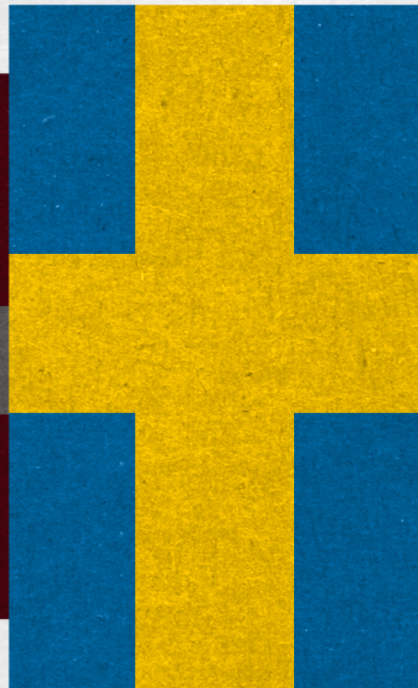


PRE-RELEASE
PARTS I & II

THE MIRAGE OF SWEDISH SOCIALISM

The Economic History of a Welfare State

Johan Norberg



REALITIES OF
SOCIALISM

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ABOUT THIS PUBLICATION

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INTRODUCTION

“What do you think of socialism?”

“I’m a Social Democrat.”

“Not a socialist?”

“No, if you call yourself a socialist, they confuse you with a lot of crazies.”

—Göran Persson, Social Democratic Prime Minister 1996-2006

Much of what the outside world thinks it knows about the Swedish model is wrong. When American politicians like Senator Bernie Sanders and Representative Alexandra Ocasio-Cortez are asked to name an example of a successful socialist economy, they often point to Sweden.

But Sweden only began to experiment with socialist ideas after it was already one of the world’s most successful societies. Its success was based on a free market model developed after an episode of radical liberalization between 1840 and 1870 and the rapid growth it unleashed. As early as 1950 Sweden was the fourth richest economy in the world, and it was also one of the freest, with public spending below 20 percent of GDP. Government was smaller than in other Western European countries and taxes were slightly lower than in the United States.

Only in the 1970s and 1980s did Sweden expand government dramatically with more spending, taxation, and regulation. It is reasonable to say that during this time Sweden was moving towards socialism. But that was an aberration in Sweden’s history, an aberration that was not associated with success. On the contrary, this was the one period in modern economic history when Sweden lagged behind other industrialized countries.

Incentives for work and entrepreneurship were weakened, and welfare dependency increased. The private sector stopped creating jobs, real wages stagnated, and many of Sweden’s most important businesses, like IKEA and Tetra Pak, fled the country. Sweden ran large budget deficits every year and got stuck in a dangerous spiral of inflation, devaluations, and debts. It ended with a deep financial crisis in the early 1990s that included a brief period when the central bank interest rate rose to 500 percent.

At that time, Sweden’s political parties decided, often in consensus, to return elements of the older capitalist model. They deregulated the economy, reduced taxes, shrank government, and introduced a set of fiscal rules that has reduced public debt substantially. The

pension system was reformed and many government-owned businesses were privatized. Sweden abolished taxes on wealth, gifts, and inheritances.

At the same time, Sweden became a pioneer in privatizing welfare services, making it possible for private providers to compete with public ones on similar terms and funding, and giving citizens the freedom to choose between different providers of elder care, health care, preschool, and education, including for-profit businesses. Around a fifth of all tax-funded welfare services are now provided by the private sector.

Sweden's level of social spending makes it a fairly average western European economy with a more open economy. Its welfare state is still larger than in the United States and other Anglo-Saxon countries, but it mostly distributes resources over an individual's life cycle rather than between groups. Sweden learned in the 1970s that a universal welfare state cannot rely on tax revenue from small groups of high-income households but has to take more in income tax from low- and middle-income groups; it also relies on revenues from a proportional value-added tax. Paradoxically, its tax structure means that Sweden's tax system is now one of the *least* progressive in the OECD.

With the exception of the size of government, the Swedish economy is now more free-market-oriented than the US economy according to Economic Freedom of the World data. After the new reform period in the 1990s and early 2000s, Sweden once again started outperforming other industrialized countries economically, creating new companies and increasing real wages.

FROM RAGS TO RICHES

On June 4, 1857, Sweden's minister of finance, Johan August Gripenstedt, surprised the other members of parliament with a broad, visionary speech about how Sweden could become a wealthy country.

Through free enterprise and a modern banking system, a national railway system and free trade, Sweden's potential would finally be unleashed, capital and labour would move to their most productive uses, and specialization and innovation would turn the economy into a powerhouse. The 43-year old minister, at that time the government's strong man, told the incredulous crowd that a new, open, and free Sweden would soon abolish poverty and ignorance. Indeed, Sweden's future "has never been more promising than it is now," said Gripenstedt, deeply influenced by the French economist Frédéric Bastiat:

we can with certainty predict a development to which perhaps no other country in Europe can equal. This requires, however, that the resources we have, but which still for the most part lie dormant, unexploited, are duly utilized. (Gripenstedt, 1871: 243)

For his audience, this vision was a bit much. Sweden was one of Western Europe's poorest countries, with a GDP per capita a third lower than Denmark's and less than 40 percent of Britain's. Gripenstedt was met with skepticism and ridicule. His hopeful speech was mocked as "flower paintings." But in the end, it would be he who would have the last laugh.

Poor but free

Sweden was very poor, but it also had great potential as Gripenstedt had suggested. That potential lay not just in its vast forests and iron ore. It was also present in its people and its peculiar history. The one thing you have to understand about Swedes is that they always heard the rustling of trees, wrote Vilhelm Moberg, the Swedish commoner's great novelist and historian (1970: 61). Sweden did not have many castles or big urban centers. As late as 1820 Stockholm only had around 75,000 inhabitants. No more than 16,000 people lived in the second biggest city, Gothenburg.

Sweden was a country of poor, but free farmers. What sets Sweden apart from almost all other European countries is that it never had a feudal system. Dense woods in a vast, scarcely populated country made it difficult for mounted knights to defeat peasant armies

or guerillas. Sweden's nobility was small and weak and as long as farmers paid their taxes to crown and church, they could control their own land and labour. In most countries, cities symbolize freedom—the place where serfs could escape in a crowd. In Swedish stories and poems, freedom is to be found in the countryside and in the forests.

This meant that the Swedish state did not face much resistance from strong regional elites, powerful aristocrats, or independent cities. Swedish kings could unify the country under national law, one administrative system, and one religion, in a way that was much more difficult on the European continent. The ethnically homogenous farmers were obviously not free in a modern sense. They were subjected to heavy taxation, regulations of business, trade, speech, and family life, and the one true Lutheran religion according to the Augsburg Confession.

Furthermore, individuals were subjected to strictures from family and village. But these were also arenas for cooperation and defense against external powers. By meeting and debating at village and parish meetings, poor farmers became accustomed to the public square, to formulating demands, arguing for their position, and making compromises. The public square was, in a sense, the nursery of modern Swedish democracy. If the village could reach a consensus, it had a strong voice it could use against lords and kings. The main powers in Sweden were the farmers and the government, and the inevitable tensions that arose between the two groups made cooperation possible and necessary. Farmers were continuously represented in the popular assembly, the Riksdag, from the sixteenth century onwards.

The economic historian Mauricio Rojas has argued that in these farming communities we find an explanation for a peculiar Swedish paradox: Proud, self-reliant individualists who are also conflict averse, consensus-oriented, and ready to submit to the collective.

No farmer was anything on his own. The farmers in our country were poor and insignificant as long as they were considered as isolated individuals. But the picture changes radically when we consider them as collective. Then hundreds of thousands of small and insignificant selves are transformed into a powerful we. (Rojas 2004: 23)

Farmers were free as a collective, which meant that anyone who deviated from the group, who did not compromise, could be a threat to everyone's freedom and thus was often ostracized. So Swedes have strong, individual opinions, but work hard to merge them into a consensus opinion, which will make their chances of winning collectively greater:

It is a balancing act between public collectivism and private individualism, between groupthink and defending ones' corner, which is extremely difficult to understand and master for an outsider. (Rojas, 2001)

This tradition of embedding decision-making processes in society makes it possible for that society to make difficult decisions. If most people have been heard throughout the process through their interest groups and representatives, they can more easily buy into the

end compromise, even if it is painful. Unfortunately, that process also makes it incredibly difficult to be a naysayer, to reject compromises, and to point out dangers and mistakes. Therefore, Sweden has a tradition of sticking to the path it has chosen and ignoring problems until they become too big to deny and everybody changes their minds at the same time. Then Swedes move fast in the opposite direction. Far from following the famed “middle way,” Sweden has often been a country of extremes. It liberalized the economy more than other countries did in the mid-1800s, socialized more than others in the mid-1900s, and then reversed course and liberalized again faster than others in the late 20th century.

Sweden’s unusual domestic peace and political representation meant that its people did not see its state as an external, occupying force, as was the case in many other European countries. This may explain the remarkably high level of trust that Swedes have in strangers and in government. Their political representation and government authorities are rarely made up of strange outsiders, but of people who look like and talk like them. Some also see the make-up of Swedish society as one reason for the Swedish work ethic. For independent farmers it never made sense to be work-shy to save strength and rob a lord or occupier of income. Swedish farmers mostly worked for themselves, so hard work and self-reliance paid off.

These farmers were remarkably literate. Sweden introduced mandatory elementary education in 1842, but as early as 1800 around 90 percent of Swedes could read. Egil Johansson, the pioneer of Swedish literacy studies, writes: “It must be regarded as an established fact that general reading was achieved without formal school attendance. Swedish home instruction was so successful that those who only received home instruction were, in reality, regarded as able to read in the official statistics” (Johansson, 2009: 55f). An important reason for the high literacy rate was the catechesis imposed by the church since 1686. Every year, the priest made home visits to ensure that everyone had a good, basic, and consistent knowledge of Lutheran teaching. This was just rote learning and did not encourage writing, but as agriculture became commercialized, bookkeeping and correspondence made reading and writing skills lucrative. In the mid-1800s, around 70 percent of military recruits could write. Lars G. Sandberg describes Sweden around 1850 as “the impoverished sophisticate” (Sandberg, 1979).

The great and often tumultuous land reforms of the late eighteenth and early nineteenth century had turned this class of peasants into small capitalists. The old system where every farmer owned several pieces of land split about the village was replaced with a connected piece of land for each farm. This undermined the village community and put an end to collective farming, but it also created strong incentives to invest in new methods and equipment, and productivity increased dramatically.

In many European countries agricultural modernization was led by elites, but in Sweden property-owning farmers took the initiative and profited from it. They introduced new technologies faster than both landed aristocrats and the peasants who rented land from them. The Swedish agricultural revolution was a “bottom-up” process (Wiking-Faria,

2009: 20), and this increasingly wealthy group became the leading supporters of the opening up and liberalization of the Swedish political and economic system that took place in the mid nineteenth century.

The reform period (1840-1870)

A period of rapid political and economic liberalization, the establishment of strong property rights, freedom to conduct business, free trade, free financial markets, women's rights.

Despite the relative freedom of its farmers, Sweden was a very unfree society in the early 1800s. It had a tightly controlled mercantilist economy where most business activities were overseen and regulated by the central government. Guilds had the legal right to control production, employment, and prices. Internal movement was restricted and shops and workshops were banned in the countryside. Just a few privileged banks were allowed, and interest rates were controlled by the government. Women had no right to own or inherit property or do business.

Property rights were weak overall. Farmers could own their land, but they were not allowed to divide it or sell it freely. Relatives and the government always had the right to acquire land before outsiders did. Sweden's most important resources were reserved for domestic use and often government use. Logging was tightly controlled and export of lumber restricted. The export of ore and pig iron was banned. High tariffs, more than 300 import bans, and about 50 export bans had the effect of generally strangling international trade.

Anders Chydenius (1729-1803), a priest from a poor rural region of Finland, then part of Sweden, was the first to propose that the country take a new direction toward political and economic liberalism.¹ His arguments for the rights of rural folk to trade freely was so popular that he was elected a representative to the priest estate in the Swedish parliament in Stockholm in 1765/66. There, he managed to implement an internationally unique statute allowing freedom of the press and abolishing censorship. King Gustaf III wrested control from parliament in 1772 and repealed the statute, but it was restored after 1809.

Chydenius published a series of pamphlets that developed an early radical form of economic liberalism inspired by Enlightenment philosophy. In *The National Gain*, published in 1765, Chydenius explained that a free market is self-regulatory since the profit motive and the price mechanism keep us all in check and stimulate us to help others and produce what they want the most. On this simple observation, Chydenius built an entire worldview that envisioned individual freedom and free markets. It was the invisible hand 11 years before Adam Smith's *The Wealth of Nations*. Step by step ideas like his helped Swedes see that there were other ways of governing themselves (Jonasson and Hyttinen, 2012).

One of Chydenius's disciples was Georg Adlersparre (1760–1835), an officer and enlightenment publicist, who called the belief in personal freedom and property rights “liberal” as early as 1804. Adlersparre was the first to translate Smith's *Wealth of Nations* into Swedish, but he was also the man behind the revolution of 1809, the only violent revolution in modern Swedish history. The king at the time, Gustav IV Adolf, had become increasingly despotic and led the country into a failed war with Russia, France, and Denmark simultaneously. In late 1808, Swedish forces had to surrender the eastern half of the country—Finland—to invading Russians and many feared that Sweden would be completely broken up. Adlersparre took control of the Western army, then issued a proclamation saying that the army had to march to Stockholm and depose the king to save the country. The king was arrested, and a self-described “liberal” faction fought for radical reform in the revolutionary parliament of 1809/10.

The French revolution served as a cautionary tale for Sweden and Parliament ended with a more guarded compromise—a compromise that survived for 165 years. It chipped away at some of the privileges of the monarchy and aristocracy, but mostly it served to create more checks and balances and give parliament a stronger role. Chydenius's anti-censorship law was also resurrected. The scene was set for decades of turbulent debates, where economically empowered farmers teamed up with liberal nobles, civil servants, and a growing bourgeoisie to advocate for more substantial change.

