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## SWEDISH LESSONS FOR POST-SOCIALIST COUNTRIES<sup>1</sup>

When reforming their own countries, several observers, ideologues and politicians in former socialist countries have pointed to Sweden as a blueprint.<sup>2</sup> It is then believed that Sweden, or the “Swedish model”, has combined the efficiency, dynamism and flexibility of capitalist market economies with the economic security and egalitarianism so highly evaluated by many social liberals and socialists. An analysis of the Swedish experience, and its relevance for former socialist countries, may therefore be of rather general interest.

When addressing this issue, it is important to realize that basic features of the economic and social system in Sweden have changed considerably over time. Though attempts to divide history into periods are hazardous, in this paper I partition modern economic and social history in Sweden into three periods. The first is the century-long time span from about 1870 to 1970, which may be called “the period of decentralization and small government”. During this period, the economic system in Sweden did not differ much from those in other countries in Western Europe, although Sweden was probably one of the least regulated economies in this part of the world. The second period, from 1970 to 1985/90, may be characterized as a “period of centralization and large government”. In this time span, Sweden acquired idiosyncratic features, though still within the framework of a capitalist market economy. The third period, from 1985/90

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Facts, figures and interpretations about Sweden in this paper are based on my book *The Swedish Experiment*, Stockholm: SNS 1997, if not stated otherwise. (This book is a slightly expanded version of a paper with the same title in *Journal of Economic Literature*, September 1997.)

<sup>2</sup> Examples are Augusztinovics (1997), Ferge (1989), Nyilas (1992 and 1995), Szalai (1986) and Tárkányi (1997).

onwards, may be regarded as a “period of transition” due to deregulation of markets for capital and foreign exchange, intensified importance of private saving and private supply of capital, comprehensive tax reforms (with lower rates, a broader base and fewer asymmetries), a shift of the macroeconomic policy regime towards greater emphasis on price stability, a stricter budget process in the public sector, as well as some (modest) attempts to reform and rewind various welfare-state arrangements.

The paper deals mainly with the last two periods. By way of introduction, I will make a few comments on the first, century-long period, as it was largely then that the foundation of today’s affluence in Sweden was established. Some of the experience from this period is also highly relevant for post-socialist countries.

### ***I. The period of decentralization and small government: 1870-1970***

In this period, the Swedish economy may be characterized as a decentralized, capitalist market system, highly open to international trade and factor mobility (of capital as well as labor).<sup>3</sup> The government was anxious to provide stable rules of the game, appropriate for an efficient capitalist market economy. Indeed, this had already been brought about in the middle of the nineteenth century (in particular, in 1846 and 1864) by a shift from mercantilist regulations to “freedom of entrepreneurship” (*näringsfrihet*). Government activity were concentrated on the “classical” functions of government, i.e., providing collective goods, an adequate and well-functioning infrastructure, as well as encouraging investment in human capital by comprehensive elementary education and the establishment of a number of engineering schools at different educational levels.

During most of this period, government spending and taxes as fractions of GDP seem to have been only between half and two thirds of the average of other countries that are highly developed today (Tanzi, 1995). It was not until 1960 that total public-sector spending in Sweden had reached the OECD average, then about

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<sup>3</sup> Expositions on the economic system during this period include Lundberg (1956), Lindbeck (1975, pp. 1-10) and Myhrman (1994).

31 percent of GDP -- as compared to less than 10 percent at the turn of the century and 25 percent in 1950.

Growth performance in Sweden was strikingly successful during this period. Sweden had one of the fastest, perhaps *the* fastest, rate of labor-productivity growth, also in terms of GDP per capita, of all countries for which records are available (except possibly Japan). The Swedish experience during this period, therefore, illustrates the fact that a decentralized market economy, highly open to international transactions, may be quite conducive to sustained productivity growth if the government fulfills its “classical” functions well.

At the very end of the period, in the 1950s and 1960s, there was an early build-up of welfare-state arrangements of about the same generosity as in other West European countries at that time. Serious disincentive problems do not seem to have materialized during this period, even though total public-sector spending gradually increased from 31 to 40 percent of GDP between 1960 and 1970. We cannot be sure, of course, whether this means that the welfare-state arrangements and related taxes in the 1960s were “harmless”, or even favorable, from the point of view of economic efficiency and growth, or if serious disincentive effects were simply delayed -- perhaps by as much as an entire decade.

The sequencing of events -- *first* relatively rapid economic growth over a very long period of time, *later* gradually more ambitious welfare-state spending -- is important to observe for those who regard Sweden as a blueprint for former socialist countries. Sweden was already a rich country when it embarked on the road to generous welfare-state spending. By that time, Sweden had also acquired what may be called “administrative maturity”, with an apparent ability to handle both the classical functions of government and emerging welfare-state arrangements, including their financing.

Turning, for a moment, to the welfare-state arrangements in today’s post-socialist countries, the generosity of such arrangements in the three richest – Hungary, The Czech Republic and Poland -- would seem to be about as great as in Sweden. For instance, the “replacement rates” in income-protection systems are about the same as in Sweden. Moreover, many social services are as highly subsidized as in Sweden. Indeed, they are often free; this is the case not only for education but also for health care, child care and old-age care (even though the

subsidies have diminished in recent years). As a result, in some post-socialist countries, the size of both “social” and total government spending today is about as high, relative to GDP, as in Sweden (Kornai, 1992b) in spite of the fact that GDP per capita in these countries is currently no more than about a fifth of the corresponding figure in Sweden (UN, 1996).

Observations like these form the background for Janos Kornai’s (1992b) characterization of some post-socialist countries as “premature welfare states”. The high ambitions of income protection and social services in these countries are partly inherited from the socialist period, though both cash benefits and in-kind services were then often tied to employment contracts; much of the costs, therefore, showed up in firms rather than in the central government budget.<sup>4</sup> The welfare-state arrangements in other post-socialist countries are still rather fragmentary.

Another important experience in Sweden during the century-long period 1870-1965/70, of relevance for today’s post-socialist countries, is that public-sector administrators seem to have been relatively honest. This was certainly no gift from heaven. It is well known that corruption flourished in Sweden during the mercantilist period in the second half of the eighteenth and early nineteenth centuries. One reasonable explanation for the relative absence of corruption in the second half of the nineteenth century and first half of the twentieth century is that public-sector administrators did not have much to “sell” after the removal of mercantilist regulations. A complementary explanation is that public-sector administrators were well paid, which may have reduced the temptation to accept bribes; they could “afford” to be honest. For instance, at the turn of the last century, high-level administrators (*generaldirektörer*) earned 12-15 times the salary of an average industrial worker.<sup>5</sup>

It is also likely that honesty evolved into a *social norm* among public-sector administrators during this century-long period. High status in the eyes of colleagues and the general public probably required honest behavior, in the sense that others expected it. The emergence of such a norm was facilitated by the fact

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<sup>4</sup> For instance, firms often owned or financed kindergartens, workers’ old-age homes, sport facilities, vacation centers, cultural institutions, etc. With the subsequent privatization many of these services were sold or dismantled.

<sup>5</sup> A main source for this information is *Sociala Meddelanden* no 5, 1927, pp. 401-402.

that it was highly consistent with the existing incentive structure for government officials. The social norm of honesty -- an important aspect of the work ethic -- was probably internalized in the value system of the public-sector administrators themselves.

This experience of relatively honest public-sector administrators in Sweden for a long period of time carries an important message to former socialist countries. It is a commonplace that permanent shortages and reliance on administrative allocations of resources bred corruption during the socialist period. This probably helps explain why the field was wide open for new types of corruption during and immediately after the process of privatization -- with lingering regulations, low relative salaries of civil servants and policy-induced uncertainty about their job security.<sup>6</sup> On the basis of the Swedish experience, I imagine that a combination of four types of policies would mitigate these problems: (i) a strong legal crackdown on corruption; (ii) relatively well-paid civil servants; (iii) strict legislation that prevents monopolization and cartellization in both the private and the public sector; and (iv) a speed-up of the process of deregulation and privatization to shorten the period during which public-sector administrators are able to “sell” permits and other favors.

