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Sweden: Ripe for 'New Economy' Gains

Assessing Government-Owned Company Reforms

Economics

Highlights of This Issue

- While Swedish economic performance may still fall short of the kind of 'new economy' gains seen in the US, Sweden has structural reforms underway which should move it further along that path.
- An aspect of the reform process considered in this report is the reform of government-owned companies. These reforms, which began last year, fall into five broad areas: (1) A 'value creation' business orientation; (2) more focused company governance; (3) leaner capital structure; (4) provision of worker incentives; and (5) more coherent internet strategy.
- Each of the five areas has the potential to contribute significantly to productivity gains in government-owned companies. Given the 25% share of government-owned companies' output in the economy these reforms should have a material impact on overall Swedish economic growth prospects.
- Among European countries Sweden may be uniquely positioned to benefit from the growing importance of e-commerce.
- However, much will depend on ongoing progress in implementing the reforms and the skill with which government-owned companies modify their business models to capture more of the gains from e-commerce. Continued macroeconomic reforms will also be important.

Overview

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■ Sweden: Ripe for 'New Economy' Gains

In a recent report entitled "Is There a New Economy and Is It Coming to Europe?"¹ the Riksbank concluded that recent US economic performance displays many aspects of a new economy which owes much to investment in information technology. For Europe however the Riksbank felt that microeconomic rigidities would pose serious hurdles to the emergence of similar new economy-type productivity gains.

There is considerable variation, however, in the readiness of EU countries to foster US-style productivity gains. In a recent Merrill Lynch Economics report we found Sweden ranked first in factors (capital supply, people, technology, government, social structure, and risks) which influence economic growth.² In a second Merrill Lynch Research report³ we found that Sweden compares favorably among EU countries (and in many categories even relative to the US) in technological development of the kind necessary to take advantage of such new economy gains.

One key to realizing such gains is integrating the various dimensions of the process so that the full impact of new information and communication technologies can be unleashed. This involves flexibility in labor, product and financial markets and a business environment in which risk taking and entrepreneurship flourish. These are the areas where European countries generally lag behind the US. But a central insight of the Riksbank study, among others, is that achieving new economy gains involves no less than redesigning the entire business process. Such reforms require maximum flexibility in the factor and product markets and a highly developed entrepreneurial spirit.

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¹ Eriksson and Ädahl (2000)

² Hartnett, Higgins and Kalmurand (30 August 2000)

³ Shipton and Cukierman (25 August 2000)

One area in which Sweden has taken steps to make concrete improvements is in the reform of government-owned companies

The principal reform is the establishment of objectives aimed at creating value in government-owned companies

The government is setting explicit performance objectives for most government-owned companies

A key element of the program is a new emphasis on transparency and accountability

Boards are being streamlined

Reforms will instill a better sense of the true cost of capital

In Sweden one aspect of this reform process has been taking place within government-owned companies, the output of which accounts for roughly one quarter of the Swedish economy. The holdings span 63 companies from telecommunications, postal services, banking, utilities, to the Royal Opera company (see appended Table 1 for a list of the top companies by revenue). The reforms, which began last year, fall into five broad areas:

1. A 'value creation' business orientation.
2. More focused company governance.
3. Leaner capital structure.
4. Provision of worker incentives.
5. More coherent internet strategy.

■ 'Value Creation' Business Orientation

The principal reform is the establishment of clear company objectives aimed at creating and maintaining value in the government-owned companies. The government, as the controlling shareholder, essentially will treat government-owned companies more like businesses.

The government is setting explicit performance objectives for most government-owned companies. Where possible performance will be benchmarked against that in the private sector. In order to meet performance targets government-owned companies will find it increasingly necessary to focus on their core businesses. This may involve company restructuring, with some units sold, others purchased, and alliances formed. This process is already getting underway, with the Swedish State Railways divested some of its non-core businesses earlier this year while an international unit was created to allow for overseas expansion. The government's residual holdings in Pharmacia & Upjohn were sold in January 1999. In February 2000 the government completed the divestment of its holdings in Celsius AB, the defense industries company. In some areas government-owned companies are expanding. Vattenfall, the utilities firm, has recently purchased utilities companies in Germany, Poland, Norway, Finland, and the Czech Republic.

A key element of the value creation business orientation is a new emphasis on transparency and accountability. Regular reports on the performance of major government-owned companies are published on a quarterly basis. There is also a regular assessment of companies' strategic orientation.

■ More Focused Company Governance

The value-based management orientation extends to the structure of the governing boards of the government-owned companies. Boards are being streamlined and board members with demonstrated business, financial or other specialized skills and experience are being recruited from outside the companies. The government's guidelines to the boards and company managers are being clarified, and valued-based management objectives are being stressed.

■ Leaner Capital Structure

Historically, government-owned companies may have undervalued state-provided capital relative to its true economic cost. In some cases this has resulted in an excessively capital-intensive business structure. It may also have permitted excessive diversification away from a company's core business. Thus the effort at present is to instill a better sense of the true cost of capital for government-owned companies, with the result that capital should be used more efficiently. Under the new regime, balance sheets are likely to shrink.

