

SMALL AND MEDIUM-SIZED BUSINESSES IN SWEDEN

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Introduction

In 2002 Sweden was ranked as one of the most innovative countries by the Global Competitiveness Report as well as the most knowledge-based economy by the IDC.¹ Given this, one would think that Sweden would be at the forefront of entrepreneurial activity. However, the Global Entrepreneurship Monitor consistently ranks Sweden in the bottom quartile when comparing its level of entrepreneurial activity to those of thirty-six other countries which are developed or in advanced development stages. I suggest that the causes of this are twofold: cultural adverseness to entrepreneurship in the past half century and burdensome government policies imposed on small and medium enterprises (SMEs).

According to modern economic growth theory, increases in productivity and economic prosperity are a result of innovation and technological progress. ("High Tech SMEs...,"

p. 11) The dearth of small and medium-sized businesses, which are usually the engines of innovation, in Sweden has had a number of negative consequences. For one thing, there is greater volatility in the labor market since the labor force has to depend primarily on the country's large corporations for private-sector employment. Many of these large corporations have been acquired or merged with foreign competitors, and many of the jobs eliminated have been in Sweden. For instance, the merger between Astra and Zeneca displaced 11 percent of the firm's Sweden-based R&D workers. ("AstraZeneca to Revamp...," p. A22) As one can see, the country is losing major sources of employment; and due to the difficulties involved in developing SMEs within Sweden, there are few firms large enough to serve as alternate sources of employment.

This article will discuss some of the economic implications of the small number of SMEs in Sweden and several major impediments to their development. First, I explore the problems associated with low levels of entrepreneurship. Secondly, I demonstrate that the

¹The IDC is a global information technology research and advisory firm.

government is, in large part, responsible for reducing Swedish society's propensity for taking risks to start businesses. This is evidenced by the difficulties SMEs face in obtaining financing and by the stringent employment regulations laid out in the 1976 Act on Security of Employment.

Problems with Low Levels of Entrepreneurship

Sweden has many large, domestically owned companies that are major sources of employment and government tax revenue. In fact, nearly 60 percent of people working in the industrial sector are employed at firms with at least 200 employees. ("Swedish Industry," p. 4) Many of the country's large firms, such as Ericsson and Scandia, are smaller than their international competitors, however; in recent years these firms have realized that they must expand their operations to foreign markets in order to survive in the global marketplace. Consequently, many of these firms have merged with, or have been acquired by, foreign competitors.

Since the mid-1990s, inward foreign direct investment (FDI) to Sweden has increased seven-fold, positioning the country as the 11th largest recipient of FDI in the world. ("Invest in Sweden...," p. 6) The increase is due, in large part, to many cross-border mergers and acquisitions (M&A), such as the one that created AstraZeneca. During the past ten years Sweden has seen some of its largest multinationals fall into foreign hands. These firms, and Swedish firms in general, represent attractive targets to the acquirers because of their developed technology, impressive productivity, and proximity to the Baltic market. The M&A activity has cost Sweden jobs, however, because the newly joined companies, like AstraZeneca and Pfizer, often prefer to move their headquarters and production centers to countries where business costs are lower.

The cross-border M&A deals have resulted in the loss of many high-value-added jobs in Sweden. For instance, in the late 1990s Astra was performing poorly in terms of bringing new products to market and was suffering because of extremely high R&D costs. The only way to

ensure the survival of Astra was for it to merge with another firm. Eventually, Zeneca proposed a merger that was supported by several of Astra's large investors including Investor, which controlled 12 percent of the voting shares. The completed merger arguably saved Astra, but many white-collar jobs were lost or transferred to England where the merged firm's corporate headquarters was located. Sweden was hard hit, having to bear 45 percent of the proposed job cuts as part of the R&D restructuring effort. ("AstraZeneca to Revamp...," p. A22)

The job losses associated with the flow of FDI have prompted critics to raise issues similar to those recently faced by the Canadian government. For example, Gunderson and Verma (p. 182) found that Canadians felt that their country would lose control over the associated jobs, that the investors would not be concerned with the social issues involved in the countries in which they have invested, and that the movement of personnel from the investor's country to Canada would inhibit the development of key Canadian personnel and entrepreneurial talent. This attitude can also be seen in Sweden where the FDI policy has been criticized because of the closure of several facilities by their foreign parent companies such as Sanmina-SCI Corp. and the tire company Continental. (Starck)