## ***II. The period of centralization and large government: 1965/70-1985/90***

The Swedish experience in this period also provides highly relevant, though rather different, lessons. As a broad generalization we may say that from the late 1960s and early 1970s, Sweden became dominated by large and centralized institutions and highly interventionist policies. Important manifestations are (i) a drastic rise in government spending (to the interval 60-70 percent of GDP); (ii) a huge increase in marginal tax wedges (to 65-75 percent for most full-time income earners); (iii) an increasingly interventionist macroeconomic policy, in particular, in the labor market; (iv) greater importance of the government for aggregate saving and the supply of capital (about half of each being provided by the government); (v) increased centralization of decision-

making *within* the public sector itself; as well as (vi) highly centralized wage bargaining designed to squeeze wage differentials. There was also (vii) a strong concentration of the structure of firms in the private sector. One important element of the earlier highly decentralized market system was retained, however, and even accentuated, namely (viii) free-trade of goods and services (excluding financial transactions).

It is important to realize that most of these interventionist policies and centralist organization of society are of rather recent origin. (See Lindbeck, 1997, pp.12-19.) While government spending, as a share of GDP, was relatively low in Sweden until about 1960, by 1970 it had become 8 percentage points higher than the OECD-Europe average, and by the mid-1990s about 17 percentage points higher (OECD data base).<sup>7</sup> Efforts to redistribute income via very high marginal tax rates increased only gradually, in particular in the late 1960s, with an upward leap in 1971. Moreover, while the *idea* of Keynesian-type full-employment policies had been promoted by the Swedish government as early as the 1930s, it had little (hardly any) influence on the policies actually pursued until after World War II. Strongly interventionist (selective) stabilization policy and tight regulation of the labor market were not introduced until the early 1970s. Active labor market policy was not pursued on a large scale until the late 1970s, although the *idea* of such a policy had already been developed in the 1950s, in particular by some labor union economists. Government saving and credit supply did not become important until the mid-1960s, partly in connection with the build-up of “buffer funds” (the so-called AP funds) in connection with the state pension system (the ATP system).

Centralization within the public sector increased gradually during the post World War II period as a result of the forced merger of 2,000 municipalities into about 280 between the mid-1950s and mid-1970s. After the early 1970s, the municipalities have also been increasingly ordered to augment their supply of services in quantities and qualities determined by the central government. Stricter political control was also exerted on various central government agencies, which had previously been rather independent of the cabinet. Moreover, even though

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<sup>6</sup> For evidence on the importance of corruption in socialist and post-socialist countries, see Galasi and Kertesi (1987 and 1990), Moody-Stuart (1997), Nagy (1993), Klemm (1991) and Holmes (1993).

<sup>7</sup> The difference is smaller if we consider that certain benefits that are taxed in Sweden are free of tax in some other countries; see footnote 11.

wage bargaining had already become highly centralized by the late 1950s, it was hardly used to squeeze wage differentials until the late 1960s, by way of so-called solidary wage policy. Centralization within the private sector also emerged only gradually after World War II, in fact often encouraged by government policies.

Thus, even though the *visions* of a highly centralized society with strongly interventionist policies may be traced back to the 1930s, 1940s and 1950s, it was not until the late 1960s and early 1970s that these visions materialized in actual institutions and policies.

Similar developments took place in some other western countries in the 1960s and 1970s. But the changes were more far-reaching in Sweden in several respects. As a result, since the mid-1960s and early 1970s, institutions and policies in Sweden have diverged from those in other western countries to the extent that it is appropriate to talk about a special “Swedish model” of economic organization and policies from around that time. Hence I devote particular attention to this period. It is also instructive to deal with a subsequent period, after 1985/90, when a partial retreat from important elements in this model took place, with related transition problems. Indeed, Sweden may be viewed as a “mini-transition economy” in the late 1980s and early 1990s.

While centralization of decision-making in socialist countries may be regarded as an intrinsic characteristic of such systems, and hence a “system-specific” feature, centralization of the economic system in Sweden after the mid-1960s was, of course, not an unavoidable characteristic of a capitalist market economy -- as witnessed by Swedish history as well as cross-country comparisons. Moreover, the centralist and interventionist development in Sweden during this period was not the result of a grand “master plan” designed to overhaul the organization of society. Rather, the change may be regarded as an *ex post* outcome of hundreds (or thousands) of separate decisions. Behind many of these decisions, however, it is possible to detect a specific view of the world, such as a firm commitment to income security, full employment and egalitarianism, as well as strong confidence in returns to scale and the efficiency of large organizations (government as well as private). There was also a strong belief in the welfare-enhancing effects of centralized political interventions in the economic lives of firms and families and, as a mirror image, considerable suspicion of markets,

economic incentives and private entrepreneurship not embodied in large corporations.

However, it remains to explain why the shift to a more centralist and interventionist economic system did not occur until the late 1960s and early 1970s. Attempted explanations have to be rather speculative. After all, the social democrats have dominated politics continuously from the mid-1930s. One conceivable explanation for the dramatic expansion of public-sector employment in Sweden from the early 1970s to the mid-1980s is that the government has served as “an employer of last resort” in order to sustain full employment. Huge macroeconomic disturbances in the 1970s and early 1980s, in particular the two oil price shocks, induced the government to expand public-sector employment faster than before simply to live up to the full-employment guarantee. This role of the Swedish public sector may be regarded as a weak version of the job guarantees in socialist countries where, however, firms rather than the central government have been in charge of this task.

It is also tempting to speculate that the rapid expansion of public sector spending, the increased progressivity of the tax-system and the more interventionist policies towards firms in the late 1960s and early 1970s had something to do with the international radicalization of political opinion at that time. It remains then to be explained why these ideological developments had a greater impact in Sweden than in other countries. One conceivable – though also rather speculative – explanation is that the new Swedish constitution dating from 1970 allowed new political winds to influence policies faster than before. Among the changes were that the first chamber in parliament (with an eight year election period) was abolished, the election period for the remaining chamber was shortened to three years, and a shift to strictly proportional elections made it more difficult to obtain a parliamentary majority

Personal factors may also have been important. A new generation of ideologically oriented former student politicians rose to political prominence in the 1970s; for instance, Olof Palme became prime minister in 1969. We may also speculate that these individuals, without deep background in the labor movement, had less authority than their predecessors to resist demand from organized interest groups, such as labor unions.

Similar, though much stronger, centralist visions were prevalent among ideologues and politicians in socialist countries during the period 1950-1990. As compared to Sweden, the starkest difference was, of course, that dominating decision-makers in the socialist countries rejected political democracy and a market system -- or were coerced into rejecting such ideas. Moreover, while government interventions in Sweden accumulated gradually, as a result of a recursive ("gradualist") democratic process, the (much more) centralized economic structure in Eastern Europe after World War II was instead abruptly imposed by totalitarian one-party rule -- indeed to a considerable extent on orders from the Soviet Union. This basically implied imposing a Soviet-type blueprint.

It is useful to consolidate the earlier mentioned characteristic features of the Swedish model during the centralist and interventionist period under two headings: (i) welfare-state arrangements, i.e., government interventions directly influencing the life of the family; and (ii) interventions in firms and factor markets. After discussing these two issues, I will attempt to evaluate the performance of the Swedish economy in terms of economic growth, macroeconomic stability and employment, and the lessons for post-socialist countries.

### ***(i) The welfare state and its financing***

#### *Driving forces*

The combination of generous welfare-state benefits and large public-sector employment in Sweden has contributed to creating a society where tax-financed individuals far outnumber those who are market-financed. Whereas there were about 0.4 tax-financed individuals for every market-financed person in 1960, the corresponding figure was 1.8 in 1995. Among the tax-financed, about a third are employed in the public sector, while the remaining two thirds basically live on transfers from the public sector (some of them only temporarily, for instance due to unemployment, sick leave or parental leave). This, of course, is the background for the high tax rates in Sweden. Similarly high figures may be found in some transition economies in Eastern Europe today. This is particularly the case in Hungary, where the ratio of tax-financed and market-financed was 1.65 in 1993 according to Kornai (1996, p.965), i.e., about the same as in Sweden.

A challenging question of political economy is to understand why the expansion of welfare-state spending and other centralist government interventions was more far-reaching in Sweden than in other developed countries from the mid-1960s and early 1970s. Reference is often made to the fact that the aging of the population started earlier in Sweden than in most other countries, with an increased need, or “rationale”, for higher aggregate spending on pensions, old-age care and health care. Labor-force participation of women also rose faster than in other countries, which increased the demand not only for child care but also for old-age care, though in this case it is reasonable to talk about “mutual causation” rather than one-way causation.