In addition to government guidelines on financial performance such as operating margins the government is also setting out targeted asset and capital ratios. There is increased pressure on government-owned companies to increase their dividend payments to the government.

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In some cases the government will require government-owned companies to privatize their debt, i.e., to borrow on the private capital markets to pay down government debt. This would raise the companies' cost of capital, but exposure to increased market discipline should lead to increased efficiencies in the use of capital and encourage increased operational efficiencies.

The government has formulated guidelines for incentive programs for employees of government-owned companies

■ Provision of Worker Incentives

In November 1999 the government formulated guidelines for incentive programs for employees of government-owned companies. The key criterion in awarding incentives, for which all employees will be eligible, will be the company's return on capital, although individual managers will have considerable discretion in how to adapt the programs for their firms. A vesting procedure will ensure focus on longer-term performance.

Worker incentive programs can result in huge gains in labor productivity

Academic studies of worker incentive programs find that such programs when implemented in the private sector can result in huge gains in labor productivity, as much as 30-40% or more, which permits significant increases in profitability even when the cost of incentives is taken into account.⁴ The problem in applying such programs to the public sector is the difficulty in many instances of measuring public sector output. How should the output of teachers or police officers or soldiers be measured? While Swedish government-owned companies include many companies for which output measurement would pose a major challenge, much if not most of the business done by companies in the government's portfolio is that for which some form of performance based pay or merit pay should be feasible. The biggest companies in the government's portfolio are after all involved in businesses which in many other OECD countries are operated by private companies.

All studies of incentive schemes emphasize the importance of program design in determining its ultimate effectiveness

All studies of incentive schemes emphasize the importance of program design in determining its ultimate effectiveness. Incentives must be provided to the right outcome (rewards for increased quantity at the expense of quality would be counter productive). Moreover, in an increasingly knowledge-based economy there should be incentives to encourage multi-tasking and contributions to group effort. Design of the incentive program should be sensitive to the needs of the organization in the information age.

In cases such as manual labor where it is possible to measure output reasonably well performance related pay in a well-designed system is likely to result in significant increases in productivity and profitability. There is no reason not to adopt PRP systems where appropriate throughout government-owned companies. Where output is less easy to measure some form of merit pay system, within a careful designed structure which aligns the work effort to the company's objectives, is likely to yield significant benefits in productivity and profitability.

■ More Coherent Internet Strategy

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Sweden is already a world leader in technology, with a higher ratio of information and telecommunications technology investment than even the US, a PC penetration rate second only to the US and an internet penetration ratio third after Finland and the US. Sweden is also a leader in B2B sales, though it lags well behind the US. However, there are many areas where use of the new technologies will have to be extended if Sweden is to maintain its leadership position.

⁴ Burgess and Metcalfe (1999)

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Use of an electronic interface for orders instead of phone, fax or e-mail, has resulted in significant cost savings

Use of on-line procurement has resulted in a reduction in costs of between 10% and 50%

Better management of inventory levels has the potential to lead to reduce capital costs significantly

With a better understanding of sales future demand can be projected more accurately and inventories can be managed more efficiently

Each aspect of an internet strategy can be mutually reinforcing

The OECD has identified five areas in which companies stand to make major efficiency gains from e-commerce applications⁵:

1. Cost of Executing a Sale.
2. Customer Support and After-Sales Services.
3. Purchase Orders and Procurement.
4. Inventories.
5. Forecasting Consumer Demand.

Cost of Executing a Sale

Verifying the internal consistency of orders and matching order, receipt and invoice may seem straightforward but in fact errors in orders are common and expensive to fix. Use of an electronic interface for orders instead of phone, fax or e-mail, has resulted in a dramatic reduction in errors with significant cost savings.

Customer Support and After-Sales Services

This is particularly important for companies selling sophisticated products. In instances when such services have been aggressively pursued cost savings of 17% of operating costs have been realized.

Purchase Orders and Procurement

The cost of purchasing inexpensive items can exceed the cost of the items themselves because of the paperwork involved in the procurement process. The use of an electronic data exchange type system for procurement can reduce errors, ensure compliance with firm policy and speed up the process. Such systems can also contribute to increased supplier competition, leading to further reduction in costs. The result has been a reduction in costs of between 10% and 50%, in addition to a sharp reduction in the required processing time.

Inventories

Better management of inventory levels has the potential to lead to a significant reduction in capital costs. In the US inventories represent 4.2% of the sale of final goods. Especially in the retail sector, where margins are typically thin, savings from more efficient management of inventories have the potential to result in a major increase in profitability.

