is impressive, given that the government does not own the country's means of production. Under the social insurance system, pensions are guaranteed to every person who has lived in Sweden for more than three years. (Swedish Institute) Low-income families, military personnel, and even stay-at-home parents are all entitled to pensions. Health insurance is also guaranteed, as well as compensation for sick leave from work. Child care is offered to all children from ages 1 to 12. This includes day care, preschool, and recreation outside of school hours. Swedish social services target the individual, family, elderly, those with disabilities, and the unemployed. Services include advice, support, encouragement, care and treatment, economic aid, economic counseling, family law, and family counseling. (Socialstyrelsen) The wide range of benefits, however, comes at a cost. According to OECD

statistics, Sweden is the only nation to contribute more than half of its gross domestic product towards taxes: 53.2 percent, 4 percentage points above Denmark, the next closest nation. (See Figure 1.) Though this has long been tradition, can Sweden continue to survive under this model?

Sweden raises government revenue from three main sources: income taxes, VAT (value added taxes), and social insurance contributions. Table 1 shows the forecasted distribution of total 2004 tax revenues by source. There are three levels of Swedish government: the Parliament (the national level), county councils, and municipalities. All three government levels have the right to levy taxes; however, income taxes, which account for 40 percent of government revenue, are collected only at the national and municipal levels. Municipal income taxes range from 29–34 percent of individual salaries, wages, and other remuneration, whereas the national taxes employ a progressive schedule with rates from 0–25 percent, *on top of* the municipal rate. This implies a 59 percent maximum income tax burden. Of the remaining 41 percent of income, residents must pay additional taxes on most of their purchases. This is typically comprised of the VAT, a 25 percent tax on regular goods *and services*.

Figure 1
Estimated Tax Revenue as Percentage of GDP (2001)



Source: "Taxes in Sweden: Some Facts and Figures."

Table 1
Distribution of 2004 Public Sector Revenues*

	Sector SEK	Portion of Total	Item SEK	Portion of Sector
Income Taxes	497.7	40%		
Households			411.5	83%
Business Sector			81.7	16%
Other			4.5	1%
Social Insurance Contributions	445.3	36%		
Employer's Contribution			343.2	77%
Other			102.1	33%
Taxes on Property	38.8	3%		
Taxes on Goods and Services	275.4	22%		
VAT			181	66%
Excise and Other			94.4	34%
Other Taxes	-6.6	-1%		
Total Tax Revenue	<u>1250</u>	<u>100%</u>		

Source: "Taxes in Sweden: Some Facts and Figures."

*Units in columns one and three are in billions of SEK (Swedish crowns).

The VAT also includes excise duties on such products as liquor, cigarettes, and gasoline. Assuming the average Swede uses his after-income-tax disposable income to purchase commercial goods and services, the total tax burden can rise to as high as nearly 70 percent. The second largest portion of government revenue is generated through company social insurance contributions, representing 36 percent of Sweden's public sector revenues. Here again the household bears the burden through decreased wages.

Aside from these three major supplies of funds, the Swedish public sector draws upon several additional relatively small tax sources to complete its budget. Corporate taxes in Sweden are among the lowest in Europe and the world at a fixed 28 percent of profits. The burden of paying taxes therefore lies heavily upon the household, with 83 percent of all income taxes originating from households and only 16 percent contributed from corporations. The rest of the national budget is comprised of personal property taxes, which include real estate and wealth taxes, yet another burden for the household.²

The Public Dichotomy

The tax burden is enormous in Sweden; but to the average Swede, this is the way it has always been. Swedes have long been accepting of their high tax structure. According to Georgetown School of Foreign Service professor Aanders Olofsgard, the prime minister holds the view that taxes are not a large public issue. Instead, the main public concern is the low quality of social services. In other words, Swedes claim to be less concerned with the price of their coverage and more concerned with the coverage itself. In fact, political candidates are wary that a platform that includes lowering taxes can actually cause them to lose votes. (Andrucyszyn) Publicly, Swedes tend to show support for their current tax structure, but privately, do their actions tell a different story?

In Sweden, there exists a dichotomy between the public voice and the public action.

²All tax information provided in the previous section is referenced from the Swedish Parliament (Sveriges Riksdag) and the Swedish Institute.

