Montreal Economic Institute
Ideas for a More Prosperous Nation

ECONOMIC NOTE

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How to explain the success of the Swedish model?

In public discussions on the role and size of government in the economy, certain intellectuals and politicians can often be heard praising the Swedish model of economic and social organization. Sweden is a country that has managed to maintain strong economic growth despite high levels of taxation and public spending that ranks among the world's highest.[1] Since the mid-1990s, Sweden's economic growth has exceeded that of most other OECD countries, including Canada. According to official statistics, the employment rate is higher and inflation remains low. Public finances are in good shape, with net public debt among the world's lowest.

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However, if these indicators offer reason to believe that Quebec may have lessons to learn from Sweden's economic success in recent years, historical and economic analyses show that these are not the lessons commonly mentioned by partisans of the welfare state.[2]

The economic history of Sweden

First, an historical look at Sweden shows us that it has not always been a wealthy country. Until the middle of the 19th century, Sweden was a relatively poor rural society with an economy relying heavily on agriculture. Per capita income was not far from minimal subsistence levels, and episodes of famine were common. However, by gradually liberalizing their economy, reducing taxes and eliminating barriers to international trade, the Swedes managed to achieve the living standards of other rich countries quite spectacularly. Sweden actually experienced the world's greatest economic growth between 1870 and 1950.[3]

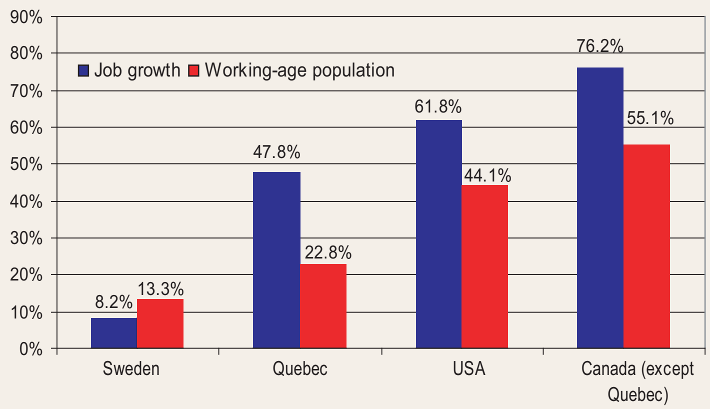
Only after this period of great prosperity did the Swedish government began to set itself apart from other developed countries with its interventionist policies, giving real meaning to the term "Swedish model".[4] Starting in the late 1960s, to be more precise, the Social Democratic Party, aiming to achieve full employment and relying on principles of equality and income redistribution, set out to increase government programs and labour market regulations. A more in-depth historical analysis brings out what economic theory could have predicted, namely that government intervention in the economy and the labour market, even if motivated by laudable goals, gave Swedes wrong incentives and resulted in perverse effects, both economic and social.

From an economic point of view, the heavy taxation required to finance all these government programs starting in the 1970s, together with excessive regulation of the labour market, stifled entrepreneurship in Sweden and greatly impeded the creation of new businesses. The proportion of self-employed workers in

1. See, for example, Polly Toynbee, "The most successful society the world has ever known", *The Guardian*, October 25, 2005.
2. Neil Brooks and Thaddeus Hwong, *The Social Benefits and Economic Costs of Taxation*, Canadian Centre for Policy Alternatives, December 2006; Jeffrey D. Sachs, "Leçons nordiques", *La Presse*, April 28, 2006.
3. Olle Krantz, *Economic Growth and Economic Policy in Sweden in the 20th Century: A Comparative Perspective*, The Ratio Institute, March 19, 2004; Angus Maddison, *The World Economy: Historical Statistics*, OECD, 2003.
4. In 1950, Swedish government tax revenue, as a percentage of GDP, was comparable to Canadian levels and close to the average of developed countries, about 21%. Contrary to popular belief, the social reforms imagined in the 1930s by Gunnar and Alva Myrdal, the founding elite of the welfare state, were not really instituted until the late 1960s and early 1970s (see Assar Lindbeck, "The Swedish Experiment", *Journal of Economic Literature*, vol. 35, 1997, pp. 1273–1319).

Figure 1

Job and population growth in Sweden and North America (1976-2006)



Sources: Statistics Canada, CANSIM Table No. 282-0002; U.S. Bureau of Labor Statistics; OECD Database on Labour Force Statistics.

the population remained the lowest among OECD countries in the 1970s and 1980s.[5] None of the 50 largest companies active in Sweden started up between 1970 and 2000.[6] These same public policies also had negative repercussions on job creation: the total number of jobs grew only 8% in Sweden during the last 30 years (see Figure 1). In fact, there was no net job creation in the private sector since the middle of the 20th century, even though the population of working-age Swedes increased by about a million persons during this period.[7] All employment growth in Sweden, tiny as it was, was due to job growth in the public sector.

