

Welfare state reform without retrenchment:
describing and explaining political change in
Sweden 1980-2000.

Andreas Bergh NB: Work in progress!

August 12, 2009

Abstract

Between 1980 and 2000 Sweden experienced increases in economic freedom well above the OECD average, but maintained high levels of taxation and social public expenditures. Public commissions have played an important role in creating political consensus. Private topping up of publicly financed welfare benefits as well as freedom of choice and competition through the use of voucher systems are likely explanations of the fact that public support for the welfare state has been constant during the entire reform process. Policymakers who wish to create a mandate for welfare state retrenchment can make use of the Swedish experience, but should do differently from what has been done in Sweden.

Keywords: Welfare state, political change, reforms, social insurance, topping up.

1 Introduction

In October 1993, *The Economist* discussed the case of Sweden.¹ The headline was "Worse and worse", and the text mentioned a number of macro economic problems: A budget deficit at 13% of GDP, a national debt at about 71% of GDP, foreign confidence in Sweden is withering, and the krona has depreciated 30 percent against the D-mark in less than a year. Swedish economists fear grave inflation, and the article quotes "super-pessimist" and political scientist Elisabeth Langby, whose book 'Winter in the Land of Welfare' was widely read this year:

Langby doubts whether the necessary changes are possible. Since more than two-thirds of Sweden's voters get their income from the government (through either state jobs or various forms of welfare payment), the electoral arithmetic of removing the deficit is frightening. (p. 58-9)

Langby's book was actually first published in 1984. It predicted a dismal future for the Swedish welfare state as a result of absent political change. The pension system was going bankrupt, but because politicians would only lose from telling voters that the old system needed to be fixed, there would be no reform, Langby predicted. Teachers would never accept competition among schools and freedom of choice through school vouchers. In fact, public procurement from private providers was viewed by Langby as an idea of economist that might possibly look nice in theory but that would never gain practical importance in Sweden. Finally, Langby was sceptical that the public sector could be trimmed and the budget deficit reasonably reduced.² In 1993, when the article in *The Economist* was published, the Swedish budget deficit was exploding. It looked as if Langby was right and her book re-released in a second edition. As it turned out, Langby was wrong on all points.

There is no denying the fact that there were several good reasons to worry about the Swedish welfare state in the 1980s. Langby was spot on in identifying some of the weak points: the pension system and the lack of competition within the public sector. Most likely, warnings such as those from Langby were important for spreading the insight that change was needed. 25 years after Langby's book, and 15 years after the article in the Economist, Sweden stands out as a remarkable example of a country that has combined high taxes and a big public sector with far reaching reforms towards economic freedom.

¹The Economist, October 9, 1993.

²Langby (1984:72-81)

This paper describes the nature of the reforms and how they came about. What can be learned from the case of Sweden, when it comes to engineering political change in a welfare state? I argue that the Swedish experience contains valuable lessons for both friends and enemies of the welfare state. I limit the discussion to three issues. None of them is a catch all explanation, but all of them are (hopefully) important enough to merit a discussion.

First: Understanding the nature of the reforms. This is important, because according to several commonly used measures, little has happened in Sweden. Taxes and social expenditures are still high, or even higher than they were in the 1980s. But as we shall see, these measures do not convey the full picture.

Second: The role of government commissions in the reform process. This is important because on many reforms (with some notable exceptions), there has been de facto agreement between the socialdemocrats and one or several right wing parties, giving both credibility and stability to the reform process. Perhaps more importantly, Swedish voters have had small opportunities to avoid reforms by voting differently.

Third: The role of topping up in maintaining political support for a big welfare state. This is important because it is an important factor explaining the continued support for the high tax welfare state even among high income earners in Sweden.

After discussing these three topics, I discuss what can be learned for welfare state reform - or retrenchment - in general, based on insights from Sweden.

2 The nature of reforms in Sweden 1980-2000

Understanding the nature of policy and political change in Sweden during the latest 30 years is not completely straight forward. In 1980, Sweden was viewed as a half-socialist welfare state. 20 years later, taxes are just as high and the public sector is just as big. Concluding from this that not much has happened would, however, be wrong. Compared to the OECD average, Sweden increased globalization more rapidly (measured by the index developed by Dreher, 2006) and has experienced above average increases in economic freedom in all areas except the one related to government size (as measured by the Fraser institute's Economic freedom index, Gwartney et al., 2008). Total public social spending, however, is still as high as in the 1980s. Figure 1 illustrate this using data from the KOF-globalization index and the Fraser institutes economic freedom index.

