Chapter 10

THE SWEDISH ECONOMIC SYSTEM

> "In the good home, equality, consideration, cooperation, and helpfulness prevail. Applied to the great people's and citizen's home, this would mean the breaking down of all social and economic barriers that now divide citizens into the privileged and the unfortunate, the rulers and the subjects."
>
> PER ALBIN HANSSON (1885–1946),
> Swedish Prime Minister

Imagine living in a country with the fourth highest **per capita gross domestic product** (GDP) in the world, 2 percent unemployment, 5 percent annual growth of GDP, virtually no poverty, low crime rates, free education through graduate school, free healthcare, a pristine environment, no engagement in war since 1814, an honest and competent government, and a strong sense of social responsibility on the part of both corporations and labor unions. Sweden fit that description in the late 1960s. The performance of the Swedish economic system inspired curiosity and admiration around the world. Yet twenty years later, the country verged on financial collapse and eventually abandoned some of the key institutions that contributed to its previous success. Although Sweden is a relatively small country in terms of population, its bold experimentation in fashioning a unique economic system provides important lessons for all nations.

Sweden became an independent nation in 1523 with a king and a parliamentary form of government. A considerable portion of its original territory was lost in 1809 when Russia captured the eastern section, which is today Finland. Sweden is endowed with abundant natural resources, including high-quality iron ore and copper deposits, extensive hardwood forests, and numerous rivers and waterfalls for generating hydroelectric power. Located in the northernmost region of Europe, Sweden's challenging cold climate and its relative isolation led to an ethnically and culturally homogenous population sharing the same religion (Lutheran), values, and ancestry. This homogeneity fostered a strong sense of social solidarity.

The most notable feature of early Swedish economic history is the absence of feudalism. Unlike most of the rest of Europe, Sweden's location, forbidding climate, and poor soil made it unattractive to the Roman Empire and other potential

conquerors. Although political institutions and authority certainly existed within Sweden, leaders were selected by democratic consensus rather than by hereditary rights. In 1335, King Magnus Erickson (1316–1374) abolished any vestiges of serfdom or slavery, so the vast majority of peasant farmers owned their land and enjoyed freedom from oppression. However, survival in the harsh climate required considerable cooperation and collective action such as working together in communal fields. Early industrial development centered around mining and logging. Manufacturing typically occurred in small factories or workshops that often provided housing, healthcare, education, and pensions for employees. In the cities, guilds controlled most economic activity until the government abolished them in 1846. At that time, Sweden was a poor, agrarian country with high unemployment and considerable poverty.

ORGANIZED CAPITALISM 1870–1931

Industrialization in Sweden began around 1870 with expanding exports of iron ore and timber to other European countries. By this time, the communal fields in the countryside had been privatized, so displaced farmers migrated to cities seeking employment in the new factories. The resulting surplus labor depressed wages and left many workers in poverty. Approximately 1.3 million Swedes (25 percent of the entire population) emigrated, mostly to America, in search of better opportunities. The government had neither the administrative capacity nor the financial means to offer much assistance, so citizens began forming associations, clubs, and cooperatives designed to protect and advance their economic interests. In 1899, forty consumer cooperatives joined together to form the Cooperative Union, a national organization that operated retail stores and offered insurance policies.

As industrialization progressed, the government gradually began to promote development and provide citizens with a social safety net. In addition to public investments in **infrastructure** such as railroads and harbor construction, the government enacted a few **tariffs** to protect Sweden's **infant industries** and granted subsidies to stimulate research and development of new products and technologies. As a "late capitalist" country, Sweden had the advantage of access to **financial capital** and technology from more developed countries. A social security system was instituted in 1913, and welfare programs began in 1918. One of the purposes of welfare programs was to persuade impoverished Swedes to remain in the country rather than emigrate.

World War I provided a tremendous boost to the Swedish economy. As a neutral country, Sweden was able to sell its exports to all combatants, and the high demand for steel and timber led to rising prices and large profits for Swedish firms. However, the end of the war brought economic disaster as the devastation of the German economy caused a sharp decline in Swedish exports. To make matters worse, a global **recession** in 1920–21 resulted in an unemployment rate of 30 percent and a drop in output of 25 percent.

The Swedish Social Democratic Party (Sveriges Socialdemokratiska Arbetarepartiet [SAP]), which was founded in 1889 with the avowed purpose of establishing socialism, won its first election in 1920 with Hjalmar Branting (1860–1925) serving as prime minister until 1923. Despite its commitment to socialism, the SAP initiated no major changes in the economy and lost the 1923 election to a liberal-conservative coalition that ruled until 1932.

From early in the industrialization process, the Swedish economy exhibited a high degree of concentration. To compete in international markets, Swedish businesses needed the **economies of scale** associated with large size. Because Sweden's population was relatively small, two or three large corporations in an industry could meet the entire nation's demand for a product. The Swedish government had no desire to break up large corporations because the economy depended on exports, and economies of scale were essential to keeping export prices low.

