

# Housing regimes and labour market mobility

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## ***Introduction***

Residential mobility, and specifically the intensity of residential mobility, varies over Europe. In Northern Europe, 20–25 percent of the households changed residence during the last two years, while in Eastern Europe less than 5 percent changed residence during the same time.<sup>1</sup> There are, of course, different reasons for this, where norms and traditions are important, but the variety of housing regimes are also important explanations. Housing regimes may affect residential mobility by different forms of lock-in effects. For example, in countries with lower transaction costs, more responsive housing supply, lower rent controls and tenant protection, and better access to credit, residential mobility appears to be higher (Caldera Sanchez & Andrews 2011).

Caldera Sanchez & Andrews' (2011) study shows which policy variables that actually lead to less mobility. Further, the existence of these policy variables differs between countries, both in presence, frequency and strength. However, Caldera Sanchez & Andrews (2011) do not investigate *why* they differ and *why and how* they have developed differently in different countries.

We can add to these different policies and formal rules, informal constraints on human behaviour (i.e. norms and ideology), but also include economic factors and call it housing regimes. The chapter follows Kemeny's definition of housing regimes (Kemeny 1981), but we limit the study to formal laws and regulations. In accordance with Douglass North's (1990) definition, we call these regulations *formal institutions*. The explanatory perspective of this study – why do formal institutions differ? – will be historical and based on institutional theories of *path dependence*.

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<sup>1</sup> See Caldera Sanchez & Andrews 2011. The countries referred to are Slovenia, Slovakia, Poland and the Czech Republic. In Hungary, Greece and Estonia around 7 percent of the household have moved during the last two years. The countries Croatia and Serbia was not included in the referred study.

We will study three Swedish housing market reforms during the past decades, which may have affected residential mobility; the development of the rental housing regime since the late 1960s, the tax reform in 1991, and the new reforms on mortgages since 2010. Besides affecting residential mobility, these reforms have the common feature of including interesting elements of path dependence and forming critical junctures, which will lead development into a new path.

### ***Theoretical starting point – Path dependence and critical junctures***

Following Kemeny, the definition of housing regime is quite wide. According to Kemeny, a housing regime can be defined as ‘the social, political and economic organization of the provision, allocation and consumption of housing’ (Kemeny 1981, p. 13). This includes regulations, laws, norms, ideology as well as economic factors. However, we will limit the study to formal laws and regulations. In accordance with Douglass North’s (1990) definition of institutions as constraints for human behaviour, we will call these regulations formal institutions of the housing market. By this, we mean laws, regulations, i.e. the rule of the game, and not the organizations (the players of the game).

The typical case of *path dependence* in politics is where actors more or less deliberately design institutions at point A, a so-called critical juncture, institutions that at later point B serve as restraints to decision-making, and thus make some policy alternatives impossible or implausible. Bengtsson & Ruonavaara (2010) summarize the mechanisms of path dependence as efficiency, legitimacy and power, implicating that events at point A make some alternatives appear more efficient, more legitimate or more powerful at point B (cf. North 1990; Hall & Taylor 1996; Thelen 1999; Pierson 2000).

The role of *positive feedback* is important to understand path dependence. Once a path has been introduced, there are gains to continue this path. The “late-comers” will gain to follow precursors. The existence of positive feedback makes the process more or less irreversible, or at least it will over time increase the costs to return to a previous state (Pierson 2004).

Path dependence explains continuity (no change), even in cases the most rational and effective would be change. However, at some points change is possible; at the so called critical junctures. This follows from the idea of *punctuated equilibrium*. This theory tells us that development and change takes place in “jumps” and is not as smooth and continuous as it

sometimes seems (Thelen 2004). These “jumps” take place at the critical junctures that may occur due to externally driven events like war, revolution, financial crises etc. The power relation at the specific point determines the outcome at the critical juncture, for example, which decisions have to be made and who will make them. A critical juncture may be analyzed from a Schumpeterian perspective where a structural crisis is viewed from a perspective of “creative destruction”. In this paradigm, increased competition leads to decreasing marginal returns, which in turn leads to a structural crisis for old technology industry. Due to the structural crisis, new technology has a chance to challenge old technology, which in turn challenges production systems, power hierarchies and paradigms. Thus, structural cycles and structural crisis may open up for critical junctures. In the structural cycles, technological change plays a major role (Schumpeter, 1992/1942).

Another important component in the model is institutional transformation. It may take place through institutional layering, which means that new elements are laid on the institutional structure. This institutional layering provides a form of incremental change. However, this incremental change and the imposed elements can change the entire direction of the institution (Thelen 2004). Thelen's model has many advantages. A problem with an overly strict use of the concept of path dependence is that it explains too much. If path dependence always applies (and in full), it would mean that development and institutional change were impossible, except for certain predetermined tracks. This would mean that the future was predetermined. Thelen's starting point in critical junctures and institutional transformation provides analytical tools to help analyze how and why housing regimes change.