Fig. 1 Indicators of political change in Sweden: Social expenditure/GDP, KOF globalization index, the Fraser institute's economic freedom index dimension 1 (government size) and average for dimension 2 to 5.

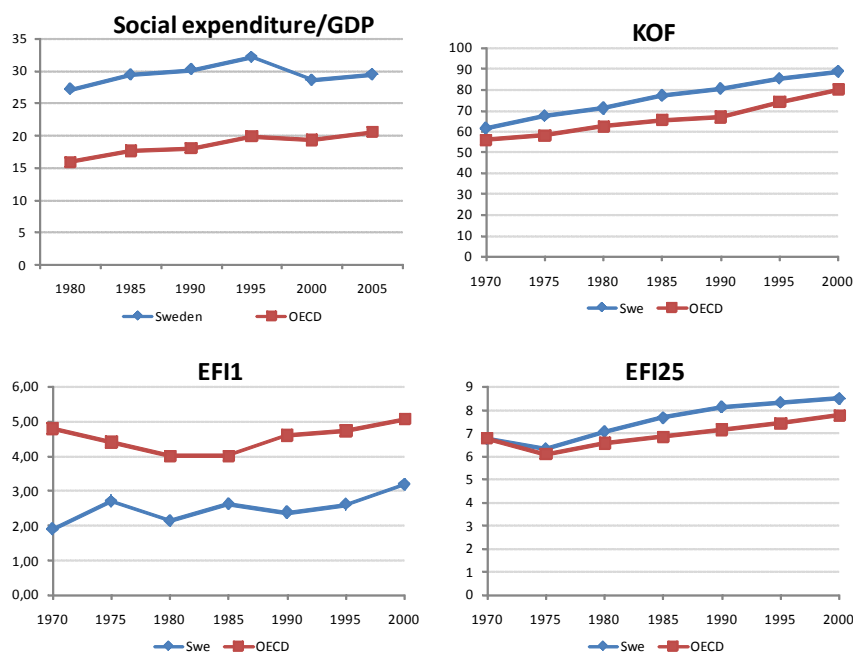
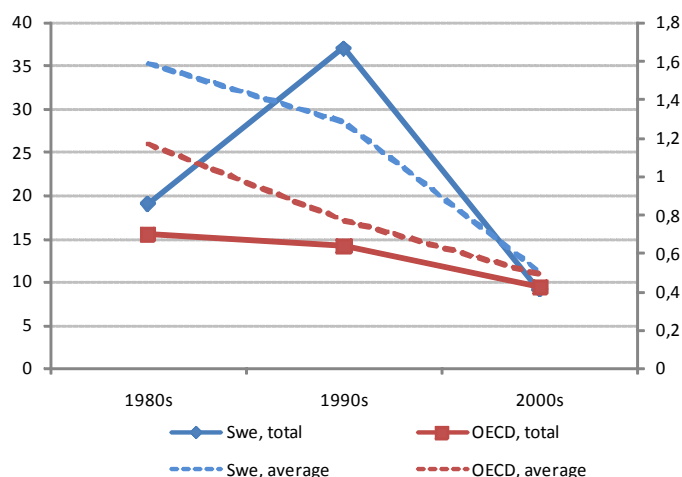


Fig. 2 shows another way to illustrate the Swedish development, based on a newly developed OECD reform database that quantifies policy advice in OECD's Economic Surveys.³ The database covers 23 OECD countries, and is based on assessments made in OECD Economic Surveys. The database shows the perceived need of reform in a number of areas, at the time around 1985, 1995 and 2005. The need for reform is described by a discrete scale containing three degrees of reform need as perceived by the OECD experts: 0 indicates little or no need of reform, 1 indicates some need of reform and 2 indicates big need of reform. Based on these assessments, two indicators of reform need have been constructed. The total measure sums the values for all areas with remarks. The average need is the average value for these areas. In other words the total measure captures an attention effect, ie. that the OECD remarks on many areas, whereas the average measure describes the size of reform need for the areas with remarks.