However, the considerable **market power** enjoyed by Sweden's large corporations gave them the upper hand in wage negotiations with workers. As a result, workers began organizing labor unions. Sweden's ethnic homogeneity facilitated the recruitment of new union members as organizers appealed to workers' sense of belonging to a large family united for mutual protection. In 1898, various **industrial unions** joined together to establish the Swedish Trade Union Confederation (Landsorganisationen [LO]), which staged a general strike in 1902 demanding higher wages and universal suffrage. Employers responded to the growing mobilization and militancy of the labor force by forming the Swedish Employers' Confederation (Svenska Arbetsgivareföreningen [SAF]).

The Demise of Organized Capitalism

In the first two decades of the twentieth century, Sweden endured more labor strikes than any other European country. The concentration of power among both workers and employers led to repeated confrontations, stalemates, and occasional violence. When the Great Depression hit Sweden in 1930, exports declined by 34 percent as other nations enacted trade barriers to protect their own industries. Faced with declining sales, Swedish companies began cutting wages and discharging workers. The government devalued the Swedish currency (krona) by 25 percent in an effort to boost exports, but a weaker currency meant that imports became more expensive, contributing to further declines in workers' standard of living.

The Depression also triggered another catastrophic event for the Swedish economy. Ivar Kreuger (1880–1932) had built a multinational business empire by borrowing money from banks and private investors. His primary business was manufacturing matches, and his company controlled about 70 percent of global match production at the time. However, the Depression revealed that Kreuger's empire was a giant Ponzi scheme, using money from new loans to repay old loans. His bankruptcy resulted not only in his suicide but also the near-collapse of the Swedish banking system and stock market. Another factor contributing to the demise of organized capitalism was an event during a protest march by striking

workers. Police opened fire on the marchers, killing several people. The ensuing public outrage left Swedes ready to vote for fundamental institutional changes.

WELFARE CAPITALISM 1932–1991

As the SAP prepared for the 1932 election, it relied on the ideas of Swedish economists Gunnar Myrdal (1898–1987) and Ernst Wigforss (1881–1977). Prior to the work of British economist John Maynard Keynes, Myrdal and Wigforss claimed that inadequate demand was the cause of recessions. The party platform called for **deficit spending** on public works projects such as schools, hospitals, roads, railways, and harbor construction to compensate for inadequate spending in the private sector. The SAP also advocated a higher minimum wage, unemployment compensation, agricultural price supports, and additional welfare programs to increase demand by placing money in the hands of the people most likely to spend it. These proposals appealed to the Swedish people as the SAP won the election in coalition with the Agrarian Party and remained in power for the next forty-four years. Prime Minister Per Albin Hansson (1885–1946) urged Swedes to think of the nation as the "people's home" (folkhemmet) in which all citizens had a mutual responsibility to care for one another as if they were family members.

The SAP made no effort to nationalize private businesses. In fact, the percentage of businesses owned by the state, which has remained relatively constant over the decades at about 5 percent, consists mainly of utilities and mass transportation. Another 5 percent of businesses are cooperatives, leaving 90 percent in private hands. So, contrary to popular perception, Sweden is not a socialist country. Instead, it has sought to develop a "middle way" between capitalism and socialism by pursuing the egalitarian goals of socialism while attempting to harness the dynamism and efficiency of private enterprise. The SAP's commitment to private ownership was reconfirmed in 1982 when it privatized several shipbuilding and steel companies that had been previously nationalized by the conservative party in order to rescue them from bankruptcy.

During the 1930s, the government's efforts to sustain **aggregate demand** through both deficit spending and a **devaluation** of the currency succeeded in reducing the severity of the Great Depression in Sweden. Output fell by only 10 percent and unemployment never exceeded 12 percent (compared to 25 percent in the United States and 33 percent in Germany). By 1936, industrial production was 50 percent higher than in 1929 and unemployment had fallen to 5 percent. However, Sweden could not rely exclusively on demand stimulation to buoy its economy. In addition to the debt burden created by continual deficits in the government's budget, the assurance of strong demand encouraged businesses and labor unions to raise prices and wages. Sweden could not tolerate significant inflation due to its dependence on exports. Inflation would reduce exports, leading to **balance of trade** deficits and loss of jobs.

The SAP sought to control inflation by relying on the cooperative nature of the Swedish people. Fighting inflation poses a **collective action problem**. Without cooperation and coordination, individual labor unions and corporations have no incentives to restrain wage and price increases because their individual restraint would have no effect on inflation unless all other unions and corporations exercised similar restraint.

Fighting unemployment also poses a collective action problem. The self-interest of employers motivates them to pay low wages and lay off any redundant labor. Yet if all employers pay low wages and fire workers, two potential problems arise. First, consumer demand may be insufficient to keep the economy growing, and second, workers may respond to low wages with strikes or reduced productivity. Having witnessed the consequences of labor unrest prior to the Depression, the Swedish government sought to resolve these collective action problems by developing institutions to enable labor unions to bargain for wages sufficiently high to sustain consumer demand and labor peace yet not so high as to erode business profitability or cause inflation.