Another central character in the reform period was the entrepreneur and member of parliament Lars Johan Hierta (1801–1872). In 1830 he created *Aftonbladet*, a very successful and influential newspaper that became the most important platform for the liberal opposition. Its radical agitation created space for more moderate reformers to emerge, such as Johan August Gripenstedt, as the establishment began to suspect that some change had to happen to prevent a revolution.

Between roughly 1840 and 1870 Sweden experienced a peaceful liberal revolution. Secure property rights were established, including the freedom to divide, transfer, buy, and sell land. The regulations that had stopped the development of the timber and iron industries were lifted. The guilds were abolished in two steps, the first 1846 and the second 1864, after which anyone, including women, could start a business and compete freely. Sweden got a joint-stock company law with limited liability as early as 1848, which it modernized in 1895. It established a banking system and deregulated interest rates. The old protectionist system was dismantled and in 1865 the staunch free trader Gripenstedt made Sweden a member of the trade treaty between France and Great Britain—a treaty with a most-favoured-nation clause, which gave each participant maximum access to the others' markets and was consequential in opening Europe up to trade.

Freedom of the press and religion were dramatically expanded. Women won the rights to own and inherit property, get an education, and have a career. The controls on the internal movement of people were abolished in 1860, and since the zeitgeist was so liberal, the government took the chance to broaden that freedom to include immigration and emigration. The primary result was the start of a great wave of emigration to America, an

exodus of around a million Swedes. Some would return with new ideas and others wrote home about their experiences, both of which spread the latest ideas about democracy, culture, and technology to Swedes still living in their home country.

Those ideas were not all centred on abolishing government intervention. In 1842, Sweden introduced mandatory elementary education. The old school system, which had as its mission the turning of upper-class students into priests or civil servants, was replaced by a practical education for everyone. Gripenstedt's government also took the controversial step (opposed by some radical liberals) of building a national railway system funded with government loans. The moderate liberals argued that government funding of public goods that benefited everyone, like basic education and a main railway line, was legitimate, while government intervention to benefit one group at the expense of others was not. That is why they supported the state building the main lines, but wanted local railway lines to be built and funded privately.

Traditionally, historians consider 1865 as the apex of the most intense reform period. That year saw the abolishment of the old parliament, based on the four estates, and in its place the institution of a new, slightly more democratic parliament, where power lay with the farmers.

In January 1867 the new parliament assembled for the first time and Lars Johan Hierta, the oldest member of parliament, delivered the welcome speech. He celebrated the reforms and warned the members not to come up with any schemes to take money out of people's pockets. One prominent observer commented: "Now there are no parties. Everybody is a liberal nowadays" (Hasselberg, 1945: 232).

The liberal era 1870-1970

All major political forces accept an open economy based on secure property rights. Sweden industrializes rapidly and experiences 100 years of growth. A modest welfare state emerges, but the public sector is still smaller than in other European countries.

Gripenstedt's reforms were often hotly contested, and some even accused him of leaving office once Swedes were about to see the devastating effect those reforms were going to have on Sweden's economy. However, eventually both the old conservatives and the new labour movement came to accept the "Gripenstedt System," at least in its fundamentals, because the concept proved to be viable. Now that work and entrepreneurship were legal and rewarded, the "poor sophisticate" got to work.

The reforms—protected property rights, freedom to start businesses, and freedom to trade—gave Sweden 100 years of growth at a rate that no other European country equaled, just as Gripenstedt had predicted. Indeed, the only country in the developed world that exceeded Sweden's 8.5-fold increase in per capita income between 1870 and 1970 was Japan, though only by a photo finish.

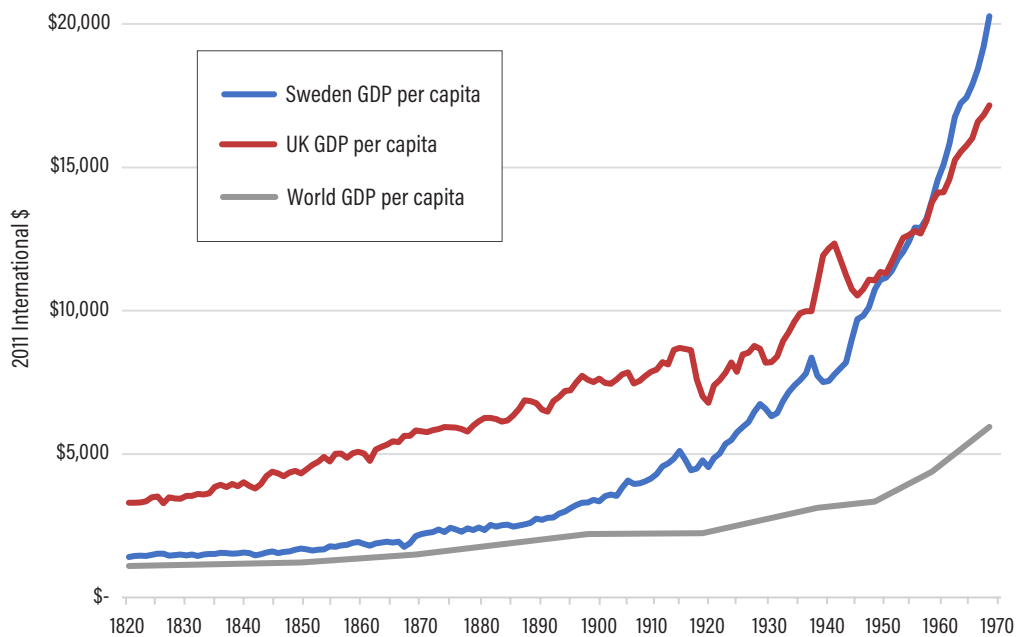
Consider Figure 1.1. It shows per capita GDP in Sweden, the UK, and the world from 1820 through 1970. At the beginning of the period, per capita GDP in Sweden was less than half that of the UK. By the 1950s, per capita GDP in the two nations was equal, and by 1970, Swedish per capita GDP exceeded that in the UK by nearly 20 percent.

Figure 1.2 lists per capita GDP by nation in 1870 while Figure 1.3 shows this same figure in 1970. In 1870, Swedish per capita GDP lagged far behind that in the UK and much of the rest of Western Europe. By 1970, however, only the US, Switzerland, and the oil sheikdoms enjoyed substantially higher per capita GDP levels than Sweden.

Figure 1.4 expands on Figure 1.1 by showing the growth in real per capita GDP from 1870 through 1970. It shows that only Japan and Saudia Arabia achieved faster growth over this 100-year period. But recalling Figure 1.3, note that despite their rapid growth, both of these countries were still significantly poorer than Sweden in 1970 (Japan's per capita GDP was 76 percent of Sweden's while Saudia Arabia's was 60 percent of Sweden's). Thus, Sweden is unique over this period as the only rapidly growing nation to also achieve a high income level. This is no easy feat.²

The first noticeable change between 1870 and 1970 was that this country rich in natural resources began to put its resource wealth to better use and develop new technologies to extract and process them. Small capitalist farmers started investing in more efficient agriculture. The forest industry, which now had permission to export its output, developed the infrastructure to export the “green gold.” From the early 1900s pulp became a

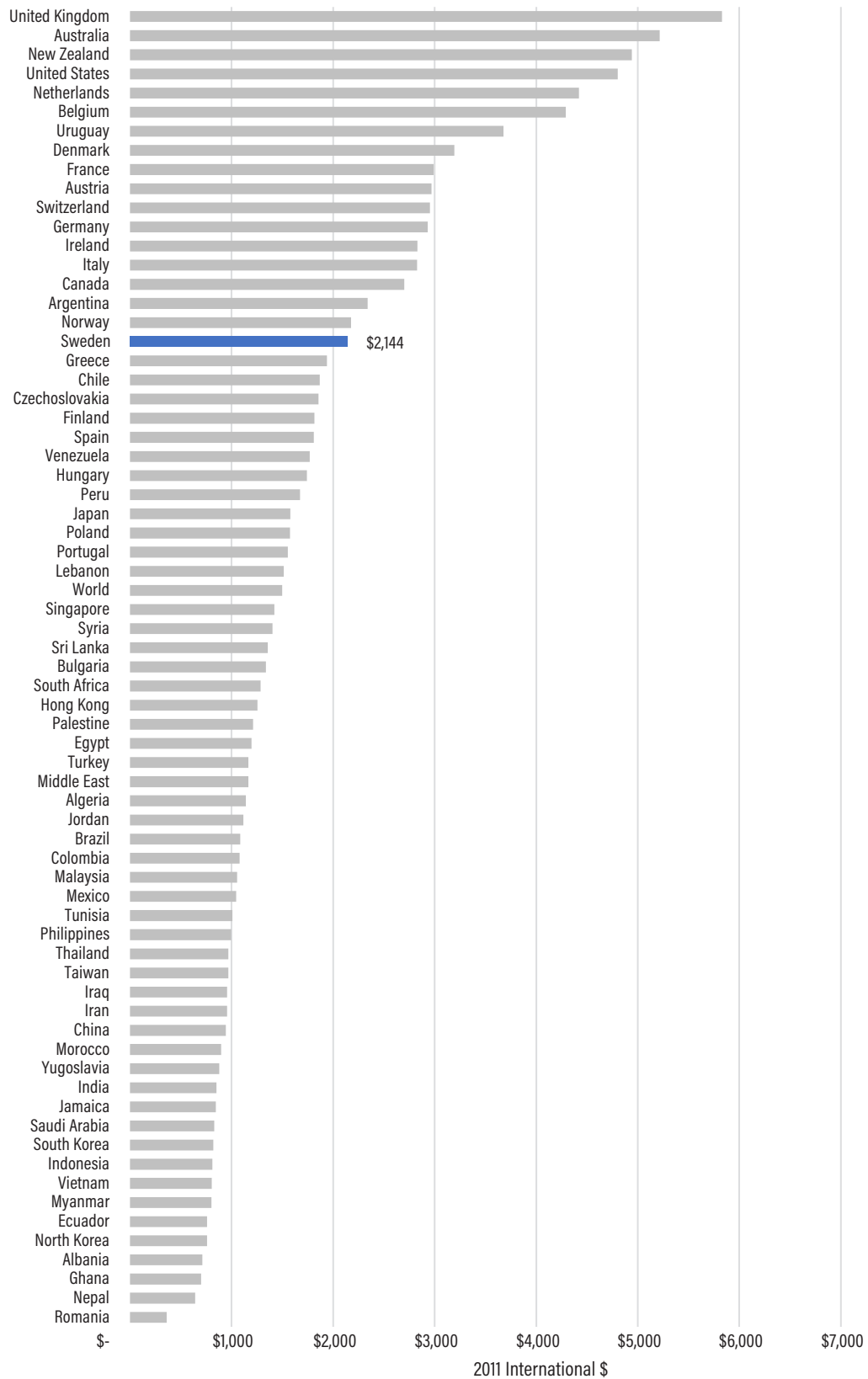
Figure 1.1: GDP Per Capita in Sweden, the UK, and the World (1820-1970)



Source: Bolt and van Zanden (2020).

Note: GDP per capita adjusted for inflation and price differences between countries.

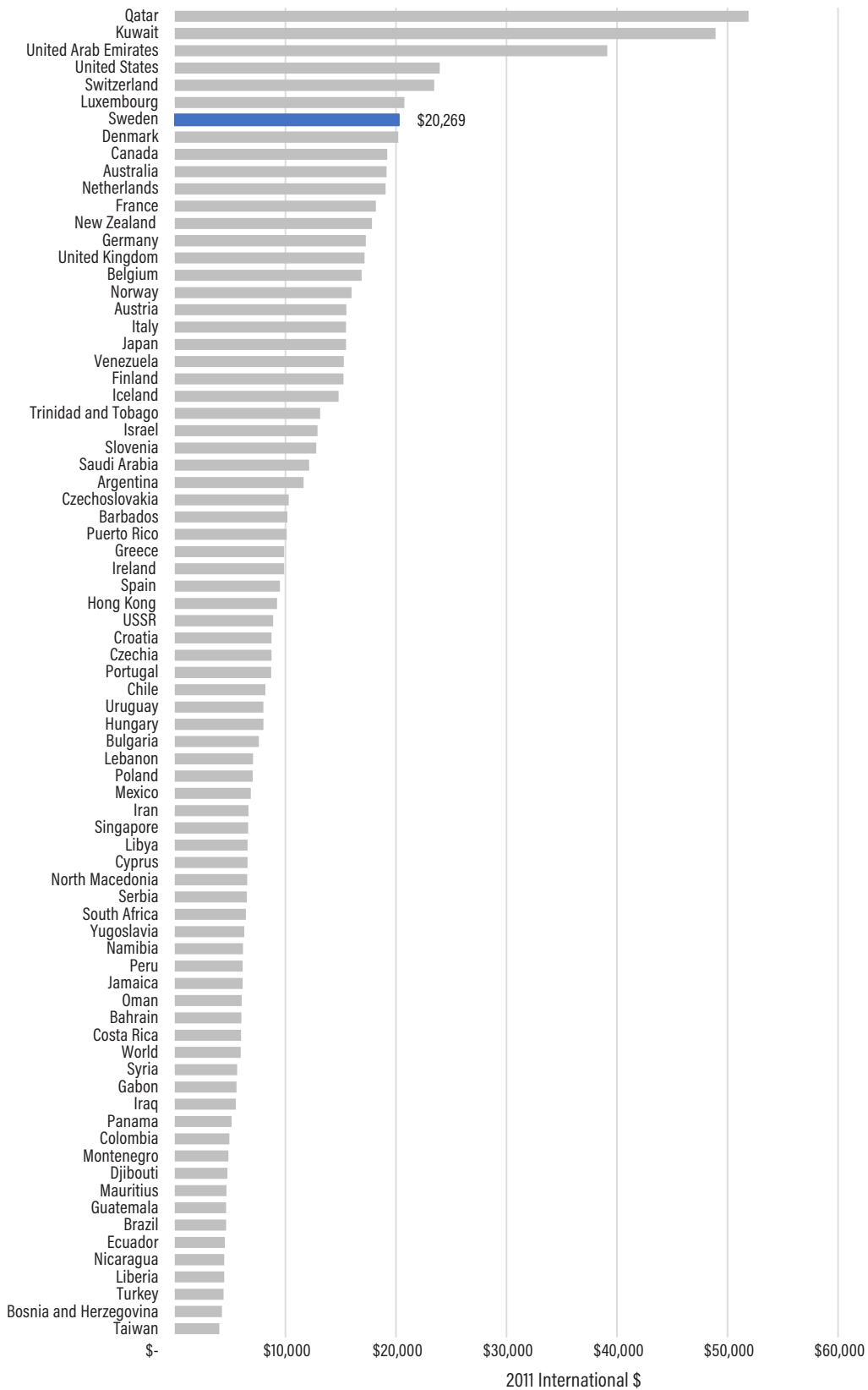
Figure 1.2: GDP Per Capita (1870)



Source: Bolt and van Zanden (2020).