³Source: Bergh & Dackehag (2009) Are OECDs policy recommendations neo-liberal? Evidence from a new reform database. Work in progress.

Fig. 2 Reform need according to OECD Economic Surveys. Right scale: Average remark score, where 2 indicates big reform need, 0 indicates no reform need. Left scale: Total remark score.



We see that in the mid 1980s, OECD remarked on 18 policy areas where Sweden was in need of reform, just slightly higher than the OECD average of 16. But the remarks on Sweden were more severe, in the database often coded as large reform need. In the mid 1990s, Sweden was given a lot of attention from the OECD. In many areas it was noted that the reform process had begun but that more was needed. Around 2005, Sweden had become an average OECD-country in terms of reform need as measured by this database. Interestingly, Sweden is now an average OECD-country and in many areas better according to the criteria that OECD use when they evaluate policy. But the size of the public sector is still well above average.

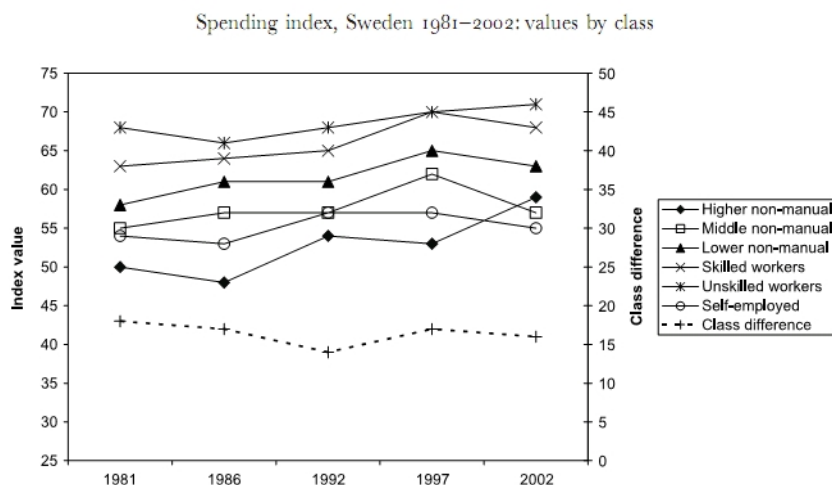
Finally, it is worth pondering public attitudes towards the welfare state in Sweden during this era of rapid change. One might expect that high income earners would gradually become less satisfied with the welfare state, or that people who liked the welfare state in 1980 have disliked the market orientation of many aspects of the welfare state. But data suggest that welfare state support has been constant or even rising during the 1980s and 1990s in all social classes. Svallfors (2004) present data based on the following survey question:

Taxes are used for different purposes. Do you think that the amount of tax money used for the following purposes should be increased, remain unaltered, or decreased?"

The alternatives mentioned are medical and health care, support for the elderly, support for families with children, housing allowances, social assistance

and employment policies. Answer categories are increase, unaltered and decrease. Svallfors aggregates and transforms the scale to a measure from 0 to 100, with the result shown in fig 3.

Fig3. Attitudes towards welfare state spending in Sweden 1981-2002. Source: Svallfors (2002).



In addition to survey evidence of state attitudes, voting behavior is also relatively stable. No anti welfare state party has emerged, and the recent success of the right wing party is typically attributed to the fact that they no longer argue for a system shift with drastically lower taxes.⁴

Having described the nature of Swedish reforms, I turn now to the question of how to explain why they were successfully implemented.

3 Explaining the survival of the Swedish welfare state

3.1 The role of public commissions

The Swedish style of policy making was documented repeatedly around thirty years ago, by, for example, Anton (1969), Elvander (1974) and Castles (1976). Policy making in Sweden was described as rational, pragmatic and consensual compared to other countries. Government commissions and interest groups played an important role in the creation of Swedish consensus. Perhaps surprisingly, Bergh & Erlingsson (2009) show that this description fits also the reform