This problem is becoming more serious because Sweden, traditionally recognized for its manufacturing sector, has seen these jobs come under attack as well. Swedish firms looking to lower their costs are moving manufacturing operations and non-core functions, such as information technology and call centers, offshore. As companies seek cost advantages, Sweden looks less favorable as a base for companies' operations. Mike Marshall, a Senior Lecturer in Economics at the University of East London, claims that "private capital has increasingly seen the traditional Swedish model arrangements as no longer being compatible with their best interests, and, with the lifting of financial controls, Swedish firms have been able to seek better profit margins (and lower labor costs) elsewhere." (Marshall, 1996)

Although the country boasts corporate taxes rates of 28 percent compared to 40 percent in the U.S., there are sizable business costs, due to stringent environmental and employ-

ment laws, and high income taxes that are not found in other countries. Thus, as firms continue to export parts of their operations, Sweden is especially at risk of losing many jobs. This is evidenced by the fact that as of 1997 only one in three jobs within Sweden's 80 largest firms were located in the country. (Blomström and Kokko, 2000, p. 77)

As large firms continue to become foreign owned or leave Sweden, there will be a lack of firms to fill the gap left by the large corporations if SME development is not encouraged. It should be noted that 84 percent of Sweden's fifty largest private corporations were founded before 1945 and that none were founded after 1969. (Henrekson, p. 35) Thus, the impediments faced by SMEs need to be reduced so that they can grow in size and fill the employment void. If this does not happen, it will probably become more difficult to maintain the welfare state as Swedes know it today.

Many organizations, however, see the high levels of FDI and the exportation of operations as a good thing for Sweden. For example, the Invest in Sweden Agency is calling for Sweden "to maintain its course towards corporate restructurings [and it] should not be derailed by the recent spate of foreign-owned business closures and consequent job losses." (Starck) The proponents of free FDI flows argue that this strategy has been successful because it has enabled many of Sweden's corporations to become major players in the international market. Without this access to FDI, they doubt whether some of these companies would have survived in the face of international competition. Even if one agrees with this argument, the Swedish workers displaced as a result of FDI or job exportation will need alternative sources of employment since the country's large public sector cannot indefinitely sustain increasing numbers of employees on its payroll. Again, Sweden needs to encourage private sector business development but, as discussed below, there are many hurdles faced by aspiring entrepreneurs.

Burdens on Entrepreneurs

Sweden has a highly educated and highly skilled workforce. Eighty-one percent of Swedes

have completed their secondary education, a percentage which is higher than 16 of Sweden's European counterparts. The country's investment in higher education, software, and R&D as a percentage of GDP has earned Sweden the distinction of being the most knowledge-based economy in the world. ("Invest in Sweden...", p. 15) Additionally, its workforce generates the third largest number of patents per capita. ("Invest in Sweden...", p. 23)

Given the statistics above, one would think that Sweden would be a highly entrepreneurial country. The Global Entrepreneurship Monitor, however, ranks Sweden as having the seventh lowest level of entrepreneurial activity out of the thirty-seven countries studied. This discrepancy in Sweden's performance can be explained by looking at the country's industrial landscape and the country's laws regarding SMEs.

Sweden is known for its world-renowned brands such as Ericsson, Electrolux, and IKEA. It is a "big-business" country where multinationals employ 70 percent of industrial sector employees. ("Swedish Industry," p. 4) In the past, the government neglected SMEs; instead, it viewed the large corporations as the main source of economic growth. In his study of Swedish corporations, Marshall found that "the development of the welfare state helped many large Swedish companies like IKEA, and the tax system undoubtedly favored the large corporations that made large investments and encouraged the already very strong trend towards concentration." (Marshall, 1996) Recently, however, the government has recognized entrepreneurial activity as an engine of growth and competition. The government's industry policies are shifting slowly away from focusing solely on large firms and, instead, aimed at supporting SMEs. (Blomström and Kokko, 1995, p. 22) The government has created organizations such as NUTEK which assist in financing start-ups and has several development programs to encourage collaboration among businesses. Although these changes are taking place, the government needs to take a more proactive approach to ensure that the reforms happen quickly so that displaced workers have more options than just being employed by an already strained public sector. The first major change has to be in the

attitudes towards entrepreneurs because Swedish culture, in general, does not recognize the benefits that entrepreneurs bestow on society.

