Policy Analysis

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Executive Summary

In 1936 the American award-winning journalist Marquis Childs published a book that would shape outsiders' perception of Sweden for a long time, *Sweden: The Middle Way.* According to Childs, Sweden, a laboratory of social and rational democratic decisionmaking, had achieved an optimal middle way between collectivism and individualism. Many others thought so too.

From the mid-1930s to the 1980s, many observers perceived Sweden, or what has become known internationally as the Swedish model, as proof that a vibrant free-market economy, characterized by competitive allocation of resources and private ownership of the means of production, could harmoniously coexist with an ambitious and successful egalitarian welfare state.

The statistics are indeed impressive. Between 1870 and 1970 Sweden progressed from an underdeveloped country to a country with one of the highest per capita incomes in the world. During that period, only Japan had a higher per capita growth rate.[1]

Sweden also built the most comprehensive cradle-to-grave welfare system in the West. The Swedish system features a steeply progressive income tax and measures aimed at equalization of incomes and opportunity. A broad political consensus supported creation of the system. Sweden seemed to present an intellectual challenge to those who argued that high tax rates and extensive state intervention would hamper economic growth.

Sweden no longer presents such a challenge. Few would now consider the Swedish system worthy of emulation. Sweden is shaken by economic crisis. Since the late 1960s its industrial competitiveness has deteriorated sharply. For two decades Sweden has had one of the lowest economic growth rates of countries that are members of the Organization for Economic Cooperation and Development.

Sweden's inflation rate (today around 10 percent) has for some time been twice as high as that of its main competitors. For a long time Sweden had a relatively low unemployment rate (1.5 to 2.5 percent), but it has recently risen to 3.5 percent.

The data in Table 1 indicate that growth of productivity generally was lower after 1973 than before. The numbers also show that no other country has experienced such a low rise in aggregate productivity as Sweden has since 1973. While the growth rate today seems to be increasing in other countries, it is not in Sweden.

The numbers in Table 2 indicate significant differences among selected countries during each time period. They also show that Sweden retained a top position until the 1970s when it dropped to the bottom position.

Figure 1 illustrates the differences in the growth rates of Sweden and other OECD nations.

Table 1
Percentage Growth in GNP per Employed Person, 1960-89

	1960-73	1973-80	1980-85	1985-89
Sweden	3.6	0.5	1.1	1.1
Denmark	3.3	1.3	1.9	0.2
Norway	3.6	2.9	2.2	3.4
West Germany	4.2	2.5	1.8	2.0
United Kingdom	2.8	0.9	2.5	1.8
France	4.7	2.3	1.9	2.2

Source: Sweden at the Crossroads, Swedish Center for Business and Policy Studies, annual economic report (Stockholm, 1991).

Table
Percentage Growth in GNP, Total and per Capita, 1870-1977

	1870-1913		1913-50		1950-70		1970-77	
	T	PC	T	PC	T	PC	T	PC
Sweden	3.0	2.3	2.2	1.6	4.0	.3	1.2	0.8
United Kingdom	2.2	1.3	1.7	1.3	2.8	2.2	1.9	1.8
West Germany	2.9	1.8	1.2	0.4	6.3	5.3	2.6	2.4
France	1.6	1.4	0.7	0.7	5.2	4.2	4.0	3.3
Japan	3.3	2.3	n/a	n/a	9.5	8.3	5.2	3.8
United States	4.3	2.2	2.9	1.7	3.0	2.1	3.1	2.3

Source: Lennart Jorberg, Swedish Economy in a Hundred Years (Stockholm: Swedish Economy, 1982), p. 23.

Figure 1
Growth Rates of Sweden and Other OECD Countries
Source: Facts and Figures on the Swedish Economy, Swedish Employers' Confederation (Stockholm, 1990) p. 7.
(Graph Omitted)

The Swedish population seems to be aware that a change of course is necessary. The ruling Social Democratic Labor party (SAP), which has dominated Swedish politics since the 1930s and been the main builder of the welfare state, is in deep trouble. The SAP's standing in the polls is between 30 and 33 percent, the worst recorded since opinion surveys began. Such results are indeed extremely low for a party that, from the late 1930s until the present, has always been able to get between 40 and 50 percent of the vote. The decline of the SAP can no longer be dismissed as a mid-term phenomenon. In the big cities, the party faces humiliation. In the last general election in September 1989, it secured 43.2 percent of the vote.

The beneficiaries of the Social Democrats' misfortune are the nonsocialist parties, which may be able to form a government after the general elections in September 1991. The Moderate Coalition party (MSP), which is conservative, and the People's party (FP), which is liberal and often called the Liberal party, are the core of the nonsocialist alliance. They have a joint economic platform that calls for privatization, deregulation, and moderate tax cuts. Those (albeit modest) steps could, if implemented, mark the beginning of a political watershed in Sweden.

What Has Gone Wrong with the Middle Way?

Sweden presented a challenge because it appeared to combine high growth rates and a welfare state. But that was not the case. To be sure, Sweden has the largest public sector in the West. Just over 60 percent of its gross national product (GNP) is devoted to government expenditures, compared with an average of 45 percent in the other OECD countries (Figure 2). Contrary to the common assumption, the large Swedish public sector is a recent phenomenon. In 1960 government spending was 31 percent of GNP, just three percentage points higher than in the United States.