When it comes to housing markets, Bengtsson & Ruonavaara (2010) point out some peculiarities that make path dependence approaches particularly fruitful in this field. First, dwellings last long; they are tied to a specific place, slow to produce, expensive, not easily substituted with other goods, etc. (Arnott 1987; Stahl 1985). Second, on the ‘demand side’ the social importance of dwelling and the emotional, social and cultural ‘attachment costs’ related to a household’s transfer from one dwelling in one housing area to another (Dynarski 1986) also have a stabilizing effect on the market, and social exclusion and norms of eligibility may add to the continuity of the residential structure. Third, housing policy can be perceived as the state providing correctives to the housing market, where market contracts serve as the main mechanism for distributing housing, while state intervention has the form of correctives, defining the economic and institutional setting of those contracts (Bengtsson 2001; cf. Torgersen 1987). This makes tenure forms crucial together with other institutions that define

the rules of the game on the housing market, and in a capitalist economy political self-restraint may be expected in changing such fundamental rights of possession and exchange. Moreover, the fact that housing is ultimately distributed in the market may in itself serve as a constraint on institutional change, since to be successful such change must be accepted not only on the political arena but also by market actors.

Thus, both housing markets and policies related to housing include specific elements that make path dependence strong and sequential analysis important. Research on housing policies also indicates relatively strong path dependence in housing policies and institutions (see e.g. a special issue of *Housing, Theory and Society* from 2010.) In principle, such material and social peculiarities can be seen as general characteristics of housing provision in general, but cultural, ideological and socioeconomic differences between countries may also be long-run effects of national differences in housing policy. In fact, state intervention in housing markets is often justified precisely by the specificities of housing as a commodity, in particular different types of transaction costs and the alleged power imbalance between property owners and tenants in rental housing.

### ***The Swedish rent-setting system***

The Swedish rental market is dominated by a statutory system of collective negotiations on rents and other housing conditions between landlords and tenant unions. This form of ‘housing corporatism’ is internationally unique but also a theoretical anomaly, since it is often claimed that consumer organisations and ‘policy takers’ are not in a position to achieve a corporatist bargaining position in relation to the state (Offe 1985, p. 239–242; Williamson 1989, p. 169–170; cf. Bengtsson 1995, p. 235–238). The main prerequisite of this ‘deviant’ Swedish system of rent-setting is the extremely strong and institutionalised Swedish *tenant movement* that has developed in parallel and symbiosis with the rent-setting system. Almost half of all Swedish rental households are members of tenant unions, which is far above other countries. The tenant movement is integrated under the auspices of the Swedish Union of Tenants (SUT).

It has been claimed that the collective system of rent-setting is an important obstacle to labour market mobility, making people unwilling to move from attractive locations where rents are kept below market value (especially in metropolitan areas). On the other hand, the political intention behind the system was precisely that tenants should not be forced to leave their

homes because of rent increases due to housing shortage. The system was established as a consequence of the rent regulation of WWII. It was fully institutionalized with new legislation in the 1960s and 1970s. In recent years, due to new legislation in response to EC competition law, the rules of the system have been changed, but so far it is not clear what the outcome will be.

The institutional basis of the Swedish corporatist rental system is the so-called *use-value system* of rent-setting, together with the system of *collective rent negotiations*. Today, virtually all rents in Sweden are set within this system. Another institutional mainstay of the system is the role of the non-profit *municipal housing companies (MHCs)* that make up the public rental sector in Sweden's universal housing regime. Before the new legislation, valid from 2011, rent negotiations in the municipal sector were based on the total cost of the company, and in the private rental sector, which is about the same size as the public sector, on comparison with the rents in the public sector. The link between the two sectors was the right to *use-value trials* based on the Rental Act, according to which a claimed rent – public or private – can be rejected as unreasonable if it is found to be considerably higher than the rents charged for dwellings with the same use-value. Such use-value comparisons used to be made primarily with the rents of public rental dwellings as benchmark, which made the non-profit municipal housing companies price-leaders in the local rental markets.

What makes the Swedish rental system corporatist even in formal terms is first that the tenant unions' right to collective negotiations is legally regulated in the Rent Negotiation Act of 1978. Furthermore, the regional *rent tribunals* that serve as court of first instance in use-value trials consist of one representative of the landlords' organisation (either private or public depending on the case) and one representative of the tenant union, together with a judge as neutral chairperson. SUT also plays an important part as political lobbyist and opinion maker, with strong links to the Social Democratic party, and is a regular participant, together with the landlords' organisations, in government commissions on housing and rental policy.

Different explanations to Sweden's unique corporatist rental policy have been suggested. The Social Democratic dominance in Swedish political life and the generally high Swedish membership rates in voluntary organisations have sometimes been pointed at, but in both respects the Scandinavian neighbours Denmark and Norway have similar records – but no comparable tenant movement. It has also been claimed that, with a large rental sector tenants are an important group to appeal to for vote-maximizing politicians (Meyerson, Ståhl & Wickman 1990). The problem with that hypothesis is that other countries, most prominently

Switzerland, the Netherlands and Germany, have larger rental sectors but weaker tenant movements. The Swedish rent-setting system is also part of a universal housing policy and an 'integrated rental market' (Kemeny 1995), but such institutions can be found in other European countries with weakly organised tenants, so that is not the complete answer either.