Cultural Adverseness to Risk

Entrepreneurs are people who organize, manage, and assume the risks of a business or enterprise with the hope of generating a return on their investment. They create wealth, which is distributed among many people such as the firm's employees and suppliers while only a small fraction of it is retained by the entrepreneur. (Legge and Hindle, p. 25) Although entrepreneurs may only receive a small portion of the wealth that they create, it may still be a large amount relative to the wealth of the majority of people in society. In the United States, there are many examples of successful entrepreneurs, such as Bill Gates, Sam Walton, and Warren Buffet, who have benefited society by creating jobs and wealth. Successful entrepreneurs are generally regarded with disdain by many Swedes, however, since they have traditionally regarded each other as equals.

Many Swedes do not look favorably on individuals who seek status through wealth accumulation. In fact, the adverse entrepreneurial environment in Europe, which is apparent in Sweden, stems partly from a cultural misunderstanding of the benefits that entrepreneurs can bring to a country.

Financing Challenges

In a culture with deep-rooted feelings of equality, such as Sweden's, it is difficult for an entrepreneur to justify his desire to start a business. It is likely that in this environment, the entrepreneur will face many obstacles even before seeking funding for his idea. First, he may have to convince his family and potential employees that it is a good idea to leave a well-paying, secure job in hopes of developing a successful business. Then, even if the entrepreneur were to gain the support of others, he still faces the fundamental problem of raising money.

The most common funding source in early-stage companies is the entrepreneur's friends and family. A major impediment that

entrepreneurs face, however, is that the personal savings rate is very low in Sweden. In a country where health care is "cradle to the grave," where education is paid for by the government, and where citizens receive numerous social subsidies, the incentive to save money is very low. In fact, from 1990–1997 Swedes saved only 5.4 percent of their disposable income while OECD Europe saved 10.9 percent. (Henrekson, p. 12) Consequently, entrepreneurs in Sweden are hard-pressed to raise funds from friends and family. Without the support of these people, an entrepreneur must often abandon his idea or seek funding from outside investors.

Swedish entrepreneurs are also at a disadvantage when raising capital from potential lenders, such as banks, because they are hesitant to lend to small businesses since they are perceived to be high-risk borrowers. According to the European Commission, the main reason that banks will not lend to SMEs is that the enterprises cannot provide enough collateral. ("SMEs in Focus," p. 7) This is especially true when dealing with service businesses. These businesses usually do not have as much collateral as firms in other industries. For example, a manufacturing firm might be able to present capital equipment as collateral, but a service firm is typically knowledge-intensive instead of capital-intensive. Hence, bankers are less likely to be satisfied with the offered collateral.

The point might be raised that since Sweden has a strong venture capital industry, the entrepreneur should seek funding from venture capitalists (VC). VCs are important in helping firms transition from the seed stage to a more developed stage. This stage is the preliminary phase in a company's development where the business plan is created and the management team assembled. ("Seed Stage Financing," p. 1) In this critical stage, the company needs money to develop its product ideas and to attract employees.

Swedish venture capital funding, however, comprises only a small amount of money that goes into SMEs. In fact, early and seed stage funding accounted for only 0.002 percent of Sweden's 1997 GDP compared to 0.045 percent in the United States, and it primarily focused on high-tech or high-growth indus-

tries. (Cowie, p. 17) Additionally, with the recent burst in the technology bubble, many venture capitalists are avoiding seed stage financing because of the high risks involved. In fact, the Swedish Venture Capital Association (SVCA) has found that Swedish seed funding has decreased since 2001. This has led to the call for fiscal incentives to promote the financing of these new businesses. (Berggren, p. 3)

Tax Laws

Swedish tax law also places small firms at a disadvantage compared to large firms. During most of the past 40 years, SMEs in Sweden have had to pay a much higher tax rate than the large corporations. SMEs cannot always use the same tax strategies as larger firms since, in many cases, they do not have subsidiaries to shift their profits and losses in tax-minimizing ways. ("Sweden: Foreign Investment")

Additionally, Sweden's extremely high tax rates make it difficult for businesses to attract equity investors. Small firms rely heavily on equity financing as a means of raising capital since it is more feasible for an SME to give equity stakes in the business to investors than it is to raise capital through debt financing. According to Henrekson (p. 10), however, an investment in 2001 by a household in a firm that yielded a 10 percent pre-tax rate of return was taxed at a marginal rate of 24.7 percent if the investment was debt and 51.0 percent if it was equity. This shows that Swedish tax law is partial to debt financing as opposed to equity financing. Large companies consequently have an advantage compared to small firms because they rely more heavily on debt financing.