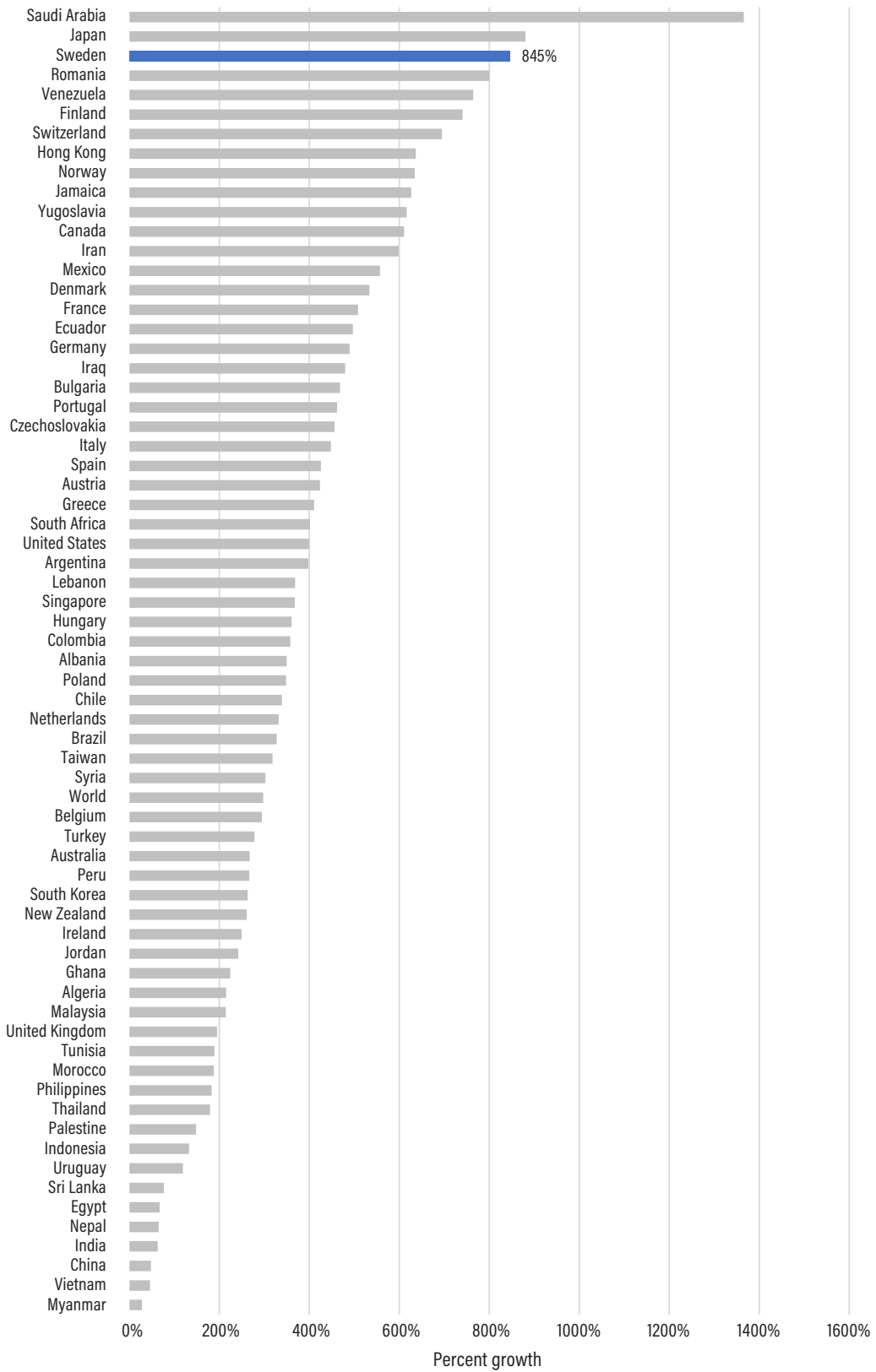
Note: GDP per capita adjusted for inflation and price differences between countries.

Figure 1.3: GDP Per Capita (1970)



Source: Bolt and van Zanden (2020).
 Note: GDP per capita adjusted for inflation and price differences

Figure 1.4: Growth in Real GDP Per Capita (1870–1970)



Source: Bolt and van Zanden (2020).

Note: GDP per capita adjusted for inflation and price differences between countries.

bigger export than timber. After deregulation and before the First World War, ironworks doubled the production and export of iron and steel. Restructuring reduced the number of ironworks by more than 60 percent, but production at each one increased 10-fold (Schön, 2000: 325).

Craftsmen, liberated from the old guild system, began competing by using new methods, offering new goods and designs, and at lower prices. The old trades were mechanized, and factories started mass-producing goods that even the poor could afford. The new financial system channeled capital to the most efficient producers, and Swedes used export revenue and profits to invest in new machinery and methods.

This laissez-faire epoch engendered a unique concept: *snilleindustrierna*—the “genius industries,” a term referring to businesses founded on an ingenious invention or the commercialisation of one, producing on a massive scale and largely for export. This was the start of Sweden’s era of multinational business.

These genius industries were often established by polymaths who were both inventors and industrialists. Lars Magnus Ericsson invented an automatic telephone exchange and founded the multi-national Ericsson company. Sven Wingquist invented the self-regulating ball bearing and created SKF. Alfred Nobel invented dynamite and built up Nitroglycerin AB (later Dyno Nobel). Gustaf Dalén invented a flashing apparatus for lighthouses and founded AGA. Gustaf de Laval’s milk-cream separator was the basis for a company that is now famous under the name Alfa Laval. Other Swedish entrepreneurs commercialized other people’s inventions: Ludvig Fredholm started ASEA (now ABB) to sell electrical lighting and generators, and Axel Wenner-Gren built up Electrolux by introducing vacuum cleaners and refrigerators to Swedish homes.

Soon, this first generation of entrepreneurs was followed by many others who sprang up from the new industrial working class. The private sector was not the only sector playing a part in Sweden’s rapid advancements; the government contributed by providing good basic schooling and sophisticated higher education in technology and natural science, which gave Sweden both breadth and excellence. This was clearly one instance when the public sector supported the private sector rather than undermined it. Helping Swedish industry compete with the most advanced methods and technologies early on in its development was a burgeoning international economy and little prejudice against practical skills. Sweden’s success was quite an astonishing achievement for such a poor country.

The growth in Sweden’s annual GDP per capita accelerated to 1.7 percent between 1870 and 1910, almost as fast a growth as in the United States (1.9 percent). Real wages increased even faster, during a period when many Swedes were emigrating to America and Swedish natural resources were attracting foreign capital. Real wages between 1870 and 1910 increased by a remarkable 2.8 percent annually, compared to an average of 1.1 percent for the US, Britain, France, and Germany. At 2.6 percent only Norway and Denmark came close to Sweden’s real wage growth (Schön, 2000: 225).

The growth in per capita GDP increased the demand for labour-saving machines. Sweden was starting to transform itself from an agricultural economy into an urbanized, industrial economy with a growing working class. Despite rapid population growth in the country, the rural population declined by a tenth between 1870 and 1910 (Rojas, 1996: 30).

The 1880s saw a long and vicious struggle over grain tariffs, which split the then dominant *Lantmannapartiet* (“Rural Men’s Party”) and gave rise to a new political landscape composed of free traders on the left and protectionists on the right. Cheap food imports had ended the recurring famines that once plagued Sweden, but farmers did not appreciate the competition. Bismarck’s protectionist Germany was in the ascendant and tariffs in Germany and France applied to foreign goods led to calls for retaliation. The protectionists grew stronger and in 1888 a conservative government took over with a new majority in Sweden’s parliament. It proceeded to implement import tariffs on both agricultural and manufactured goods.

In economic terms, the new tariffs were not as consequential as the free traders had feared and the protectionists hoped. They were not adjusted for inflation and so declined in real terms, and the dramatic reduction in transport costs from the country’s increased use of steamships and railways more than offset the loss from the tariffs. Sweden’s trade continued to grow. Between 1890 and 1910 Sweden’s exports grew by 3.7 percent annually (Schön, 2000: 227).

However, the tariffs had political consequences. The classical liberal idea that government should be a rule setter and neutral arbiter was dead. If landowners could pick the pockets of consumers, why shouldn’t other classes organize to take what they wanted? One historian writes: “After the protectionist victory, parliament was drowned by a wave of proposals that had in common that they all wanted the government to intervene both here and there” (Kilander, 1991: 205). In 1889 the Social Democratic Party was founded on a free trade platform, but also on the idea that workers shouldn’t be content with just waiting for the rewards of economic growth. They should also seize the means of production. Many liberals were sympathetic to the workers’ frustrations and began to accept limited forms of social protection. In April 1888, the liberal newspaper *Dagens Nyheter* wrote: “State socialism [tariffs] which benefits the powerful, by necessity demands state socialism that benefits the small and weak as well” (Hasselberg, 1945: 345-348).

The rise of new conservatives and social democrats did not spell the end of the Gripenstedt System. Until 1930, public spending did not surpass 10 percent of GDP. In a small economy dependent on imports and exports with competitive international companies, both capital and labour saw the importance of an open economy. And the limited government model produced impressive social and economic outcomes. Conservatives modernized their policies in a pro-business direction. Where they had once said that a strong and interventionist government would hold industrialization back, now they said that only such a government could protect and guide the industrialization of society. During the election campaign of 1911, the new conservative party even claimed to represent a middle

way between classical liberals and the new social liberals who supported various forms of social protection.

The social democrats also adapted, as they saw the success of the liberal economy and were influenced by economists like Knut Wicksell, Gustaf Cassel, and Eli Heckscher, who explained the importance of free enterprise and an open economy. Socialism turned out not to be a vote winner, and Sweden's rapid growth suggested another path: Instead of killing the goose that laid the golden eggs, they pointed out that those eggs might be sufficient for all classes, but under a different form of distribution.

In a highly influential 1926 book the young social democrat Nils Karleby urged fellow socialists to abandon their obsession with ownership. Socialism should be a guiding principle not merely an organizational form. In Karleby's view, socialists should use the power of the market—competition, prices, and the profit motive—to create as much wealth as possible, but focus on redistributing the rewards through taxation and a combination of government-provided social services and income support programs. Karleby's perspective was so important for social democrats that when one future prime minister, Ingvar Carlsson, was called in 1958 by then prime minister Tage Erlander to interview for a job, Erlander had just one question for him: "How well does Carlsson know his Karleby?" (Westerholm, 2018).

During the 1920s, under the leadership of Per Albin Hansson, the social democrats were transformed from a party of class war and socialism into a patriotic party for all classes. Hansson's vision was *Folkhemmet*, "The people's home" (a concept that radical conservatives had previously used)—a unified people under a paternal but caring and tolerant government. The social democrats started portraying themselves as the inheritors of the Swedish tradition of consensus politics and piecemeal democratic change. Their approach was very different from that of working class parties on the continent who tried to confront the capitalist system head on.

A groundbreaking new agreement for the labour market soon came to be seen as a central part of the Swedish model. During the early 1900s Sweden was one of the countries with the most work days lost to strikes and lockouts. The government planned to intervene, but both employers and unions wanted to prevent it from setting rules and wages. In 1938, the main trade union confederation LO and the employers' association concluded a national framework in Saltsjöbaden that set rules for negotiations and industrial action and gave the LO secretariat the power to suspend conflict aid to member unions that did not abide by compromises. The tradition of consensus and compromise that framework launched has been called the "Saltsjöbaden spirit," and is credited with changing the Swedish labour market from being wild and confrontational to being generally peaceable.

In 1932, the social democrats formed a government and held power until 1976 (except for three months in 1936), an incredible 44-year stretch. Some observers, like Herbert Tingsten (who abandoned socialism after having read Hayek's *Road to Serfdom*), suggested that the social democrats could only hold onto power so long because they lacked a soul.

In his view, they were shape shifters who turned into whatever the voters wanted for the moment. But another way of seeing their success is that they were Karlebyans who didn't care much about the basic organization of the economy as long as it delivered the goods that they wanted to redistribute. As Mauricio Rojas puts it: "The focus was no longer on transforming the factories, but people's lives outside the factories" (Rojas, 1996: 37).

Slowly but steadily the government took on new powers and responsibilities, but at its heart it remained a limited form of redistribution on top of a free market economy. Describing the situation in 1938, the minister of finance, Ernst Wigforss, explained that the government had only aimed for a "modest reform program," and that "the size of our assets had to be considered before we could recommend further steps along this path" (Wigforss, 1980: 296). Until the Second World War, income taxes were flat for most Swedish workers at a rate of around 15 percent.