We cannot rule out such explanations in terms of size and structure of the rental sector, party politics, ideology or traditions of collective action, but since the housing regimes of other countries have similar features, while the Swedish housing corporatism is unique, they are obviously not sufficient as explanation. So, it seems well justified to look for a more contingent explanation in terms of path dependence. This is what we try to do in the following brief history of the Swedish rental policy.

#### *Introducing rent control 1942 – the root of housing corporatism*

Sweden succeeded to stay out of WWII, but housing production went down and rents went up. In 1942 a provisional rent control was introduced, combined with direct security of tenure. The rent tribunals that were responsible for the implementation consisted of one neutral chairperson and one representative of each party on the housing market. A national Rent Council, with representatives from SUT and the National Federation of Swedish Property Owners (SPO), was also appointed to serve as board of appeal and to make decisions on annual adjustments of rent levels. In practice the Rent Council had strong and discretionary influence on the development of the rental market during the war – and as it turned out also for considerable time after.

The decision of 1942 was politically uncontroversial and regarded as a practical and provisional response to the crisis. No one seems to have foreseen its formative importance. Actually the legislation was to survive until 1978 and leave its traces long after that as well. Thus, the Rent Control Act of 1942 represented the starting point of Swedish rental corporatism. It also meant the final political acceptance of the tenant movement. Already in the thirties, SUT had said no to wildcat strikes and other militant conflict weapons. Now the co-responsibility of the implementation at all levels of the rent control guaranteed the organisation strong influence.

The rent control of 1942 can be seen as the critical juncture for the Swedish rental corporatism. Two major changes in the system have taken place since, the first in the period

1968–1978 when the wartime rent control was finally abolished, the second in 2011 when new legislation on MHCs and rent-setting was introduced. In both decision processes, however, we can trace the path back to the 'provisional' and at the time uncontroversial legislation from 1942.

*Abolishing rent control 1968–78 – new legislation, same path*

In the years following WWII a comprehensive housing reform was launched. The foundation was laid for the universal housing policy that has prevailed since. The MHCs were the cornerstone of this policy, and they were now given their present role to provide housing to all types of households regardless of income.

Housing shortage did not go down after the war, and there was political consensus that the Rent Control Act could not be abolished immediately. Instead it was prolonged year after year, always with the explicit reservation that it was only provisional and should be discontinued once the market had reached balance. However, one problem remained to be solved: tenants' security of tenure was now a generally accepted social norm, which was difficult to uphold in an unregulated market.

A solution to this dilemma was not found until 1968 when a new permanent Rental Act was finally passed. The wartime rent control was replaced with the use-value system of rent-setting described above. The leaders of SUT were in fact the creative inventors of this rather original system – first introduced in a provisional law from 1956 – and when the idea was accepted by the corporatist counterpart SPO, the political parties willingly followed suit. The new, more liberal use-value system of rent-setting was accepted by the parliament in 1968 and successively introduced in different parts of the market, last (1978) in privately owned estates in large cities. Needless to say the organised interests in the rental market played a major role in the protracted and rather complex transition process between the two systems.

Swedish rental corporatism reached its peak in 1978 with the Rent Negotiation Act. Until then the system of collective negotiations – in contrast to the use-value paragraph – had been voluntary, but now the tenant unions' right to collective rent negotiations was laid down in law. The STU movement did not get a formal monopoly, but it is clear from the government bill that they normally were expected to represent the tenants. The legislation was actually proposed by a non-socialist government, and it was accepted by the parliament almost

unanimously. Even before the new legislation almost all public and about half of all private rents were decided in collective negotiations and with support of the Rent Negotiation Act, the collective system was soon implemented in almost the whole private sector as well.

The successive replacement of the rent control of 1942 with the use-value system undoubtedly represented an important change, from cost-based rent-setting to negotiated use-value rents. Still, this particular solution would hardly have been possible if the corporatist foundation had not been laid in the wartime rent control and its implementation.

From the eighties a certain polarisation was discernible in the housing debate, and the non-socialist parties now criticized the drawbacks of the use-value system. The liberal-conservative Bildt government that came to office in 1991 launched an overall assault on the Social Democratic housing policy and also proposed changes in the rental policy, although still within the general boundaries of the corporatist system. However, when SUT launched an attack on 'market rents' and supported it with opinion polls that indicated that the majority of Swedish tenants were against the proposed changes, the government soon backed down and settled for only minor adjustments, in reality without much effect.