The public voice shows through votes that there exists a broad acceptance of high taxes, but public actions that include non-market transactions, as well as a growing involvement in the underground economy, suggest that Swedes' private lives may be inconsistent with their public lives. Despite the underlying socialist system, individually some citizens may be thinking of themselves, rather than the group. A former left wing party leader, for example, was known as a leading advocate for higher taxes, until it was discovered that she had made illegal deductions of 150,000 SEK [\$19,000³] from her income, approximately one whole third of her salary. (PWC, Ohrlings)

The risk of a system that places heavy tax pressures on all of its citizens is that people are then likely to join the underground economy. Such an underground economy has a much larger opportunity to expand, given that its potential members are not limited to those usually inclined to break the law. In its 2002 Tax Mobility Report, the Swedish Tax Committee notes "new and troubling trends, such as the shift in attitude that has made it socially acceptable to openly discuss one's own criminal conduct in working off the books." ("Committee on Tax Base Mobility, 2002 Report Summary," p. 34) It goes on to describe this trend as the crossing of a boundary, where it is feared that the recent public apathy towards tax law may cause a serious deterioration of domestic tax bases.

The willingness of people to bypass their fiscal responsibility can be disheartening. In 1980, Gunnar Myrdal, Swedish Nobel Laureate in Economics, stated that "Swedish honesty has been a source of pride for me and my generation. Today, however, I have an uneasy feeling that, due to bad tax laws, we are more and more becoming a nation of cheats." (Brodin, p. 3) Further intangible effects of the social pressures and their resulting distortions will be discussed later in the article. An unfortunate truth is that Swedes care about their country, but are faced with an extraordinary dilemma: help Sweden or help themselves. Perhaps this is the reason for the simultaneous public support for high taxes and private participation in under-

ground activity. However, despite the public voice, the real answer lies in what a nation does, not necessarily what it says; what the nation is doing is expanding an uncommon and often illegal economy that has public officials up in arms and eight percent of potential tax revenues completely lost. ("Committee on Tax Base Mobility, 2002 Report Summary," p. 33)

The Legal Public Action

It is certainly true that the level of taxes has affected the service sector of the Swedish economy. Sweden's high taxes on labor induce households to produce desired services themselves rather than to seek professionals in the service sector. (Henrekson, p. 17) This unpaid personal work can include any personal services, but it consists mostly of home improvement and maintenance. Stifling entrepreneurship, the personal service sector is uncommonly large in Sweden.

An example of this trend is the IKEA phenomenon. The Swedish company IKEA is the world's leading discount home furnishings store. According to the company web site, the IKEA concept is "finding simple solutions, scrimping and saving in every direction." (IKEA) Founded in Smaland, Sweden, IKEA captured the national market from self-serve warehouses by selling flat-packed furnishings that required home assembly. Concurrent with the Swedish attitude, IKEA advertises on its web site, "We don't charge you for things you can easily do on your own." Taking full advantage of the Swedish tendency towards avoiding any household labor costs, IKEA grew into a major international company. Yet even today, with a vast global presence, IKEA is still most popular in Sweden. In fact, of all countries with at least ten IKEA stores, Sweden has more than twice the number of stores per capita compared to any other nation. Sweden is host to approximately 1.4 IKEA stores per million residents, more than 23 times the ratio in the United States. IKEA still attributes its success to its mission statement: to offer a wide range of home furnishings with good design and function at prices so low that as many people as possible will be able to afford them, *and still have money left!* (IKEA) However, it is the long sought-after "money left" which may be draw-

³All currency conversions in this article are rounded for simplicity. They are performed at a rate of 1 U.S. dollar = 7.7 SEK, reflecting the market rate as of May 11, 2004.

Table 2
1997 Distribution of Labor Hours in Sweden

Taxed Labor	5.90 billion hours	43% of Total Labor Hours
Black Market Labor	0.67 billion hours	5% of Total Labor Hours
Unpaid Labor	7.00 billion hours	52% of Total Labor Hours

Source: Henrekson, Remarks to Martindale Center Student Associates.

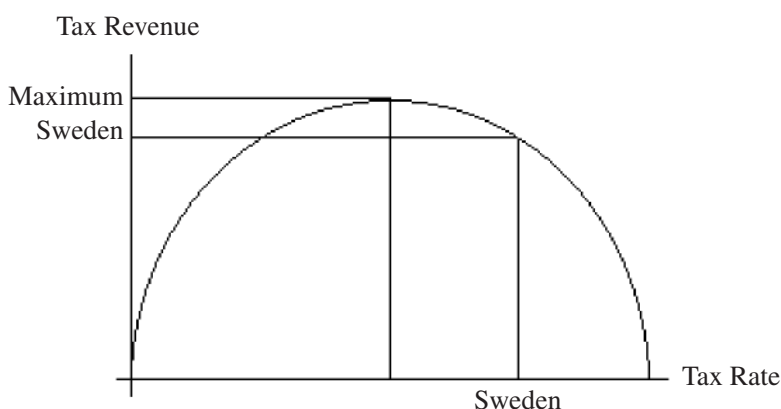
ing Sweden's economy into potentially dangerous situations.