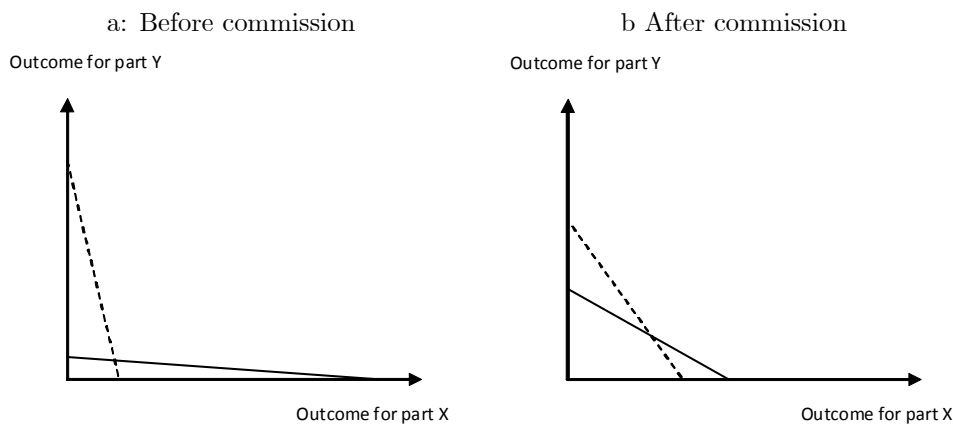
⁴With the possible exception of New Democracy 1991-1994. Add evidence from SOM?

period in Swedish politics. Commissions facilitate reforms in several ways:

- They create a common way to perceive problems.
- Commissions also identify possible reforms by functioning as early warning systems.
- Commissions serve as an arena where input from social science and from civil servants can influence policy.
- Commissions can contribute to creating personal trust among central policy makers.
- Commissions also serve an important role in identifying winners and losers of reforms. Thereby they are also important in the process of turning Kaldor-Hick improvements into Pareto improvements by finding ways to compensate losers of reforms.

To illustrate the effect that commissions may have, consider two bargaining parties with different views on the nature of the gains from a potential reform. Part Y feels that reform does little good for them, but mainly benefits part X (as indicated by the drawn line in the figure below), whereas part X believes exactly the opposite (as indicated by the dashed line). If both parts have a skewed world view, a proposal reasonable to part X is not even feasible according to part Y - and vice versa. After a commission process, where parts encounter experts and scientists, their world views may converge and the possibilities to agree on reforms increase.

Fig 4: The effect of a successful commission on bargaining parts' world view



3.2 The role of topping up

In most modern welfare states, it is increasingly common that citizens complement publicly financed benefits with privately financed benefits. For example, Scandinavian welfare states typically offer positively income-related (Bismarckian) social insurance benefits against various risks, including sickness and unemployment. It is now common to complement social insurance coverage with private and/or occupationally negotiated insurance schemes (see for example Ståhlberg, 2003). The interaction between public and private welfare expenditure have important political implications, that have been analyzed theoretically in a number of public choice papers: Epple and Romano (1996b) and Anderberg (1999) analyze pensions, Besley and Coate (1991) and Gouveia (1997) study the public provision of any private good.

These theoretical models produce three insights of empirical relevance related to the political support for big welfare states:

First, a system where private welfare expenditure are allowed to complement the tax financed benefits provided by the welfare state, will always have at least as high political support as a system with only public provision.

Second, under broad circumstances a mixed system will have strictly higher political support than a pure system, ie. systems with public or private provision only.

Third, there is a "choking level" for some public benefits, caused by the fact that individuals who demand more than what is provided can buy topping up on the market, but individuals who demand less than what is provided by the welfare state, can not sell off this on the market.

To demonstrate that the argument is very general, I construct below a model of Bismarckian social insurance to illustrate these insights and to show that they apply also for the type of social insurance that dominates a welfare state like Sweden: Insurance against income losses, where the benefit is defined as a replacement rate of the insured income. The model used is similar to the one used by Petretto (1999), although Petretto considers health insurance covering expenditures for health care and focus on utilitarian welfare maximizing policies. My focus is instead on political support.