#### *Adapting to the EU – new legislation, path uncertain*

In 2002 and again in 2005, SPO formally reported the state of Sweden to the European Commission for giving state aid to the MHCs, contrary to EC law. The argument was that MHCs received economic support from the municipalities, although they competed in the same market as the private landlords. In this situation a government commission was given the assignment to scrutinize the prerequisites of the MHC sector and in 2008 it delivered a comprehensive report, where two alternatives were presented, 'business-oriented' and 'cost-oriented' MHCs. In the former alternative, MHCs were to be run according to business principles, much like private property owners. The 'cost-oriented' alternative would be feasible only if the Swedish system could be exempted from the general EU ban on state aid. In both alternatives MHC rents would no longer serve as the norm in use-value comparisons, but be replaced by negotiated rents in general. This lingering emphasis on collectively negotiated rents actually illustrates the general acceptance of the corporatist system of rent-setting.



Whereas SPO supported the ‘business-oriented’ alternative, both SABO (the national organization of the MHCs) and SUT expressed strong criticism. The government was reluctant to propose legislation without support from the large organizations so the question was now in a deadlock, where a decision on the European level seemed like a likely outcome. A year later, however, when SABO and SUT presented a joint proposal, according to which the use-value system should be kept, but based on comparison not only with MHC rents but all types of negotiated rents, in accordance with the government Commission’s proposal. The MHCs were to be run according to ‘business-like’ principles but still, somewhat paradoxically, promote the housing provision of the municipality.

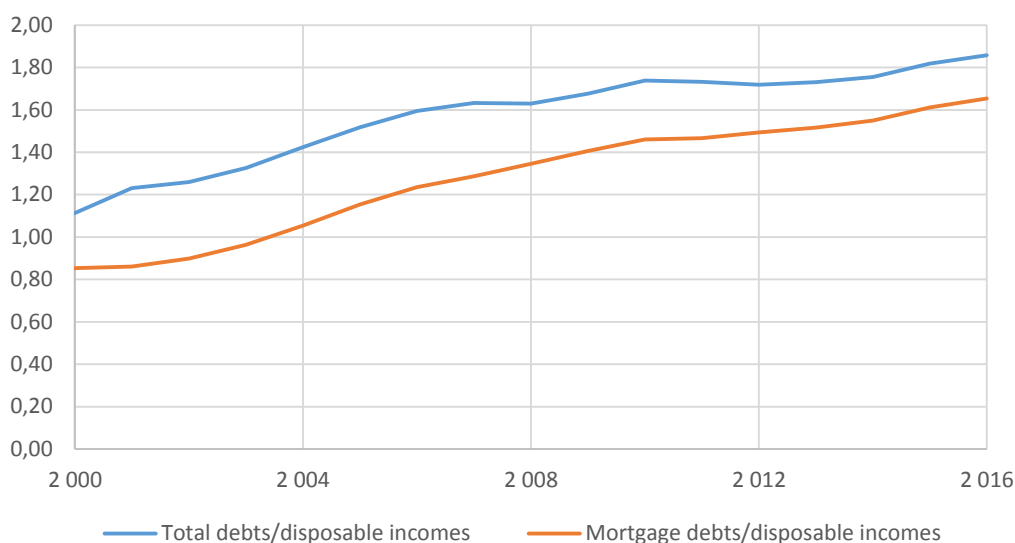
This agreement opened up the locked political situation. The key was that SUT had now given up its defence of the self-cost principle and the role of MHC rents in use-value comparisons. SPO soon joined their corporatist counterparts, and with the new Law on Municipal Housing Companies, in force from 2011, the parliament followed the organizations’ compromise. SPO now withdrew their report to the European Commission, so the Swedish housing regime was never finally tried on the European level (Elsinga & Lind 2013). Again the organized interests had functioned as the main driving force in Swedish housing policy, this time in promoting a thorough-going change of the system they had built up and implemented over 40 years. The EU competition legislation gave SPO an opening that was exploited with the formal report to the European Commission, which punctuated the previous equilibrium. The new legislation can be seen as an attempt to find a new equilibrium that can function within the auspices of the European competition legislation.

Although the new legislation has been in force for seven years, it is still too early to say what the final outcome will be. The main observation reported so far is about increasing differences in the municipalities’ use of their MHCs. When it comes to rent-setting, many negotiations have stranded and been taken to central mediation and to the rent tribunals, but at the time of writing a comprehensive evaluation of the results, in legal and economic terms, is still lacking. Obviously, the corporatist organizations are important players in the interpretation and implementation of the partly contradictory legislation they sewed together. So, most probably, corporatism will continue to be a central characteristic of the Swedish rental system.

## ***Political interventions on the housing market to stabilize household debt***

Another example where we argue that path dependence has been of critical importance concerns the recent reforms to reduce the growth of household debts. Since 2010, the Swedish Financial Supervisory Authority recommends that any mortgage that uses the residence as collateral should not exceed 85 percent of the market value. In 2016, the same authority prescribed that all new mortgages with a loan-to-value ratio exceeding 50 percent must be amortized, and additional mortgage repayment regulations were introduced as late as March 2018. A mortgage cap or a maximum amortization period can affect residential mobility because of their impacts on housing demand and housing supply; the effect on housing supply may occur because of loss aversion amongst home owners. In many ways, the Swedish example mirrors the development in other countries. Figure 1 illustrates how the households debt ratio has increased rapidly primarily due to increased mortgages.