In the 1960s Sweden's public sector was not the largest in the OECD; West Germany and the United Kingdom had public sectors as large, and the Netherlands' public sector was larger. But in the 1970s the other countries stabilized public spending while Sweden increased it greatly. In recent years Sweden has moderated its spending, but it still spends much more of its GNP on its public sector than do the other OECD nations.

Swedish tax levels have also pulled away from those of the rest of Europe (Figure 3) and the United States in recent years. In 1960 tax levels in Sweden were about equal to U.S. levels. In the next two decades, however, Swedish income and social security taxes rose much more rapidly than did comparable levies in the United States. By the end of the 1980s government revenues in Sweden as a percentage of GNP exceeded levels in the United States by more than 20 percentage points (Table 3).

Figure 2
Public Expenditures as Percentage of GNP for Sweden and Other OECD Countries.
Source: Sweden at the Crossroads, Swedish Center for Business and Policy Studies, annual report (Stockholm, 1991), p. 78. (Graph Omitted)

Figure 3
Tax Receipts as Percentage of GNP for Sweden and Other OEDC Countries, 1965-87
Source: Facts and Figures on the Swedish Economy, Swedish Employers' Confederation (Stockholm, 1991), p. 9. (Graph Omitted)

Table 3
Tax Burden as Percentage of GNP, 1988

Country	Percentage
Sweden	55.3
Denmark	52.1
Netherlands	48.2
Norway	46.9
Belgium	45.1
France	44.4
Finland	37.9
West Germany	37.4
United Kingdom	37.3
Italy	37.1
Switzerland	32.5
Japan	31.3
United States	29.8

Source: National Association of Swedish Taxpayers.

Sweden's rapid economic growth occurred before the imposition of the welfare state. As government control became more pervasive and entrenched, previous gains were eroded and were insufficient to maintain Swedish prosperity. Sweden was able to delay the negative effects of state in- tervention because of its unique history. Thus, what has been perceived as a successful welfare state has in reality been a failure.[2]

The Success Story: 1870-1930

Sweden was a latecomer to modern economic growth. When growth began in 1870, per capita income was substantially below that of most other West European countries. From 1870 to 1970 Sweden's per capita growth rate was second only to Japan's. In the 1970s it reached the level of the United States. (The growth rate may be estimated at 2.1 percent for Sweden, 1.5 to 2 percent for most other Western countries, and 3.1 percent for Japan.)[3] As was the case in most other countries, the growth rate in Sweden was higher after World War II. But the acceleration was greatest elsewhere; so in the postwar era the Swedish per capita rate was below the average for Western Europe but higher than that of North America.

The period 1890-1930, which saw the first stage of the development of Sweden's manufacturing sector, was one of the most impressive periods of modern Swedish economic history. Starting as a backward country that relied on the export of raw materials, Sweden developed into a producer and exporter of sophisticated manufactured products. In 1890 manufacturing accounted for 2 percent of exports; in 1913, 13 percent; and in 1946, 25 percent. To a large extent, the expansion during the first decades of the 20th century was based on Swedish inventions: steam turbines, ball bearings, and so on.

Geography and history combined to give Sweden circumstances favorable to economic, political, and social success enjoyed by few other countries. Its geographic area is large and its population is small; so Swedes have a large amount of usable and valuable living space, which endows life in both city and country with advantages not enjoyed by many other European people. Add to that rich supplies of coniferous timber, water power, iron ore, and other valuable minerals, and you have the potential for economic success. The supply of natural resources was distributed in such a way that when Sweden's rapid economic growth started, spurred by external demand for Swedish exports (mainly forest products), the benefits were widely diffused rather than concentrated. Furthermore, the Swedish population remained ethnically and culturally homogeneous, which may have created an atmosphere of cooperation and avoided tensions.

Sweden had other advantages. It enjoyed 150 years of peace and was spared the burden of the two world wars. It reaped economic benefits from its neutrality. Sweden also had efficient institutional arrangements, including property rights, that created incentives to channel resources into their most productive uses. Freedom of business and trade was guaranteed by law in 1864. A substantial increase in agricultural productivity took place before industrialization, mainly as a result of land-consolidation reforms. Private initiative developed an advanced capital market in the mid-19th century.

There also emerged a well-paid, competent, and honest class of civil servants. The small scope of government responsibility during the ultraliberal period minimized official corruption. Government was limited, but it did create an economic infrastructure and promote educational reform. The government borrowed money, but the importation of capital relieved the pressure on the domestic capital market, leaving funds for private long-term borrowing.

Apart from tariffs on some agricultural and manufactured products, there was no large-scale mercantilist policy to promote exports or hinder imports. The manufacturing sector had to compete in the world market from the beginning. Swedish multinational corporations appeared early. Many firms that today form the backbone of Swedish industry were created during the country's initial period of industrialization.[4]

Sweden went on the gold standard in the 1870s, abandoned it during World War I, but returned to it from 1924 to 1931. Under a postwar policy of contraction, intended to return the krona to prewar par, the krona became undervalued, which made it possible for Sweden to achieve a real growth rate of 4 percent a year through the 1920s.