3.3 Topping up and political support for Bismarckian social insurance

Each agent i has preferences \succsim_i over three constitutions: pure social insurance (S), social insurance with topping up (T) and market insurance (M). The ordinal preferences of an agent over these constitutions are easily described by ordering the alternatives from the most to the least preferred, for example TSM. Each agent ranks the three alternatives according to their expected utility. The expected utility from social insurance is

$$EU_i^S = (1 - \rho_i) u(y_i(1 - t)) + \rho_i u(ry_i), \text{ with } u' > 0, u'' < 0. \quad (1)$$

Here y_i is individual income, t is the tax rate and r the replacement rate in social insurance. The probability that individual i suffers from income loss is denoted ρ_i . Note that benefits are not subjected to taxation, though this assumption is not important for the results. Expected utility from pure market insurance is

$$EU_i^M = (1 - \rho_i) u(y_i - a_i) + \rho_i u(q_i^M y_i). \quad (2)$$

Here, q_i^M is the utility maximizing amount of coverage bought by i when the premium is determined by a multiplicative markup c over the actuarially fair premium. Formally,

$$q_i^M = \arg \max_{q_i} (1 - \rho_i) u(y_i - a_i) + \rho_i u(q_i y_i), \text{ where } a_i = \frac{q_i c \rho_i}{1 - \rho_i}. \quad (3)$$

The multiplicative loading cost c reflects imperfect competition and the costs private firms incur to obtain information about individual risks. It is assumed that private firms can handle the adverse selection problem by using a costly risk discrimination technology. Finally, expected utility from constitution T, social insurance with topping up, will be

$$EU_i^T = (1 - \rho_i) u(y_i(1 - t) - a_i^T) + \rho_i u((r + q_i^T) y_i), \quad (4)$$

where q_i^T is the utility maximizing amount of topping up coverage bought by i , and a_i^T the associated premium:

$$q_i^T = \max \left(0, \arg \max_{q_i} (1 - \rho_i) u(y_i(1-t) - a_i) + \rho_i u((r + q_i) y_i) \right). \quad (5)$$

Note that q_i^T is non-negative: It is not allowed to sell social insurance coverage on the private insurance market.

Because social insurance pools risks across all agents and is financed by proportional taxes, the tax price will be non-actuarial to the advantage of high-risk agents and unfavorably for low-risk agents. In monetary terms, there will be net-receivers and net-payers.

Definition 1 *Agent i is a net payer $\Leftrightarrow t(1 - \rho_i) y_i > \rho_i r y_i$.*

In this setting, there are two potential motives for individuals to support social insurance: The redistribution motive and the insurance motive. The redistribution motive can be traced back (at least) to Meltzer & Richards (1981) and amounts to net receivers supporting social insurance because they gain monetarily from the redistribution. Less trivially, net-payers may support social insurance because of the insurance motive: If they are sufficiently risk avert and market insurance is sufficiently inefficient because of adverse selection problems, net-payers will prefer constitution S to M. For actuarially fair insurance, full insurance is optimal. But since social insurance is risk pooling, it follows that net payers have an ideal replacement level below 1, whereas net receivers would ideally prefer more than full social insurance coverage - though this is not allowed.⁵ Let r_i^* denote i 's ideal social insurance:

$$r_i^* = \min \left(1, \arg \max_{r \in [0,1]} (EU_i^S) \right). \quad (6)$$

For net payers, the level of market inefficiency c will be important for her ranking of the three alternatives T, S and M. Therefore we define a special level of c denoted \tilde{c} as follows:

Definition 2 *For every agent i , such that $t(1 - \rho_i) > \rho_i r$, \tilde{c}_i is the level of c such that $c < \tilde{c}_i$ implies $M \succ_i S$ for all $r \in (0, 1]$ and $c = \tilde{c}_i$ implies $M \sim_i S$ for $r = r_i^*$.*

The important consequence of this definition is that whenever $c < \tilde{c}_i$ we know that i will have M as her most preferred constitution. In other words,

⁵The fact that when insurance price is actuarially unfair, full insurance is never optimal was originally proved by Mossin (1968).

\tilde{c}_i is the amount of market inefficiency needed to induce i to support social insurance. Note that \tilde{c}_i is only defined for net payers: Net receivers has a positive return to social insurance, so the market alternative is never the most preferred alternative. Having described how preferences are determined, we now turn to political support.