How, then, were these rationales for increased government spending “translated” into political actions? It is hardly surprising that the political process in democracies has been able to carry out this translation -- voters made demands and political entrepreneurs offered to satisfy them. Similar mechanisms are also likely in totalitarian countries, as the leadership could be expected to strive for popularity and status in such societies too, in particular perhaps in semi-totalitarian regimes. For instance, Kornai (1996) has argued that the socialist governments in Poland and Hungary became more anxious to please their citizens by implementing generous benefits in the 1970s and 1980s, as totalitarianism gradually softened.

It is often hypothesized that the “universality” of welfare-state arrangements in Sweden, covering all income classes, tends to generate broad political support for generous and continuously expanding government spending, as a majority of voters either have a stake in the benefit systems or are employed in the public sector. Cross-country studies also suggest that the budget process has been softer in Sweden than in most other developed countries – prior to a budget reform in the mid-1990s. In the same way as production firms in socialist countries are characterized by “soft budget constraints” (Kornai, 1980), the budget process in the public sector in Sweden has shown similar characteristics.

A more profound question is *why* the budget process was allowed to be so soft. Part of the explanation may be that policies in Sweden, including economic policy, tend to rely on *discretion* rather than on fixed rules. *Ad hoc* seems to be the basic principle of political interventions in Sweden; strict budget processes would

certainly be an obstacle to such decision-making. In other words, the “political culture” in Sweden may be a partial – although perhaps not very profound -- explanation. In particular, constitutional and other legal rules designed to constrain political decision-making have not been an important element in Swedish politics after World War II. Nor has the notion of balance between different authorities -- government, parliament, and the judiciary. We may say that this political philosophy of *ad hoc*, i.e. policy actions in response to current events, was institutionalized in the new constitution in 1970, which seems to have inspired more by Rousseau than by Montesquieu.

Another conceivable explanation for the drastic increase in public-sector spending in Sweden in the 1970s and 1980s is that organized interest groups turned increasingly to the government for support and privileges. Indeed, while many interest groups in Sweden, as well as in other countries, were originally established to serve their members professionally, including direct bargaining with other groups in civil society, they have increased the resources devoted to lobbying for various favors from the government. Metaphorically, we may hypothesize that organized interest groups have gradually been transformed from largely “Putman-type” organizations, vitalizing civil society, to rent-seeking organizations as described in works by Gordon Tullock, Anne Krueger and Mancur Olson. This is probably a general phenomenon in pluralistic democracies rather than a specific Swedish phenomenon. The unique Swedish aspect is rather the strong political influence of one specific interest group, namely labor unions. This is the case, in particular, for the central organization of blue-collar workers (LO), largely as a result of its alliance with the dominating political party in the country, the Social Democrats.

It is, in fact, appropriate to say that economic and social policies in Sweden after World War II have been dominated by the alliance between the Social Democratic party and labor unions, often in conflict with managers of firms and employers’ associations. It is, therefore, quite misleading to characterize Sweden as a “tripartite” society with strong consensus among unions, the employers’ association, and the government -- in particular since the mid-1970s. LO has not only taken initiatives for new government policies in many fields, in confrontation with the employers’ organizations. It has also exerted strong veto

powers against government policy proposals, in particular, in the case of Social Democratic governments.

The political influence of the central labor unions have been less during periods of non-socialist government – 1976-1981 and 1991-1994. But the modest retreats initiated by such governments from previously enacted legislation in favor of unions have in many cases been reversed by the next social democratic governments – the main exception being the “wage earners funds”, legislated in 1982 and abolished in 1994.

In principle, we may expect rent-seeking activities of various interest groups to promote corruption. The Swedish experience suggests, however, that open corruption in the form of cash payments to *individual* politicians or public-sector administrators, in exchange for favors, may be kept within reasonable bounds even in countries with “big government”. The earlier mentioned social norm of honesty among public-sector administrators seems to have survived both the expansion of government interventions and the fall in relative wages of high-echelon public-sector employees. Today, high-level government administrators do not earn more than about twice the salary of an average industrial worker (after tax) in Sweden. This suggests that the “history dependence” of the social norm of honesty may be quite strong, once such a norm has been well established – even if the norm may not survive indefinitely.

In the case of Sweden, part of the explanation for limited corruption may be that the expansion of government interventions has been directed more towards households than firms; large-scale corruption perhaps develops more easily in the case of firms than households. Moreover, government interventions in Sweden have relied more on incentives (taxes, benefits and subsidies) than on physical regulations and permits (except mainly in financial markets); the latter are probably more vulnerable to corruption than the former because of their more discretionary case-by-case nature.

All this does not mean that Sweden is free from exchanges of favors between private agents and political parties in control of the government. But rather than cash payments to individuals, mutual favors between the government and private individuals take the form of job appointments in exchange for political loyalty – a practice that seems to flourish in all countries. It is my (subjective)

impression that political appointments, by contrast to the emphasis on competence, have played an increasingly important role in the public sector in Sweden in recent decades.

Another form of political exchange is legislated privileges and cash transfers to *organizations*, and hence indirectly also to their representatives, in return for their support to a political party in power. The unique feature of Sweden in this respect is the importance of such exchange between the government and various organizations connected with the Social Democratic Party, also to finance the salaries of the representatives of these organizations. They include not only unions but also tenant organizations, cooperative housing organizations, organizations of pensioners, party-affiliated study organizations, youth organization and leisure organizations -- and their officials -- in exchange for their support to the Social Democratic Party. There is no question that this exchange of favors is an important explanation for the power base of the Social Democratic Party in Sweden. Some observers would call this “rent-seeking” rather than “corruption”. But the distinction is rather subtle. If a corporation gets government contracts in exchange for gifts to a ruling political party, this is probably regarded as corruption in most democracies. It is not clear why the exchange of favors, largely in cash, between other types of organizations and the government should be looked upon differently.

It may take some time before strongly organized interest groups play the same role in former socialist countries as in Sweden and other parts of Western Europe after the destruction of much of “civil society” during the socialist period. A corollary is that close connections between interest groups and the state have not (yet) emerged; “traditional corruption”, with cash payments to individuals rather than to interest-group organizations, seems more prevalent.

In the case of Sweden, it is also tempting to hypothesize that increased competition between political parties in a world with receding party loyalty among the electorate tends to result in an “overshooting” of the welfare state. By this I mean that voters would have opted for less expansion if they, and politicians, had been able to take all decisions simultaneously, and if they had also been able to predict all costs to society at large in advance, including delayed disincentive effects. This hypothesis is an application of the common notion that the political

gains from providing additional *selective* benefits to various interest groups are higher than the political losses due to higher taxes which are usually *general* and hence paid by most citizens.

The political ideology of leading politicians is, most likely, also part of the explanation for the magnitude and form of increased public-sector spending in Sweden. One example is the ambition among dominating Swedish politicians to “mobilize” female labor, by stimulating them to shift from work in the household sector to work outside the household, which tends to raise measured GDP.

Similar political ambitions were probably behind the encouragement of labor-force participation of women in socialist countries after World War II. Indeed, in several of these countries, female labor-force participation reached rather high levels earlier than in Sweden.<sup>8</sup>

Another example of the role of ideology in Sweden is the ambition among politicians to standardize various welfare arrangements. All adults are supposed to work (or try to get jobs) in the open labor market, though in many cases in the public sector. All children should ideally get the same type of day care, organized by the municipalities, and subsequently also the same type of schooling. Old-age care was also supposed to be supplied by the public sector. As a mirror image, private initiatives have been discouraged in these fields. Standardized housing facilities in huge municipal housing complexes were also provided. Behind this ambition may be detected the view that housing is a “social right” rather than a market good, and that access to this right should be rationed by the authorities -- an idea that was pushed much harder, of course, in socialist countries.<sup>9</sup>

It is somewhat paradoxical that political ambitions to enforce standardized solutions to these various problems were accentuated (in the 1970s) just before the population started to become more heterogeneous in various respects (professionally and ethnically), and individual preferences developed in more “individualistic” directions according to available attitude studies (T. Pettersson, 1992; Ziehe, 1993).

### *Achievements*

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<sup>8</sup> For instance, it was not until around 1980 that labor-force participation rates of females in Sweden reached the same level as in Hungary (ILO, 1990).