Organized Labor

The LO and the SAF were already well-established organizations in Sweden, where they represented more than 50 percent of all workers and most large employers. In 1938, under the threat of government intervention in labor negotiations, the LO and SAF met in the city of Saltsjobanden and agreed to standardized procedures for collective bargaining. First, all disputes would be settled through consultation and negotiation rather than strikes. Second, employers would provide "just cause" for any layoffs and would fund state-run unemployment compensation programs. Third, the LO and SAF would engage in annual centralized collective bargaining to reach agreements on wage increases, working hours, and fringe benefits that were binding on all parties. Finally, the Saltsjobanden Accord established a policy of "wage solidarity," assuring equal pay for equal work throughout the economy regardless of the productivity or profitability of different industries. Workers in more profitable industries were expected to restrain their wage demands so that workers with similar jobs in less profitable industries could receive similar wages. Largely as a result of centralized collective bargaining and wage solidarity, Sweden experienced no major strikes between 1940 and 1970.

World War II provided a huge stimulus to the economy as neutral Sweden once again supplied both the Allies and Germany with iron ore and machine parts. As the war ended, Sweden feared a recurrence of the deep recession following World War I. However, with no damage to its own productive capacity, the nation was able to provide equipment and materials to rebuild war-torn Europe, and the economy boomed.

In the postwar era, labor negotiations became even more centralized. Wages were, for the most part, determined by negotiations at the national level in which representatives of both labor and employers negotiated with one another in the presence of government mediators. This bargaining process included not only the LO, representing blue-collar workers, but also the Central Organization of Salaried Employees, the Swedish Confederation of Professional

Associations, and the Federation of Government Employees, representing white-collar workers.

Strong demand for exports after World War II placed strains on the policy of wage solidarity. Firms in the export sector of the economy grew so rapidly that they needed to offer higher wages to attract more workers. However, such actions would undermine wage solidarity and threaten the cooperation between unions that was essential to maintaining wage stability throughout the economy. In 1951, two economists working for the LO proposed a solution to this dilemma.

The Rehn-Meidner Model

Two economists, Gosta Rehn (1916–1996) and Rudolph Meidner (1914–2005), claimed that a continued policy of wage solidarity would actually improve the efficiency of the economy. The previous argument for wage solidarity was that the creation of a sense of solidarity and fairness among all workers would keep wages and prices from rising too quickly. Rehn and Meidner added another claim—if similar jobs were paid the same in all industries, then industries with higher productivity would be more profitable than industries with lower productivity. Capital markets steer financial capital toward the most profitable industries; therefore, resources would flow out of low-productivity industries such as textiles, clothing, and footwear into high-productivity industries such as shipbuilding, petrochemicals, and steel. In other words, by preventing high-productivity industries from bidding up wages, the policy of wage solidarity would keep wages in those industries relatively low, leading to higher profits and expansion. Over time, the Swedish economy would transition away from less productive industries as resources flowed toward more productive industries.

The decline of less productive industries would cause many workers to lose their jobs, so the Rehn-Meidner model also included policies to assist laid-off workers in finding new employment. The government established programs to hire workers in public sector jobs; to create job placement services; and to provide subsidies for vocational training, job searches, and moving expenses. In addition, corporations were given tax incentives to reinvest their profits, expand productive capacity, and create new jobs. Underlying the Rehn-Meidner model was an ethical proposition—if the economy as a whole improves by closing factories and laying off workers in less productive industries, then the burden of job loss should be borne by society as a whole rather than by individual workers who lose their jobs. The LO adopted the Rehn-Meidner model in 1962.

Over the years, Sweden developed additional policies to stabilize the economy and minimize unemployment. Employers received subsidies for retraining their workers or offering them incentives for early retirement. Beginning in 1955, corporations were permitted to reduce taxes on up to 40 percent of their profits by placing the money into a reserve fund held by the Swedish central bank (Riksbank). Firms needed government approval to take money out of the fund, so government gained some control over the timing of investment spending. The goal was to reduce investment spending during economic expansions, when it might overstimulate the economy and eventually lead to **excess capacity**, and to increase investment during recessions when additional spending would sustain aggregate demand and reduce unemployment. The government also controlled construction permits, issuing more permits during recessions, and gave loans and subsidies to industries threatened by international competition. These policies contributed to annual growth rates in excess of 5 percent and unemployment rates of around 2 percent during the 1950s and 1960s.

Large Corporations

Sweden's small size meant that if corporations grew large enough to compete in international markets, they became **oligopolies** in the domestic market. **Concentration ratios**, the percentage of industry output controlled by the four largest firms in an industry, averaged more than 80 percent in major industries. Economic concentration was further increased by a single company, Investor AB, that held controlling interest in many of the largest Swedish firms. These firms accounted for one-third of Sweden's GDP and employed approximately 25 percent of the labor force. A single family—the Wallenbergs—owned 40 percent of Investor AB. Even today, wealth is highly concentrated in Sweden. One percent of households own about 75 percent of stocks, and 90 percent of households own none. Sweden has more billionaires per capita than does the United States.