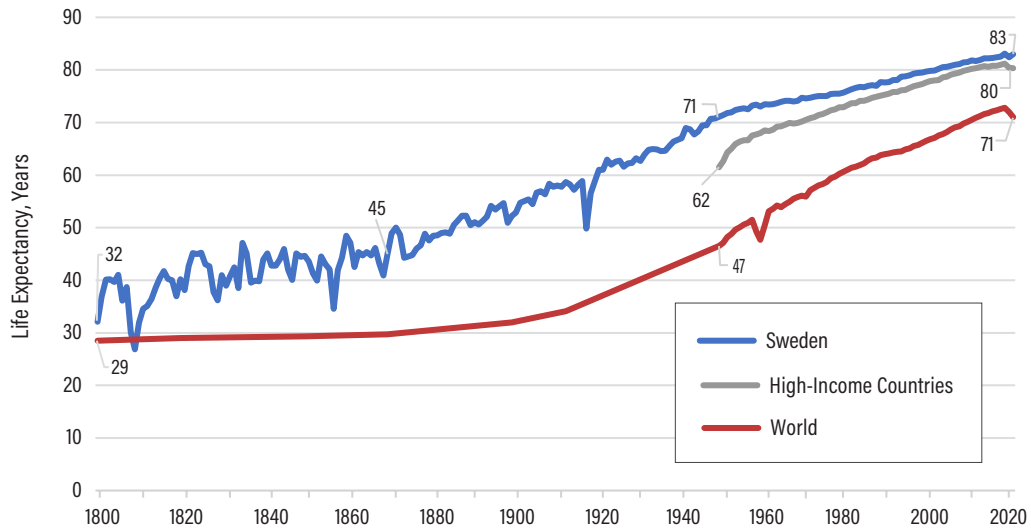
The modest welfare state was also a consensus project and even though the social democrats often led the way, the opposition soon caught up. After having studied 61 significant votes on government expansion in the Swedish parliament during the 20th century, the political scientist Emil Uddhammar concludes that in only 27 percent of the cases did any center-right party express a reservation. Indeed, the opposition often wanted even more spending on their pet projects. For example, the conservatives wanted more child benefits and the social liberals more support for child care. When center-right parties, in a major break with free market principles, gave the farmers' central organization monopoly rights to control the price of milk in 1932, the only opponents were the social democrats (Uddhammar, 1993).

However, milk was an exception. Interventions were still limited and the economy delivered enough to make them sustainable, especially during and immediately after the Second World War when neutral Sweden with an intact industrial base could export products to countries destroyed by the conflict. Economist Mancur Olson thinks that one reason why Sweden's interventions did not harm the economy was that its interest groups represented a large share of the country's economic capacity. Narrow interest groups tend to lobby for specific favours and subsidies, but larger, all-encompassing organizations know that their members are affected by the policies they propose and, therefore, they have an incentive not to hurt the country's productive capacity. They therefore tend to lobby for interventions that are general and support the economy at large, for example education and infrastructure, rather than tariffs and subsidies (Olson, 1990). Compared to its international counterparts, the Swedish Employers Confederation has been more pro-market than pro-business, arguing for less regulation and low taxes rather than industry-specific favours. The main trade unions have been much more willing to accept free trade and creative destruction to benefit the economy as a whole than have their counterparts in other countries.

In 1950, with the Gripenstedt System largely intact and after having stayed out of two world wars, Sweden had achieved the fourth highest per capita GDP in the world, just behind the United Kingdom to that point. Sweden was by then a success story, the

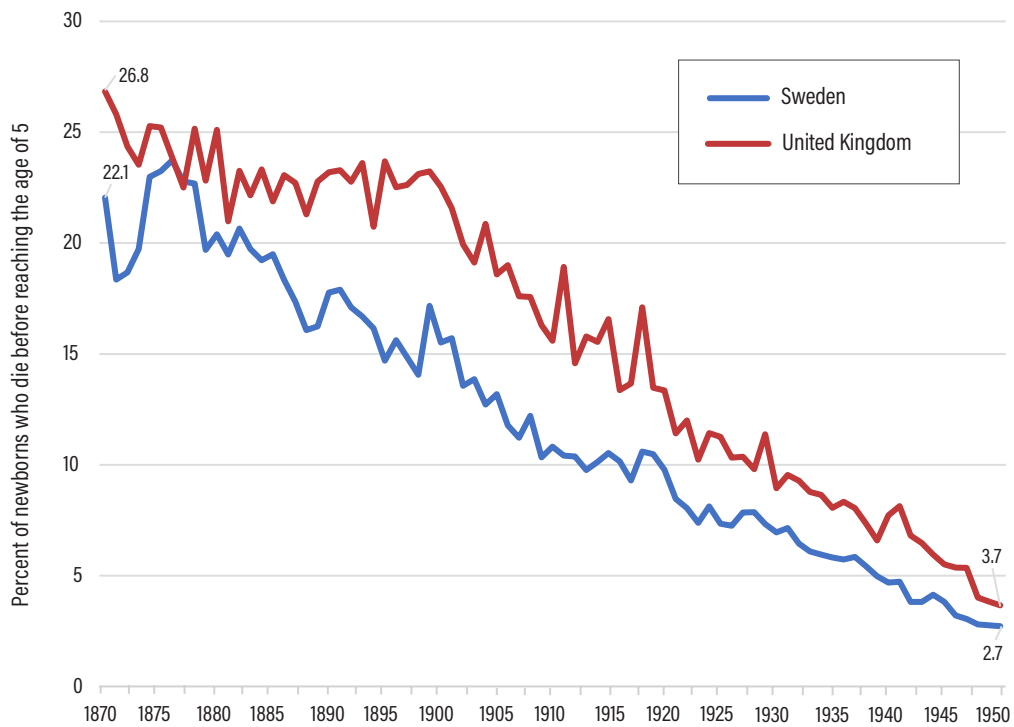
envy of the world. Between 1870 and 1950, life expectancy had increased from 45 to 71 years (see Figure 1.5). Child mortality declined from 22.1 to 2.7 percent (see Figure 1.6). Maternal mortality declined by over 90 percent (see Figure 1.7) (Our World in Data, 2022b; 2019).³

Figure 1.5: Life Expectancy at Birth (1800–2021)



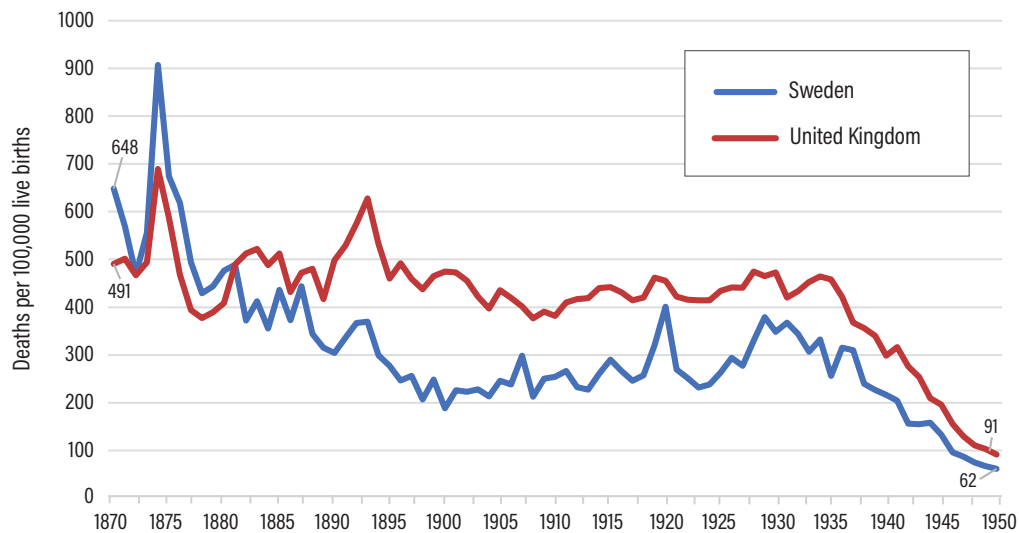
Source: Our World in Data (2022a).

Figure 1.6: Infant Mortality (1870–1950)



Source: Our World in Data (2019).

Figure 1.7: Maternal Mortality Rate (1870–1950)



Source: Our World in Data (2022b).

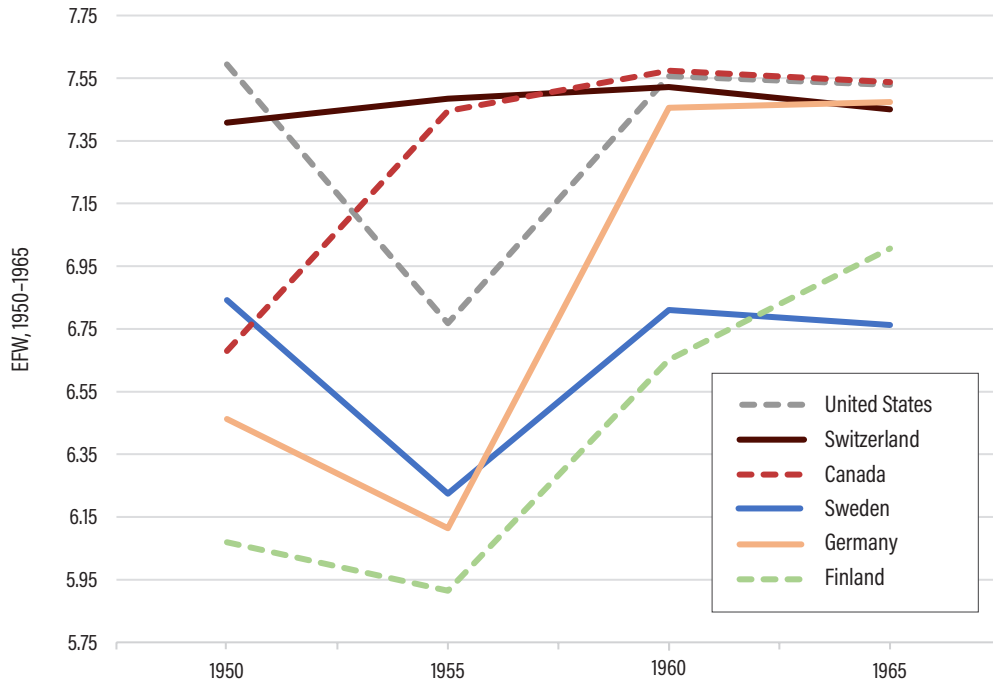
Note: The maternal mortality ratio is the number of women who die from pregnancy-related causes while pregnant or within 42 days of pregnancy termination per 100,000 live births.

Big government was still no more than a glint in the politicians' eyes. The government had created a number of income support programs for the poor and old and it subsidized education and infrastructure. But those interventions were generally limited and mostly designed to support an open market economy rather than undermine or replace it. With a few exceptions, like the milk cartel, the economy was decentralized, run bottom-up through voluntary decisions by individuals and businesses with the consequences being borne largely by the decision-maker. In this sense, Sweden was by the mid-1900s clearly a “capitalist-inclined economy,” to borrow the terminology suggested by Jim Ottesen in the introduction to this series.

In 1950, Sweden was the third freest economy in the developed western world, after the United States and Switzerland, according to attempts to extend the Economic Freedom index retrospectively (see Figure 1.8) (Lawson and Murphy, 2019).⁴ Public spending as a share of GDP, shown in Figure 1.9, was below 20 percent, well below countries like Britain, France, and West Germany. Taxes as a share of GDP were slightly lower than in the United States, and the highest marginal tax rate was 20 percentage points lower than in that country (Bergh, 2022: 50, 58).

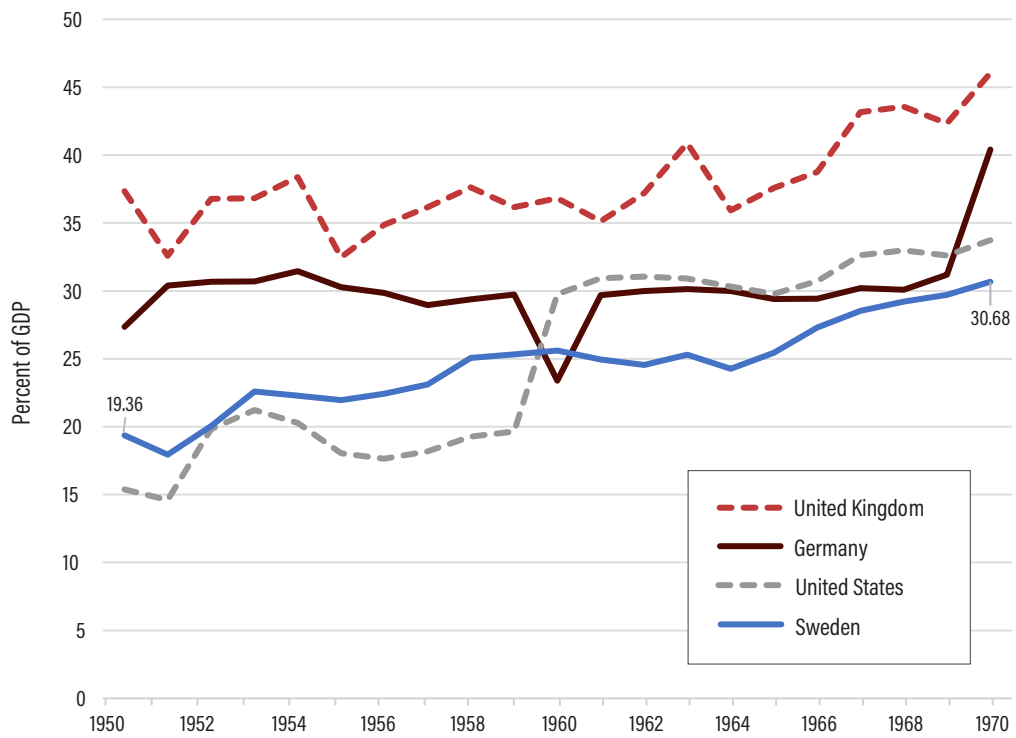
In other words, Sweden was one of the richest, healthiest, and most successful societies the world had ever seen—and that was before it was a generous welfare state and had started experimenting with socialist ideas. But that very sense of unequalled wealth and almost automatic progress is key to understanding what came next. After 100 years of growth, Swedes started to take their good economy for granted and forgot where it came from. It became difficult to resist calls for even more redistribution and a government program for every social problem. Prime Minister Tage Erlander has talked about “the

Figure 1.8: Economic Freedom (1950-1965)



Source: Lawson and Murphy (2019).

