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The Economics of the Swedish Welfare State:
Paradise Lost?

Hans Brems

College of Commerce and Business Administration
Bureau of Economic and Business Research
University of Illinois, Urbana-Champaign

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Hans Brems, Professor
Department of Economics

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THE ECONOMICS OF THE SWEDISH WELFARE STATE: PARADISE LOST?

Hans Brems

ABSTRACT

The paper examines some of the economic problems of a modern welfare state:

Wage pressure may generate non-Keynesian unemployment. Keynesian policies applied to non-Keynesian unemployment may generate inflation. Very narrow wage differentials may extinguish the signals a market is trying to send, keep wage earners from heeding them, and generate short-run misallocation. Long-run incentives to acquire skill and education may be destroyed.

Very high marginal income-tax rates may distort the choice between leisure and work and the choice between consumption and saving. Very large government-budget deficits may generate domestic crowding-out or foreign indebtedness. Either way the future is being sacrificed for the present; the economy is living beyond its means.

Successive devaluations may offer short-run relief but make long-run stabilization harder.

HANS BREMS
99 Commerce West
1206 S. Sixth Street
Champaign, IL 61820

HANS BREMS

(217) 344-0171
1103 SOUTH DOUGLAS AVENUE URBANA, ILLINOIS 61801

THE ECONOMICS OF THE SWEDISH WELFARE STATE: PARADISE LOST?

Schumpeterian Sweden

Schumpeterian capitalist development was propelled by the innovating oligopolists. In that sense Swedish industrial history is Schumpeterian: brilliant in engineering and efficient as organizers, a small number of innovators founded corporations like Ericsson (1876), ASEA (1883), and SKF (1907). They were so successful that Sweden was soon too small for them: the twenty largest Swedish multinationals have as many employees outside Sweden as inside. SKF is the

In the fall of 1987 BREMS of the University of Illinois lectured at the universities of Gothenburg, Stockholm, and Uppsala. In sorting out his impressions of the Swedish economy he has benefited from both the Brookings report edited by Barry Bosworth and Alice Rivlin and the Swedish comments on it edited by Hans Söderström.

world's largest ball-bearing manufacturer, larger than Timken.

But Swedish history is Schumpeterian in another sense: Schumpeter believed that the very efficiency of capitalism would make room for the welfare state and, perhaps, eventually for socialism. The fifties and sixties were the heyday of what became known as "the Swedish model". The model was a teamwork of industry, labor, and government.

Industry responded to relentless wage pressure by designing ever better new vintages of capital goods and retiring old ones sooner. Unions cooperated by favoring new technology, by refusing to accept interfirm or interindustry wage differentials, and by keeping up the wage pressure. The government cooperated by subsidizing geographical mobility, thus helping to resettle labor released from old vintages, old firms, or old industries. The government also absorbed released labor by expanding the public sector in the form of better health care, better education, and larger transfer payments but--for forty-four years of labor government--never in the form of nationalization of industry.

All good things come to an end, and so did the Swedish model. The ever larger public sector superimposed on an ever smaller manufacturing sector made the Swedish economy vulner-

able to oil shocks and Japanese competition in shipbuilding and steel. Nowhere in the OECD countries was the decline of industrial production after 1974 as protracted as in Sweden: the other countries surpassed their 1974 level by 1977, Sweden not until 1980. Part of the reason why the transformation signals went unheeded for so long was that the new nonlabor government coming to power in 1976 tried to save jobs by bailout schemes in the form of massive subsidies or outright nationalization.

By the eighties Sweden had double-digit inflation, a central-government deficit of 14 percent of gross national product, and a foreign debt of 20 percent of gross national product. Labor came back to power and started a new deal. The Brookings report and the Swedish comments on it (see For Further Reading) will help us see some of the problems of such a new deal.

The key to labor's economic and social program is equality or, as Swedes say, *jämlikhet*. The proper place to begin with *jämlikhet* is the labor market.

The Labor Market

9/10 of the Swedish labor market is unionized--versus 1/5 of the

U.S. labor market. Whether employed by the government or by private industry, Swedish blue-collar workers are organized in the Federation of Labor, *Landsorganisationen*. White-collar workers have their own federation, *Tjänstemännens Centralorganisation*. On the other side of the bargaining table is government or, in private industry, the Federation of Employers, *Svenska Arbetsgivareföreningen*--without counterpart in the United States.

Swedish unions must be the world's most powerful. How have they used their power?

Current doctrine of a "natural" rate of unemployment suggests that successful unions will establish a real wage rate which is too high in the sense that at that rate supply will exceed demand. The excess supply, called the "natural" rate of unemployment, is acceptable to labor in the sense that it will not push the real wage rate down.

Being acceptable to labor, such "natural" unemployment is voluntary, hence not Keynesian in its nature. Still, well-meaning government may try to apply Keynesian policies to it, say by accelerating the growth of the money supply, thus stimulating demand.

Let prices respond more readily than the money wage rate. Then firms will experience a deceleration of the real wage rate, temporarily reducing the actual rate of unemployment below its "natural" rate. But at the next round of collective bargaining, labor will restore the original real wage rate and with it, the "natural" rate of unemployment. The government has failed. Repeated attempts to apply Keynesian instruments to non-Keynesian unemployment will also fail: instead of a long-run reduction of unemployment, they merely generate successive rounds of inflation.