Definition 3 *Political support for social insurance PS is the number of voters who prefer S or T to M :*

$$PS = \#\{i \in [1, N] \mid S \succ_i M \text{ or } T \succ_i M\}.$$

Claim 1 *Assuming that T is not available, political support for social insurance will depend on c and r as follows:*

a) *if $c = 1$, then $r = 1$ maximizes political support for social insurance such that all net-receivers support social insurance and no one else does.*

b) *PS is weakly increasing in c for all $r \in (0, 1]$.*

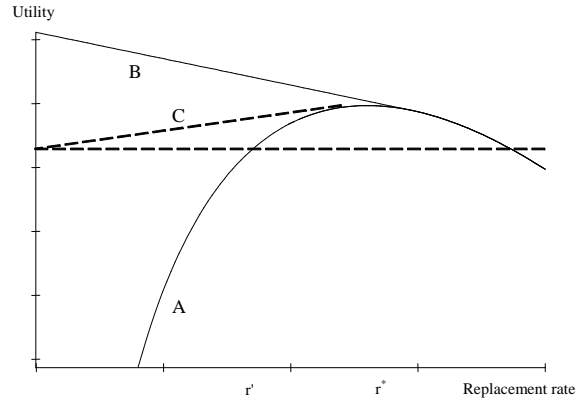
Proof. a) If net-receivers would buy private insurance they would buy full insurance at a actuarially fair price. With social insurance, they get full insurance at a price below what is actuarially fair, and hence no net-receivers will prefer market insurance. For the same reason, net-payers will never prefer social insurance. Lowering r below 1 will never induce net-payers to support social insurance, but will induce net-receivers to prefer market insurance if the utility lost from insufficient coverage is bigger than the utility lost by having to accept fair premiums.

b) Follows because $\frac{\partial EU^M}{\partial c} < 0$ and $\frac{\partial EU^S}{\partial c} = 0$. ■

This leads to the main result:

Proposition 1 *When T is available, PS is weakly decreasing in r .*

Proof. First, note that net-receivers will always have TMS or TSM preferences. Thus, lowering r will never induce a net-receiver to prefer M when T is available. Second, consider the preferences of net-payers as illustrated in the figure below:



Curve A shows utility for a net payer with no topping up, which is maximized at r^* . Curves B and C illustrate utility when topping up is allowed under two different levels of c . For $c < \tilde{c}_i$, i will prefer $r = 0$, that is pure market insurance, and will for sure buy topping up when $r < r_i^*$ (curve B). For $c > \tilde{c}_i$, (curve C) private insurance is more expensive than social insurance, but when social insurance coverage is sufficiently less than optimal, i will nevertheless choose to buy some topping up. For $r \in (r', r^*)$ the agent will have TSM-preferences, and for $r < r'$, preferences will be TMS. The horizontal part of curve C is the utility from pure market insurance. ■

In other words, the choking level result (Gouveia 1997) makes another appearance: There is a replacement level above which low-risk individuals would like to sell off protection, because the welfare state gives them more than they demand (and also charges them for it using taxes).

4 Concluding discussion: How to increase support for welfare state retrenchment

The case of Sweden illustrates a welfare state that has survived thanks to, among other things, its adaptability. In several areas, reform need has been identified and handled in a way that has preserved not only the welfare state itself, but also the political support among voters for the welfare state. Thus, taxes and public expenditure in Sweden are still among the highest in the world. But the case of Sweden also contains some lessons for policymakers wishing to shrink the welfare state.⁶

⁶There are, of course, rational as well as ideological reasons for the goal to shrink the welfare state. For example, the high tax wedges necessary to finance the welfare state are likely to hinder the development of the service sector - cf. Davis and Henrekson (2004)

Simply put, if Swedish policy makers have maintained welfare state support (even among high income earners) by doing certain things, policy makers wishing to create support for shrinking the welfare state, should refrain from doing these things. Based on the analysis so far, I suggest that the following five will help to create political support for shrinking the welfare state.

- Do not initiate public commissions.

Without public commissions, changing circumstances to which the welfare state must adapt will be noticed later, there will be less political agreement on the nature of these circumstances and less time to create consensus on reforms. As a case in point, the need to reform Swedish pensions was identified at an early stage. This made it possible not only to agree on a new system, but also to phase in the new system gradually over a 16-year period. Using standard median voter analysis, Selen and Ståhlberg (2007) demonstrates that this long phasing in period was crucially important in making the reform politically possible.