Figure 1.9: Government Expenditures as a Share of GDP (1950-1970)



Source: Mauro, Binder, and Zaman (2015).

dissatisfaction of raised expectations.” As people get more, they want even more, and the Social Democrats responded to this the only way they could. So began Sweden’s brief but consequential experiment with socialist policies.

Notes

- 1 I have written extensively on Sweden’s classical liberal history in Norberg (1998).
- 2 Due to both simple mathematics and “catch up growth,” it is easier for relatively low-income small economies to grow rapidly than it is for high-income large economies to grow rapidly.
- 3 The maternal mortality ratio is the number of women who die from pregnancy-related causes while pregnant or within 42 days of pregnancy termination per 100,000 live births.
- 4 According to this index, Honduras, Sri Lanka, and Mauritius in the developing world also beat Sweden in 1950.

THE RISE AND DECLINE OF SOCIALISM

For a long time, the economist and Nobel laureate Paul Krugman had a stock answer to the question of what kind of society he wanted: “Sweden in the summer of 1980” (Krugman, 1999). He thought that Sweden had by then found the perfect middle way between free markets and government intervention.

Not that it satisfied everyone. In 1980, Francois Mitterrand, who would be elected French president just a few months later, complained that Swedish socialism was not enough:

Sweden is insufficiently socialistic, for despite an unparalleled redistribution of income among social groups, it has not struck capitalism a mortal blow, in the heart of its power: the ownership of the major means of production. (Revel, 1982)

Sweden never became a textbook socialist country, with the means of production in government hands. Social democrats considered taking control of big business with the “Employee Funds,” a labour union plan from 1976 in which a portion of company profits taxed by the government were to be used to buy shares in Swedish companies with the goal of transferring those companies from private hands to collective ownership, but it was rejected by public opinion and watered down substantially after an ambitious campaign from business groups. However, the whole climate of ideas in Sweden was infused by socialist ideas in the 1970s and ’80s, ideas both inherent in the social democratic project and some from external forces. And a system of tight regulations, price controls, and tax increases rapidly centralized the economy. Decision-making that had previously been decentralized to individuals and businesses was now taken over by politicians and government authorities, and the consequences—good or bad—were born by taxpayers collectively rather than by those who had made the decisions. In this regard, and to use Jim Ottesen’s terminology, in the 1970s, Sweden changed from being a capitalist-inclined economy to being a socialist-inclined economy.

The Socialist era: 1970-1990

Sweden experiments with socialism, the public sector expands rapidly, the government raises taxes and regulates the labour market. Sweden loses businesses and entrepreneurial talent and economic growth declines.

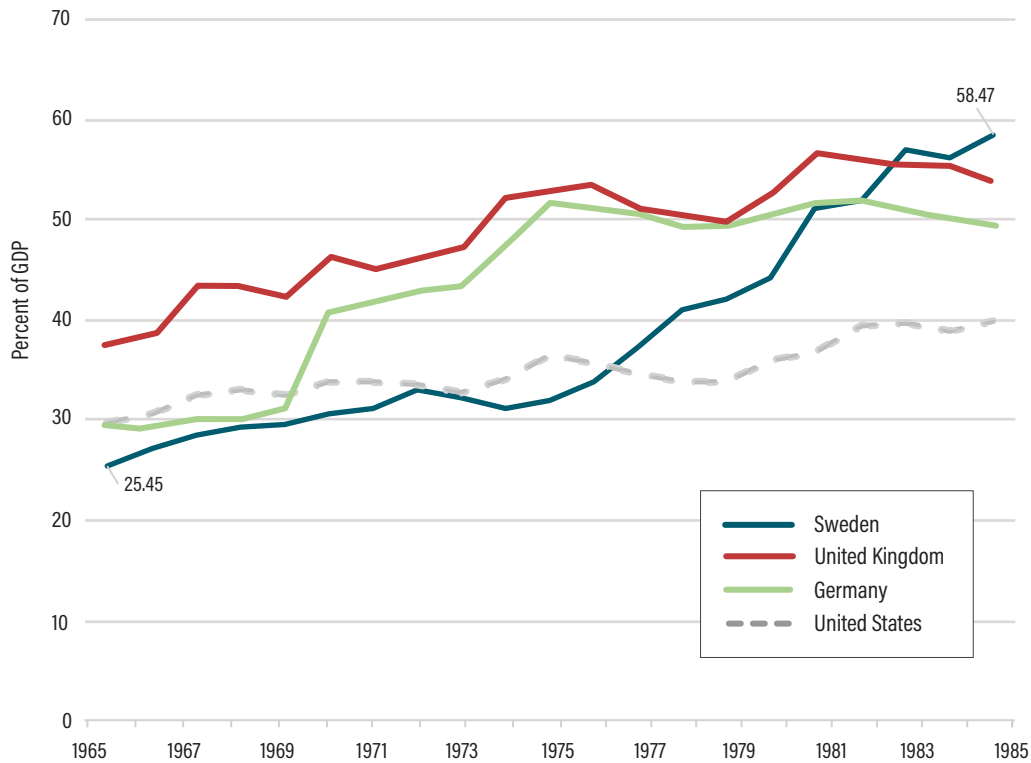
The government line from Nils Karleby's days, often echoed by the opposition, was always to redistribute as much as the economy could afford, and most of the debate centered on different opinions about how much redistribution the economy could bear and how fast. In the 1960s Sweden was on top of the world. The country had globally admired companies, an educated work force, and an open and competitive economy that delivered high growth, decent profits, and higher wages. And as late as 1970 total public spending as a share of GDP was lower in Sweden than in countries like the United States, Britain, and West Germany. The conclusion many drew was that now the economy could afford a very big government indeed. The time for patience was over.

The social democrats were also taken aback by the strong socialist current among students and intellectuals in the late 1960s, and their attempts to build alliances with the working class. Social democrats were used to an intellectual hegemony after having been in power since 1932, but now they were under strong pressure from outside forces to do more than just administer progress. Under Prime Minister Olof Palme, the social democrats responded by throwing caution to the wind. Tellingly, it eventually turned out that almost no leading social democrat really believed in the Employee Funds because by undermining the whole system of private enterprise it risked killing the goose that laid the golden eggs. One of Palme's ministers even claimed that Palme did not think such funds belonged in a democratic society (Pettersson, 2002). In a scandalous episode, on the eve of the parliamentary vote on introducing the funds, a photo journalist captured the finance minister scribbling a poem about them, deriding them as "shit." The social democrats almost nationalized Sweden's biggest companies against their better judgment, just to make sure that they were not outflanked on the left.

The government now socialized consumption faster than ever, which led to an unprecedented expansion in the size of government. In just 20 years, public spending more than doubled, from 25.4 to 58.5 percent between 1965 and 1985 (see Figure 2.1) (Our World in Data, Undated). This came primarily from a rapid expansion of social services like health care, elderly care, and child care, and transfers like pensions and housing allowances. The marginal tax rate for blue collar workers increased from less than 40 percent in 1960 to more than 60 percent in 1980, and for white collar workers to above 70 percent. The payroll tax rose from 12.5 percent in 1970 to 36.7 percent in 1979 (Myhrman, 1994: ch. 6). Capital gains were taxed as income, at progressive rates. In a series of steps, the corporation tax increased to almost 60 percent in the 1980s, even though it also offered generous deductions.

At the same time, the government raised the costs of doing business with a whole battery of regulations aimed at solving every conceivable problem and inequity. In 1970, Sweden introduced an opaque system of price controls, which forced businesses to negotiate price changes with business groups and government authorities. When Sweden devalued its currency it often implemented temporary bans on all price increases. Now it also gave up on the traditional Sweden model where labour market affairs were left to negotiations between business organizations and trade unions. Starting in 1974, the government regulated labour protection substantially, defining lawful reasons for termination and

Figure 2.1: Government Expenditures as a Share of GDP (1965–1985)



Source: Mauro, Binder, and Zaman (2015).

requiring that workplaces needing to fire staff for redundancy do so according to seniority (“last in, first out”).

As Mitterrand is sometimes quoted as telling Swedes, perhaps apocryphally: “In France, we socialized corporations and liberated people; you did the reverse.”

It is not difficult to understand why foreigners were fascinated by the Swedish experiment of the 1970s. Here was a small country that experimented with socialist ideas, at least in terms of extensive regulation of businesses and very high taxes, and yet it seemed to be oddly successful. Far from desperately poor, it was one of the richest countries in the world, with successful export companies, high employment rates, and impressive levels of trust among individuals and between individuals and government. Those who were learning about Sweden for the first time confused the long-lasting preconditions that made the experiment possible with the outcome of it; they failed to see that this experiment was, in fact, starting to erode some of those preconditions and had run into problems almost from the start. It was like the old joke: “How do you end up with a small fortune? Start with a large one.”

The oil crisis of 1973-74 revealed a productivity crisis throughout the western world. In Sweden, self-assured politicians, endeared to a vulgar form of Keynesianism, responded by

trying to bridge the recession with a massive stimulus program that supported both extra demand and production for stockpiling. In this overheated climate, wage and payroll tax increases raised labour costs by 40 percent in just two years, 1975 and 1976. The result was a cost crisis that almost destroyed Swedish manufacturing and exports. Just as the rest of western Europe rebounded from the crisis and the export giant Sweden should have prospered, it entered a deep recession. From 1974 to 1977, steel production in the country decreased by 30 percent, shipbuilding by half, and much of the textile and mining industries collapsed (Magnusson, 1996: 476).

While Sweden used to welcome and facilitate restructuring, now the government doled out massive corporate subsidies to keep workers employed. This policy continued from 1976 to 1982 under center-right governments, at which time the social democrats finally lost power—but not the battle of ideas. Critics talked about the government’s “industrial emergency room,” where failed businesses were given a few extra years of life at an enormous cost to taxpayers. In 1977, the ship-building industry was in effect nationalized (and phased out) and in 1978 much of the steel industry was taken over by government and only returned to modest profits and eventual privatization after almost half of the workforce was let go and most of the plants and product lines were eliminated.

Table 2.1: Political Affiliation of Swedish Governments

Years	Political Affiliation
1945-1976	Social Democratic
1976-1982	Center-Right coalitions
1982-1991	Social Democratic
1991-1994	Center-Right coalition
1994-2006	Social Democratic
2006-2014	Center-Right coalition
2014-2022	Social Democratic/Green coalition

The one consistent policy that various governments have used to try and make their economies more competitive is to devalue the currency. In Sweden, the currency was primarily fixed against the deutsche mark and eventually the European Currency Unit (ECU), the European Economic Community’s basket of member country currencies. In 1976, the Swedish krona was devalued by 3 percent, in April 1977 by 6 percent, and in August the same year by an extra 10 percent. In September 1981 it was devalued by 10 percent, and finally, in 1982, just after the Social Democrats had returned to power, it was further devalued by a whopping 16 percent.

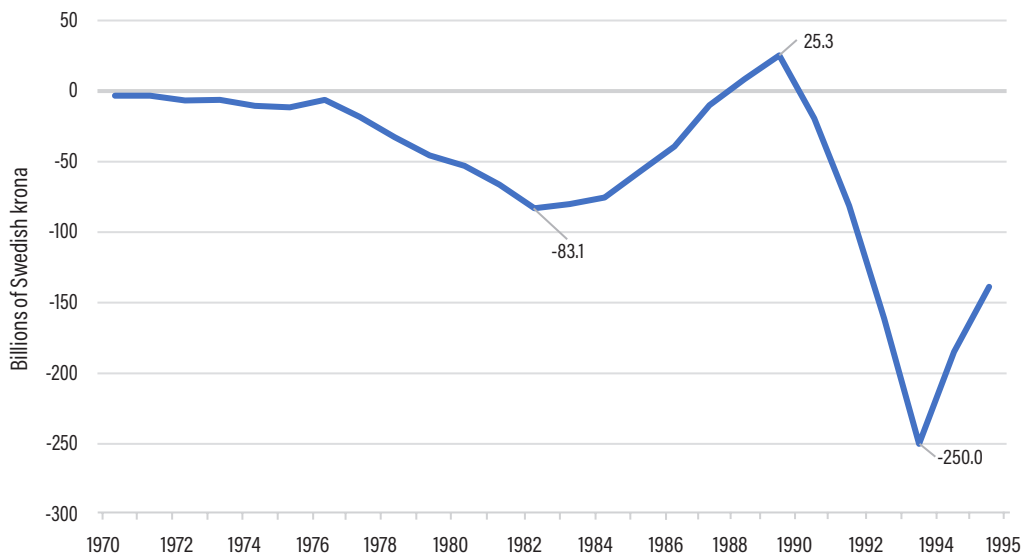
These devaluations, some of which had to be undertaken simply because trade unions immediately demanded higher wages to compensate workers for the last devaluation, undermined the purchasing power of Swedes. In combination with the international economic boom of the 1980s, the 1982 super devaluation hid many of the structural

problems in the Swedish economy, problems that would come back with a vengeance in the early 1990s. Unions soon returned with demands for higher compensation, and inflation surged. The devaluations did boost the export sector, but in an erratic, unpredictable way that undermined long-term investments and distorted the price mechanism. Instead of letting market forces encourage productive companies and punish uncompetitive ones, all export companies were given an irregular boost of performance-enhancing exchange rate changes, while devaluations protected unproductive domestic businesses from imports. The Swedish export share of OECD markets continued to slip, however, and between 1970 and 1990 dropped by almost 30 percent.