Figure 1. The debt ratio of Swedish household



Source: Statistics Sweden

The global financial crisis that was initiated in 2007 when BNP Paribas froze their funds has increased the awareness of the macroeconomic risks associated with taking on large household debts. Several financial innovations, such as interest-only-mortgages, were introduced in many countries before 2007, and they have contributed to the rise of debts in

several countries<sup>2</sup> (André, 2010; Dam et al., 2011; Frisell and Yazdi, 2010; Muellbauer, 2012; Muellbauer et al., 2015; IMF, 2012; Mian and Sufi, 2010; 2012; Duca et al., 2011). Recent research has found that periods with high debt levels and/or rapid growth of household debts are often followed by an economic recession (IMF, 2012; Bornhorst and Ruiz-Arranz, 2013; Jordà et al., 2013; Mian and Sufi, 2010; 2012; Mian et al., 2013; Cecchetti et al., 2011). Consequently, several countries have tightened their mortgage standards in recent years. For example, Canada, Sweden and the Netherlands have recently sharpened regulations regarding mortgage amortization schemes (Schembri, 2014; De Vries and Burrows, 2013; Financial Supervisory Authority, 2017).

Sweden did not, like some other countries, experience a sharp drop in house prices when the financial crisis hit the world economy in 2007. Nonetheless, there is significant concern about the increasing debt ratios. There is no official data on mortgage repayments in Sweden at the aggregated level but it is well known that average repayment times on mortgages have increased. In a sample survey, the Financial Supervisory Authority (2013) concludes that the share of interest-only-loans increased from 63 to 71 percent between 2007 and 2012 but probably the increase started considerably earlier than 2007. Consequently, in recent years Sweden has introduced new macroprudential tools in order to stabilize the debt ratio.

We argue that one can analyze the run-up to the current Swedish situation by thinking in terms of path dependence. The years of the early 1990s can be perceived as a critical juncture that led the Swedish economy on to a new path which has gradually evolved into the current situation. The 1990s involved several political and macroeconomic reforms that both increased the probability of the latter development of a surge in house prices and household debts and made it costly to reverse and choose another macroeconomic regime; these are two essential elements in most theoretical definitions of path dependence (Pierson, 2004).

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<sup>2</sup> E.g. Australia, Belgium, Canada, Denmark, England, France, Greece, Iceland, Ireland, the Netherlands, Portugal, Spain, Italy, Sweden, and the US

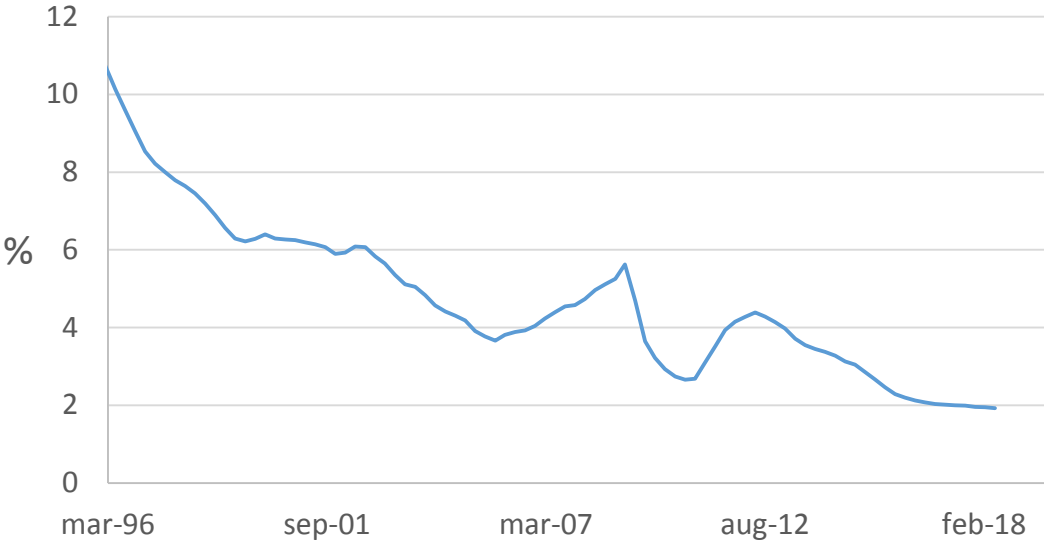
*The new path initiated in the 1990s increased the probability of the current situation on the housing market and mortgage market*