- Increase social insurance benefits above the choking level

As demonstrated above, low risk groups will prefer less protection than high risk groups in social insurance schemes. Providing lower protection levels and allowing topping up is therefore a smart strategy for maximizing political support. Doing the opposite means overinsuring low risk groups and charging them using taxes. Because we know that in many cases, high income correlates with low risk of income loss, this strategy thus forces high income earners to pay for benefits they value relatively little.

- Forbid topping up of welfare services

Public consumption such as education and health care is qualitatively different from social insurance protection, in that high income earners demand more of this rather than less - compared to low income earners. The long run income elasticities for education and health care exceed 1, which means that as we get richer, we prefer to spend an increasing share of our income on these areas (see Fogel 1999; Bergh 2008). . As demonstrated empirically for the case of health insurance by Hall and Preston, people who pay twice (ie. both pay taxes and buy market insurance) support cutting back on public health care spending.

- Do not use vouchers

Vouchers have at least two effects that contribute to welfare state support: They increase efficiency and they allow people to choose among different publicly financed providers of welfare services, thus decreasing the utility lost by not being able to choose freely on the market.

- Increase tax-progressivity

As shown by Gouveia (1997), the tax price is an important factor determining welfare state support among high income earners. Increasing progressivity means increasing the tax price for high income earners and ceteris paribus this decreases their political support for the welfare state.

References

- Anderberg, D.: 1999, Determining the mix of public and private provision of insurance by majority rule, *European Journal of Political Economy* **15**, 417–440.
- Anton, T. J.: 1969, Policy-making and political culture in sweden, *Scandinavian Political Studies* **4**, 88–102.
- Bergh, A.: 2008, A race to the bottom for the big welfare state?, in A. Bergh and R. Hååijer (eds), *Institutional Competition*, Edward Elgar, Cheltenham/Northampton.
- Bergh, A. and Erlingsson, G. .: 2009, Liberalization without retrenchment: Understanding the consensus on swedish welfare state reforms, *Scandinavian Political Studies* **32**(1), 71–94.
- Besley, T. and Coate, S.: 1991, Public provision of private goods and the redistribution of, *The American Economic Review* **81**(4), 979–985. 00028282.
- Castles, F. G.: 1976, Policy innovation and institutional stability in sweden, *British Journal of Political Science* **4**, 203–216.
- Dreher, A.: 2006, Does globalization affect growth? empirical evidence from a new index, *Applied Economics* **38**(10), 1091–1110.
- Elvander, N.: 1974, Interest groups in sweden, *Annals of the American Academy of Political and Social Science* **413**, 27–43.
- Epple, D. and Romano, R. E.: 1996, Public provision of private goods, *Journal of Political Economy* **104**(1), 57–84. 00223808.
- Fogel, R. W.: 1999, Catching up with the economy, *American Economic Review* **89**(1), 1–21.
- Gouveia, M.: 1997, Majority rule and the public provision of a private good, *Public Choice* **93**(3), 221–244.

- Gwartney, J., Lawson, R. and Norton, S.: 2008, Economic freedom of the world: 2008 annual report, *The Fraser Institute. Data retrieved from www.freetheworld.com* .
- Hall, J. and Preston, I.: 1998, Public and private choice in uk health insurance, *Institute for Fiscal Studies Working Paper Series* **W98/19**.
- Mossin, J.: 1968, Aspects of rational insurance purchasing, *Journal of Political Economy* **76**(1), 553–568.
- Petretto, A.: 1999, Optimal social health insurance with supplementary private insurance, *Journal of Health Economics* **18**, 727–745.
- Selen, J. and Stahlberg, A. C.: 2007, Why sweden’s pension reform was able to be successfully implemented, *European Journal of Political Economy* **23**(4), 1175–1184.
- StÅehlberg, A.-C.: 2003, Occupational welfare, in T. M. Andersen and P. Molander (eds), *Alternatives for welfare policy. Coping with internationalisation and demographic change.*, Cambridge University Press, Cambridge, pp. 189–206.
- Svallfors, S.: 2004, Class, attitudes and the welfare state: Sweden in comparative perspective, *Social policy and administration* **38**(2), 119–138.