So far we have discussed the abstraction of an overall wage rate. Behind it we find the reality of specific wage differentials. Pursuing their goal of equality, their *jämlikhet*, unions have also used their power to reduce wage differentials--all sorts of wage differentials: between government and industry, between industries, between firms in the same industry, between skilled and unskilled, and between male and female labor. Such reduction of wage differentials raises problems.

Economists know that in the short run such interference with the market mechanism will generate excess demand for labor priced too low. Excess demand has manifested itself in wage drift. Eco-

mists also know that interference will generate excess supply of labor priced too high. Excess supply has manifested itself in a chronic unemployment of youngsters and oldsters alike. Such chronic unemployment has been disguised by removing both groups from the labor market, the youngsters by training schemes and public works, the oldsters by premature pensioning. Finally economists know that in the long run wage differentials too narrow to reflect differences in skill and education will reduce the incentives to acquire such skill and education. Both for Sweden and the United States the Brookings report found a significant and positive rate of return on education but found the Swedish rate to be lower than the U.S. rate.

An important wage differential is the differential between government and industry, so let us take a closer look at government as an employer. Government produces public goods, and public goods are not distributed via a market but are produced according to the law and made available at zero price to qualified recipients. In 1985 Swedish government proper produced 21 percent of gross national product: Swedish defense, police, hospitals, schools, universities function according to the law. A lengthy labor conflict

would seriously disrupt a flow of public goods the government is committed to deliver and the recipients expect and depend on. Furthermore, in producing its 21 percent of the gross national product the government employs 25 percent of the electorate. A labor conflict, then, would be pitting politicians against 25 percent of their voters!

As a result of all this the government finds it hard to resist wage demands--harder than does private industry. Rational unions should follow the path of least resistance and bargain first with government, next with industry--asking for matching increases. Until 1975 industry traditionally opened collective bargaining. But after 1975 the rapidly growing public sector has occasionally assumed the role of a wage leader.

We shall understand the role of government as a wage leader even better when we look into wage differentials *within* government: government wage differentials are traditionally narrower than private ones. At the top end of the scale the highest-paid government employees are paid less than the highest-paid private ones. As a result government finds it difficult to keep its best computer experts, tax experts, professors, or airforce pilots. At the opposite end of the scale the lowest-paid government em-

ployees are paid more than the lowest-paid private ones. As a result the private sector finds it difficult to keep skilled blue-collar workers. Pursuing their equality, their *jämlikhet*, unions will then try to make the private wage rate match the public one. Again the public sector becomes a wage leader.

Big Government is much more than an employer.

Government Consumption, Investment, Transfer and Interest Payments

In 1985 Swedish government proper (not including government enterprises such as railroads) produced 21 percent of gross national product but disposed of 34 percent of it in the form of government consumption and investment: government consumed and invested not only its own output but also that of private industry supplying, on the consumption side, food for school lunches and toys for day-care centers and building, on the investment side, schools, hospitals, highways, and defense installations.

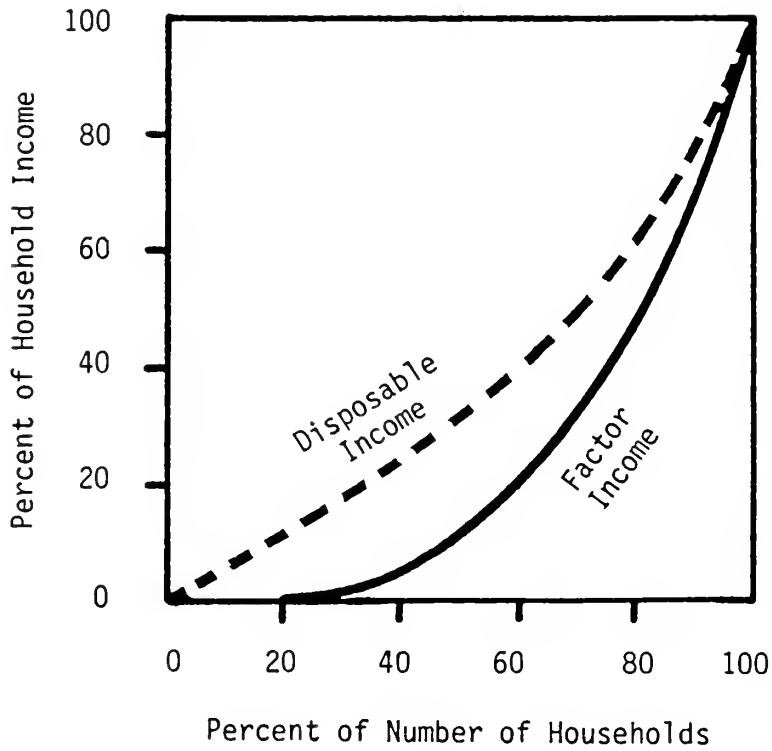
Transfer payments are the hallmark of a welfare state. In 1986 Swedish government proper (including the social-security system) distributed transfer payments amounting to 25 percent

of gross national product.