How successful then were the centralist and interventionist policies in Sweden after about 1970? There is no question that the ambitions to provide high income security and ample social services were realized. Policies also seem to have contributed substantially to reducing poverty, as well as to making the overall distribution of disposable income relatively compressed. In this sense, welfare-state policies basically attained established targets.<sup>10</sup>

Some welfare-state arrangements have also improved economic efficiency and economic growth. Not only do various social insurance arrangements compensate for well-known imperfections in private capital and insurance markets. Positive external (interpersonal) effects of investment in human capital also mean that economic growth may be promoted by subsidies to education, as well as by prenatal care and child care outside the home -- at least for children from low-income families.

It is often also argued that various welfare-state arrangements -- including social insurance, social assistance and compression of the distribution of income -- have contributed to social and political stability. This point is also highly relevant for today's post-socialist countries. Recent electoral gains by "reformed communists" in the latter 1990s are often interpreted as dissatisfaction with deteriorating income security and a widening of the dispersion of income during the transition period, which contrast with the rather high economic security and low measured income inequality during the socialist period.<sup>11</sup>

### ***(ii) Interventions in firms and factor markets***

While socialist countries have nationalized production firms, in Sweden it is instead the income and service production of households that have been nationalized, or more accurately "communalized". This shows up in the national

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<sup>9</sup> See Dániel (1989), Enyedi, Lackó and Szigeti (1994).

<sup>10</sup> One indicator that welfare-state policies and related taxation have been important in reducing the dispersion of disposable income is that the dispersion of the distribution of disposable income is only about two thirds of the dispersion of factor income (with Gini coefficients of 0.2 for disposable household income and about 0.33 for factor income).

Moreover, during the period when the wedges between the distribution of factor income and disposable income were widened, from the late 1960s to the early 1980s, the distribution of factor income for the fully employed did not become more dispersed, rather the opposite. Thus, the Swedish experience does not provide much support for the often expressed hypothesis that higher benefits and more progressive taxes will simply be "shifted" onto higher factor prices, hence mitigating attempts to equalize the distribution of disposable income.

accounts, with “public consumption” having reached about 30 percent of GDP in Sweden in the 1980s, as compared to 10-15 percent in most other countries in Western Europe. By contrast, government ownership of production firms has been smaller in Sweden than in most other West European economies during the post World War II period -- 8-10 percent of value added in the business sector.

This does not mean that the government has abstained from trying to influence the operations of firms. The most important tools for exerting such influence have probably been selective taxes and subsidies and capital-market regulations. An example is tax incentives to induce firms to invest retained earnings rather than pay dividends. Another important ambition has been to make firms shift their investment from booms to recessions, though in the 1970s and 1980s these policies were gradually turned into selective subsidies to branches of industry and geographical regions regardless of the cyclical state of the national economy.

It is important to emphasize that these attempts to influence the size, composition and timing of real investment were pursued in a regime with detailed regulation of capital markets, including controls of interest rates. By keeping interest rates low, indeed often negative in real terms, it was possible to squeeze profits without a collapse of investment incentives. Moreover, foreign-exchange control limited the possibilities of firms and holders of financial assets to shift their investment abroad.

One effect of these policies was that the government (and central bank) favored low-cost capital flows to residential construction and a number of large corporations – in addition to loans to the government itself. It is easy to understand that these policies created quite arbitrary allocations of investment – using rates of return as a benchmark for an efficient allocation of resources.

Another typical feature of policies in Sweden towards the business sector has been the ambition to partition off the returns of firms from the earnings of their owners. Important tools for that purpose have been double taxation of profits and taxes on capital gains. Thus, the government has tried to prevent private owners from becoming rich when firms make handsome profits. This is one reason for the low level of private saving, in particular household saving. The

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<sup>11</sup> See Adam (1984), Atkinson and Micklewright (1992), Flakierski (1981) and Galasi (1995).

government has tried to compensate for this by high government saving and capital supply.

From an ideological point of view, these policies may be characterized as attempts to create “capitalism without capitalists”. This is hardly a viable economic system, in particular if we want a vital sector of small private firms, which cannot easily acquire equity capital from abroad.

The intellectual and political background to these ambitions cannot be understood without referring, again, to labor unions, especially the central organization of blue-collar workers, LO. Four closely related policy ambitions of unions were particularly influential in forming policies from the late 1960s to the early 1980s: (i) to squeeze profits between rising wage costs and a fixed exchange rate; (ii) to compress the distribution of wages drastically (“solidary wage policy”); (iii) to enhance job security for those who already have a job (“insiders” in the labor market), and in this context increase union influence at the work place; and (iv) to shift the ownership of firms to collective, tax-financed “wage-earners funds”.

The unions asserted that the first two types of policies would not only redistribute income to labor, in particular unskilled workers. Such policies were also asserted to be favorable for productivity growth, as low-profit firms would be forced to contract or even close down. Potentially negative effects on aggregate employment and investment could, it was argued, be effectively counteracted by administrative devices, such as mobility-enhancing labor market policies, public-sector employment, government provision of capital and selective investment subsidies or tax concessions to firms that invest. In this way, union wage policy and interventionist government policies were supposed to be integrated. In fact, this attempted integration may be regarded as a distinct feature of the so-called “Swedish model”.

Though many low-productivity firms did indeed contract or disappear as predicted, aggregate capital accumulation also fell gradually from the mid-1970s, in connection with a falling rate of return on real investment. Moreover, when profits were locked into firms with historically high profits, the old production structure tended to be conserved. This counteracted the ambitions of unions and government to speed up the rate of structural change.

Naturally enough, aggregate private employment did not flourish in this environment. While the number of public-sector employees has increased by about 700 000 since 1965, the private sector has contracted by about 500 000 employees.

The influence of unions on government policies also shows up in legislated changes in the property rights of firms. When labor unions were not able to achieve their ambitions concerning job security and union power via bargaining with employers, they could often get what they wanted via legislation instead. Important examples are laws that expand union influence within firms, such as legislation that gives unions powers over hiring and firing decisions. Thus, even though the formal ownership of firms has usually been unchanged, the *content* of property rights has certainly changed.

In the mid-1970s and early 1980s, the idea of creating “capitalism without capitalists” was replaced, however, by outright ambitions among union leaders to supplant private capitalism with collective ownership under strong union control. The proposed tool was tax-financed “wage-earners funds”. The proponents argued that these funds would also prevent capital accumulation in firms from making private individuals richer.

Even if the proposed wage-earner funds were designed to make Sweden a socialist country, the proposal differed in two important respects from nationalization in the socialist economies in Eastern Europe. The most important difference was, of course, that the suggested transformation to socialism in Sweden was supposed to be gradual and conducted in the context of a democratic society. Another important difference was the “corporatist” nature of the proposal. The boards of the funds were supposed to include representatives of unions, employers’ associations and the state, though it was assumed that the funds should pursue industrial policies according to the values and ambitions of unions.

The proposal was basically, though somewhat reluctantly, accepted by the leadership of the Social Democratic party. A revised version was implemented in 1983, but in diluted form after heavy criticism from the political opposition, business leaders and others (including some economists). After a decade, however, the funds were abolished by a non-socialist government in 1994; at that time the funds had acquired shares corresponding to about 8 percent of the Swedish stock market. The adventure of wage-earners’ funds is as close as

Sweden has ever been to becoming a socialist country, though with representatives of unions rather than the state in the driver's seat.

***(iii) Economic performance I: Economic growth***

Even though the ambitions of social and redistributive policies seem to have been realized to a considerable extent in Sweden, this is obviously not sufficient in order to judge the consequences for the living standards of the population, including the poor. It is also necessary to consider the effects on aggregate economic growth.

By contrast to the century-long period 1870-1970, economic growth has been rather slow after about 1970 relative to other developed countries. I choose to look at the development after 1970 simply because the economic system in Sweden changed considerably during the second half of the 1960s and the first half of the 1970s. While per capita GDP increased by altogether 52 percent in the OECD area as a whole during the period 1970-1990 (weighted average), it increased by only 40 percent in Sweden. During the period 1970-1997, the difference is even greater: 62 percent for the OECD and 42 percent for Sweden.

In 1970, Sweden was fourth among the developed countries in terms of the *level* of GDP per capita, 6 percent above the OECD average (*excluding* the developing countries Mexico and Turkey). By 1990 Sweden had fallen to ninth, five percent below the OECD average, and by 1997 to fifteenth, 14 percent below the OECD average (*still excluding* Mexico and Turkey).