Two critical reforms in Sweden during the 1990s were the adoption of a low-inflation target and the adoption of a flexible exchange rate. Having to combine an inflation target with a flexible exchange rate was the result of the gradual liberalization of capital movements initiated by rich nations in the 1970s.<sup>3</sup> When the exchange rate is fixed and there are free capital movements, Central Banks cannot set a domestic key policy rate that significantly deviates from the world interest rates because there will be a pressure on the currency to appreciate or depreciate. However, under floating exchange rates, the Central Bank can control the key policy rate and other (short-term) interest rates, which means that they can affect inflation. Therefore, under free capital movements, the Central Bank can accommodate economic shocks through monetary policy and control inflation only if there are flexible exchange rates (Jonung, 2000). The inflation target was implemented in 1995 after high inflation had been observed for over two decades. Thus, the Swedish Riksbank needed to devote major resources to bring inflation expectations down (we elaborate on this more in the next section). When public inflation expectations started to fall, the Swedish Riksbank was able to successively lower its key policy rate, and consequently lending rates to the household sector started to decrease as well. Low interest rates have been identified as one of several fundamental variables that can explain the rapid increase of house prices and mortgage debts (The Swedish Riksbank, 2011). As such, the new macroeconomic regime that was initiated in the 1990s has contributed to an increased probability of the latter development of peaking house prices and rising household debts, which, however, were not foreseen in advance. Figure 2 illustrates how nominal interest rates have decreased gradually since the early 1990s.

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<sup>3</sup> In 1990, capital movements were liberalized between several European countries in order to prepare for the European monetary union.

Figure 2. Average lending rates to Swedish households (all outstanding loans)



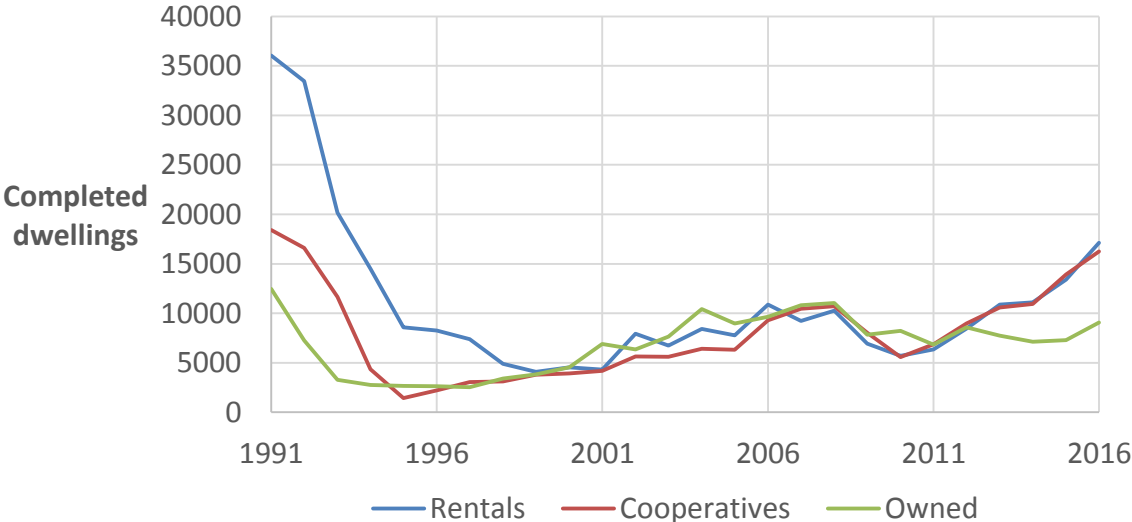
Source: Statistics Sweden

The informed reader may object that besides low inflation expectations and a low key policy rate, there are additional explanations for the declining market interest rates in recent years. Low inflation expectations partially explain why nominal interest rates are low and house prices have increased, but in recent years, real interest rates have been low as well. The common opinion is that high savings in emerging economies and a bias amongst investors to save in safe assets have generated a large supply of saving across the world (IMF, 2014). Thanks to free capital movements, large savings surpluses in Asia could be invested abroad, putting downward pressure on domestic interest rates in developed countries. Thus, the liberalization of capital movements is part of the critical juncture that led the Swedish economy into a new path, explaining the current situation.

Besides low interest rates, an additional factor that explains the surge of house prices and increase in household debts is a low supply of housing and low levels of new construction, especially in the metropolitan areas (see e.g. The National Board of Housing, Building and Planning, 2013). It is well established that an increase in housing demand (e.g. because of reduced mortgage interest rates or population growth) will have a stronger impact on house prices when housing supply is limited and/or inelastic (Glaeser et al., 2005). An important part of the reform package in the 1990s was a tightening of fiscal policy, because government debt and budget deficit were currently high. From 1997, member states of the EMU are bound to the growth and stability pact that aims to impose fiscal discipline. The adoption of stricter

rules and a stronger emphasis on the long-term macroeconomic outcome was an indirect critique on the Keynesian policy of the 1950s and 1960s and the discretionary policy used to tackle the stagflation during the 1970s (in Sweden in particular). One part of the tightening of fiscal policy was to dismantle construction subsidies gradually. For instance, the government abrogated interest rate subsidies on new construction of rentals, reduced interest deductions on mortgage loans and raised VAT on new construction (National Housing Credit Guarantee Board, 2011). Figure 3 illustrates that construction of new dwellings has been low since the early 1990s and that the decline is mainly due to decreased construction of rented dwellings. Several factors can explain the relatively low levels of new construction from the 1990s onwards (although in recent years new construction picked up again). While the sharp drop in the beginning of the 1990s was mainly due to economic recession and that real interest rates increased, the permanent decline can to some extent be explained by the dismantling of construction subsidies.<sup>4</sup> To summarize, the critical juncture of the early 1990s involved several structural changes that we argue have raised the probability of the rapid increase in house prices and mortgage debts.