Fewer companies were created in Sweden and the ones already in existence did not expand. In fact, by 1990, the Swedish economy had not created a single net job in the private sector since 1950, even though the population had increased by one and a half million people. All employment creation took place in the public sector (Davidsson and Henrekson, 2002). As Figure 2.2 shows, the Swedish government ran budget deficits every year from 1970 to 1987. Public debt, shown in Figure 2.3, increased from less than 18 percent of GDP in 1970 to over 70 percent in 1985 (IMF, 2023).

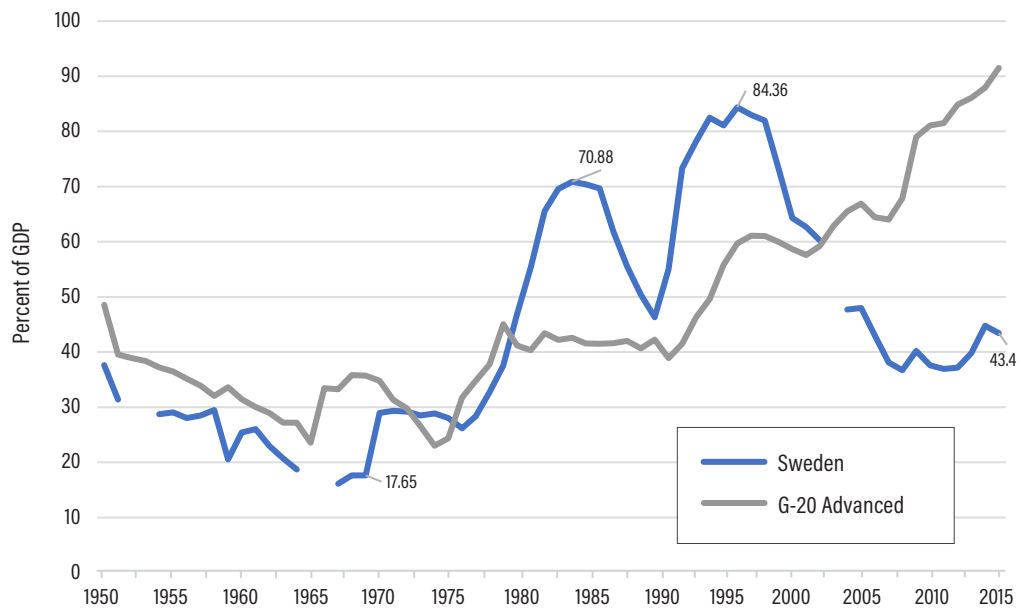
This is the one period in modern history when Sweden lagged behind other industrialized countries on many measures. The rate of investment declined from a couple of percentage points above the OECD average to a couple of percentage points below. Figure 2.4 shows productivity growth, as measured by GDP per employee. Swedish productivity increased by an average of 4.6 percent per year from 1960 to 1970, but it only increased by an average of 2.0 percent per year from 1970 to 1990. Over this same period, OECD average annual productivity growth was 3.2 percent per year (Feenstra, Inklaar and Timmer, 2015).

Figure 2.2: State Budget Balance (1970-1995)



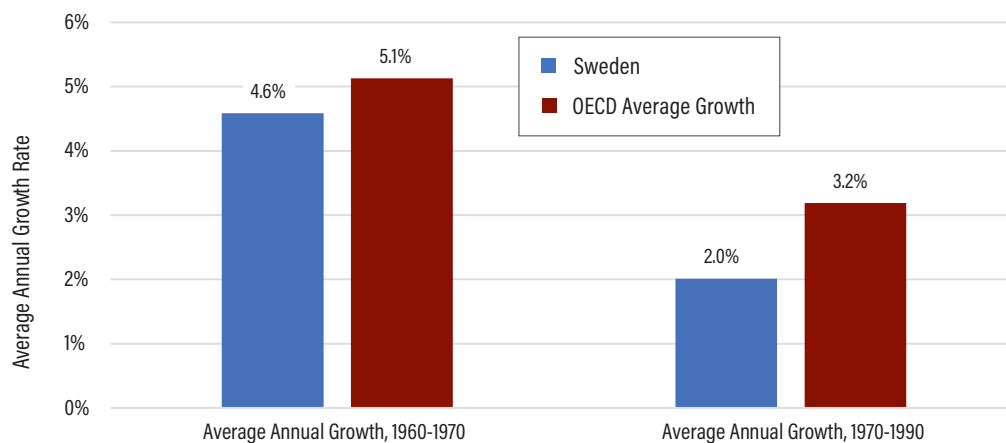
Source: Öljemark (2022a).

Figure 2.3: Public Debt as a Percent of Gross Domestic Product (1950–2014)



Source: OMF (2023).

Figure 2.4: Average Annual Growth in Productivity Per Worker (1960–1970, 1970–1990)

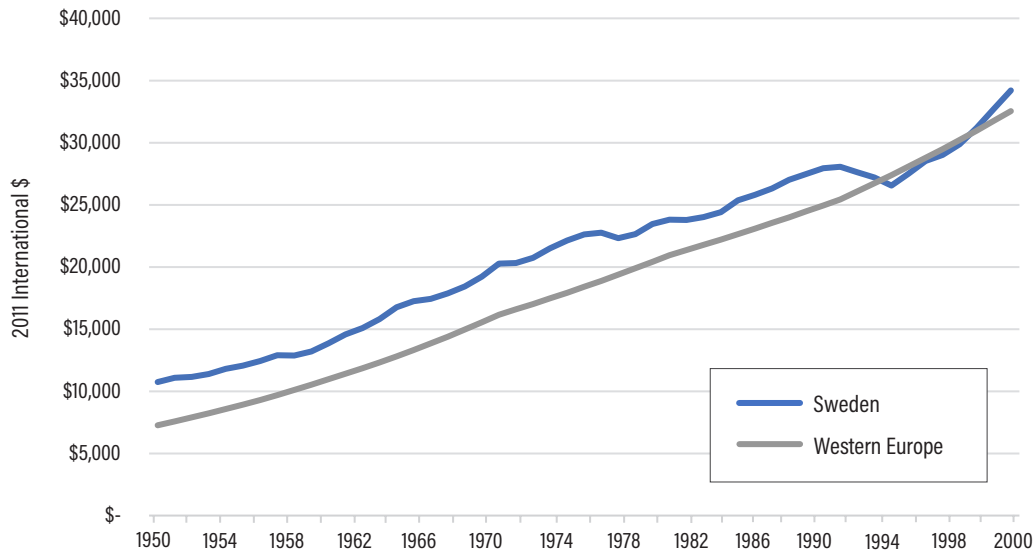


Source: Feenstra, Inklaar, and Timmer (2015).

In 1970, Sweden's per capita GDP was 25 percent higher than that of the rest of Western Europe; in 1980 it was just 14 percent higher.¹ And as Figure 2.5 shows, for a brief moment in the midst of the crisis in the early 1990s, Sweden's per capita income was below the Western European average. The fourth richest country on the planet was suddenly just the 10th richest (Öljemark, 2022b; Groningen Growth and Development Centre, 2022; Bolt and van Zanden, 2020).

This was not a golden era, as some outside observers would now have it. In fact, it was more like Sweden's *Atlas Shrugged* moment.² Many of the country's most important

Figure 2.5: Real GDP Per Capita (1950–2000)



Sources: Groningen Growth and Development Centre (2022); Bolt and van Zanden (2020).

Note: GDP per capita adjusted for inflation and price differences between countries.

companies, entrepreneurs, and individualists left the country, primarily because taxation was suffocating and often made it impossible to pass family companies on to the next generation.

In 1973, the founder of the furniture giant IKEA, Ingvar Kamprad, left Sweden, and the foundation that owned the company was moved to the Netherlands. Tetra Pak moved its headquarters to Switzerland in 1981 and Fredrik Lundberg, one of Sweden's richest entrepreneurs and investors, left the country in 1985. Sweden became one of the most equal countries on the planet partly because many wealthy Swedes left and set up shop elsewhere.

The two greatest Swedish sports stars of the era, tennis player Björn Borg and alpine skier Ingemar Stenmark, moved to Monaco to escape taxes. In 1976, Sweden's most famous film director, Ingmar Bergman, was arrested for tax evasion during rehearsals for a play at the Royal Dramatic Theatre. The charges were dropped, but Bergman suffered a nervous breakdown, left for Germany shortly thereafter, and swore never to make another film in Sweden. In that same year, Astrid Lindgren, the author of Pippi Longstocking and other beloved children's books, wrote an article about how she had been forced to pay taxes in a single year at 102 percent of her income, effectively causing her to lose money for every krona she earned.

Sweden did become more equal during this period. The income Gini coefficient declined from 0.26 in 1967 to around 0.2–0.23 in the 1980s. This was probably one of the lowest levels of inequality in the world and many outside observers still hail it as a success story.

However, as economists Anders Björklund and Daniel Waldenström argue in a recent paper, this is hardly relevant for present inequality debates since the reason inequality was so low was that the Swedish economy had become dysfunctional. Sweden did not increase equality by raising the bottom, but by destroying incentives to work and save through high taxes and inflation. Sweden chased high-income earners away, and few replaced them (Björklund and Waldenström, 2022).

In fact, for the first time since the Industrial Revolution, Swedes were becoming worse off financially for a sustained period. Nominal wages grew, but because of rapid inflation, real wages declined between 1975 and 1985. In 1995, the average real wage had been stagnant for two decades (Ekonomifakta, 2023a).

The summer of 1980—the year in which Paul Krugman felt Swedish society was at its ideal best—Swedes occupied themselves by reading a long-running series of articles by public intellectuals from both the left and the right on the arts pages of various newspapers warning that the Swedish experiment with socialism had degenerated into a semi-totalitarian state that undermined rule of law, civil society, and free enterprise, and chased businesses and talent out of the country.

As Figure 2.4 showed, productivity growth was slower in the 1970s and 1980s than it had been in the 1960s. But even more problematic was the effect the changes had on some of the cultural traits that Swedes took pride in. An historically strong work ethic and a reluctance to accept public benefits created a wealthy society that, in turn, made it possible to finance a big welfare state through very high taxes. But as Margaret Thatcher famously said, sooner or later you run out of other people’s money. And sooner or later, you undermine behaviour if you financially punish it enough.

In the early 1980s, 82 percent of Swedes said it was never justifiable to claim government benefits to which you are not entitled. Thirty years later just 55 percent agreed with that statement (Sanandaji, 2015: 75). After generous sick leave benefits were implemented, Swedes who were objectively healthier than any other population on the planet were suddenly “off sick” from work more than almost any other population. As early as 1978, one of the founding fathers of Sweden’s welfare state, the economist Gunnar Myrdal, complained that the traditionally honest Swedes were obsessed with escaping tax, and were turning into “a population of cheats” (Myrdal, 1978).

The Crisis (1990-1994)

A spiral of deficits, devaluations, and inflation collapsed Sweden’s economy leading to a major financial crisis. The country endured three years of negative growth and, for a short period, a 500 percent interest rate.

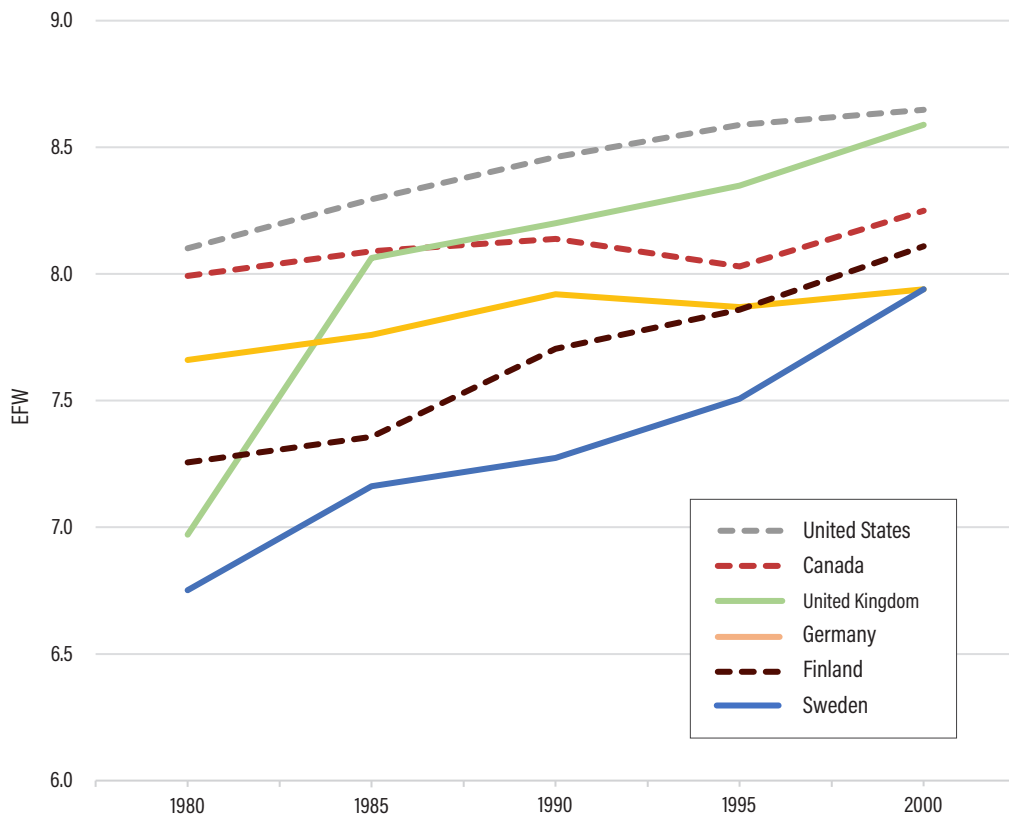
When times seemed most desperate and when many had convinced themselves that Sweden could not be reformed, the country’s political establishment again surprised outsiders by rejecting the socialist experiment, and started working hard to return to the economic

model that had been so successful in the past. Between 1980 and 2000, Sweden climbed almost 1.2 points on the 10-point Economic Freedom of the World Index scale. That improvement compares to less than a 0.4 rise for the Reaganite United States and 1.4 for Thatcherite Britain (Gwartney, Lawson, Hall, and Murphy, 2021). Figure 2.6 shows economic freedom in Sweden and five comparator nations. This was a period in which many countries were liberalizing. But Sweden’s efforts were especially pronounced and enabled it to begin to catch up with the other Western capitalist nations.