From a social point of view, dependency on the state began growing at the same pace as the proliferation of programs and interventionist policies. The proportion of Swedes drawing their income from tax revenue (working for the government or receiving public transfers) climbed continuously between 1970 and 1995, rising from 28% to 65%.[8] This growing dependency on the government by much of the population, combined with efforts to escape taxation (by working under the table or evading taxes) on the part of a growing number of overtaxed citizens, worsened in the 1970s, to the point that the founding father of the welfare state himself, economist Gunnar Myrdal, was led to say that Sweden had become a "nation of wanglers".[9]

The policy of income redistribution had of course its share of perverse effects, and yet it provided only meagre results. Income redistribution through government transfers was based on taxes collected from the middle class and the wealthy and ended up mainly benefiting these same well-off groups. In the mid-1980s, the poorest quintile in Sweden received just 15% of public transfers, only half what the poorest quintile in Canada was getting.[10]

The overall result was that government spending increased rapidly with the growth of the welfare state, rising from 31% to 60% of GDP between 1960 and 1980. Starting in 1970 and until the middle of the 1990s, the share of public spending in Sweden's GDP stood between 12 and 30 percentage points above the average level of public spending among OECD countries. At the same time, real GDP per capita in Sweden declined markedly compared to average levels in these countries. The fourth-richest country in the world in 1970, Sweden gradually fell to the 16th spot in 1995, rising timidly to the 13th spot since then. By looking at Figure 2, it can be seen that the Swedish standard of living, adjusted to take account of purchasing power parity, fell in relative terms each time public spending rose compared to the other OECD countries (and vice versa).

The liberalization of the Swedish economy

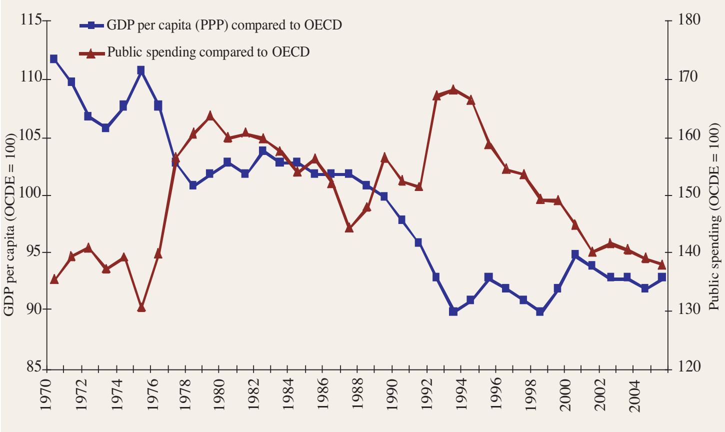
In the early 1990s, the relative impoverishment of Sweden picked up speed as the country went through its worst economic crisis since the 1930s. Between 1990 and 1993, the

Real GDP per capita in Sweden declined markedly compared to average levels in OECD countries from 1970 to 1990.

5. Steven J. Davis and Magnus Henrekson, *Economic Performance and Work Activity in Sweden after the Crisis of the Early 1990s*, National Bureau of Economic Research, Working Paper No. 12768, December 2006.
6. Magnus Henrekson, "Entrepreneurship: A Weak Link in the Welfare State?", *Industrial and Corporate Change*, Vol. 14, No. 3, 2005, pp. 437-467.
7. Davis and Henrekson, *op. cit.*, Note 5.
8. This proportion rose to 60% in 1990, before the economic crisis that hit the country (A. Lindbeck, *op. cit.*, Note 4).
9. Cited by Erik Norrman and Charles E. McLure, "Tax policy in Sweden", in Richard B. Freeman *et al.* (ed.), *The Welfare State in Transition: Reforming the Swedish Model*, University of Chicago Press, 1997, pp. 109-153.
10. Vito Tanzi and Ludger Schuknecht, *Public Spending in the 20th century: A Global Perspective*, Cambridge University Press, 2000. See also Andreas Bergh, "The Middle Class and the Swedish Welfare State: How Not to Measure Redistribution", *The Independent Review*, Vol. 11, No. 4, Spring 2007.

Figure 2

Relative decline in living standards and relative growth in public spending in Sweden (1970-2005)



Sources: OECD, *Economic Outlook No. 80*; OECD, *National Accounts (database)*, and calculations by the author. Note: the OECD data cover the 23 wealthiest countries.

country's overall production fell by 5%, and the unemployment rate climbed by more than eight percentage points, standing at 10.3% in 1993. Public finances quickly hit a dead end. At the peak of the crisis, in 1993, public spending exploded and reached 72.4% of GDP. Budget deficits grew year by year, hitting a peak of 14.4% of GDP in 1993.[11] During this time, public debt was increasing at an exponential pace, going from 46% of GDP in 1990 to 81% in 1995.

Already in the 1980s, doubts had begun to arise regarding the Swedish model, with Sweden's relative economic performance slowing and the welfare state gradually increasing the tax burden of the average worker, but no government had the political will to undertake the fundamental reforms that were required. In the 1990s, however, successive governments showed pragmatism and were not afraid to question certain dogmas that were paralyzing the country's economy. With help from economic recession and the public finance crisis, political leaders had no trouble convincing the rest of the population of the urgency in reforming the welfare state, the limits of which had become readily apparent. With the approval of many stakeholders, they then decided to create more room for market mechanisms: decentralization of administrative powers, deregulation and opening of public monopolies to competition, loosening of labour market regulations, lightening of tax and regulatory burdens, and so on.