Figure 3. New construction in Sweden



Source: Statistics Sweden

<sup>4</sup> Figure 3 does not, however, illustrate the regional dimension. Particularly in the metropolitan areas, new construction has not kept pace with population growth.

*Recent steps forward are following the current path*

Furthermore, the current situation can be better analyzed by thinking in terms of path dependence because there have been elements of positive feedback. As previously explained, positive feedback refers to when each new step that is taken along an existing path increases the probability that the next step will follow the same path.<sup>5</sup>

At the time, the adoption of flexible exchange rates and of low inflation targets among several countries of the world were highly motivated after decades of high inflation, failing exchange-rate targeting and reoccurring currency crisis around the world. The first country to adopt an inflation target was New Zealand in 1990 and soon a number of industrialized countries followed. In Sweden, the speculative attacks against the Swedish Krona forced the Swedish Riksbank to allow the Krona to float in 1992. The low inflation target is practiced since 1995.

As mentioned above, changing path into the new macroeconomic regime was accommodated by several new regulations. For example, fiscal policy was tightened through several regulations, and a new legislation that guaranteed the independence of the Central Bank and prescribed that monetary policy must aim for price stability was put in place in 1999 (Jonung, 2000). Also, the introduction of a low inflation target required significant human capital investments in order to gain knowledge of the impact of monetary policy on the real economy (e.g. GDP, employment) as well as on nominal variables (consumer price inflation, interest rates). Financial transmission channels have been explored since the Great Depression (see e.g. Keynes, 1936), but the adoption of a low-inflation target implied that government officials at the Swedish Riksbank needed to adopt new ways of thinking on how to analyze monetary policy (The Swedish Riksbank, 2018:1). Specifically, the Swedish Riksbank needed to shift focus from using the key policy rate to protect the fixed exchange rate to using it to control inflation. Also, they needed to improve their competence in producing inflation forecasts (The Swedish Riksbank, 2018:2). The Swedish Riksbank had to recruit top analysts from academia as well as from the enterprise sector and they needed to make considerable effort communicating the new inflation target to the public in order to make it credible and to lower inflation expectations. At the time, public confidence in the Swedish Riksbank was low, due to management of the recent financial/currency crisis and they needed to improve their reputation to be able to successfully implement their new policy (The Swedish Riksbank, 2018:2). As such, the time, effort and money that were invested in the successful implantation

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<sup>5</sup> The concept of “positive feedback” is discussed in Pierson (2004).

of the low inflation target may have increased the resistance towards choosing another path in the future among civil servants as well as among politicians. Furthermore, the global structural reforms of freeing up capital movements and the fact that many other countries are today practicing low inflation targets are additional factors that make choosing another path more difficult.

Proving our point, recently there has been a discussion around the world (including Sweden) on how the current inflation targets can be modified without abandoning them. The inflation targets came under scrutiny in the aftermath of the global financial crisis which showed that that current version of inflation targets around the world have not sufficiently addressed asset prices bubbles and the risk of hitting zero inflation (or even deflation) (Frankel, 2012; Krugman, 2014; Calmfors, 2010). There is concern that monetary policy will not be able to counteract the next major economic downturn (see e.g. Krugman, 2014). Consequently, in the aftermath of the global financial crisis there have been steps taken to modify the existing inflation targets around the world. There have been proposals about employing flexible inflation targets, to raise the inflation targets and to introduce different macroprudential tools that can complement monetary policies to maintain financial stability (see e.g. Krugman, 2014). For example, the US Federal reserve has adopted a flexible monetary policy allowing them to attach equal importance to employment levels and inflation and there has been a discussion about similar adjustments in Sweden (see e.g. Svensson, 2014). Sweden's neighboring country Norway has proposed changes in legislation suggesting that the government should set the inflation target (instead of an independent central bank) also set targets for the real economy (e.g. for employment). Also, several countries are looking at new macroprudential tools to ensure financial stability and to constrain the growth of household debts. As mentioned above, Canada, Sweden and the Netherlands have recently sharpened regulations regarding mortgage amortization schemes (Schembri, 2014; De Vries and Burrows, 2013; Financial Supervisory Authority, 2017).