Thus, from 1870 to 1930 Sweden was characterized by limited government, free trade, free enterprise, and social mobility. The result was a class of able entrepreneurs in trade, industry, and banking.

The Social Democrats came to power in 1932 and have dominated the government ever since. They have never polled less than 40 percent of the vote; their closest rivals have mustered about 25 percent. The SAP's rise marked the beginning of a more activist, Keynesian economic policy.[5] The standard history of Swedish politics holds that the Social Democrats took power during the depression of the 1930s and ended mass unemployment with their Keynesian fiscal policies. That interpretation of events has been influential in keeping the Social Democrats in power, but it is misleading.

In fact, thanks to a large devaluation after the abandonment of the gold standard in 1931, the depression in Sweden was relatively mild, and recovery--led by an export boom--began before the Social Democrats came to power. According to the late Swedish economist Erik Lundberg, the depreciation of the krona in September 1931 was the necessary condition for economic recovery. A stable and sound fiscal policy lent support to Sweden's recovery but was not instrumental in creating it.[6] That view is supported by most Swedish economic historians. According to Lars Jonung, only the years 1933-35 witnessed an expansionist fiscal policy. At that time, the upswing had already begun. During 1935-36 fiscal policy was contractionary not expansionary.[7]

Although a Keynesian-inspired fiscal policy gained an intellectual following in the 1930s, after final abandonment of the gold standard, the policy was of no practical significance until after World War II.

Moreover, contrary to the Social Democrats' version of history, Sweden was not a backward country before they took over. As noted, Swedish success preceded the Swedish model. Before the welfare state, before the enactment of Keynesian policies, and before the practical dominance of the Social Democrats, Sweden already had a growing, vibrant, successful economy with a per capita gross national product higher than that of most other countries (Table 4).

Table 4
Swedish per Capita GNP Relative to That of Other European Nations

	1870	1900	1913	1929	1938	1950	1973
Relative to average	0.68	1.0	1.27	1.57	1.63	2.28	1.64
Relative to top-ranked country	0.39	0.51	0.7	0.71	0.85	1.25	0.97
Position	16	9	9	8	5	1	2

Source: Center for Business and Policy Studies, Annual Report (Stockholm, 1990), p. 18.

The 1930s: Build-up of the Swedish Model

Sweden was a latecomer not only to modern economic growth. Democratic institutions and the build-up of welfare-state policies also began later than in most European countries. Universal suffrage was not implemented until the early 1920s.

The first social-welfare reform--a general old-age pension bill--was passed in 1913. Several other programs were started in the following decades, but their effects were limited. Despite a slow start, a cradle-to-grave system was successively built up. The main part of the transfer and social-insurance system included children's allowances, income-related housing benefits, sick-pay insurance, a system of grants and loans for college and university students, unemployment insurance, and various pension schemes.

The Political Situation

One important impetus for the Swedish model was the political domination of the Social Democrats, who came to power in 1932. They have dominated Swedish politics to this day. Few if any political parties in the West have been able to maintain such long-standing political domination in a country. The SAP gained its position by giving the impression that it had pulled Sweden out of the depression of the 1930s by building up the welfare state. Until now it has not mustered less than 40 to 50 percent of the vote, to the second most popular party's 25 percent. The Social

Democratic vote has been both large and stable. Since the end of World War II, support for the SAP has varied within an extremely narrow band. Under Sweden's proportional representation system, the Social Democrats have always been near, if they did not actually achieve, a parliamentary majority.

With the rise of the Social Democrats there emerged fairly stable political loyalties to leftist and center-rightist blocs as well. The leftist bloc, which includes the Moscow-oriented Communist party receives about 6 percent of the vote. The center-rightist bloc includes the MSP (conservatives, closer to Helmut Kohl than Margaret Thatcher), the left-of-center (by international standards) FP, and the agrarian-based Center party. While overall support for the center-rightist bloc has been around 45 percent, support for individual parties has fluctuated wildly. Today polls give the MSP 22 percent, the FP 11 percent, and the Center party 9 percent.

In the last election, the environmentalists entered the Riksdag, or parliament, with 5 percent. Today's polls indicate that the Green Ecology party may not get the 4 percent necessary to gain seats in the upcoming election. On the other hand, two new parties that should be included in a broadly defined center-rightist bloc may do so. One is the Christian Democratic party; the other is the so-called New Democracy party, a party with a populist strain and a conflicting platform. On the one hand, it campaigns on a strong free-market, anti-tax platform calling for larger tax cuts than any of the other nonsocialist parties. On the other hand, it wants to give the municipalities a free hand to raise taxes (the central government limits them currently), restrict immigration, and implement other interventionist proposals.

Thus, for a long time the SAP had the necessary strength to carry out its welfare-state ambitions.[8]

Other Key Characteristics of the Model

The Swedish model that originated in the 1930s has not yet been defined. In its most simplistic definition, the "middle way" implies something between a free-market economy and one based on central planning. But the Swedish model was not simply some loosely defined middle way. A description of the components of the model follows.

Unions and Centralized Bargaining. Key parts of the Swedish system are strong unions and centralized wage negotiations without government interference. Ninety percent of Sweden's blue-collar workers belong to a union; white-collar membership is 80 percent. After a period of labor strife in 1938, a concordat was signed by the blue-collar Labor Organization (LO) and the Swedish Employers Confederation (SAF). That concordat has been the basis for industrial peace.