The power of Sweden's oligopolies has traditionally been limited by two factors. First, competition from imported goods forces Swedish producers to remain competitive in terms of price and quality. Second, Swedish citizens have the alternative of buying from the many consumer cooperatives in the country. Half of Swedish households belong to the Kooperativa Förbundet (KF), a nationwide confederation of thirty-nine consumer cooperatives with more than three million members. As the largest retailer in Sweden, KF encompasses cooperative insurance companies, automobile dealerships, department stores, and grocery stores. The very size of KF gives it bargaining power in purchasing goods from manufacturers.

Social Policy

During the 1960s and 1970s, Sweden devoted a higher percentage of its GDP to government expenditures on social programs than any other developed nation. Generous social benefits, coupled with wage solidarity, gave Sweden the most equal after-tax distribution of income and the lowest rate of poverty in the world. Students enjoyed free education through graduate school and received monthly stipends to cover living expenses for any education beyond high school. The educational system provided the same quality of education to all students, and the high quality of public schools made private schools unnecessary.

Healthcare benefits, including dental care, treatment by physicians, hospitalization, and prescription drugs, were free and available to all citizens. Partly because of the excellence of Swedish healthcare, the country stood second only to Japan in average life expectancy and low infant mortality rates. The government

covered all childbearing expenses as well as many childcare fees. For each child born, the government provided 450 days of paid leave from work to be divided between the parents in any manner they chose until the child reached eight years of age. During the first 360 days, the parents received 90 percent of their working income, and the last 90 days were subsidized at the same rate for all households. In addition, families received an annual allowance to defray childrearing expenses for each child younger than sixteen years of age. Each worker received twenty-four days of fully paid sick leave per year. In-home assistance for the elderly and marital counseling were provided free of charge. In an effort to achieve gender equity, the government provided grants to pay vacation expenses for nonworking spouses.

All citizens older than age sixty-five received a pension equal to two-thirds of their annual income during their fifteen highest paid working years. The funding for this pension came solely from employers. Unemployment benefits covered 90 percent of a worker's previous earnings for a period of ten months. Welfare programs were available for citizens unable to earn a living. In addition to cash allowances, indigent families could apply for housing benefits, stipends for each child, and day care for children.

Swedes justified their generous welfare state on both moral and economic grounds. Many Swedes viewed the country as one big family and therefore felt a moral obligation to ensure that all citizens were cared for and secure. Beyond that, they also believed that providing social benefits represented an investment in **social capital** that improved the economy by creating increased trust and cooperation. They assumed that citizens who feel valued and supported by their nation would reciprocate with increased productivity and cooperation in moderating wage and price increases. When individuals trust that others will cooperate, collective action problems become easier to solve. For example, Sweden had to maintain price stability to keep its export industries competitive in international markets. But price stability is a **public good** because everyone benefits from it, although individual businesses and labor unions have no incentive to restrain their prices and wages unless others do the same. Through centralized collective bargaining, this collective action problem was solved, but mutual trust between business, labor, and government was essential to secure the necessary cooperation.

Swedes also believed that greater equality generated through social programs would benefit the economy by reducing crime and the waste of human resources associated with poverty and unemployment. In addition, programs providing education, retraining, and counseling represent investments in **human capital** and therefore contribute to increased productivity. Government spending on the development of human capital may actually reduce the need for spending on unemployment compensation and welfare.

Culture

The prevalence of trust, solidarity, and cooperation in Sweden, coupled with a strong work ethic, provided the cultural basis for the impressive performance of the Swedish economy. Far from resenting the taxes needed to fund the welfare state, most Swedes viewed high taxes as their contribution to maintaining the "people's home" or folkhemmet. In fact, the Swedish word for tax (skatt) also means "treasure." Citizens shared their treasure and believed that all individuals, including themselves, benefited as a result. Sweden's ethnic homogeneity contributed to public acceptance of the welfare state. Welfare benefits were viewed not as money taken from "us" and given to "them" but as compensation to those members of the national community who were unfortunate enough to bear the burden of unemployment so that labor markets could remain flexible and dynamic.

The strong sense of social solidarity in Sweden explains an 80 percent turnout for national elections. Laws against trespass are limited, so hikers in the countryside are free to cross property lines. The dominant religion, Lutheranism, treats all people as equal in the eyes of God and thus supports the egalitarian and consensual nature of Swedish society. However, most Swedes rarely attend religious services.

Despite a cultural predisposition to form social groups and to favor an active government, Swedes also value individual autonomy and have a reputation for being reserved in social interactions. This apparent paradox can be resolved by understanding that Swedes view groups and government as expanding their freedom and opportunity by solving collective action problems and by providing resources for the development of individual capacities. For example, free day care allows both parents to work full time. Social psychologists suggest that when a culture emphasizes group activity, individuals need to protect their privacy as a haven from the social pressures of collective existence.

Critics of Swedish culture have charged that economic security and equality lead to a bland existence due to the lack of opportunities to take risks and earn high rewards. They point to high divorce and suicide rates as evidence of a general malaise in Sweden. However, an alternative explanation is that Swedes divorce more frequently because generous social programs reduce the financial pressures to remain in a failing marriage and because Swedish culture attaches less social stigma to divorce. Similarly, Swedes do not regard suicide as shameful for family members, so self-inflicted deaths that might be reported as accidents in other countries are acknowledged as suicides in Sweden.