Thus, Sweden has not only -- as Switzerland and the United States -- lost some of its previous lead in terms of GDP per capita due to productivity "catch-up" by other countries. About a dozen OECD countries have, in fact, overtaken Sweden in the international "income league". Countries contemplating the Swedish model (as developed from about 1970) as a blueprint for rapid economic growth do not have much to go on.

How do we then explain the sluggish productivity growth in Sweden after about 1970? It is helpful to distinguish between "proximate sources" of economic growth, exerting direct influence via the production function, and background factors influencing the proximate sources themselves. According to conventional growth accounting of proximate sources, the slowdown of productivity growth in Sweden is

associated with retardation of the accumulation of real capital, a slowdown in the reallocations of resources, and lagging improvements in technology (including the organization of production). According to a study of the business sector by Ragnar Bentzel (reported in Lindbeck, 1997, Appendix 2), retardation of the accumulation of real capital would be responsible for a quarter of a percentage point of the fall in labor productivity growth, slower reallocation of resources for about three quarters of a percentage point and slower technological (and organizational) development for about one percentage point, reflected in the “residual” of the calculations. Slower accumulation of human capital is also likely to have played a part, though it has not been possible to quantify the importance of this factor, which in Bentzel’s growth-accounting analysis of Sweden is incorporated in the “residual”.

It is even more difficult to quantify the influence of various *background forces* underlying these proximate sources. In the case of investment in real capital assets, it is natural to refer to the fall in the return on such assets relative to capital costs from the late 1970s; as we have seen, this fall was in fact a deliberate policy strategy for a considerable period of time. The return on investment in human capital, including higher education and the acquisition of skills by workers, also fell due to the compression of wage differentials and the increased progressivity of the tax system. Indeed, while the after-tax rate of return on university education seems to have been about 10 percent in the late 1960s (according to conventional static calculations), it had fallen to about two percent by the early 1980s. This probably goes a long way in explaining the fall in the acquisition of university degrees in the 1980s and early 1990s. In fact, fewer individuals born in the 1960s than those born in the latter 1940s have acquired university degrees.

The slowdown in the reallocation of labor was probably also related to the drop in the reward for changing jobs. In the 1970s there was also a shift from mobility-enhancing policies in the labor market to subsidies to declining sectors and regions in Sweden. The deterioration of the incentive structure for individual employees has, of course, also created well-known substitution effects against work intensity and the strife for promotion, as well as substitution effects in favor of leisure, do-it-yourself work, barter and work in the underground economy.

It is important, however, to realize that the disincentive effects of taxes and welfare-state benefits are not *uniquely* related to the size of aggregate government

spending or taxes. Indeed, disincentive effects may vary considerably between two countries with the same level of welfare-state spending, depending on the “fine structure” of the benefit and taxation rules. For instance, strong actuarial elements in the social insurance system may help mitigate economic distortions even when government spending is high. Similarly, taxes that provide the same revenues to the government (as a percent of GDP) may have distinctly different effects on economic incentives, depending on the relation between marginal and average tax rates, as well as on the existence of asymmetries in the taxation of different types of earnings and assets.<sup>12</sup> However, for a given structure of welfare-state arrangements and taxes, a further increase in public-sector spending, above a certain point (which is difficult to determine exactly), will necessarily result in damage to economic efficiency and growth.

The fall in the rate of technological and organizational change, as measured by the “residual” in growth accounting exercises, is more difficult to explain. When comparing the development with other countries, one explanation has clearly been technological and organizational catch-up by others, though this cannot explain why Sweden has been *overtaken* by many countries. It also seems as if the expansion of sectors with high value added and rising terms-of-trade has been rather sluggish. There may also have been a relatively slow rate of improvement in product quality during the 1970s and 1980s, which is an additional element of the process of technological catch-up by other countries; see Lindbeck (1997). Barriers to technological and organizational change are, of course, likely to have been much more pronounced in Soviet-type economies than in western economies, including Sweden.<sup>13</sup>

***(iv) Economic performance II: Macroeconomic policy and full employment***

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<sup>12</sup> There are also *measurement problems* in connection with government spending. For instance, while benefits are taxed in some countries (such as Sweden), they are untaxed in other countries. This tends to exaggerate the size of public-sector spending in countries with the former system relative to countries with the latter system. While public-sector spending in Sweden in recent decades has been 20-25 percentage points higher than the average of OECD countries (as a share of GDP), the figures shrink to 10-15 percentage points if benefits are measured net of tax.

<sup>13</sup> See, for instance, the discussion about such obstacles in Adam (1989), Polref (1981), Gomulka (1986), Jeffries (1992), Kornai (1980 and 1986), and Lavigne (1994.)

Sweden has often been hailed for its successful full-employment policy. Indeed, it turned out to be possible to maintain approximately full employment until the early 1990s, in spite of the fact that unemployment increased mercilessly in most countries in Western Europe from the mid-1970. How was this accomplished? And why did full employment finally break down in Sweden in the early 1990s, with open unemployment rates reaching the OECD average of over 10 percent according to internationally standardized statistics -- in addition to a sizable group of individuals in early retirement (8 percent of the labor force)?

Contrary to widely held beliefs, in particular among foreign observers, it cannot be argued that full employment in the 1970s and 1980s was the result of “responsible”, i.e., employment-enhancing, centralized wage bargaining and successful incomes policy by the government. From about 1970 until the mid-1990s, nominal wage costs increased by a factor of seven, while after-tax real wages were basically constant. An increase in nominal wage costs by a factor of seven seems to be a rather clumsy way of bringing about constant real wages after tax.

It is true that real wages in Sweden were “flexible” during this period, in the sense that they fell in connection with tendencies towards higher unemployment. However, this was not brought about by nominal wage restraint but by recurring devaluations. Moreover, occasional attempts by the government to pursue an incomes policy were not very successful. For instance, when the government was particularly heavily involved in wage bargaining in the mid-1970s, nominal wage costs per hour increased by 65 percent during a three-year period.<sup>14</sup>

It is also impossible to explain the low unemployment rates in the 1970s and 1980s by *either* the construction (and administration) of the unemployment benefit system *or* so-called active labor market policy -- other popular explanations among Swedish politicians and foreign observers. Neither type of policy could prevent a collapse of full employment when the economy was exposed to serious macroeconomic shocks that dramatically reduced the number of vacancies in the early 1990s. Without vacancies, it is hardly possible to

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<sup>14</sup> An exception is the government-appointed Rehnberg Commission in the early 1990s, which convinced labor unions to accept a dramatic retardation of the rate of nominal wage increase.

implement strict work requirements in the unemployment benefit system. Active labor market policy, designed to help individuals “swim” from unemployment islands to vacancy islands, is also rather powerless under such circumstances.

The only realistic explanations of why unemployment was low in Sweden during the 1970s and 1980s are (i) that real wage costs, as mentioned above, were reduced from time to time by a series of devaluations in connection with wage-cost crises, *and* (ii) that public-sector employment increased gradually until about 1985 (Lindbeck, 1997, pp. 69-81). When politicians, in the midst of a severe wage-cost crisis in the early 1990s, came to the conclusion that the “devaluation cycle” should be brought to an end, and no further increase in public-sector employment be allowed, full employment broke down. Thus, it would seem that full employment had been maintained in Sweden during the 1970s and 1980s by methods that were not sustainable in a long-run perspective -- assuming that devaluations and increased public-sector employment could not go on forever.

The abruptness of the rise in unemployment in 1992 and 1993 was accentuated by a number of exceptionally severe negative macroeconomic shocks at that time, including high real international interest rates, a crisis among domestic financial institutions and a collapse of construction activity (after the financial and construction bubbles in the 1980s), as well as a drastic fall in the household consumption rate, partly in response to higher after-tax real interest rates, falling asset prices and probably also greater uncertainty about jobs and entitlements in the social insurance system.

There are interesting lessons from the employment experience in Sweden. First of all, it is important that both domestic macroeconomic policy and the system of wage formation are consistent with the chosen exchange rate regime. If wage costs cannot be kept under strict control, a fixed-exchange regime is quite hazardous in a world with huge and highly mobile international financial capital. As soon as international portfolio managers notice, or suspect, that a specific currency is overvalued, speculation in a future devaluation is bound to emerge and result in drastically raised interest rates and related damage to national economic activity. Second, cost accommodations via devaluations and increased government employment are not sustainable strategies for bringing about full employment. Third, though strict implementation of “work requirements” in the unemployment

benefit system and active labor market policy are useful complements to other policies, they cannot *replace* such policies.