There were three reasons for Sweden undertaking the wave of reforms. First, there was widespread discontent among the general population with the government’s encroachment on their liberties. Public intellectuals, including many on the left, began to question the economic and social cost of big government. A strong opposition to an ever-growing state had started to emerge as a result of the international tide moving towards free-market ideas, but also as a result of a business-led campaign against socialism that had been started as a reaction against the Employee Funds.

A multi-year series of public reports examining democracy and power that had been initiated by the social democratic government (*Maktutredningen*) raised several issues about the powerlessness of individuals. The reports showed that Swedes paradoxically

Figure 2.6: Economic Freedom (1980-2000)



Source: Gwartney, Lawson, Hall, and Murphy, (2022).

felt less in control in the areas that they were in charge of collectively than in areas largely characterized by private-sector markets.

The public sector is largely structured according to the principle of standardized solutions. The surveys show that many who come into contact with the public sector feel powerless in silence. Areas such as education and health care are characterized by a lack of choice. (SOU, 1990: 404)

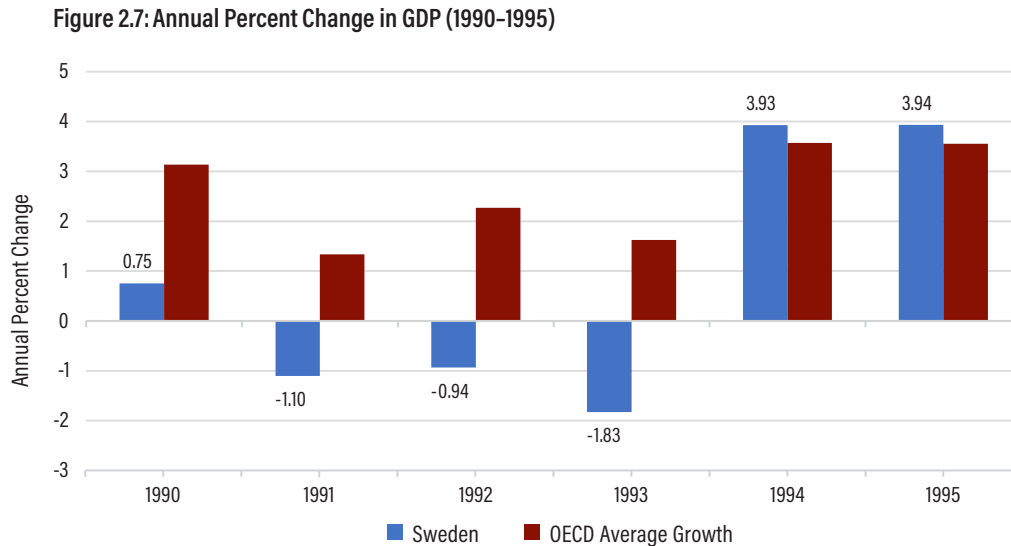
These findings had a profound effect on the social democrats who began to discuss ways of making the public sector more accountable and giving citizens more choice. Ideals of autonomy and self-reliance from the early independent cooperative and labour movement were suddenly on the agenda again.

Second, its economic model was in trouble. Sweden lagged behind other countries and suffered from a lack of entrepreneurial dynamism. By 1995, not a single net job had been created in the private sector for almost half a century. Of Sweden's 50 biggest companies in 1995, the only three that had been founded since 1970 were controlled by the national government or the city of Stockholm. A large number of the biggest companies were 100 years old and had been founded during Sweden's *laissez-faire* period (Jakobsson, 2007).

In the social democratic party a group of reformers in the department of finance came to the conclusion that the only way to save the welfare state was to implement some aspects of economic liberalization. Nicknamed "the Chancellery Office Right," they initiated some deregulation in the domestic aviation and taxi markets, lifted controls on bank lending in 1985, and removed foreign exchange controls in 1989. They also deregulated farming and replaced quasi price controls with market forces. In 1990, the government and the opposition liberal party started a major revision of the tax system, moving towards a flatter tax system with fewer loopholes for individuals and companies. In October 1990, the government decided it was time for Sweden to join the European Union so it could benefit from a common European market (after having ruled out the idea publicly just months earlier). In other words, reforms had begun before the financial crisis of the early 1990s and had been initiated by social democratic governments.

But then came the third reason, the 1990-94 financial crisis (see Figure 2.7). The crisis was deep and devastating—the country endured three years of negative growth—that ended once and for all the wishful thinking about a unique Swedish approach, a Swedish *Sonderweg*. The 1990-94 financial crisis created a political consensus that substantial reforms had to be made. Those reforms included reducing spending and liberalizing markets so the country could regain its stability and start growing again.

The 1990-94 crisis was a consequence of long-running problems of productivity and competitiveness that had never been solved. Instead, they had been kicked down the road in a spiral of deficits, devaluations, wage increases, and inflation. The government had promised that the 1982 episode was "the last devaluation," and since then it had

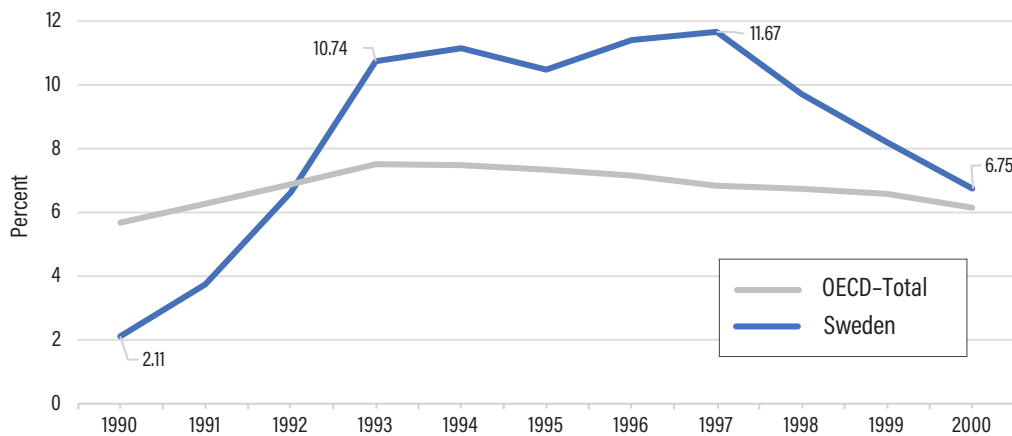


been groping around in a search for other ways of dealing with rising domestic costs. But instead of compensating for those rising costs with a more restrictive fiscal policy, the government continued to expand social programs. Since the inflationary boom raised tax revenues, the government could even present a budget surplus in 1988, which was taken as a sign that all was well and that it could keep spending.

The severity of the 1990-94 crisis also had more specific causes. The reforms of the 1980s were disjointed and ill-timed. For political reasons, it was much easier to open the credit taps than to change the tax system, so the former came five years earlier than the latter. When the minister of finance, Kjell-Olof Feldt, wanted to abolish credit controls in 1985, prime minister Olof Palme famously said, “Do whatever you want. I don’t understand anything anyway” (Feldt, 1991: 260). This deregulation unleashed a lot of liquidity in an economy that still had a grossly distorted incentive structure: The central bank held onto a loose monetary policy which, in combination with high inflation, turned interest rates negative. Before the tax reform of 1990-91, high marginal tax rates made deductions for interest rate payments even more lucrative, encouraging indebtedness and speculation. Currency controls kept most of the credit boom within the country’s borders since Swedes were legally constrained from investing outside of Sweden. The result was a real estate bubble after 1986.

What can’t go on forever, won’t. One trigger for the resulting financial crisis was sharply higher international interest rates after German reunification and speculative attacks on Sweden’s fixed exchange rate with the European Currency Unit (ECU). In February 1990 the desperate social democratic government proposed an extraordinary “Stop package” to freeze wages and prices for two years and ban strikes and dividends. It was soundly rejected in parliament and the government resigned, only to return 11 days later without these policies. However, Feldt, the minister of finance, left politics entirely. He would

Figure 2.8: Unemployment Rate, Sweden and OECD Average (1990–2000)



Source: IMF (2022)

later go on to describe the moratorium as “theoretically unreasonable and practically impossible” (Feldt, 1991: 459).

Another trigger for the financial crisis was the 1990-91 tax reform. The return to more normal conditions and incentives turned many economic projects that had been perfectly rational under the old, inflationary system into financial time bombs. Marginal tax rates, deductions, and inflation declined, and the real interest rate jumped from 1 to 2 percent in 1991 to more than 10 percent at various times in 1992. Swedes, who had a negative savings rate of 5 percent in 1988, had started to save 8 percent of their income by 1992. The commercial and residential housing market crashed and threatened to bring the whole banking system down with it. Unemployment, shown in Figure 2.8, surged to over 10 percent and remained elevated for half a decade. The central government budget deficit reached 10.6 percent of GDP in 1993.

The immediate political priority was to stem the outflow of capital from Sweden and defend the link to the ECU. When both Finland and Britain left the fixed exchange rate in September 1992, a desperate Swedish Central Bank took the drastic step of increasing the short-term interest rate to 500 percent (yes, *five hundred* percent) for a few days. Two major crisis packages agreed by the government and opposition failed to restore confidence and on November 19, 1992, the fixed exchange rate was abandoned, and the krona depreciated by 27 percent against the ECU. Once and for all the idea of controlling the value of the currency was abandoned, and the central bank instead established a goal of keeping inflation around 2 percent.

The capitalist welfare state (1995–)

A new reform period with economic liberalization, lower taxes, and privatization establishes a new Swedish model, which combines a large welfare state with a more open and deregulated market economy.

“A failure must be described as a failure” commented prime minister Carl Bildt (who had taken over in September 1991) as the fixed exchange rate collapsed. But another way of looking at this episode is that it marked the death of a failed two-decade-long experiment and the birth of a new Swedish model, one that combines a generous welfare state with an open and competitive free market. It is a “capitalist welfare state” as the economist Andreas Bergh (2016) has called it.

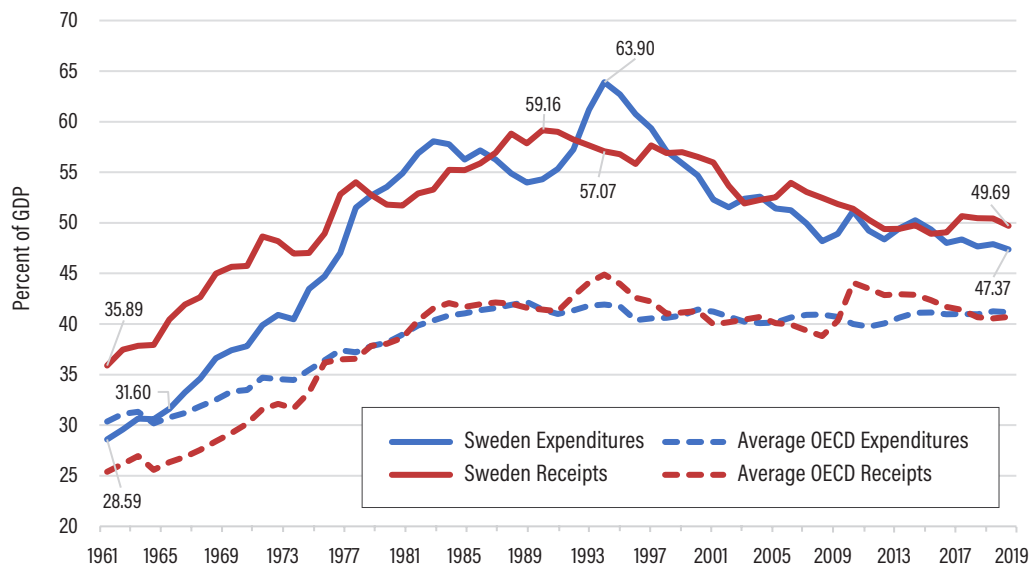
Often a financial crisis results in nothing more than fiscal austerity. In Sweden in the 1990s, however, it was met with an ambitious program of structural reforms of the economy, the government, and the public sector. One reason that the ambitious program worked was that the four-party, center-right government under Carl Bildt was reform-oriented and determined not to repeat the mistakes of the 1976-1982 governments, specifically, of administering social democracy and allowing economic stagnation to take hold. Several ministers and their advisors were steeped in liberal thought and inspired by economists like Milton Friedman and Friedrich Hayek.

Another reason that the program worked was that the reforms had been carefully prepared in advance, including through public commissions, in anticipation of potential legislation. Many of the reforms had been initiated or published under previous governments. This meant both that ideas could be turned into policy proposals quickly, and that there was the potential for political consensus. The reports of the public commissions have been compared to early warning systems, pointing out challenges ahead and thereby creating a common way of perceiving the problems that will arise and the changes needed to address them (Bergh and Erlingsson, 2009).

In November 1992, the Bildt government gave Assar Lindbeck, a leading social democratic economist (until he fell out with the party over the Employee Funds), the task of leading a commission to get Sweden out of the crisis. In just three months the commission came up with 113 proposals to improve the political process and make the economy more competitive. Many of the proposals had been suggested in previous public reports, but Lindbeck’s recommendation gave them an extra sense of urgency. Lindbeck’s report was very popular among some groups and very controversial among others, so it sparked fierce debate. In the end, though, many of its proposals became reality.

