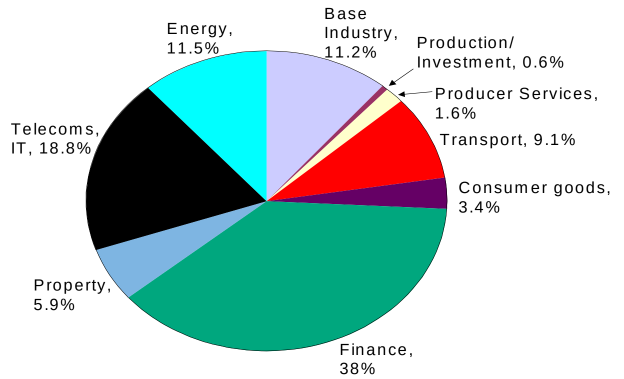
Sweden: Blazing the Reform Trail

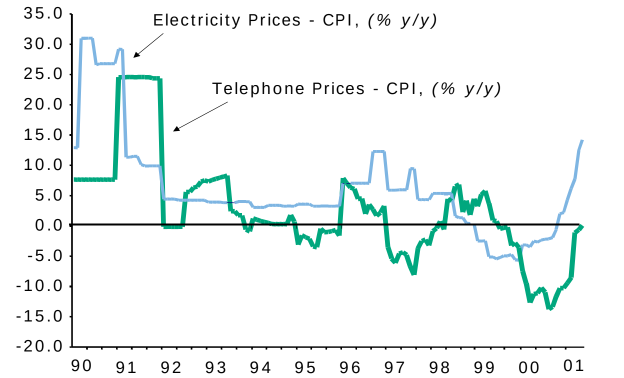
- **Current reforms taking place in the Swedish public sector can be considered "revolutionary" in the context of economic reforms taking place across Europe.**
- **After having tackled its fiscal imbalances, the Government is now in the process of restructuring the public corporate sector. This is crucial, given that it is the largest industrial owner in Sweden.**
- **These public sector reforms have key implications for the economy, including intensifying competitive pressures, boosting productivity, bringing down prices and freeing up public resources.**

Chart 1: Government Corporate Portfolio*



*Source: Ministry of Industry, Employment and Communication, * By sector and shareholder equity, as of December '00*

Chart 2: Utilities' Prices - CPI



Source: Sweden Statistics

Reforming the public sector

The "buzz word" in Europe is structural reform, with Governments across the European Union having committed to stepping up the pace of economic reforms in their respective countries. Here, Sweden stands out as a leader, tackling the growing imbalances in its pension system, reforming the labour market, liberalising the domestic markets and, finally, improving the efficiency of the public sector.

With the Swedish Government having already implemented extensive public sector reforms in the early '90s, tackling its Budget imbalances by turning around its deficit of 12.3% of GDP ('93) to a surplus worth around 4% at present, it has taken reforms one step further. After its project launch in '99, the Government is taking an active role in reforming its management of public sector corporations.

This has clear implications for the economy, given the Government is the largest industrial owner in Sweden, with public corporations (listed and unlisted) valued at around SEK500bn, with the value-added to total GDP estimated at 7.5%, and state firms valued at about 25% to domestic corporate valuation. Given its extensive ownership, the Government is also the largest employer in Sweden, responsible for about 230,000 jobs.

The benefits from the metamorphosis of the Swedish public sector are becoming evident. The reform of the public corporate sector will boost the growth potential of the Swedish economy through improving the returns of public corporations, intensifying market competition, increasing productivity and, ultimately, supporting dis-inflation. Indeed, as already seen from the deregulation of public utilities (telecommunications and electricity, for example) this contributed to a significant fall in prices in these sectors over the late '90s and early '00.

The latest phase of reforms in the Swedish public sector are particularly important given that they can be considered "revolutionary" in the context of economic reforms taking place across the rest of Europe. Notably, the Swedish Government has directly intervened to change the management style of public corporations, adopting a "private sector" discipline. The changes introduced in the operation of state-owned companies have meant the Government is breaking away from "old-style" policies - including regulation to curb competition, ineffective usage of capital and labour, inventory mismanagement and lack of transparency - and, instead, running the entities in the manner of a private corporation.