There are both similarities and differences in employment policies in Sweden and the socialist countries -- before full employment broke down in the early 1990s in both cases. While the Swedish government functioned to some extent as “an employer of last resort”, the state-owned firms in socialist countries had a similar obligation, regardless of the financial consequences for firms. While aggregate demand management and recurring devaluations in Sweden boosted labor demand, and occasionally also created an overheated labor market, socialist countries were characterized by *permanent* excess demand for labor, indeed a crucial element of the shortage economy (Kornai, 1980). One important background factor was, of course that prices were regulated below potential equilibrium values. Another was “soft budget constraints” with (nearly) unlimited availability of credit, which made it possible to neglect both profitability considerations and the financial structure of firms. One consequence was a relentless willingness to invest -- a phenomenon Kornai (1980, 1992a) has baptized “investment hunger”.<sup>15</sup> As we know today, this was an even less sustainable situation than full employment policies in Sweden, in the sense that the whole system finally broke down.

### ***III. Sweden as a transition economy: 1985/90-***

#### ***(i) Reforms and retreats***

Discussion of emerging economic problems, including slow productivity growth and rapid inflation, intensified in Sweden towards the late 1970s. But it took a very long time before politicians tried to do much about these problems. One reason was simply that many relevant policies had, and still have, strong support among the electorate, another that adequate policy measures would have required considerable deviations from widely held ideological beliefs among politicians, in particular, within the Social Democratic Party.

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<sup>15</sup> It is interesting to note that a similar weakness – the neglect of rates of return and balance-sheet considerations -- turned out to harm a number of fast-growing countries in Pacific Asia in the late 1990s.

The first sign of retreat from previous policies was a modest tax reform in 1983 (by the Social Democratic government), with a reduction in the top marginal income tax rate from 85 to 72 percent and a reduction to 50 percent of the marginal rates against which deficits in capital income accounts could be deducted for tax purposes.

What made the 1983 tax reform politically feasible? Economists' criticism of the tax system, based partly on systematic empirical studies, was probably influential. Everyday experience and casual observations -- by economists, journalists and the general public -- were probably more important, however. For instance, in a widely read article about the Swedish tax system, Gunnar Myrdal (as early as 1978) asserted, on the basis of casual observation, that "Sweden had become a nation of cheaters". Moreover, some influential politicians seem to have been convinced that the tax system contributed to the long-term growth problems of the country.

The 1983 reform of capital-income taxation was facilitated by the fact that the government did not get any *net* revenues from this type of tax. On the contrary, the government *lost* revenue in connection with capital-income taxation. The explanation is that individuals were able to report deficits in their capital account, partly because of large loans on real estate and clever capital-market transactions; these deficits could be deducted from labor income when taxes were assessed. A specific factor that helped make this reform politically feasible was probably that it dealt with rather technical issues, and that it was difficult for the general public to see through the distributional consequences.

The next major retreat from centralist government interventions was the deregulation of capital markets in the mid-1980s and the subsequent removal of foreign exchange controls in the late 1980s. Such reforms had been demanded by the business community for a long time. Representatives of banks and Swedish multinational firms in particular regarded such regulation as restricting international competitiveness. Examples from other countries, and recommendations of international organizations such as the OECD, were also referred to by those who favored deregulation. Many firms had also learned to avoid various regulations in connection with the growth and internationalization

of financial markets outside the strictly regulated banking sector in Sweden. Thus, the regulations looked more and more like a Swiss cheese, at least to some firms.

These deregulations did not create serious political complications for the Social Democratic government. Although previous advocates of strict regulation of financial markets probably regarded its removal as ideologically unfortunate, they seem to have accepted it, reluctantly, as necessary under existing real-world conditions. Part of the explanation as to why it was politically feasible to remove this regulation was probably that hardly any interest groups argued against the reforms. It is also tempting to hypothesize that, as in the case of the reform of capital-income taxes in 1983, the general public was not very engaged in these rather technical issues. It must have been difficult for the general public to assess the consequences for their own situation, as the reforms were motivated by rather abstract principles about the efficiency of capital and foreign exchange markets.

International examples were also significant in the case of the comprehensive tax reform in 1990-91. Indeed, this reform followed a rather common international pattern at the time: lower rates, a broader base and removal of various asymmetries in the taxation of different types of earnings and assets. The new tax reform was the result of an agreement between the Social Democratic government and a number of non-socialist parties that had argued for such reforms for a considerable time. The 1990-91 tax reform was ideologically and politically much more difficult for the Social Democratic party than both the 1983 tax reform and the deregulation of financial markets. One reason is that the distributional consequences were more apparent. More specifically, income tax rates became less progressive, which gave rise to serious ideological concern among activists within the Social Democratic Party. Most likely, the reform was facilitated by erosion of the legitimacy of the tax system among the general public, respected individuals, including both leading politicians and some labor union leaders, declared that the existing tax system was “rotten” and “perverse” -- echoing Gunnar Myrdal’s assertions.

It is clear, however, that different individuals alluded to quite different matters when they characterized the tax system in this way. Some critics (a number of economists and politicians at the center and right of the political spectrum) referred to the high marginal tax rates, hence to the fact that most

individuals could keep rather little (usually about 30 percent) of additional earnings. Others, such as labor union leaders, instead criticized the tax system because it allowed the rich to avoid taxes by smart capital-income transactions. Thus, political support for the 1990-91 tax reform was based on a rather unholy alliance of individuals with varying complaints about the tax system. But it was exactly the formation of this unholy alliance that made the tax reform possible from a political point of view.

It is worth noting that all these reforms were decided *before* Sweden ran into an acute macroeconomic crisis and serious financial problems for the government sector in the early 1990s, with an accumulated decline in GDP by 5 percent, a rise in “total” unemployment (open unemployment *plus* individuals taken care of by various labor-market programs) to 13 percent and public-sector budget deficits reaching 12 percent of GDP. This illustrates that it may occasionally be possible to reform laws and regulations in a more market-oriented direction without an *acute* macroeconomic crisis and financial problems for the government.

These reforms were probably facilitated by greater realization that the long-term growth performance of Sweden was slipping, that the regulations in capital and foreign exchange markets did not function as the proponents had hoped and that the legitimacy of the tax system was being eroded. A specific explanation for the political feasibility of the 1990-91 tax reform was, no doubt, also devoted work by a small group of committed leading politicians, in particular the two ministers in the Treasury Department of the Social Democratic government and the leader of the Liberal Party, as well as top-echelon bureaucrats in the Treasury Department.

All four reforms -- the two deregulations of financial markets and the two tax reforms --- were initiated from the top rather than from below. Indeed, the Social-Democratic government seems to have chosen a minimum of consultation with its members in these cases, perhaps in order to speed up the political process and hence avoid the build-up of political grass-roots resistance. Of course, the sustainability of reforms introduced in this way is an open question. International commitments make it unlikely, however, that capital and foreign exchange market regulations will be reintroduced unilaterally in Sweden. The fate of the tax system

is more uncertain; indeed, it did not take long before the marginal tax rates were raised again, by between four and eight percentage points. Moreover, as the tax reform in 1991 violated long held ideological principles, it is easy to understand that some Social-Democratic politicians and administrators responsible for this reform had to pay a political price for pushing it; in fact, several of them subsequently disappeared from high political and administrative positions.

By the early 1990s, a number of welfare-state problems had also been identified in Sweden. One type of problem was *unwanted adjustments in individual behavior*; another was *changes in the external environment* of the welfare state.

The former problem was a result not only of marginal tax distortions, but also of the huge increase in the number of beneficiaries due to moral hazard and, to some extent, cheating with benefits. In other words, the welfare state created its own “clients”, which meant that the economic costs for society at large became much higher than expected when the reforms were enacted.