The Demise of Welfare Capitalism

The oil crisis initiated by the Organization of Petroleum Exporting Countries (OPEC) in 1973 marked the beginning of the end of welfare capitalism in Sweden. The **stagflation** that afflicted Western nations throughout the remainder of the 1970s was particularly challenging for Sweden because of its heavy reliance on exports. In 1976, the SAP lost its first election since 1932 to a coalition of centrist and conservative parties. However, the popularity of the welfare state forced even a conservative government to maintain most social benefits. When the SAP regained office in 1982, it initiated reforms in the welfare state, but significant change would not come until the system reached a crisis in 1991. The demise of welfare capitalism occurred as a result of several changes.

End of Capital Controls

Under the Bretton Woods system established at the end of World War II, flows of financial capital across national borders were restricted. When Sweden abolished **capital controls** in the mid-1980s to attract more foreign capital, corporations and affluent citizens could avoid high taxes by moving money and production facilities overseas. This massive "capital flight" drained the Swedish economy of an essential resource.

International Competition

By the 1980s, Japan and Germany had grown into economic powerhouses, and both nations were export-oriented. In addition, low-wage producers throughout Asia flooded global markets with low-priced goods. As a result, Swedish corporations faced downward pressure on both prices and profits. To maintain profitability, they reduced production costs by relocating some operations abroad and by pushing for greater flexibility in labor markets so that wages could be reduced and redundant labor laid off.

Growth of Government

As economic growth slowed, declining tax revenue and rising claims on social benefits created a fiscal crisis for the Swedish government. Any government facing a weak economy confronts two options. Either it can pursue a policy of austerity by reducing spending in order to balance the government budget, or it can accept a growing budget deficit as necessary to maintain aggregate demand and prevent the economy from sliding even deeper into recession. Based on the success of demand stimulation during the Great Depression, Sweden again chose the latter option. The government increased spending and created public sector jobs to employ citizens who were losing their jobs in the private sector. It also granted new subsidies to industries such as shipbuilding, steel, and wood products. By 1981, government expenditures and transfer payments accounted for more than 65 percent of the GDP.

Funding for these additional programs required higher taxes. During the 1960s, taxes took only 27 percent of national income, but that number rose to 42 percent in 1975 and 52 percent by 1990. In 1983, the top marginal income tax rate stood at 84 percent, and corporations paid a tax on profits of more than 50 percent in addition to a payroll tax of 35 percent on their wage costs. Consumers faced not only a personal income tax but also a **value-added tax** (VAT) of 19 percent on the sale of most goods and services. The composition of government spending also changed. Whereas social spending during the 1960s had been aimed primarily at education and healthcare, both of which contribute to the formation of human capital, much of the additional government spending after the mid-1970s went toward welfare, subsidies, and administrative costs, which had little effect in raising productivity and improving economic performance.

The Swedish government subsidized weak industries in the belief that tax revenue from those industries was essential to funding the welfare state. However, the subsidies merely masked the growing inability of Swedish firms to compete in global markets. Acknowledging this, the government began facilitating the transition of capital and labor to new industries such as chemicals, pharmaceuticals, telecommunications, and engineering, hoping to achieve **comparative advantage** due to Sweden's highly educated labor force. This policy yielded some promising results, but a recession in the late 1980s offset any gains in tax revenue from new industries. The government finally conceded its financial inability to continue the generous social benefits and labor market interventions of previous decades.

Loss of Trust and Cooperation

As long as the Swedish economy prospered, virtually all citizens benefited from the unique institutions of centralized collective bargaining, wage solidarity, and the welfare state. However, these institutions relied on high levels of trust and cooperation. Workers trusted that if they restrained wage demands, corporations would reinvest increased profits in the Swedish economy and create more jobs. Workers also trusted that if they maintained high productivity by working diligently, they would share in a growing economy. Corporations trusted that if they refrained from raising prices, other firms would do the same to prevent inflation. Citizens trusted that government would use their taxes to promote the well-being of the Swedish people. When the economy faltered in the mid-1970s, this trust and willingness to cooperate eroded. Individuals, unions, and corporations began to defect from cooperative agreements, seeking to protect themselves from the consequences of a stagnant economy.

Decline of Work Ethic

One manifestation of defection on the part of individuals was a declining sense of social responsibility that obligated people to work hard, fulfill their civic duties, and care for their fellow citizens. These social norms formed the foundation of the Swedish economy, and as they dissipated, the economy suffered. For example, workers began to abuse the generous provisions for paid sick leave. In the late 1980s, the average Swedish worker took thirty-five days of sick leave per year, and Sweden was devoting 3 percent of its GDP to sick pay.