Forecasting Consumer Demand

The ability of firms to understand their customers better offers many opportunities to improve business performance. With a more comprehensive and timely understanding of sales future demand can be projected more accurately and inventories can be managed more efficiently. Where customers are allowed to customize their order on the web businesses can gain valuable intelligence on shifting trends in demand, thereby allowing more accurate production forecasts and planning. In cases where the good is offered on a 'build-to-order' basis, information can be passed on to suppliers allowing the entire supply chain to benefit from the increase in intelligence on customer preferences. In pilot studies in the US auto industry savings of 20% have been realized with such systems.

Each aspect of an internet strategy can be mutually reinforcing and will complement reforms taking place in the other four areas.

⁵ OECD (2000), p. 61.

For the 1990s as a whole Swedish productivity growth has averaged about one-half a percentage point above that of the 1980s

Given the importance of government-owned companies these reforms should have a material impact on overall Swedish economic growth

Much will depend on ongoing progress in implementing the reforms

Among EU countries Sweden may uniquely positioned to benefit from the growing importance of e-commerce

It seems likely that we are at the early, if not initial, stages of this transformation, with most of the gains yet to come

■ Assessment

The current economic expansion in Sweden bears some resemblance to the expansion in the US. Though not as long or as strong as the US, the Swedish expansion is strong on an historical basis and has been accompanied by a rapid reduction in unemployment with so far only modest inflationary pressures. Over the last year Riksbank officials have noted unexpected strength in Swedish productivity growth. For the 1990s as a whole Swedish productivity growth has averaged about one-half a percentage point above that of the 1980s.

In trying to explain the increase in productivity in the 1990s the Riksbank has pointed to structural changes such as deregulation, a credible low-inflation policy centered on inflation targeting, stable public finances and EU membership⁶. The Riksbank also noted the importance of increased competition from globalization, the rapid development of IT, and a cyclical element to the increase in productivity.

The contribution from reforms in the government-owned companies is by contrast a relatively recent development. It is probably too early to make any definitive assessment of the contribution from this source to recent Swedish productivity performance. Nevertheless, each factor we have discussed above has the potential to contribute significantly to growth in the productivity of government-owned companies. Given the 25% share of government-owned companies in the economy these reforms should have a material impact on overall Swedish economic growth.

Much will depend on ongoing progress in implementing the reforms and the skill with which government-owned companies modify their business models to capture more of the gains from e-commerce. Continued macroeconomic reforms will also be important. The government has cut taxes this year but Swedish tax rates are still among the highest among OECD countries. There is much that could be done to improve the wage negotiation process which would complement the transition to a knowledge-based economy.

Merrill Lynch Research reports cited at the beginning of this report suggest that among EU countries Sweden may uniquely positioned to benefit from the growing importance of e-commerce. A similar view was expressed in recent study by Forrester Research⁷, which projected Sweden to be the top e-commerce EU country in 2004, by which time 10.1% of total Swedish commerce might done over the internet.

These trends of ongoing reform of government-owned companies and expansion of e-commerce should be reinforcing and complementary. The efficiency gain which flow from a fuller implementation of e-commerce business models will reinforce the new 'value-creation' business orientation. Performance targets will be easier to meet if the efficiency gains from e-commerce are exploited fully. Companies which are successful in implementing their e-commerce business plan will use capital more efficiently. Worker incentive programs can be combined with the organizational transformation necessary to take full advantage of the shift to a knowledge-based economy. It seems likely that we are at the early, if not initial, stages of this transformation, with most of the gains yet to come.

⁶ Sveriges Riksbank (1999Q4), p. 41.

⁷ Forrester Research (1999)

Table 1: Largest Swedish Government-Owned Companies Ranked by Revenue

Ranking	Corporation	Revenues (1999; SEK Bn)	Employees (1999; 1,000s)
1	Telia AB	52.1	30.6
2	SAS Group AB (21.4%)	41.5	28.8
3	Vattenfall AB	27.7	8.0
4	Apoteket AB	26.1	9.4
5	AssiDomän AB (35.5%)	24.5	17.1
6	Sweden Post AB (Posten AB)	24.2	50.2
7	Nordic Baltic Holding AB (18.1%)	23.1	18.9
8	Systembolaget AB	16.6	3.2
9	Swedish Railways (SJ)	14.9	15.1
10	Svenska Spel, AB	13.5	0.5
11	Samhall AB	9.3	26.2
12	Civil Aviation Authority (Luffartsverket)	4.7	3.9
13	V&S Vin & Spirit AB	4.0	0.8
14	Luossavaara-Kiirunavaara AB, LKAB	4.0	3.2
15	Statilga Akademiska Hus AB	3.3	0.4
16	Civitas AB	2.4	N/A
17	Svenska Kraftnät (National Grid)	2.1	0.2
18	Om Gruppen AB	1.9	2.3
19	Lernia AB	1.9	2.4
20	Swedish Maritime Administration	1.4	1.4
21	Teracom AB	1.3	0.8
22	The Swedish Motor Vehicle Inspection Co.	1.1	2.2

Source: Government Owned Companies Annual Report summary 2000

Sources Applicable to the Whole Report

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