Obvious examples of the second problem, i.e., changes in the external environment of the welfare state, are demographic changes, in particular the aging of the population, the rise in labor-market participation of females, and the slowdown of productivity growth. All these factors also tended to increase welfare-state spending relative to the tax base. The rise of unemployment in the 1990s obviously accentuated these problems. It is not completely true, however, that these changes were “exogenous” in relation to the welfare-state arrangements themselves. To some extent, all these factors were a *result* of the build-up of welfare-state arrangements -- perhaps even the aging of the population. The slow rate of measured productivity growth in the public service sector, as compared to manufacturing, also tended to raise public-sector spending, as a fraction of GDP, even if the number of public-sector employees had remained constant – an application of the celebrated “Baumol’s Law”.<sup>16</sup>

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<sup>16</sup> A slow rate of measured productivity growth in the public-service sector is, of course, a general rather than a specific Swedish phenomenon. In the national accounts, the productivity growth in the public sector is schematically set at zero in Sweden. Available studies indicate, however, that productivity growth in most of the public sector was *negative* (minus 2-4 percent per year) during the 1980s. Thus, statistical conventions seem to have overestimated, rather than underestimated, GDP growth in Sweden.

Even though these problems were identified a long time ago — in Sweden as well as in other developed countries — it has turned out to be difficult to do anything about them. There are several reasons for this. One is that cuts in previously promised benefits may create serious difficulties for individuals who have adjusted their lives to existing benefit systems. Many individuals may, for instance, have abstained from personal saving and voluntary insurance policies. It is also easier for the general public to see the direct distributional consequences in the case of welfare-state reforms than when complex tax codes are revised or financial markets are deregulated. Hence, changes in benefit systems are bound to generate socioeconomic conflicts and political controversy.

In the case of Sweden, it is also important to note that 65 percent of the electorate is tax-financed today. It may, therefore, be difficult to convince a majority of voters that they should support policies designed to cut government spending (as a share of GDP), or even policies that avoid new rounds of increased spending. Many voters probably have to be convinced that such cuts are, in fact, in their own long-term interest, even if they would lose in the short run. If this is not possible, Sweden may have reached “a point of no return” in terms of government spending.

There may also be complex *psychological* problems when welfare-state spending is rewound. For instance, voters are more likely to be upset by losing a benefit which they already have than by never having received it in the first place - a hypothesis consistent with Kahneman and Twerski’s “prospect theory” (which assumes that utility functions are steeper to the left than to the right of the initial position). In other words, individuals may have acquired subjectively felt property rights to existing benefits.

Another difficulty when rewinding welfare-state spending is that we can never be *sure* how large the problems with existing systems actually are. As a result, there will always be politicians and observers, including some economists, who deny that existing taxes, regulations and benefit systems actually do create serious problems.

How do we deal with this issue of *genuine uncertainty*? I would suggest that we apply the same type of “safety principle” as in the case of, for instance, environmental policy. Environmental disturbances often do not show up soon after

a rise in pollution. There are always observers who deny that serious problems do exist, or are even likely to arise. Large negative effects may suddenly emerge, however, when certain threshold values are reached after a time lag. This is particularly likely to occur if the ecological system is suddenly exposed to some exogenous shock, such as an extreme weather disturbance. Irreversibilities may then delay the possibilities of repairing the system. Nowadays, however, even vague suspicions of severe, and perhaps also irreversible, damage are regarded as an argument for avoiding ecological disturbances just because of these lags and irreversibilities.

Similar delays and irreversibilities may exist in economic and social systems, since economic behavior is often influenced only after considerable time lags. For instance, habits and social norms inherited from the past may constrain various disincentive effects for a while, which means that early warning signals may not reach either the general public or politicians. This is a particularly serious problem if it subsequently takes considerable time to restore earlier habits and social norms after they have already been adjusted to a new incentive structure.

These observations make a strong case for being on the alert for early warning signals, and hence for trying to avoid "overshooting" of welfare-state spending in the first place. Thus, there is a strong case for adhering to the same "safety principle" as in environmental policy. This advice, of course, is also relevant for former socialist countries when building up welfare-state arrangements. Even though such advice may be too late for some of these countries, it is certainly relevant for post-socialist countries that have not yet built up comprehensive welfare-state arrangements.

Against this background, it is easy to understand that cuts in welfare-state benefits turned out to be politically difficult in Sweden. The cuts were initiated by the non-socialist government in 1991-1994 by reducing replacement rates to 80 percent in various social insurance systems -- despite the protests of unions and the social-democratic opposition. In the aftermath, however, when the Social Democrats returned to power in the fall of 1994, they continued the policy by cutting replacement rates to 75 percent.

It is quite clear that these cuts were politically facilitated by the financial crisis of the government in the early 1990s, as the government could then say that

it had “run out of cash”. But heavy reliance on this “empty pocket” argument raises the question of whether the reforms will be sustainable when the budget deficit is removed. There is some danger of using “the wrong argument for the right thing”. Indeed, when the government budget moved closer to balance in 1997 and 1998, the Social Democratic government promised that replacement rates in several social insurance systems would be raised again, though it is not clear by how much.

The pension reform in 1998, based on an agreement in 1994 between a number of political parties, was probably also facilitated by the acute financial crisis of the government. In this case, however, politicians did refer to structural arguments, in particular to the risk that the old pensions system would not be viable in the long run.

The old pension system, the so-called ATP system, was initiated in 1960. It was basically a benefit-based pay-go system, with full pensions (after 30 years of income) amounting to about 60 percent of the income earned during an individual’s 15 best years. A buffer fund (the so-called AP fund) was also established. The *new* system will create a stronger connection between contributions and benefits, as pensions will be based on accumulated income over the entire lifetime of the individual. This means that the implicit tax wedges in the system will be *somewhat* smaller than in the old system (except for low-income groups), although this was not a major argument in the official motivation given by politicians. In the future, the system will basically still be pay-as-you-go, though with a small funded portion (based on 2.5 percentage points of an individual’s contributions of altogether about 18 percent). The individual will be allowed to decide on his own which institution, private or public-sector, should be given the responsibility of managing the funded portion of the contribution. The new pension system decided on in 1998 is also designed to make the distribution of income between retired and active citizens more robust to both variations in real-wage growth and changes in the remaining life expectancy of pensioners.

Clearly, the reform of the Swedish pension system is less radical than reforms that have recently been made, or at least contemplated, in other countries, including some post-socialist countries. One reason for the modesty of the pension reform in Sweden is probably that the existing system, at the present time, is far

from financially “broke”, though it would probably not be viable in the long run. It is also tempting to speculate that the general public in Sweden is still less suspicious about entitlements promised by the state than is the general public in several other countries, including former socialist countries. Moreover, the Social Democratic Party has long regarded the ATP system as one of its main achievements, indeed somewhat of a fetish. The party has therefore had great difficulty in admitting that the foundations of the system have to be reformed. The party has even found it difficult to accept the small funded portion of the new system, with the right of the individual to let private institutions administrate the funds.

Efficiency problems and related high costs in day care, education and health services have also generated heated discussions, but so far very little genuine reform. The financial crisis of the public sector during the 1990s resulted in a reduction in the number of employees in public-service production by about 10 percent, and probably also considerable efficiency gains as well. Organizational changes have been modest, however, and the reluctance to allow private and cooperative alternatives is still strong. These areas have to be regarded as basically “unreformed” from an organizational point of view.

Not only taxes, financial regulations and various social-insurance arrangements have recently been reformed in Sweden. A number of *constitutional changes* have also been implemented, largely to constrain asserted tendencies for the public sector to “overspend”. Examples are shifts to a longer election period (4 years instead of 3) and greater independence for the central bank, which has been assigned a strict inflation target (of two percent, plus-minus one). Another example is that the budget process has been stiffened considerably. The new budget process will start with formal decisions about the aggregate level of spending, which will subsequently be broken down into individual items -- rather than the other way around, which was a tendency in the earlier budget process.

A more active anti-cartel policy, according to EU rules, may also be in the cards. (Anti-cartel policies have been very lax in Sweden, probably due to Swedish politicians’ weak belief in the advantages of competition.) *Attitudes* among politicians and the mass media towards small firms also seem to have improved considerably in recent years (such attitudes were antagonistic in the

1970s and early 1980s). Moreover, after the shift to a floating exchange-rate regime in the fall of 1992, and the fall in inflation, the risk of new cost crises for tradables has diminished.