Under the arrangement, the LO and the SAF met periodically to agree on wage levels and working conditions in light of national income, labor productivity, the balance of payments, and other factors. Three coalitions of white-collar unions bargained on behalf of most salaried employees. Export-oriented industry set the pattern for wage increases, and that pattern was followed by the economic sectors not exposed to international competition and by the public sector. The increase in labor productivity within the competitive sector, plus changes in world market prices at given currency exchange rates, provided the basis for calculation of wage increases.[9]

The wage agreements were by no means ideal. They distorted relative prices, and there was an ominous element of the corporate-state ideology behind them. Nevertheless, they were positive in two ways: First, they were honored. Union discipline was strict and reliable. Employers knew where they stood once an agreement was made. Second, the unions recognized the right of employers to hire, fire, allocate work, and direct the workers.

Centralized wage negotiations were a prerequisite for the so-called solidaristic wage policy of equal pay for equal work, regardless of a company's ability to pay. The model's architects argued that narrow wage differentials would speed up the shift of the economy from low-productivity to high-productivity sectors by weeding out unprofitable firms and favoring more productive ones. Swedish labor unions realized the importance of flexibility and labor mobility. Unemployment insurance played a minor role; most labor-market programs addressed retraining, mobility assist ance, and temporary relief work. Thus, unemployment was not subsidized. The unemployment rate has not been higher than 3.5 percent during the past 30 years.[10]

Free Trade. Sweden depends heavily on foreign trade. Exports and imports account for 30 to 35 percent of GNP. That may explain why there was always a consensus in Sweden about the desirability of free trade. Except for agriculture, which became protected in the 1930s, the Social Democrats never attempted to operate a closed economy. Swedish industry thus was forced to find ways to survive in competition with foreign industry.

No Nationalization. The SAP did not nationalize industry on a large scale. Although nationalization was a point of principle in the Social Democrats' program, it was never implemented. Industrial policy until the 1970s was essentially limited to two government procurement programs for advanced technology for military aircraft and nuclear power. In both cases, development took place at private firms, not at government facilities. Until 1970 government-controlled manufacturing amounted to 5 percent of the total. State ownership and management, where they existed (e.g., railways and public utilities), were guided by professional ethics and not hampered by political considerations.

No Economic Planning. Nor did the SAP try to impose national economic planning. That does not mean that the state did not influence the use of resources to a large extent. High taxation and the welfare state inevitably influenced their use. But there is a difference between that kind of intervention and central planning. The latter produces inefficiency and does not allow remedial adjustments. The former also produces inefficiency, but other things can mitigate its effects (free trade, for example) and thus delay its harmful consequences. That is what occurred in Sweden. The strong base of sound economic policy could withstand a welfare-state onslaught in the 1950s and 1960s--for a while anyway.

The 1950s and 1960s

The 1950s and 1960s are considered the heyday of the Swedish model. Rapid economic growth and a simultaneous step-by-step build-up of the welfare state occurred during a period of great political consensus and harmony among unions, employers, and the Social Democrats. Recall that by the early 1950s Sweden was by far the richest country in Europe. Its per capita GNP was twice the European average and 25 percent above that of Switzerland, which ranked second. From 1950 to 1970 GNP grew at an average rate of 4 percent, or 3.3 percent on a per capita basis. From 1950 until 1965 Sweden's share of the world's exports increased. The Swedish model thus entailed export-led growth under capitalist conditions. In retrospect, it is clear that the model operated under a type of quid pro quo. In return for its political stronghold and resources with which to build the welfare state, the SAP agreed to free-market policies in the manufacturing sector.

However, it is easy to exaggerate the apparent harmony in Sweden. There were fierce ideological battles between Socialists and nonsocialists. The most important fight began in the 1940s. After the war, the Social Democrats, with the support of the LO, adopted a platform calling for far-reaching central planning and nationalization. That platform was defeated by business organizations and the political opposition. After the defeat, which almost cost the Social Democrats the 1948 elections, the party opted for a policy of gradually building up the welfare state. That was a wise strategy politically because within the ranks of labor there was strong opposition to socialist experiments conducted for ideological reasons. It has been possible, however, to implement radical redistributionist policies in the name of social solidarity, with support from large groups outside the labor movement.

Swedish unions for many years were led by intelligent people who understood better than many of their international counterparts that entrepreneurship, the profit motive, and adaptation to new productivity-enhancing techniques created wealth. The union leaders, along with the SAF and the Social Democrats, never killed the goose that laid the golden eggs. In retrospect, one could interpret the situation as less than ideal but perhaps as good as a political process might produce.

The developments of the 1950s and 1960s had important political consequences. Although it was private enterprise that created wealth, while the government could only distribute it, the Social Democrats (like any group) cleverly persuaded the electorate that their policies were responsible for Sweden's prosperity. Business people concluded that they would have to live forever with social democratic policies. The opposition became demoralized, and thus its effectiveness was curtailed. Eventually, the nonsocialists decided that the only way to win power was to adopt a platform similar to that of the Social Democrats. Some people warned that intervention would be harmful in the long run, but few took the warnings seriously. Sweden's fortunate situation enabled its economy to rest on its laurels and forestall the impact of gradual interventionism. The end of the 1960s was a period of optimism fueled by nearly 100 years of uninterrupted economic growth. Yet the tendencies toward deterioration were becoming evident. Swedish optimism turned out to be unrealistic and unwarranted.