Table 2, which contains estimates of taxed and untaxed labor, provides a more general view of the level of activity that escapes the eye of the tax collector. Apparently, more than half of the work done in Sweden is performed outside the official sector. This may explain why, compared to other OECD countries, Sweden's service sector is particularly small in the areas of household related services, laundry, durable goods repair, retail sales, hotel, and restaurant sales. (Henrekson, p. 16) Swedes spend more time working in the personal service sector than the residents of any other developed nation. For example, in the personal home improvement sector, Swedish men work an average of 4 hours per week, compared to 2.8 hours for U.S. men and less than 1 hour for Japanese men. (Henrekson, p. 16) It is apparently the case that the result of the high tax structure forces Swedes to rely on the one

source they know is free of taxation — themselves. As a result, the emergence of a large, efficient service sector competing successfully with unpaid work is less likely in a large welfare state than in countries with lower rates of labor taxation. (Henrekson, p. 18) In fact, the high Swedish tax level, represented in Figure 2 on a Laffer Curve, gives rise to the argument that the Swedish government could actually raise more revenue with a lower labor tax rate.

With a lower tax rate Sweden might benefit in two ways. First, despite the actual rate decrease, total tax revenue may increase due to the increased participation in taxable services. The government could then use the additional revenue to relieve a portion of the existing tax burden or improve the services of the social welfare state. Secondly, the increased demand for services could encourage entrepreneurship, as well as a more efficient service sector. These unrealized benefits to both the social and economic systems could be considerable.

Figure 2
Laffer Curve



Source: Investopedia.com.

The Illegal Public Action

Although Swedes go to great lengths to avoid taxes, there is a growing portion of the population that is now resorting to the evasion of taxes. According to the Swedish Committee on Taxation, the underground economy is the single most important issue facing the tax system in Sweden today. According to a 1998 study based on the “currency demand approach” (explained below), current levels of the Swedish underground economy are estimated to be as large as 18–23 percent of gross national product. In the same study, the United States was estimated to have underground activity representing only 9 percent of GNP. (Frey, p. 13) Perhaps more startling, however, is that the study showed that since 1960, the underground economy in Sweden has grown approximately 925 percent. (Frey, p. 16)

The currency demand or currency discrepancy approach is an indirect macroeconomic measure that can be used to estimate the size of an underground economy. It is based on the assumption that, in order to make detection less likely, underground transactions are paid for in cash. By measuring the difference between the amount of cash in circulation and the amount used in official transactions, one can infer that the difference can be accounted for by the underground economy. Another indicator of unofficial activity is the low Swedish labor force participation rate relative to those of other countries, an especially interesting phenomenon in Sweden, considering that it also faces a serious problem of employment absenteeism. With unemployment in 2004 already high, around 10 percent, an additional 15 percent of working individuals are absent from work each day, but collecting wage benefits. (Committee on Health and Welfare) A group may exist that is working in the unofficial sector *and* collecting benefits in the official sector at the same time. Opportunities to abuse the system are plentiful, and the Swedes seem to be taking full advantage.

There are three main methods of tax evasion in Sweden: value added tax fraud, the smuggling of high tax goods, and a reversion to the barter trade system. First, let us consider simple VAT fraud. Transactions in Sweden

often take place without receipts. This allows the seller to more easily not report the sale, while also allowing the consumer to bypass the 25 percent value added tax. Each transaction is minute relative to GDP, passing under the radar of tax officials, but the increased personal comfort level involved with such transactions has created a mass of non-receipt purchases covering a spectrum of consumers large enough to affect macroeconomic levels. A 1980 consumer research survey asked members of an organization of small firms, “Have you done a job in the underground economy without a receipt this year?” Affirmative answers were given by more than 25 percent of construction workers and 11 percent of health and social care workers. (Tanzi, p. 237) In a rapidly growing underground economy, one could expect these figures to be much higher today. The largest portion of underground activity takes place close to the home, in construction subsectors such as painting, carpentry, and plumbing. The average construction worker, for example, worked an estimated 350 hours in the underground economy per year in 1980. (Tanzi, p. 239) This implies that the average construction worker, who works five days per week, allows his clients to evade their VAT one of every five days.