The reforms are being driven forward by the Swedish Ministry of Industry, Employment and Communications, which was created in January '99, from the amalgamation of the Ministries of Labour, Communication, Industry and Trade as well as from the Ministry of the Interior. This new Ministry now overseas the majority of the management of 59 public companies, with the rest of the responsibility mainly falling under the Ministry of Finance and Ministry of Health and Social Affairs. This is more efficient that the prior management structure, whereby the management of state-owned companies was widely dispersed over all of the Swedish Government Ministries. Moreover, as part of the restructuring, the Government has wisely separated company management from the regulatory side, whereas the prior structure had the two units covered by the same workers.

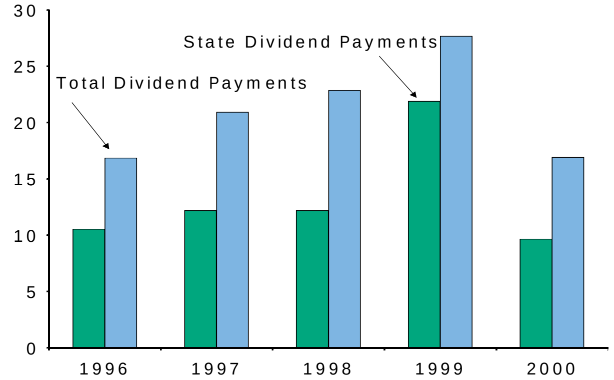
The reforms in the public corporate sector are taking place in two crucial phases, with phase 1 represented by the "financial transformation", with the prime objective in the reforms to create value for the company shareholders. This includes: enhancing the performance potential of state-owned companies, and optimising the capital structure of the firms. Phase 2 - "e-transformation" - represents the specific focus on the implementation of technology strategies.

Creating value

There has been a clear goal of improving the valuation of Swedish public entities, with the Government (and, ultimately, the tax-payer) controlling shareholders. This has seen a remarkable shift in the focus of public business in Sweden, with extensive corporate restructuring completed over the past few years and, certainly, there is more to come. Indeed, as part of this process, the privatisation of public-owned companies is already well underway, since the early '90s.

Although the Government has sold off a notable percentage of its stake in publicly-held companies - the latest being the IPO of 30% of its holdings in Telia in '00 - a substantial amount of its "privatisation" has actually taken the form of transferring public entities into limited companies. The Government's current plans are to retain full control (100% stake) in "natural monopoly" companies, such as the main utilities, transport and health (pharmaceuticals). Nevertheless, at the same time, it has deregulated many of these key sectors of the economy to enhance competition, including changing anti-competition regulation. The positive effects of this have already been seen in the

Chart 3: Annual Dividend Payments*



*Source: Ministry of Industry, Employment and Communication, * of public sector companies, SEK bn*

sectors of telecommunications, electricity supply, the postal service, air transport and the railways.

There has been an increased focus on improving the profitability of "core" business operations of state-owned companies - through restructuring and mergers with private sector companies. Meanwhile, "non-core" businesses have either been sold by the Government or alliances have been sought with domestic/foreign private sector corporations. The most extensive restructuring efforts have been in four public sector companies - AssiDomän (forestry products), Celsius (defence), SJ (state railways) and Telia (telecommunications).

- Extensive restructuring of AssiDomän has seen the de-merger of the forestry assets group and the sale of non-core business lines (Corrugated and Containerboard this year) as well as various joint ventures with the private sector.
- Celsius - one of Europe's largest defence groups - has undergone an extensive corporate re-shuffle, including the sale of 25% of the Government's stake to Saab ('99), the sale of several business arms (Kockums, a 50% stake in ASC and the sale of Bofors Weapon System). Numerous joint ventures have also been initiated across Europe.
- At SJ, outside of the core passenger services, other business lines have been streamlined or sold off, making it one of the most profitable railway operators in Europe.
- 30% of the Government's stake in Telia was sold in an IPO last year, and the Parliament has just approved the sale of the rest of the Government's holdings. Telia has also streamlined its business, by selling off 51% of Telia Enterprises to Industri Kapital this year and a stake in Tess SA.

With regards to enhancing value, the Ministry has been working on plans to ensure that a regular assessment of the performance of state-owned companies is available to the public, with the publication of regular financial reports, to improve the transparency and accountability of state firms. Indeed, the Ministry has already introduced the publication of quarterly corporate financial reports, which are posted on its website, as well as comprehensive annual company reports.