The declining work ethic can be understood with reference to the concept of a hierarchy of needs developed by psychologist Abraham Maslow (1908–1970). With a prosperous economy supported by a generous welfare state, Swedes felt secure in meeting their needs for survival and safety, leaving them free to focus on higher needs for love, social esteem, and self-actualization. Too often, however, these nonmaterial needs conflicted with productivity. For younger workers, who had grown up knowing only prosperity and economic security, rates of absenteeism were 50 percent higher than for older workers.

The welfare state undermined civic virtue in other ways as well. High taxes pushed significant amounts of economic activity into the **underground economy** as citizens engaged in barter or failed to report income to the government. After paying high taxes to fund numerous social programs, many citizens

felt no further obligation to demonstrate concern for the well-being of others. For example, the bonds between generations weakened as Swedes devoted less time to elderly parents. Paradoxically, the welfare state, which arose on the basis of social solidarity, eventually undermined community spirit and fostered increasing individualism.

Demands for Socialism

One sign of worker defection from the cooperative agreements underlying the Swedish economic system was an effort by labor unions and factions within the SAP to move beyond welfare capitalism to socialism in which workers collectively owned the means of production. In 1975, the economist Rudolph Meidner proposed a plan in which all firms employing fifty or more workers would be required to issue new shares of stock each year equal to 20 percent of their pretax profit. These shares would be placed in a union-controlled fund so that unions would gradually gain majority interest in firms, and workers would effectively own and control the nation's productive assets. Despite strong opposition from employers, the government enacted a milder version of the Meidner Plan in 1983. The revenue from a tax on both profits and payrolls was divided among six regional, union-controlled funds that purchased shares of corporate stock. However, no single fund was permitted to acquire more than 8 percent of a company's stock, meaning that workers collectively could not gain controlling interest in any firm.

Another change that increased workers' influence over corporate decision-making occurred in 1977 with the passage of a law requiring firms to establish "works councils" of elected worker representatives who consulted with management on a wide range of issues, including working hours, safety conditions, training, and potential plant closings. In addition, every firm with more than twenty-five employees was required to have two union representatives on its board of directors. These changes may have been welcomed in a more cooperative environment; however, Swedish employers viewed them as hostile attacks on the prerogatives of management and another example of defection from the agreements reached in the 1938 Saltsjobanden Accord.

Breakdown of Wage Solidarity

The policy of wage solidarity was designed to equalize wages for similar work across all industries. By keeping wages in high-productivity industries lower and wages in low-productivity industries higher than they would have been without the policy, profits would increase in high-productivity industries. As a result, high-productivity industries would expand, whereas low-productivity industries would contract, and overall productivity would rise.

However, wage solidarity required a high degree of trust and cooperation because many of the parties involved had incentives to pursue their short-term self-interest. Workers in high-productivity industries could gain higher wages by bargaining separately with their employers. Similarly, firms in high-productivity industries could attract more skilled workers by raising wages. Employers in low-productivity industries could increase profits by cutting wages. Wage solidarity began to crumble as loss of trust undermined cooperation between labor unions and employers. The first signs of defection occurred in expanding industries needing to increase employment. Because employers were prevented from paying higher wages to attract additional workers, they offered shorter hours, longer vacations, and opportunities for overtime work, all of which had the effect of driving up per-unit labor costs and creating an inflationary bias in the economy.

Workers also began to defect from wage solidarity. Labor unions divided into four separate federations—two for blue-collar workers in the public and private sectors and two for white-collar workers in the public and private sectors. Public-sector employees had no incentive to restrain their wage demands because they faced no competitive pressures from global markets. White-collar employees in the private sector, believing their skills to be more valuable than average, began aggressively demanding higher wages. The policy of wage solidarity was gradually abandoned and replaced with negotiations based on profitability and productivity in each industry.

Breakdown of Centralized Collective Bargaining

By 1983, the entire process of centralized wage negotiations began to break down; several large unions representing highly skilled workers and employer groups representing "high-tech" firms boycotted the negotiations and met separately. The "high-tech" firms claimed a need for greater wage flexibility in order to respond to the pressures of international competition. As labor unions began negotiating separately with employers, no single union felt constrained in its wage demands, and labor costs began to increase dramatically. With its heavy dependence on exports, Sweden's balance of trade turned negative, which contributed to an economic crisis in 1991. By that date, any remnants of centralized wage bargaining were gone as the employers' federation refused to participate.

The demise of wage solidarity and centralized bargaining in Sweden provides an instructive lesson in labor relations. As long as mutual trust existed between labor, business and government, wage restraint could be achieved. But if any one of the parties abandoned the trust, a downward spiral developed. When government ended its commitment to full employment and a social safety net, unions no longer felt secure and demanded higher wages. With unions no longer cooperating in restraining wages, Swedish corporations began shifting operations abroad, further undermining the trust between labor and management and leading to even more aggressive bargaining by unions. Inflationary pressures created by higher wages reduced Swedish exports, resulting in lower profits for corporations and less tax revenue for government. The government was then forced to further reduce spending on social programs and the downward spiral continued.