However, debates on how to modify and/or complement the current inflation targets are primarily focusing on ways forward within the existing macroeconomic regime. For example, adopting a flexible inflation target in Sweden would not necessarily even require a change in legislation.<sup>6</sup> Similarly, the new macroprudential tools that have been introduced to stabilize household debts, such as regulated mortgage repayments, have been introduced without modifying the inflation target itself. Thus, such recent steps are largely modifications along

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<sup>6</sup> See e.g. Svensson (2014)



the current path and therefore constitute examples where positive feedback mechanisms are present.

### ***Interest tax deduction and the heritage of the 1991 tax reform***

Another regulation that has been discussed in the light of increasing house prices and household debts is the interest tax deduction. The argument has been that if these deductions were less generous, house prices would probably be lower. The current tax deductions (30 percent on interest rates) is a heritage from the Swedish tax reform in 1991. The idea behind the 1991 tax reform was to obtain a broader tax base, but lower tax rates. It was adopted by the Swedish Parliament in June 1990 with broad political support, and was then one of the most comprehensive tax reforms in any country ever (Agell et al. 1995). Income tax was lowered, VAT increased and broadened, capital and property taxation completely reformed, just to mention some of the content of the reform (Åberg 1995).

The tax reform in 1991 was a result of a two decades long domestic tax policy debate as well as influences from abroad. In the 1970s, there was an intensified domestic debate about the high marginal income taxes (sometimes above 100 percent). The 1981 agreement between the Centre Party, Liberal Party and the Social Democratic Party (at the time called “The wonderful night”) lowered marginal taxes to 50 percent. Major tax reforms were also implemented in a large number of other countries, for example United States, Australia, Canada, New Zealand and the UK during the 1980s. The distinguishing feature of all these reforms was basically alike: a broadened tax base by, for example, restraining deductions and exceptions, increasing indirect taxes' share of tax revenues and making income tax more uniform (Agell et al. 1995).

Taxes that may affect residential mobility, like property tax and capital gains tax, were also affected in the tax reform 1991. The new property tax meant increased taxes for most property. Agell et al. (1995) show that the new property tax led to tax increases for all households that had a marginal tax below 75 percent before the tax reform.

Another important part of the tax reform concerned the taxation of income of capital. Interest earnings and capital gains became an income category of its own called capital income. In the old system, these incomes had been added to the wage income, which resulted in higher marginal tax. In the tax reform 1991, the tax became flat, set to 30 percent. In addition, the tax

deduction for interest expenditures was set to 30 percent. The idea behind this was to construct a symmetric tax system. The old system, due to its asymmetrical construction, had opened up for tax planning, which the new tax reform aimed to close. This idea about a symmetrical tax system is still a constraint in the current debate about tax deductions. Further, the system of tax deductions has systemically favoured home owners over tenants. Today this has created a strong lobbyism against reducing interest tax deductions.

To conclude, even though the tax deductions on interest rates today is a heritage of the tax reform 1991, the tax reform was not the same kind of critical juncture as the examples earlier. The tax reform 1991 did not occur due to revolution or war. Instead, it was an example of an endogenous process. On the way, there were many factors that were important; a pre-debate in the 1970s on taxes, the agreement 1981, a public debate during 1980s which coincided with structural change, major tax reforms in several countries (which gave international comparisons). One could consider each of these as critical junctures, and what happened after were examples of endogenous processes, for example positive feedback or institutional layering.

## *Discussion*

History has shown that that path dependence matters greatly for the design of and reform capacity of housing policy. However, history has also shown that, once a critical point is reached, policy makers are at least sometimes capable of changing path into a new regime. In this chapter, we have shown how wartime regulations formed the post-war rental regime. There have been reforms along the path, but these reforms have been incremental. A war is, of course, an exogenous factor. However, critical junctures can arise due to endogenous processes as well. One example is the process that led to the 1991 tax reform. The structural reforms of introducing a low inflation target and flexible exchange rates were the result of both endogenous and exogenous factors. The economic situation from the 1970s and onwards led to a situation with high inflation and large governmental budget deficits. The exogenous factor was the financial crisis of 1992. This was the igniting sparkle for the reforms that led the regime on to a new path. However, the new path contributed to the current situation with increasing property prices, increasing household debt and a shortage of rental housing.

What critical junctures can we expect in the future? In recent years, the Swedish debate on housing has intensified, due to low levels of new construction over two decades, an historical

high of inflation-adjusted house prices and a general shortage of rental housing with long waiting times and increasing homelessness. Major housing market reforms have been suggested that would lead the housing regime on to a new path. Such proposals include the introduction of more market-oriented pricing on the rental market and a major tax reform on property and other forms of capital, encompassing interest rate deduction, capital gains tax and property taxes. A third example is a renewed discussion on means-tested ‘social housing’, which has been a dead issue in Sweden since the 1940s. This is, of course, a reaction to the growing difficulties for households in the low end of the income spectrum to get access to decent housing.

So far, despite growing public debate, only few and rather modest housing market reforms have come up on the political agenda. However, recently policymakers have signalled an increased willingness for major reforms that potentially requires a wide political acceptance. The future will tell.

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