The 1970s and 1980s: A Rude Awakening

The 1970s saw a breakdown of the Swedish model and the rules that had guided it. By the end of the decade, an entirely new set of policies and institutions had appeared. Even before the decade began, the LO and the Social Democrats had adopted a new, more radical attitude toward the labor market. The notion of full employment was applied not only to the labor market as a whole but also to submarkets, such as married women, the handicapped, and employees in particular branches of production and regions.

The Riksdag passed an employment-security bill that created strict rules for seniority and a right to almost life-long employment and mandated prolonged waiting times for dismissals during periods of slack labor demand. A second law dealt with trade-union participation in company decisionmaking and representation on boards of directors. New work-environment legislation was also passed.

In time the solidaristic wage policy was extended to include general wage equalization, compressing wage differentials not only within job categories but also among different occupations and skills.

In the late 1960s the Social Democrats adopted a more activist industrial policy that reflected a shift in emphasis from labor mobility to job preservation. One characteristic of the economic policy of that period was an increase in the number of policy targets. There was new interest in "regional balance," the environment, and the distribution of wealth, including subsidies to various industries. As a result, economic policy became more complex.

The collapse of the Bretton Woods international monetary system in 1973 freed the Swedish authorities to pursue a more expansionist monetary and fiscal policy. High nominal wage growth and weaker productivity growth caused costs in Sweden to rise nearly 30 percent faster than in competitor countries from 1974 to 1976. After 1974 investment fell to a level 40 percent below the record that had been set at the beginning of the 1970s. The dramatic decline in business profits and the threat of bankruptcy characterized the economy when the center-rightist bloc came to power in 1976.

Although nominally nonsocialist, the postwar era had given the SAP such a strong monopoly on the formulation of political policies that the nonsocialists also based their policies on a social democratic framework. Furthermore, they suffered from a Swedish "Herbert Hoover syndrome." The Social Democrats had long argued that they alone could safeguard full employment, prosperity, and the welfare state. A victory for the nonsocialists, they maintained, would bring a return of mass unemployment and uninhibited "raw capitalism." Once in power, the Liberal and Center parties were particularly sensitive to the issue of unemployment. They used subsidies to industry, such as the shipyards, and public-sector projects to avoid an increase in the unemployment rate.

Industrial policy programs rose from 1 percent of GNP in 1970 to 5 percent in 1979. The government took over the three largest steelworks and merged them into a state company. The same thing happened in shipbuilding and textiles. Nationalization and public-sector jobs were used to maintain full employment. From 1970 to 1982 total public-sector spending rose 6 percent a year. The public sector's share of employment went from 20 to 33 percent between 1970 and 1983.

There were other bad signs. The budget deficit grew from 1 percent of GNP in the mid-1970s to 14 percent in 1983. Inflation ran at 10 to 12 percent a year. Average productivity, which had increased 5 percent a year during the 1960s, dropped to 2.5 percent and 1 percent in the 1970s and 1980s, respectively.

When the Social Democrats returned to power in 1982, they announced that they would cure the economy by pursuing a third way between Keynesian reflation and unemployment. The new government devalued the krona by 16 percent. It raised taxes to turn the budget from deficit to surplus. Meanwhile, the booming international economy boosted Sweden's exports, thereby reducing unemployment. But any relief was only temporary. Since 1985 GNP has grown by an average of 2 percent per year, well below the OECD average of 3.5 percent. The Swedish GNP stagnated in 1990 and will shrink in 1991.

A loose stabilization policy and big nominal wage increases coupled with sluggish productivity have pushed up inflation and diminished international competitiveness to the pre-1982 level. The new third way has failed. Sweden is facing a cost crunch similar to that of the mid-1970s.

The Public Sector and the Tax System

Classic "collective goods" make up only 10 percent of the Swedish public sector. By far the largest part of the recent expansion in public spending can be explained by local-government consumption (including health care), the sharp rise in central government transfers to business and individuals, social security payments, and interest payments.

Sweden's commitment to socialism has been almost complete in the social-services sector. Whereas other countries may experiment with competition in the provision of those services by means of vouchers or tax deductions, Sweden favors uniform-tax-financed public monopolies that charge low or sometimes zero fees. As far as those monopolies are concerned, one size fits all. Schools have similar curricula; health care is under an almost military plan; and so on. Private alternatives in health care, education, old- age care, day-care centers, and other personal matters have been almost legislated out of existence or are unable to compete with the subsidized public sector.

The size and structure of the Swedish public sector are supposed to reflect a desire to use the welfare state as an instrument for greater "social utility." But as we know, resources are limited and have to be rationed. Public choice scholars such as James Buchanan, Gordon Tullock, and William Niskanen have convincingly argued that the allocation of public resources depends on the relative strength of pressure groups. There are strong signs that Sweden is no exception.[11]

Subsidized day-care centers are one of the biggest items in the expansion of the public sector. Subsidies amount to about $12,000 per child a year. The biggest beneficiaries are upper-middle-class and upper-class professionals. Other types of inequalities arise between those who get and those who do not get rationed services such as free higher education in schools with limited entry and old-age centers for parents. To some extent, the distribution becomes a "welfare state lottery."[12] That is because a growing public sector reflects a shift toward more political and administrative decisions and less reliance on the market process. The supply of a service provided through political channels is not determined by consumer demand, as it would be in a free market.