Financial Deregulation

In 1985, the government enacted legislation removing many of the regulations on the financial sector, including banks and capital markets. The goal was to make Sweden more attractive to international investors, but the result was catastrophic. Banks took full advantage of deregulation by expanding credit so rapidly that a speculative bubble developed in the stock market and real estate. The bubble burst in early 1990, and bank losses were so severe that the financial sector nearly collapsed. The government took control of 25 percent of all bank assets, and two banks were nationalized at a cost of $18 billion, or about 4 percent of the GDP.

The financial crisis spilled over into the real economy, leading to a serious recession and negative growth for the next four years. Housing prices dropped by 25 percent, and the commercial real estate market lost 42 percent of its value. In terms of job loss, the recession of the early 1990s was worse for Sweden than the Great Depression. The Social Democrats lost the 1991 election and were replaced by a coalition of four conservative parties led by Carl Bildt. Unlike the conservative government that held office from 1976 to 1982, the new coalition pledged to make fundamental reforms in the Swedish economic system.

A NEW DIRECTION?

Although the Social Democrats regained power in 1995, they were a changed party. Prime Minister Göran Persson, the leader of a faction within the party known as "renewers," pushed the party to endorse reforms aimed at reducing social benefits and increasing incentives to work. In 2006, the Social Democrats again lost power, defeated this time by the Moderate Party. The SAP received only 35 percent of the vote, its worst showing since before the Great Depression. However, in 2014, the Social Democrats once again regained control of the government. Despite the turnover in political administrations, Sweden has undertaken substantial reforms to its economic system since the crisis of 1991.

Taxes

Tax reforms reduced the progressivity of the tax system. The top marginal income tax rate, which had been 84 percent in 1983, is now 56 percent, and the top rate on corporate profits has been reduced from 50 percent to 22 percent. Between 2005 and 2008, the inheritance tax, the wealth tax, and taxes on residential property were all eliminated. To recoup some of the lost tax revenue, the regressive VAT that consumers pay on the purchase of goods and services rose from 19 percent to 25 percent (except for 12 percent on food and other essential goods), and formerly exempt categories of spending such as entertainment, public transportation, telecommunications, and personal services became subject to the VAT.

Another aspect of tax reform has been the growth of what economists call **tax expenditures**. When the tax system contains provisions for deductions, credits, and other loopholes, the effect on the public budget is the same as if government had given subsidies to the affected parties. When the reduced progressivity of the tax code is coupled with tax expenditures, income is actually being redistributed from poor to rich, not vice versa. The primary goals of tax reform have been to make Sweden more appealing to investors, to increase the incentives for productive activity, and to reduce the incentives for tax avoidance and evasion.

Government Spending

The Swedish government has become a paragon of fiscal responsibility. The ratio of government spending to GDP has dropped from 67 percent in 1993 to 49 percent. The government budget has been in surplus every year since 1998 except in 2004, and as a result, the **national debt** as a percentage of GDP has dropped from 70 percent in 1993 to 35 percent. Several changes place restraints on government spending. Since 1996, the legislature (Riksdag) sets an annual ceiling for government spending and a target for the rate of inflation. The Swedish Fiscal Policy Council, a group of independent experts, then audits the government's budget to determine whether it is designed to promote economic growth and ensure the long-term financial viability of the government.

Social Benefits

Most social benefits have become less generous, and the criteria for eligibility have been tightened. Unemployment benefits are now lower than in most other developed nations. To reduce the cost of social benefits, the government allows private businesses to compete with government agencies in providing healthcare, education, child care, and elder care. In the cases of education and healthcare, citizens receive vouchers to be redeemed for services with either a public or private provider. A voucher system creates competition between public and private providers in order to reduce cost and improve quality.

The Meidner Plan

The conservative government elected in 1991 scrapped the Meidner Plan that placed shares of corporate stock into regional funds controlled by labor unions. The shares were transferred to government agencies and subsequently sold to private investors in order to generate funds to finance research and promote economic growth.

Industry-Level Labor Negotiations

Although centralized wage bargaining was abandoned in the late 1980s, the government initiated industry-level negotiations in the 1990s covering about half of all workers. The goal was to restrain wages through cooperation between unions in the same industry.

Financial Reform

Two notable reforms occurred in the financial sector of the economy. The Swedish Central Bank, the Riksbank, is now completely independent of the government so that monetary policy has become, in principle at least, free from political pressures. The Riksbank can now pursue unpopular policies (e.g., raising interest rates) to fight inflation. The second reform occurred in 1991 when the government

abolished the investment reserve fund that permitted corporations to reduce taxes by placing part of their profits in a fund held by the Riksbank. That fund enable the government to control the timing of investment spending in order to stabilize the economy, but the conservative administration insisted on reducing government involvement in private decision-making.

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The initial impact of these reforms was negative. To protest cuts in government spending, public employee unions of physicians, postal workers, teachers, and transit workers staged major strikes, which crippled the economy. Between 1990 and 1993, the unemployment rate rose from 1.5 percent to 8 percent while GDP fell by 5 percent. However, between 1993 and 2010, the Swedish economy grew at an average annual rate of 2.7 percent compared to 1.9 percent for other countries in the European Union.