If my earlier diagnosis of Sweden's poor economic performance after about 1970s is correct, recent reforms of institutions, policies and attitudes among politicians have increased the probability of more favorable economic development in the country in coming years -- provided these reforms turn out to be sustainable. Indeed, productivity growth increased considerably in the 1990s, although it is still too early to say if this was a temporary effect or if it reflects a new long-term trend.<sup>17</sup> Manufacturing output has also recovered and had considerably exceeded the previous peak by 1998. The employment situation, however, has still not improved much.<sup>18</sup>

***(ii) Transition problems and the sustainability of reforms***

I have emphasized that reforms and retreats of the centralist economic system in Sweden in the late 1980s and early 1990s were initiated by (i) changes in the economic, demographic, international and social "environment" of the Swedish model; and (ii) undesired endogenous behavioral adjustments, largely induced by various types of disincentive effects. Other factors were probably also (iii) an increased understanding of the functioning of economic and social systems; and (iv) negative experiences of central planning (also in socialist countries) and of attempted "fine tuning" of macroeconomic policies. Moreover, deregulation of capital and foreign exchange markets made it increasingly difficult to retain lower rates of return on capital domestically than in the outside world. Thus, this deregulation undermined important aspects of "the Swedish model".

The policy shift in a market-oriented direction in the late 1980s and early 1990s could not avoid creating short-term transition problems. The deregulation of domestic capital markets contributed to the rapid expansion of credits (by 18 percent per year) in the second half of the 1980s, which contributed to overheating

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<sup>17</sup> In the early 1990s, productivity growth was enhanced when some of the least productive firms were closed down in connection with a fall in manufacturing production by about 15 percent. After the cycle had reached bottom, in 1993/94, productivity growth has been enhanced by higher capacity utilization.

<sup>18</sup> The employment level in the economy as a whole fell from about 4.5 million in 1990 (4.3 in 1988) to about 4.0 million in 1994, and has subsequently stayed at about that level.

and inflating the national economy. These effects were accentuated by the fact that the Swedish tax system favored borrowing, as interest rates were deductible against high marginal tax rates, while the taxation of returns on important real assets, such as owner-occupied houses and durable consumer goods, were low or even zero.

Even if the central bank had *tried* to counteract these inflationary tendencies, it would not have succeeded very well as long as the exchange rate was fixed. (A shift to a floating exchange would have created greater national autonomy for monetary policy.) Moreover, by deregulating capital markets *before* the removal of foreign-exchange control, the increased demand for real assets (including real estate) was bottled up within the country. This contributed to the enormous increase in asset prices in the second half of the 1980s and the related building boom.

These developments in the late 1980s also laid the foundation for the subsequent collapse of asset prices and construction activity in the early 1990s, and the related crisis for financial institutions which had lent extensively to the building sector. These were an important background factors for the depression in Sweden at that time. Deregulation also made it apparent that the allocation of resources over several decades of regulated capital markets had deviated strongly from traditional profitability criteria. One component of the economic crisis in the early 1990s was, therefore, the necessity of making microeconomic adjustments in connection with the transition to a more uniform tax system and an unregulated market for capital, including foreign exchange, with positive real interest rates.

The issue of “proper” timing and sequencing of reforms is raised by the experience in Sweden from the mid-1980s to the mid-1990s. I refer, in particular, to the fact that serious macroeconomic problems were accentuated by removing domestic capital market regulations before the removal of foreign exchange control and before the enactment of a comprehensive tax reform. It is sometimes argued that we should not worry about such problems. The argument is that politicians are well advised to seize any “window of opportunity” that happens to open up for politically difficult but important reforms. Sometimes it is even argued that economic problems associated with specific timing and sequencing of economic reforms are a “blessing” from a political point of view. If an isolated

reform in one area creates new problems in other areas, this outcome is asserted to make it easier to continue the reform process -- an idea similar to Hirshman's vision of the advantage of "unbalanced growth". An extreme version of this argument is that politicians have to accentuate problems before they can solve them -- and that they may even get political credit for solving problems they have created themselves. The Swedish experience in the late 1980s and early 1990s shows, however, that tensions created by "poor" timing and sequencing of reforms may also create serious economic and social problems.

### ***(iii) Remaining reform tasks***

In spite of partial retreats from centralist and interventionist economic and social policies in Sweden, many potentially important obstacles to successful performance of the Swedish economy still exist. For instance, marginal tax wedges remain very wide. This not only creates well-known efficiency losses. It also results in employment difficulties for low-productivity workers, for whom wages cannot adjust downward in proportion to the tax wedges. This is a particularly important problem for the household service sector, as household production is a close substitute for purchases in the market in this case.

The benefit systems still subsidize non-work relative to work among low-productivity workers. For the time being, it is impossible to do much about this without reducing government spending. Public-service production has not yet been reformed much, though over-staffing was cut during the financial crises of the government during the 1990s. Competition is not yet encouraged, or even allowed, in this sector. Double taxation and a plethora of regulations still create serious problems for small firms and obstacles to the entry of new ones. The housing market is still in bad shape due to rent controls and monopolistic rent policies pursued by public housing institutions (owned by municipalities). The labor market has not yet been reformed much either. I refer not only to legislation about hiring and firing costs but also to the system of wage formation, i.e., basically wage bargaining. This is not only an issue of aggregate nominal and wage costs. The rigid structure of *relative* wages is another problem -- as in several other countries in Western Europe. There is not much awareness among

unions and politicians of the role of relative wages either for employment performance or efficiency of the allocation of labor.

Another remaining problem is that the rules of the game in the economic system, as determined by the government, are still quite unstable. For instance, tax rules tend to be changed all the time -- also after the 1990-91 tax reform. Social insurance rules have turned out to be even more unstable. There have been more than 200 changes in these systems since 1990. Such rule instability reflects a genuine dilemma, as the advantage of changing *bad* rules conflicts with the ambition of having *stable* rules. The most reasonable compromise between these conflicting ambitions is to prepare changes of bad rules so well that the rules do not have to be changed again shortly afterwards.

The problem of rule instability is, of course, much more serious in the post-socialist transition economies, at least before the system has “settled down”; see Ékes (1997) and Newbery (1991). In Hungary, 20 changes were introduced in personal income tax regulations and 15 changes in social insurance regulations in early 1998 (*Heti Vilaggaz dasag*, Dec. 22, 1997).

A short time horizon in politics, undoubtedly accentuated by the mass media, is another reason for unstable rules. Politicians are tempted to intervene with new rules and regulations as soon as some concrete problem in society has been highlighted by the media. Harold Wilson once remarked: “in politics the long-run is three weeks”. It is worth thinking about constitutional rules that mitigate this myopia in politics. Indeed, this is a common problem for all countries.

#### ***(iv) Main lessons***

What are then the main implications of the “Swedish case” for post-socialist countries? Let me summarize them in six points.

1. Those in post-socialist countries who suggest the adoption of Swedish-style welfare arrangements should bear in mind that Sweden was a far wealthier society when it instituted such arrangements. Moreover, Sweden had already developed a competent class of public-sector administrators as well as social norms of honest behavior among these.

2. Strongly interventionist policies in Sweden, in particular generous welfare-state arrangements, did accomplish important social goals – high income security, considerable income equality, little poverty. But this seems to have come at the expense of a high and rising costs in terms of productivity and economic growth. Moreover, by the 1990s in connection with negative macroeconomic shocks, policies had become unsustainable. It is likely that the costs would be more serious in post-socialist countries, given the relative low level of per capita income, and the more competitive international economic environment today.

3. Tripartite bargaining, which has been an important element of policy-making in Hungary, Poland, and the Czech Republic, has been much less important in Sweden than generally believed by foreign observers. It has also been much less successful than reputed abroad. Real wages were not kept down, and full employment was not promoted, by concerted agreement of wage constraint between unions and firms in cooperation with the government. The main instruments were instead periodic devaluations and increased public-sector employment. These mechanisms turned out to be unsustainable in the early 1990s.

4. The Swedish experience suggests that people react more strongly when something is taken away than when they fail to achieve some new benefit -- in keeping with theorems of prospect theory. This has made attempts to reform and unwind the welfare state very difficult in Sweden, and perhaps as well in societies such as Hungary and Poland. In post-socialist societies which have not established extensive welfare systems, it implies a need for caution.

5. Eastern Europe, like Sweden, is likely to suffer from unstable rules of the game – probably more so, given the uncertainties and depth of the transition. Sweden's experiences suggest that this is a serious problem.

6. Post-socialist countries should be aware that Sweden has experienced considerable macroeconomic disruption because of mistakes in the sequencing of reforms: most importantly, the de-regulations of domestic capital markets prior to tax reform and the removal of foreign exchange controls. This illustrates the importance of proper sequencing of reforms in transition economies.

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