The lack of competition, moreover, leads to a waste of resources. A big public sector requires a voluminous body of regulations, which results in a cumbersome bureaucracy and large interest groups that depend directly on the government.

Figure 4 shows how large a segment of the electorate depends directly on the public sector. The dotted black bars show how many are employed in the public sector. The striped ones include dependents such as pensioners, people employed in government-sponsored retraining programs, and the like. Although the quality of Swedish public services still compares favorably with that of services in other countries, there are indications that the laws of economics do indeed apply to Sweden. Swedes have begun to notice a distinct deterioration of quantity of services. The public infrastructure is falling apart in some cities. There are serious staff shortages in education, resulting in a fall in quality, and health care, causing long queues for routine operations. (The wait for hip replacement or cataract operations can be more than two years.)

Figure 4
Percentage of Electorate Dependent on the Public Sector
Source: Sweden at the Crossroads, Swedish Center for Business and Policy Studies, annual report (Stockholm, 1991), p. 84.
(Graph Omitted)

One reason for Sweden's economic development during the postwar years was the shift of resources from low-productivity to high-productivity parts of the economy. But the growth of the public sector has reversed that trend. Many people now acknowledge that the public sector is in need of urgent reform and that merely pouring more money into it will not improve matters.

A large public sector requires high taxes. Sweden has them, particularly high marginal tax rates. The high mar- ginal tax on work and capital has created a large difference between the increment of production that an employee, entrepreneur, or investor can contribute and the amount of income he is allowed to keep. The system thus drives a broad wedge between production and individual compensation. Table 5 illustrates the problem.

Table 5
Wages and Taxes

Country	Gross Wages, 1987(a) (krona)	Wages after Taxes, 1987(b) (krona)	Change in Real Wages after Taxes, 1980-87 (%)
Switzerland	197,859	141,592	4.9
United States	145,796	140,072	2.6
Canada	124,186	132,559	-15.0
Japan	152,102	116,892	1.9
United Kingdom	122,732	105,310	18.5
Netherlands	158,073	97,578	-1.4
West Germany	166,053	97,356	0.3
Italy	144,870	96,582	-0.2
Belgium	165,297	87,632	-10.7
Norway	164,122	84,433	3.3
France	133,388	84,058	2.0
Denmark	172,874	81,920	-8.8
Austria	131,990	80,981	5.5
Sweden	154,950	74,886	-0.6
Finland	122,723	69,358	3.7

Source: Business and Industry Information Group, "Sweden's Prosperity in Comparison with Other Countries" (Stockholm, 1989), p. 5.

Note: The countries are ranked according to net wages, adjusted to show the purchasing power of the respective currencies.

a Includes social contributions.

b Adjusted to show purchasing power.

According to the OECD, Swedish industrial workers' gross wages (including employers' social security contributions) were the seventh highest in the 15 industrial nations in 1987. Real after-tax wages for Swedish industrial work- ers fell by 0.6 percent between 1980 and 1987, despite a 72 percent rise in gross wages in the same period. In 1989 Sweden's top personal income tax rate was 72 percent (it was 80 percent in the early 1980s). An average worker could pay as much as 60 percent of his income in taxes. Adding the 25 percent value-added tax and the 40 percent payroll tax results in a wedge of about 80 percent. Such a tax system, together with a flat salary scale, erodes the incentive to work, train, and save. Unsurprisingly, Swedes are on the job fewer hours a year than any other workers. According to studies, cutting tax rates would increase the "labor supply" 5 to 10 percent.[13]

The effect of high tax rates on professionals is startling. Swedish doctors work an average of only 1,600 hours a year, compared with 2,800 worked by U.S. doctors.[14] It pays doctors to stay home and paint their own houses rather than spend their time practicing medicine and hire painters. The result for society as a whole is a diminished division of labor.

Another thing that encourages absence from the workplace is the Swedish system of sick pay, which is more open to abuse than are those of other countries.[15] Not only is there no limit on the number of days that can be claimed at almost full compensation, but sick pay is doled out by the state insurance program, not by the employer. So claims are badly monitored. The average Swede was sick for 26 days in 1988, far more than in any other country. However, the Swedish system is being changed. Compensation will be diminished, and employers will help monitor the system.

Most Swedes realized long ago that their tax system was perverse. Not only did it discourage hard work and thrift, it also did little to foster equality--its original aim.[16] Although taxes were steeply progressive on paper, it was possible to become rich by exploiting loopholes in the system. For example, people borrowed and used the interest payments to lower their effective tax rate, or invested money in lightly taxed assets such as housing.

But not everyone had access to the loopholes. Information about how a complicated tax and transfer system operates is far from a free good available to everyone. People in higher income brackets are usually better motivated and more able to evade the high tax rates. To circumvent the system, firms engage in widespread bartering with employees over fringe benefits, such as subsidized meals or vacation-oriented conferences. Individuals also turn to barter; an economist may pay his dentist by doing the dentist's income tax return.