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From an administrative point of view, one of the central government's first initiatives was to give counties and municipalities responsibility for looking after budgets and making decisions regarding key services provided to citizens, particularly in the areas of health care, education, security and culture. The decentralization of power to the local level was accompanied by a complete reorganization of government agencies, with some of them merged or even eliminated in certain cases. Those that remained obtained greater autonomy in managing and supplying services as well as in the hiring, compensation and dismissal of staff. Compensation for government employees is now based on performance and no longer just on the seniority principle. Lifetime employment for public sector employees does not exist anymore in Sweden, and temporary contracts are proliferating. Job security is thus guaranteed only by an employee's competence.

In terms of supplying public services, political decision-makers chose to call upon the expertise of the private sector and to open up competition in many areas of activity. In health care and education in particular, services are supplied in part by private companies, even if financing remains totally public (for example, in the form of education vouchers since 1992, giving parents the same public subsidy whatever school they choose for their child, whether it lies in the private or public sector). The Swedish government also deregulated a number of public monopolies and other sclerotic industries: air and rail transport, taxis, electricity, telecommunications and postal services, as well as the retail sector and the sale of alcohol, have all been liberalized to various degrees.[12] These liberalizations provided for a considerable lowering of the costs of these services. Public transit is an excellent example:

11. Mats Persson, "Swedish Government Debts and Deficits, 1970-1995", *Swedish Economic Policy Review*, Vol. 3, No. 1, 1996, pp. 21-59.
12. Stefan Fölster and Sam Peltzman, *Competition and Regulation in Swedish Markets – An Analysis of Remaining Problems*, Center for Business and Policy Studies, September 2006.

in Stockholm, since 1993, operation of the subway, buses and suburban trains has been opened to competition. Delegated management has brought costs down substantially, saving the local public transit corporation 110 million euros a year. These savings have helped cover the costs of massive investments over many years. Meanwhile, public transit's market share has risen, and levels of use, measured in completed daily trips, went up 20.6% between 1993 and 2006.[13]

Long challenged by prices and inflation rates far higher than elsewhere, Sweden also saw its prices converge toward those found in other developed countries. Productivity has increased more sharply than in the 1970s and 1980s and also compared to other countries. Between 1994 and 2005, productivity in the private sector grew on average by 3.3% a year, one-and-a-half times faster than the average in OECD countries.[14]

In the labour market, the main reforms have led to a considerable loosening of legislation on temporary jobs. In addition, although the unionization rate still remains close to 80%, wage negotiations were greatly decentralized to the local level in the 1990s. One study shows that only 7% of workers covered by collective agreements in Sweden now have centrally negotiated working conditions. The authors of this study also note that, although this decentralization has led to a slight increase in income inequality, real net wages have risen among all categories of workers along with productivity rises. This contrasts with the period from 1970 to 1995, when the real net wages of industrial workers did not increase at all.[15]

In tax matters, a recent government decision to abolish the wealth tax is the latest in a series of reforms implemented in the 1990s aimed at reducing the tax burden of Swedes. The most substantial reforms, however, involve corporate taxes, which now are among the lowest in the world, making companies more competitive in an increasingly globalized market. Capital invested by companies is far more lightly taxed in Sweden than in Quebec or the rest of Canada.[16] With lower obstacles to investment, job and wealth creation can move ahead.[17]

Sweden is back on the road to progress after conducting wise and courageous reforms, most of them inspired by the free market economy.

Sweden's current economic environment is obviously not perfect. A number of economic sectors are still isolated from competition, the unemployment rate may be much higher than published statistics indicate[18] and the taxes paid by Swedes are still among the highest in the world. Nonetheless, Sweden is back on the road to progress after conducting wise and courageous reforms, most of them inspired by the free market economy. In this sense, it can be considered a model.

13. Storstockolms Lokaltrafik (SL) – 2002 and 2006 annual reports.
14. McKinsey Global Institute, *Sweden's Economic Performance: Recent Developments, Current Priorities*, May 2006; OECD, *Sweden: achieving results to sustained growth – OECD country reviews of regulatory reform*, March 2007.
15. Peter Fredriksson and Robert Topel, *Wage determination and employment in Sweden since the early 1990s*, Center for Business and Policy Studies, September 2006; Lindbeck, *op cit.*, Note 4.
16. See Luc Godbout, Pierre Fortin and Suzie St-Cerny, *La défiscalisation des entreprises au Québec est un mythe*, Working Paper 2006/03, Research chair in taxation and public finance, Université de Sherbrooke, October 5, 2006.
17. Other measures taken by the Swedish government to encourage investment include a loosening of restrictions on foreign ownership. See Ulf Jakobsson, *The Globalisation of Swedish Economy*, Confederation of Swedish Enterprise, March 2007.
18. By including unemployed persons in job retraining programs as well as Swedes who have taken early retirement and those on artificially extended sick leave. See Terence Roth, "Sweden's Hidden Jobless: Labor Economist Asserts Unemployment Near 20%", *Wall Street Journal,* June 1, 2005.

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