As Figure 2.9 shows, during the next few years, Sweden cut public spending substantially, moving both expenditures and revenue closer to the OECD average. The country also reduced the benefit levels in its social security systems. Nineteen state-owned companies were privatized and public investment funds that had interfered with the investment decisions of private businesses were abolished. Private and commercial radio and television stations were permitted for the first time. Railways, buses, and domestic aviation were deregulated. The telecom and energy sectors were opened up to competition. Private employment agencies were permitted, and unemployment benefits reduced. The last vestiges of the price control system were abolished, with the infamous exception of rent control, which has continued to make it very difficult to get a rental apartment in

Figure 2.9: General Government Spending and Receipts as a Share of GDP (1961-2019)



Sources: OECD (2021c); and OECD (2021d).

growing cities like Stockholm. The central bank was given an explicit inflation target of 2 percent annually.

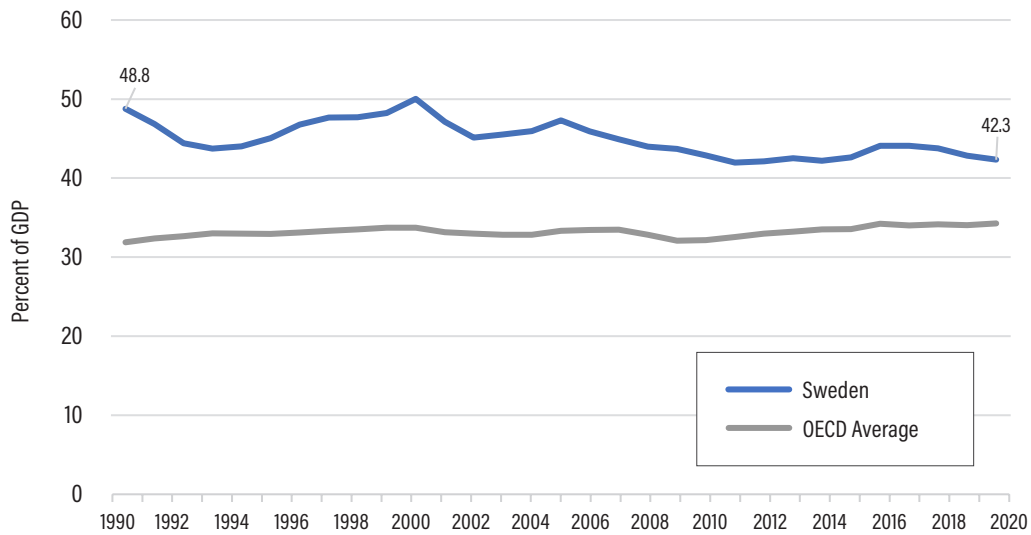
In 1992, Sweden initiated an ambitious opening up of public services when it created a national school voucher system, which gave families the freedom to choose independent schools for their children's education. Private alternatives in government-subsidized child-care, elderly care, and health care started to proliferate. Municipalities were given greater freedom to organize themselves and experiment with new forms of management and roles for private providers. Government funds for municipalities earmarked for specific uses were replaced with more general funds.

In 1994, parliament decided to introduce a new pension system, which replaced defined benefits with defined contributions and included a "break" that automatically reduces payments in bad times. It also included individual accounts, which can be invested according to personal preference. In 1995, Sweden joined the EU and got access to the internal market and freedom of movement across the continent, even though, paradoxically, to conform to EU regulations Sweden also had to re-introduce regulations, subsidies, and tariffs in the agricultural sector, which had just been abolished.

Some of the reforms of the 1990s aimed to make the political process more sustainable and less prone to short-termism. The parliamentary term of office was extended from three to four years to avoid governments operating in perpetual campaign mode. In 1997, the government introduced a new budget process that set a limit for total spending in advance. Any later increase in spending in one area had to be financed within the budget and taken from some other area.

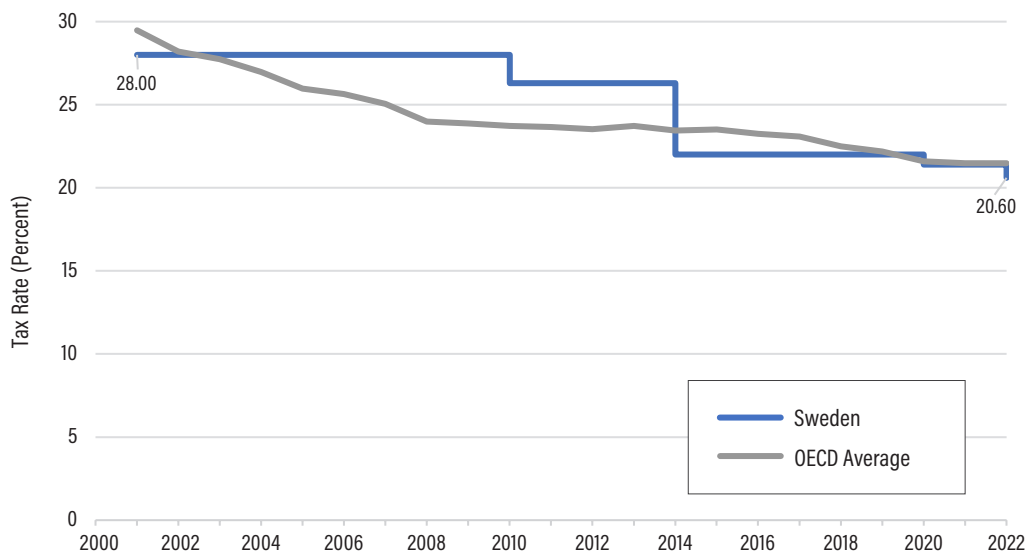
The 1990s marked another great reform for Sweden after which the country was in many ways more open and less regulated than other countries. Sweden still has a large government, but it is much less of an outlier than it was. Public social spending is 25.5 percent of GDP, just the 8th highest in Europe and far below France’s 31 percent (OECD, Undated a). As Figure 2.10 shows, total tax revenue as a percentage of GDP declined from almost 50 percent in 1990 to around 42 percent in 2020. The corporate tax rate, shown in Figure 2.11, which had been far above 50 percent in the 1980s has been repeatedly

Figure 2.10: Tax Revenue as a Percent of GDP (1990-2020)



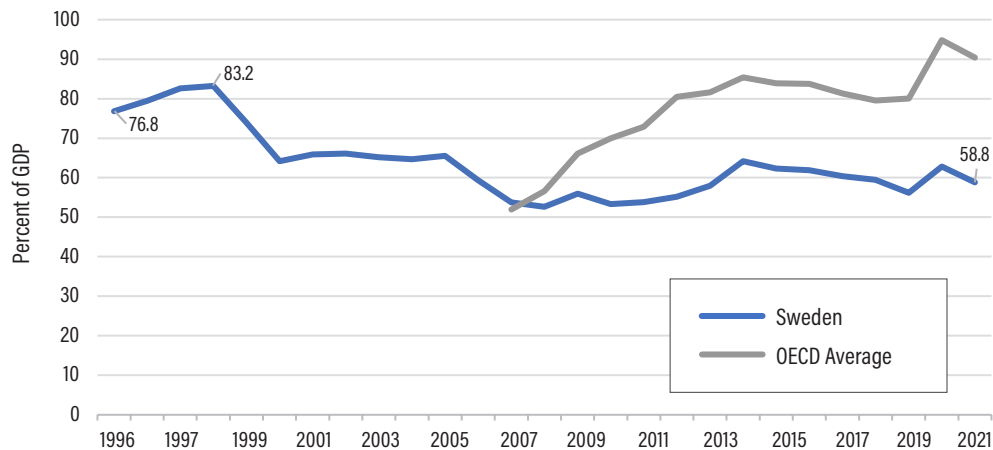
Source: OECD (2021a).

Figure 2.11: Corporate Income Tax Rate (2000-2022)



Source: OECD (Undated b).

Figure 2.12: General Government Debt as a Share of GDP (1995–2021)



Source: OECD (2021b).

lowered and is today 20.6 percent. Capital gains used to be taxed as personal income and therefore at a progressive rate. They are now taxed at a proportional rate, between 15 to 30 percent, depending on the sort of capital. Taxes on wealth, gifts, and inheritance have been abolished. And yet, as shown in Figure 2.12, Sweden's public debt has come down from a peak of 83.2 percent of GDP in 1998 to 58.8 percent in 2021.

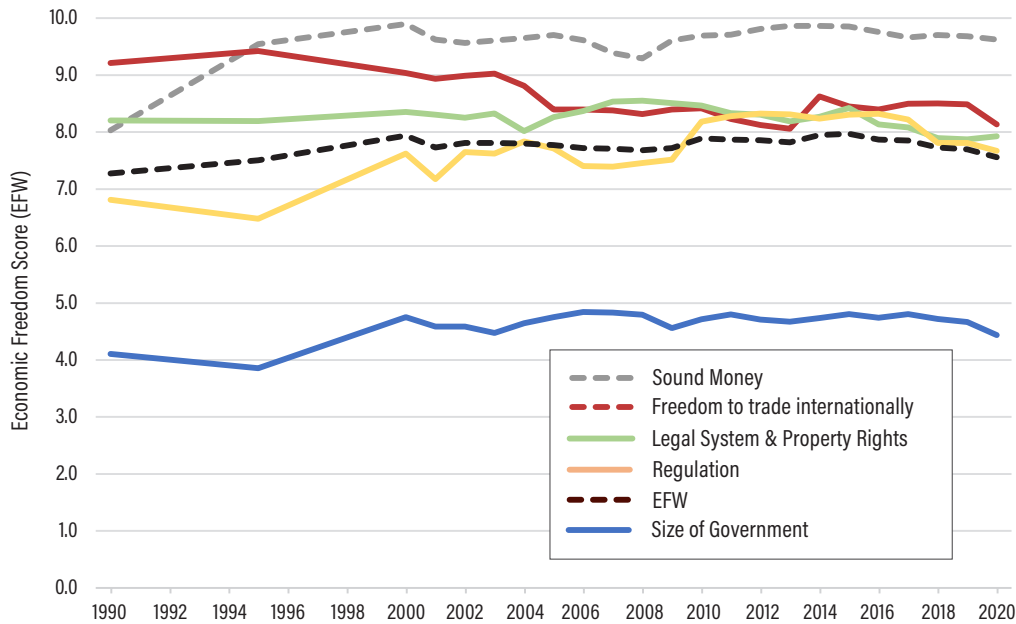
Since 1995 the Swedish economy has once again begun to outperform that of other high-income countries in growth per capita, and has once again begun to spawn successful international companies including Skype, Spotify, King, Mojang, and Klarna. Real wages, which were stagnant between 1975 and 1995, increased by around 70 percent between 1995 and 2021 (Ekonomifakta, 2023a).

In the Global Competitiveness Index of 2019 Sweden is ranked as the world's 8th most competitive economy (4th in Europe). In the macroeconomic category, it got a perfect score of 100.

However, Sweden is still a big welfare state; total public spending is around 50 percent of GDP, as shown in Figure 2.9. The country's economic comeback after 1995 challenges the idea that big government will always hurt an economy. One explanation for Sweden bucking that trend is that it compensates with a more open and deregulated economy in other ways. Figure 2.13 demonstrates this. It shows overall economic freedom and its five constituent components from 1990 through 2020. While Sweden continues to score low on the size of government component of economic freedom, it scores highly on all other measured components of economic freedom. Compared with citizens of most other countries, Swedes enjoy high levels of regulatory freedom, freedom to trade internationally, sound money, and legal protection of their persons and property.

In the World Bank's Ease of Doing Business Index 2020, Sweden is ranked as the 10th easiest country in which to do business out of 190 countries (5th in Europe), which is a

Figure 2.13: Economic Freedom and Its Components in Sweden (1990–2020)



Source: Gwartney, Lawson, Hall, and Murphy (2022).

remarkable turnaround for a country where doing business was seen as hopeless in the 1980s, forcing many of the most successful companies to leave the country. In the Economic Freedom of the World Index, Sweden has more economic freedom than the United States in three out of the five areas.

In the 1990s, Sweden also gave up the pipe dream of making the wealthy pay for it all. Swedes learned that you could either have a big government *or* make the rich pay for it all, but you couldn't have both. High earners and successful businesses are too few and too important for the country's economy to deter or chase away with high taxes. Scaring off high earners and successful businesses had not just hurt innovation and risk-taking, it had also threatened the long-term financial basis for the welfare state. Now Sweden relies more on consumption taxes and flat payroll and local income taxes that it did before the reforms, which means that most citizens pay for most public services out of their own pockets and that the country is once again a more attractive place to do business (more on this in the next chapter).

Furthermore, not all big governments are created equal, and a major difference between them is how much knowledge is needed for government intervention to succeed. Some interventions, like Keynesian stabilization policies, targeted industrial policy and subsidies and protections for particular sectors, require a lot of centralized knowledge to function, and so are more prone to failure. On the other hand, there are other programs that are less dependent on superior centralized knowledge, like automatic cash handouts and welfare systems where individuals chose providers and pension systems with no defined benefits, and where individuals chose their own retirement age and where benefits are adjusted

accordingly. Andreas Bergh has coined the phrase “Hayekian welfare states” for projects that do not rely on much centralized knowledge, and since the 1990s, the Swedish welfare state has moved substantially in that direction.

The 1970s and 1980s increasingly look like an aberration in Swedish history, both in terms of policy and economic outcomes. Sweden, which had been an open capitalist economy during the miraculous century between 1870 and 1970 then moved in a decidedly socialist direction by increasing the size of government, regulations, and taxes. The result was a 20-year period that hurt the economy’s competitiveness and citizens’ living standards, and that ended in the terrible financial crash of the early 1990s. Then came a sharp retreat from socialist policies and the country implemented reforms that once again moved Sweden back to a broadly successful, capitalist-inclined economy.

As Kjell-Olof Feldt, the social democratic minister of finance from 1982 to 1990, summarized Sweden’s late 20th century experience: “What we believed in as young socialists turned out to be impossible in practice” (Josefsson, 2006: part 6 of 7).

Notes

- 1 GDP per capita has been adjusted here for inflation and price differences between countries.
- 2 In Ayn Rand’s 1957 novel *Atlas Shrugged*, talented and hard working individuals leave an increasingly authoritarian society.

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