The problem is not that it is impossible to get rich in Sweden but rather that it is difficult to remain so by honest productive activities. In a society in which they cannot easily increase their income or accumulate wealth by ordinary work, people turn to the zero-sum game of transferring income from one to another through the political process instead of engaging in the positive-sum games of producing income through work, capital accumulation, or productive risk taking.

Summary

Sweden's dismal economic performance from 1970 to 1990 was no less striking than its high growth from 1870 to 1930. But is the Swedish model dead? The answer ought to be yes. The rules that guided it exist no more. Any implicit pact that included free enterprise has been gone ever since the late 1960s when the LO and the SAP--as well as the non- socialist governments of 1976-82--began to replace free-market policies with more and more government intervention. The labor-market policies of the Swedish model were also gradually abandoned. Labor mobility and reliance on market forces were replaced by job preservation, bailouts for losers, and nationalization.

The original model of centralized wage negotiations also exists no more--which should not be regretted. Today wage determination is a mess. As the public sector has expanded, "wage leadership" has partially shifted to sheltered parts of the economy where big pay raises do not price workers out of jobs. There is a mix of centralized and decentralized wage negotiations in which the dominant issue is the relative pay of different groups.

Modern Swedish economic history deals a blow to the myth of a successful middle way. Sweden's experience demonstrates that over time a welfare state based on socialistinspired ideas of income redistribution erodes wealth-creating forces. It is also a reminder that a mixed economy does not have a "stable equilibrium." Each step in the short run seems not to bring economic harm. But there are no built-in correctives. As problems arise, the choice is to undo previous interventions or to intervene further. Free-market scholars such as Mises and Hayek have shown that the political process has a bias toward more rather than less government intervention.[17]

That is especially true in Sweden, which has built-in destabilizers. The Swedish political climate has always favored intervention. Socialists and the likeminded have dominated postwar Swedish thinking and the media to a greater degree than they have in any other Western nation. Furthermore, there are few constitutional checks on government intervention. The present Swedish constitution, which dates from 1975, gives almost unlimited power to the majority in the unicameral Riksdag to tax and spend as it wishes.

The fact that the economy ran well for so long made many Swedes blind to economic realities. They thought the economy would be able to adjust to whatever intervention it was subjected to and continue to deliver. Today they know better. They understand that Sweden cannot go on living on past success. They also realize that there may exist no trade-off between a little less growth and more welfarestate security. The welfare state requires substantial growth to fund its programs. Lower growth means fewer resources. Ironically, the welfare state undermines the very wealth-creating forces on which it depends.

Rapid economic growth is the most efficient way to reduce absolute poverty. A slow-growing economy means that various groups have to fight for a larger share of a shrinking pie. The result is determined by political forces, not by "objective social needs."

The Swedish welfare state can be seen as a gigantic experiment in social engineering. It was thought that by giving supposedly benevolent, rational politicians and bureaucrats the power to impose nationwide uniform regulations on housing, agriculture, consumer matters, and so on, a just and egalitarian society would emerge. Sweden arguably has been fortunate to have comparatively honest public servants and public services that compare well with those of other countries. For those reasons, and because economic decline is a recent phenomenon, the Swedes have not historically been hostile to government intervention.

But slowly more and more Swedes are realizing that the long-run result of their system is that some people--who are neither more benevolent nor more rational than others--are given discretionary power to impose their will on the rest of society. Swedish citizens are also starting to realize that a policy based on an egalitarian spirit, with no clear boundary between equality and envy, ends up harming the poorer members of society most. A society that is too envious to allow its innovators to reap the benefits of their work risks having no resources to distribute.

Will Sweden Be Able to Change?

In the last 10 years significant changes have taken place in the intellectual climate in Sweden. When radical socialist proposals were put forth in the 1970s, key business representatives and leading Swedish free-market intellectuals realized that people's understanding of political economy had to be changed. Free-market think tanks were set up, and books were published. Free-market ideas have begun to penetrate Swedish society.

Furthermore, Sweden is an open economy strongly dependent on foreign trade and exposed to foreign influence and competition. With capital and labor highly mobile, Sweden will have to bring its policies into line with those of its main competitors--or risk loss of its most productive assets and people. Sweden's openness has already had important consequences. In the 1980s the Social Democrats freed the Swedish financial markets from previous restrictions. Foreign exchange controls were abolished in 1989. Those moves reflected a clear recognition that Sweden, as a tariff-free economy, had no alternative but to embrace free capital movement. Until the mid-1980s Sweden had exercised tight curbs on the movement of money to protect its financial system from foreign encroachment. But those curbs increasingly came to be seen as an obstacle to economic growth and thus to the country's ability to compete with its main trading rivals.

The highly protectionist agricultural system is being dismantled over a five-year period; subsidies for farmers are being phased out, and controls on imported food will eventually be removed. Another important development is Sweden's request for membership in the European Community. The prevailing view among the political elite is that it is difficult, if not impossible, for a country that relies so heavily on trade with the rest of Europe to be shut out from that market.