Another source of tax evasion in Sweden is the smuggling of high tax goods. Goods with high excise taxes such as tobacco, gasoline, and alcohol are the typical objects of illegal import and trade. For example, a 700-milliliter bottle of gin costs about \$12 in France and about \$32 in Sweden. As a result of these high prices, pensioners living near Sweden’s southern border can make extra cash by driving back and forth from Denmark with their trunks full of untaxed beer. (Daley, p. 1) In the past, Sweden has repealed tax hikes, such as the 1998 cigarette tax, based on information of increased smuggling. (Ukraine Alcohol and Drug Information Centre) Yet the 2004 Swedish Tax Committee still believes that decreasing the high excise taxes will not result in an increase in public sector revenue.

Perhaps the most popular practice in the Swedish underground economy is the use of barter. To combat the enormous levels of taxes on goods and services, many Swedish residents

are reverting from a transaction-based economy to a barter trade system. For example, a genealogist may research the ancestry of her dentist after he fixes her teeth. A plumber can decorate his home with oil paintings from a customer of his who is an art dealer. (Brodin, p. 4) It is estimated that as much as one-third of all blue-collar work performed by painters, carpenters, mechanics, and the like is actually performed untaxed. (Tanzi, p. 239) Although portions of this work could be paid for in cash, and as such would constitute VAT fraud, more difficult to detect are payments made in trade. In fact, studies made by Schneider (1994) and Rogoff (1998) have shown that between 20 and 30 percent of underground transactions in all countries are paid for by means other than cash. (Frey, p. 4) One can expect this percentage to be larger in Sweden. Although the line between performing a favor and earning a wage may be thin, the OECD defines wages and salaries in Sweden as “the total remuneration, in cash or *in kind* [in trade] payable to all persons counted on the payroll (including home workers), in return for work done during the accounting period ‘regardless of whether it is paid on the basis of working time, output, or piecework and whether it is paid regularly or not.’ ” (“Measuring the Information Economy 2002...”) Though it may seem harmless to those involved, barter trade is a method of tax evasion. While each barter transaction represents a profit to the individual, the country of Sweden incurs the loss.

To search more deeply towards the root of Sweden’s problem, it is necessary to explore all possible causes of underground economy participation. Bruno Frey and Friedrich Schneider believe that there are three major reasons a person would join an underground economy in any nation: to escape the burden of taxation, to escape government regulation, and to obtain work. All three conditions exist in Sweden. Tax burdens of over 70 percent have led to evasion; government control and taxes on excise goods have led to smuggling; and unemployment, near 10 percent in 2004, is high. To the unemployed, the benefit of underground work is two-fold: it is available and it is tax-free. Furthermore, all immigrants, a group that is already statistically more likely to participate

in the underground market, must wait until all legal arrangements are completed (a period of up to two years) until they can engage in ordinary employment. (Tanzi, p. 234) Sweden’s system gives rise to almost every possible incentive to join the underground economy.

The major concern that arises from the growing underground sector is the loss of tax revenue. The 2002 Committee on Tax Base Mobility Report cites three specific areas of economic concern held by the Tax Committee: VAT fraud, hidden financial assets, and illegal imports. It is estimated that the loss from VAT fraud per year can be as large as 10 billion SEK (\$1.3 billion). (“Committee on Tax Base Mobility, 2002 Report Summary,” p. 33) The loss of income resulting from hidden financial assets based outside of Swedish jurisdiction totals around 8 billion SEK per year (\$1 billion). (“Committee on Tax Base Mobility, 2002 Report Summary,” p. 33) In addition, corporate tax havens account for up to 5 billion SEK in losses per year (\$0.625 billion). The Committee lists as its final concern the loss of taxes due to illegal imports of alcohol, tobacco, and fuel, totaling near 4 billion SEK per year (\$0.5 billion). All totaled, aggregate tax losses constitute 8 percent of tax revenues, or 4 percent of GDP.