Enhancing performance potential

The Government has been phasing in plans to ensure that public companies are run as profitable entities, adopting the following measures:

- Setting performance objectives for state-owned companies;
- Streamlining the public company boards, with the hiring of "outside" expertise from the private sector. Notably, 75% of the board members are new hirees as are 65% of the CEOs;
- The appointment of a Board of Directors (primarily from the private sector) to oversee the management of the public corporate portfolio; and
- Incentives to improve labour productivity, including the introduction of bonus and/or performance-related pay packages. This scheme has been introduced for all levels of employment, with the bonus payment structure determined by value creation.

Optimising the capital structure

Crucial to improving the efficiency of public corporations in Sweden is improving the return on capital, which has, in the past, been relatively poor. Thus, in restructuring the state-owned companies into limited corporations, investment managers within the Ministry of Industry, Employment and Communication have set financial targets for most of the public sector companies, including operating margins and capital and asset ratios. State-owned companies are also expected to pay regular dividends, taking surplus capital and transferring the money back to the shareholders.

Specific state companies will also be expected to privatise their debt, which would entail borrowing on the capital markets to pay down existing SEK76bn worth of public sector debt. Public companies would, therefore, borrow on the basis of the health of their own balance sheets, rather than relying on funds raised by the Government. This puts added pressure on public companies to improve their earnings potential as required to meet repayment obligations.

Technology strategy

This is a cornerstone of the Swedish Government's reform strategy, with plans to capitalise on Sweden's leading role in information technology, as detailed in our recent note "*Sweden: A US-Style Economy in Disguise ?", April '01*. As presented in its IT Bill in March last year, the Government has pledged to raise funding for IT infrastructure, implement tax relief to encourage the purchase of IT equipment, improve IT-related legislation and promote IT educational services - all part of its "e-business" plan. In particular, the Government is heavily promoting the usage of the internet for business, as well as the introduction of technological equipment to cut down the "paper trail", and therefore cut costs by 5-50% in various industrial sectors. If current plans are realised, this could equate to almost SEK30bn in cut costs (for companies that are managed by the Ministry of Industry).

The Ministry of Industry follows state firms' IT progress with its "e-index", which measures the extent to which main public firms have realised cost-savings from the implementation of internet systems. Indeed, as of Q1 this year, the "e-index" rose to 41% (versus 39% in Q4 '00), which indicated that these companies have implemented systems able to save them around 40% of the estimated potential cost savings. The greatest savings have, so far, been in the transport and services sectors, whilst the forestry industry is lagging - its "e-index" stood at only 28% in Q1.

Still more work to be done

Although it will take time for the Swedish Government to witness the full returns from its reformation of the public sector, the gains from prior structural reforms are already becoming evident. Indeed, the early 1990s in Sweden were characterised by a rising fiscal burden, inflexible product markets, low productivity gains and significant price hikes. And, subsequent to years of economic reforms:

- Competition in Sweden's industrial sector has risen, with about 85% of state-owned enterprises now facing competition in their own market (according to the OECD);
- The Swedish Government has one of the best fiscal positions in Europe;
- Productivity has picked up, to around 2.5% y/y, compared to around 1.5% in the early '90s;

- Swedish prices have started to converge on EU levels;
- Capital gains from the restructuring of public sector companies has opened the door for tax cuts (particularly income taxes), helping to alleviate Sweden's high tax burden; and
- The returns from the privatisation of public companies have allowed the Government to start buying back its debt, contributing to a reduction in the risk premium.

There is, however, still a substantive amount of work for the Swedish Government to press ahead with and it is essential that it remains committed to the latest public sector reforms. Both the OECD and Swedish Competitive Authority have identified that barriers to industrial competition need to be reduced further in Sweden, and, certainly, the reform of state-owned entities will assist in improving competition in various industrial sectors - particularly in transportation, finance and utilities.

In Sweden, there is still the existence of significant cartels, monopolistic practices and markets that are overly regulated and/or funded by the Government. Although Swedish price inflation has been running at a lower rate than the average of the European Union, Sweden's price levels are still over 20% above the EU average. This is particularly the case in the areas of beverages, health care, services (hotels and restaurants), transportation and housing. Further deregulation is also required in the energy sector (electricity). And, many of these sectors are where the Government still has high corporate exposure.

Given the Government's extensive portfolio, there is also scope for it to press ahead further with the privatisation of state-owned companies - as witnessed by the Parliament's latest decision to allow the Government to sell off its remaining 70% stake in Telia. This would pave the way for the Government to free up financial resources and further reduce its debt burden (at present around 60% of GDP) as well as boost investment or cut taxes.