If the intellectual arena looks promising, the political arena is more mixed. There are strong coalitions of vested interests that may try to resist reform. The Moderate party, the only party that advocates an alternative political course including cuts in taxes and spending and privatization of state-owned companies, public utilities, and some social services, could be the leading force in a new government after September 1991. But it will be unlikely to form a government on its own. Furthermore, not even the Conservatives favor radical reforms. They would want the tax burden and public-sector expenditures to be in line with the European average. There is still no popular demand that the welfare state be reduced in any fundamental way. Only a few free-market intellectuals favor that. The Liberals are much more cautious than the Conservatives. They are especially skeptical about privatization of Sweden's monopolistic social sector. They might accept contracting out public services as a way to trim the welfare state, but they would still want the public sector to exercise a decisive influence on the allocation of "social services."

The Social Democrats, admitting that past policies no longer work, emphasize not expansion of the public sector but efficient use of limited resources. But they have yet to form a serious program to tackle Sweden's problems.

It is likely that the September elections will give Sweden a new nonsocialist government. If present opinion polls are accurate, it will mean the end of 60 years of Social Democratic dominance. The SAP will be one party among others. That in itself should be an important event.

A new nonsocialist government will be a multiparty coalition that might have difficulty forming a coherent new political program. A more definite change will have to wait.

After the collapse of communism, some Swedes (especially the Social Democrats) thought the Swedish model would be an attractive choice for the newly emerging democracies of Central Europe. But it has not been. Poland, Hungary, and Czechoslovakia have wisely chosen to look for free-market solutions. Other nations in that region show little interest in the Swedish model.

What should be recommended to anyone who hopes to succeed with the Swedish model? Follow the first hundred years of capitalist growth and avoid the subsequent mistakes.

Notes

[1] Assar Lindbeck, Swedish Economic Policy (London: Macmillan, 1975), p. 11.

[2] Public-sector expenditures and tax receipts as part of GNP are approximate measures of the extent to which govern ments intervene in economies. Those figures are convenient in the sense that one can compare one country with another. But they don't tell the full story. Regulations, for in stance, don't show up in such statistics. A country may thus have a small public sector but still be exposed to a great deal of government intervention. As far as Sweden is concerned, there are few indications that it was more regu lated than other comparable Western nations until the 1960s. Foreign trade was freer than in many nations, and free enterprise predominated.

[3] Lindbeck, p. 11.

[4] Among them are ASEA (heavy electrical equipment), SKF (roller bearings), and LM Ericsson (telephones and later electronics). From the interwar period came Volvo (cars) and Electrolux (refrigerators and vacuum cleaners).

[5] In 1930 the Social Democrats introduced a bill in the Riksdag, calling for a more activist unemployment policy. They won the 1932 election, but they were a minority. To get their bill through the Riksdag, they made a deal with the agrarian party, and the Social Democrats switched from their traditional free-trade policy toward a protectionist stance for farm products.

[6] Erik Lundberg, Economic Crisis Now and Then (Stockholm: Center for Business and Policy Studies, 1983), pp. 75-82.

[7] Lars Jonung, "Knut Wicksell's Norm for Price Stabiliza tion and Monetary Policy during the 1930s," in Economic Debate and Economic Policy: 100 Year Anniversary of the Swedish Economic Association, ed. Jan Herin and Lars Werin (Stockholm: Association of Swedish Economists, 1977).

[8] The Social Democrats were twice in coalitions with the Center party (1932-36 and 1951-57). During World War II there was an all-party coalition. From 1957 to 1976 and from 1982 until today, the Social Democrats have been in office alone, though most of the time with the tacit support of the Communists, who command 5 percent of the electorate. The nonsocialist bloc that ruled in various combinations from 1976 to 1982 consisted of the Conservatives, who today garner 18 percent of the vote; the Liberals, with 14 per cent; and the Center party, with 10 percent. When the bloc took power in 1976, the Center party was the largest, with about 25 percent.

[9] Market forces have influenced wages more than would ap pear from the formal wage agreements. Between agreements, wages in particular firms have "drifted" in response to supply and demand. That drift reduces both Sweden's ability to control labor costs through centralized bargaining and the microeconomic costs of the wage-determination system.

[10] See John Burton and Peter Stein, How Sweden Works (Lon don: Adam Smith Institute, 1988).

[11] See James Buchanan and Gordon Tullock, The Calculus of Consent (Ann Arbor: University of Michigan Press, 1962) or William Niskanen, Bureaucracy and Representative Government (Chicago: Aldine Atherton, 1971).

[12] Assar Lindbeck, "Income Distribution in a Welfare State," European Economic Review 21 (1983).

[13] "Survey: The Swedish Economy," The Economist, March 3, 1990, p. 10.

[14] Ibid.

[15] Ibid., p. 16.

[16] It should be said here that although personal taxation has been very high, Swedish business taxation has been low, thus providing incentives for investment and job creation. Generous write-off systems for capital investment and inven tory have resulted in the average Swedish business's paying an effective tax rate of 25 percent, among the lowest in the industrialized world.

The tax system has been biased in favor of big compa nies. New businesses have not made enough profit to take full advantage of deductions. So investment in big compa nies was in effect subsidized. Furthermore, retained prof its have been taxed much less heavily than distributed prof its; that allows firms to avoid taxes by setting aside money for future investment. That practice, combined with lower taxes on capital gains than on dividends, has locked capital into big firms. New businesses have also faced greater difficulties raising capital. High income-tax rates and risk have discouraged the emergence of a venture-capital market.