Although Sweden's reforms have moved the nation closer to neoliberal capitalism, the welfare state is still very much alive, particularly with regard to benefits aimed at the parents of young children. Maternity leaves from work last for a full year with 75 percent of salary. At least one month of that year's leave must be taken by the father. Workers have ninety days of sick leave to care for sick children, and the government continues to provide subsidized day care and family allowances for each child up to the age of sixteen. Universal free healthcare and education are still intact. Swedes remain convinced that an extensive welfare state is essential to supplement and improve the functioning of a market economy.

Despite tax cuts on income and assets, Sweden's tax burden as a percentage of GDP is 47 percent, the second highest of any nation after Denmark. The government still employs 30 percent of the labor force. Sweden has the most unionized labor force in the world, with 67 percent of blue-collar and 73 percent of white-collar workers belonging to labor unions. (Even soldiers, teachers, and physicians have their own unions.)

The fact that the Swedish economy has outperformed most other developed nations since 1993 defies the neoliberal claims that high taxes, a large government, generous social benefits, and powerful labor unions are obstacles to economic growth. In the words of former prime minister Göran Persson, "a bumblebee, with its overly heavy body and little wings . . . should not be able to fly—but it does."

The Swedish experience provides several valuable lessons for other nations. First, high taxes do not necessarily discourage productive activity. In fact, the opposite may be true. Sweden has one of the highest **labor force participation rates** in the world, and many workers hold two jobs in order to bolster household after-tax income.

Second, in assessing the role of government in the economy, the most important factor is not the size of government but the specific roles that government plays. A small government can suppress growth if it acts as a **predatory state** extracting wealth to benefit government officials and their allies in the private sector. A large government can stimulate growth with policies that supplement and support the market by providing infrastructure, solving collective action problems, and maintaining stability.

Third, social benefits can be so generous that they undermine individual initiative and responsibility. However, some social benefits are consistent with maintaining incentives to work. Sweden's social benefits are now aimed more at assisting citizens to become productive members of society rather than consigning them to idleness and dependency. Most social benefits target areas where positive **externalities** and the **free-rider problem** prevent the market from responding fully to essential public needs (e.g., education, healthcare, and child care). The Swedish government has managed to maintain extensive social benefits despite budget cuts by improving the efficiency of delivery and by eliminating or reducing benefits such as unemployment compensation that do not improve productivity.

Fourth, national governments cannot ignore competitive market forces from outside the country. Sweden's cooperative institutions worked remarkably well before globalization reduced barriers to the free flow of capital, resources, and goods around the world. However, faced with competitive market pressures, the Swedish economy faltered, and the nation was forced to scale back its commitment to equality and security for all citizens.

Fifth, nations can improve their competitiveness in the global economy in two ways. The neoliberal approach calls for gaining **competitive advantage** by lowering production costs through tax cuts, deregulation, reducing social benefits, and weakening labor unions. Sweden has moved in the direction of neoliberalism, but its primary focus has been on enhancing competitiveness through improving infrastructure and **human capital** through education, healthcare, and funding for research. Increasing skills, knowledge, creativity, innovation, entrepreneurship, and social mobility all raise productivity and improve competitiveness. Much of Sweden's current success is attributable to its strength in fields such as information technology, software development, and telecommunications. All these industries are based on one primary resource—human knowledge. Swedes believe that a degree of economic security encourages entrepreneurs to undertake the risk of starting new businesses because social benefits create a safety net that reduces the cost of failure.

The strength of Sweden's new form of capitalism was demonstrated by its remarkable resilience after the global recession of 2008. By 2010, the economy was growing at an annual rate of 5.5 percent, a figure significantly higher than in other industrialized nations. Sweden learned valuable lessons from the recession of 1990–94 that helped to mitigate the effects of the Great Recession. After the near-failure of the banking system in 1990, bankers were much more cautious in their lending than in the United States and other countries. Also, the government's commitment to fiscal discipline led to budget surpluses leading up to the Great Recession. With its fiscal house in order, the Swedish government was able to respond quickly to provide additional stimulus to the economy. In addition, much of that stimulus was applied through what economists call "automatic stabilizers." With Sweden's extensive array of welfare programs, as soon as citizens began losing jobs, spending on social benefits automatically increased. The government did not need to engage in lengthy debates about approving a stimulus package and developing projects to receive funding. Finally, Sweden's decision not to adopt the euro and to keep its own currency, the krona, proved to be beneficial. As Swedish exports began to decline during the recession, the krona depreciated, making exports less expensive to foreigners and sustaining economic growth.

Sweden provides testimony to the importance of community and consensus-building in a healthy economic system. Despite the breakdown of centralized collective bargaining, wage solidarity, and other forms of social cooperation, the degree of social cohesion and cooperation in Sweden remains high. In the past, this feature of Swedish culture could be explained by ethnic homogeneity, but as a result of extensive immigration, 25 percent of the current population is non-Scandinavian. Yet, labor unions, corporations, government, and citizens continue to exhibit a high degree of social responsibility and commitment to maintaining a high quality of life for the "people's home."

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