Another tax hurdle faced by entrepreneurs is the method by which stock options are taxed. In Sweden, employee stock options are taxed as wage income instead of as capital income. This taxation method is similar to the one used in the U.S., but income taxes are much lower in the U.S. than in Sweden. In Sweden, options are taxed at a rate of about 68 percent, whereas normal capital gains are taxed at 30 percent. (Davidsson and Henrekson, p. 93)

Options are attractive forms of compensation, especially in rising equity markets, as they benefit both the employer and the employ-

ee. The employer can provide the employee with stock options in lieu of cash. Consequently, a cash-strapped company can use its cash for other purposes. The employee also benefits if the company does well and goes public. His stock options will rapidly appreciate and have the potential to be worth much more than a cash salary. Here again, the small firm is at a disadvantage because large firms typically do not rely as heavily on stock options. Because of these tax laws, an entrepreneur is forced to either forfeit larger equity stakes in his business or provide less compensation to his employees.

Employment Laws

In addition to the tax disadvantages, entrepreneurs in Sweden are confronted with stringent labor laws meant to protect the largely unionized workforce. In fact, as of 2001 approximately 85 percent of blue-collar workers and 79 percent of white-collar workers were unionized. These are extremely high percentages compared to those in countries with high levels of entrepreneurship, such as the U.S., where only 14 percent of non-farm wage earners are unionized.

The Swedish unions' extensive membership base has empowered them to be a dominant force in the shaping of the country's labor laws. In 1976 the Swedish government, with the help of organized labor, drafted the Act on Security of Employment (LAS) to increase employee rights and job security. This law severely constrains Swedish employers in their hiring and firing decisions; and although the LAS affects all employers, it is particularly burdensome to SMEs as I explain below.

The law allows for termination because of shortage of work, but it stipulates certain rules which must be followed. For example, the LAS requires that "in the event of notice of termination due to shortage of work the employer is obliged to follow a special order of priority. This entails priority for continued employment for those who have been employed longest (the 'first in, last out' rule)." ("Facts and Figures...") If the market later rebounds and employers need more workers, the LAS requires that "employees who are dismissed with notice due

to shortage of work have priority for re-employment for up to nine months after the termination of employment.” (“Facts and Figures...”) This can be particularly damaging in the fast-paced, high-technology industries where employees add value when their knowledge is current and applicable; the LAS, however, makes it difficult to terminate employees when their knowledge is obsolete. Instead of hiring new talent, the SMEs must spend their resources retraining existing employees. This requirement is less burdensome for large corporations that have developed training programs, but it is much more costly for SMEs.

Although these laws seem good for the workforce in general, they are somewhat short-sighted. SMEs must be able to rapidly adjust their workforces in response to changing market conditions. The law protects employees in the short-term, but it hampers the ability of small businesses to compete and grow.

Conclusions and Recommendations

In the early twentieth century, Sweden’s policies encouraged innovation and small business growth. This allowed such companies as IKEA, Ericsson, and Electrolux to develop and eventually become the multinational powerhouses that they are today. In the mid-twentieth century, however, the business climate in

Sweden dramatically changed. The government shifted its attention from nurturing small and medium-sized businesses to focusing almost completely on the country’s large firms. Today SMEs do not have the available resources to make the transition to large-sized firms. SMEs could benefit from a reevaluation of the country’s tax and employment laws. The taxes on equity financing could be lowered to encourage investors to provide funding to entrepreneurs, and the employment laws could also be restructured to allow SMEs to be dynamic and competitive.

While foreign investors’ interest in Swedish firms is good in the sense that it allows Sweden to remain competitive in the global marketplace, it results in lost jobs within the country. We have already seen this behavior occur in the merger between Astra and Zeneca, and Ford and Volvo, and the closings of several large foreign firms in Sweden.

The inflow of foreign capital into Sweden is going to continue and there will be more lost jobs. For this reason, the government should institute policies that make the business climate more favorable for small and medium-sized businesses. The first major change should be in the attitudes towards entrepreneurs. Once this change occurs, the changes needed in the tax and employment laws would be likely to follow.

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