The intangible factor, which should not go unnoticed, is the unhealthy relationship between citizens and the government created by the underground economy. (Frey, p. 8) Political unrest in a social welfare state can be dangerous, given the high percentage of Sweden’s labor force employed in the public sector. In 1997, 37 percent of Sweden’s labor force consisted of public sector employees, compared to 14.6 percent for the United States. (European Foundation...) In order to maintain a united Sweden, the mistrust created by the underground sector must be attended to. Residents must trust that their benefits will be of the highest possible quality, and the government must trust that the population will stay loyal in honoring Sweden’s tax laws. Instead, by participating in the underground economy, each citizen is, in essence, rebelling against the system. Many scholars viewed the recent “no” vote by Sweden in the euro referendum as a popular decision predicated upon social con-

cerns more than financial concerns. The people used the referendum as a tool to send a message of defiance to the government. Despite a strong “yes” push from Swedish financial scholars and public officials, the people voted against government pressure in order to demonstrate their autonomy. They are using the underground economy as that same tool, demonstrating the government’s lack of control over its population.

Despite concerns from the Swedish Tax Committee, the current disincentives to participate in the underground economy may still not be strong enough. Without doubt, the largest deterrent against tax evasion is the expected punishment. The average penalty for misreported income is a 40 percent additional penalty to taxes that should have been paid. The maximum punishment for serious tax evasion is normally two years in prison. (Swedish Institute) However, illegal immigrants, a growing group in Sweden, have little incentive to adhere to the rules of a country to which they do not officially belong. For Swedish citizens, the traditional moral code may act as a deterrent; however, in a country where misreporting taxes is becoming commonplace, the Swedish moral code appears to be weakening in the context of taxes. In short, neither the moral nor the legal deterrents are accomplishing their goals, and Sweden must act to find a different solution.

Possible Solutions

Sweden has taken a positive first step by identifying several of the problems created by its high tax system. As mentioned before, the Committee on Taxation has recognized underground activity, and Swedish academia has identified the major issues surrounding the personal service sector. Now, however, Sweden should take the next step to correct its tax distortions. To attack the root of the problem, the government might consider attempting to create a shift in public attitudes regarding tax avoidance and evasion. The Swedish moral code and the social welfare tradition should be enforced using suggestion, education, and law. An obvious plan of action is to make the tax-evading population less comfortable by increasing deterrence. An

increase in the size of the audit system, coupled with an increase in penalties, should generate an immediate contraction of the underground economy. In addition, the public might be better educated on both the negative effects of the tax distortions they create and the positive effects that could be created with a shift of transactions towards the official economy. Sweden should also strive to take advantage of the entrepreneurial spirit that is represented in the underground economy and channel it into the official sector. This would improve the domestic economy while at the same time relieve stress on the social welfare state.

A restructuring of Swedish tax bases may be necessary to correct the tax distortions. The government should evaluate the incentives created by the current system and find a way to promote social welfare without encouraging underground activity. A simple decrease in excise taxes could help encourage more domestic spending and limit the instances of tobacco and alcohol smuggling. Another method to relieve individual tax pressure is to better balance the tax burden between corporations and households. Although Sweden’s corporations would object to an increase in corporate taxes, an offsetting decrease in the wealth and capital gains tax would encourage entrepreneurs. This increase in entrepreneurship would help offset any losses from emigrating corporations, while at the same time help to promote Sweden’s economic future.

Finally, a different type of national tax may also deserve consideration. Although a major factor in the ousting of Margaret Thatcher in the U.K., a lump sum tax might succeed in a nation such as Sweden, which prides itself on economic equality. A lump sum tax is a fixed tax that has to be paid by everyone, regardless of income. Since it does not influence employment or spending decisions, it is viewed as an efficient tax. Though perceived as unfair in Britain, a lump sum tax cannot be avoided or evaded using tactics of VAT fraud or barter trade, and therefore may be beneficial to Sweden. These are only a small number of suggestions. To actually solve the problem of the underground economy, Sweden must explore the issue in much more depth than the scope of this article allows.

In conclusion, Sweden's high tax structure has created an interesting situation. An abnormally large personal service sector coupled with a growing underground economy has shed light on a potential flaw of the Swedish system. The personal service sector is preventing adequate entrepreneurial growth. Not a single one of the 50 largest firms in Sweden was founded after 1969. (Henrekson, p. 26) Per capita, Swedes perform more unpaid work than any other developed nation; and an inefficient tax structure may be leading to both lower economic development as well as potential tax loss-

es. Yet despite the evidence of these negative indicators, Sweden is still ranked among the top 25 countries in GDP per capita by purchasing power parity. Scholars are left to ponder the survival of the Swedish model, but public sector officials might want to shift their thoughts towards economic reform and the restructuring of a system that has long been Swedish tradition. Sweden may not always have the luxury of contemplating how its system has remained healthy in the midst of high tax distortions.

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