Some Swedish transfer payments have (less generous) U.S. counterparts such as unemployment and social-security benefits. But other categories have no U.S. counterparts: Swedish parents, for example, are entitled to a 12-month maternity-paternity leave with government-financed pay; man and wife share the leave as they prefer. A large network of government-financed day-care centers provides labor-intensive care: two trained adults for every five children under three. The government pays family allowances for each child under sixteen, rising steeply with family size.

Jämlikhet of income distribution may be measured graphically by a Lorenz curve: on the horizontal axis arrange households according to income, beginning with the poorest households. The vertical axis shows the percent of household income earned by the poorest x percent of households shown on the horizontal axis. If all households had the same income the Lorenz curve would be a diagonal: x percent of the households would earn x percent of household income. Our diagram shows Lorenz curves for factor income and disposable income in Sweden, 1984. Factor income is income earned in current production.

INCOME DISTRIBUTION OF SWEDISH HOUSEHOLDS IN 1984



Bo Sandelin, *Den svenska ekonomin*, Rabén & Sjögren, 1987, p. 122.

HANS BREMS
99 Commerce West
1206 S. Sixth Street
Champaign, IL 61820

Disposable income is factor income *plus* transfer payments including social-security benefits *minus* taxes including social-security premiums. Our diagram shows that the poorest 20 percent of the households earn no factor income at all but do earn about 10 percent of all household disposable income. Because of her narrow wage differentials Sweden's factor-income Lorenz curve is unusually high. Because of her generous transfer payments and high taxes Sweden's disposable-income Lorenz curve is also unusually high--lying about halfway between a diagonal and the factor-income Lorenz curve.

Not all Swedish transfer payments go to households: in 1986 transfer payments to private industry amounted to 4 percent of gross national product.

Interest paid by government used to be negligible. But the budget deficits of the eighties have raised it to 4 percent of gross national product.

In 1986 government expenditure was 67 percent of gross national product. How is such expenditure financed? There are two ways.

Taxation

High taxation is new in Sweden. According to the Brookings report

tax revenue has risen from 24 percent of gross national product in 1950 to 61 percent now. The marginal tax rate is 71 percent.

Such taxation will seriously distort the leisure-work choice. Consider an employee making, say, 100 *kronor* per hour and make two assumptions dear to neoclassical theory. First, the employee will extend his leisure to the point where his last leisure hour is just worth his take-home pay had he worked that hour, i.e., a mere 29 *kronor*. Second, an employer will hire labor to the point where the last man hired adds a product just worth his gross pay, i.e., a full 100 *kronor*. If the employee decides to spend his hour as leisure, then, the economy is in effect giving up 100 *kronor's* worth of product to give him a mere 29 *kronor's* worth of leisure. If leisure carried its true and full price tag, the employee might demand less of it.

Between 1965 and 1985, when the marginal tax rate rose from 55 to 71 percent, the number of hours worked per Swedish employee aged 25-64 declined sharply: by 18 percent for men and by 25 percent for women. In the United States the corresponding decline was 6 percent for men and women alike.

Private saving is even more discouraged than work. A wealth tax resting on top of, but not deductible from, the in-

come tax may easily make the marginal after-tax return on additional private saving turn negative.

Budget Deficits

Budget deficits are also new in Sweden. The central-government deficit rose from 1 percent of gross national product ^{in 1976} to 14 percent in 1983 but has subsided to 5.6 percent in 1985.

Budget deficits, too, will have to be financed, and there are only two ways of financing them. Under pure money financing of a deficit the government issues noninterest-bearing claims upon itself called money. Here the problem is that a larger money supply may fuel inflation. Under pure bond financing of a deficit the government issues interest-bearing claims upon itself called bonds and sells them in the capital market, leaving it to future generations to service the debt. Here the problem is that a larger bond supply may raise the real rate of interest, thus crowding out private investment. The Swedish government tried to avoid that effect by selling bonds denominated in foreign currency in foreign capital markets.

Thus it came to pass that budget deficits became part of Sweden's foreign debt. By the early eighties such debt had risen to 20 percent of gross national product. Because of its foreign-currency denomination the debt in *kronor* would rise in proportion to any Swedish devaluation of the *krona*.

That brings us to the international aspect of the Swedish economy.

Expansive Economic Policy in A Small Open Economy

Sweden is a very small and a very open economy: her gross national product is a mere 3 percent of ours, but she exports 33 percent of it. The Swedish government traditionally favors an expansive economic policy, but how much scope does a very small and very open economy have for such a policy?

For a starter consider the extreme case of a Sweden surrounded by a world economy with which she maintains completely free trade and capital movements and maintains a completely fixed exchange rate. Let us boldly ignore transportation costs and perishable commodities. Then all commodities will

be traded internationally at prices determined by world supply and world demand and by the monetary policy of the leading large countries. In such an extreme case what is the scope for an independent Swedish economic policy?

First, if Sweden tries to adopt a monetary policy more expansive than that of the surrounding world, her nominal rate of interest might initially fall. But under free capital movements Swedish capitalists would then place their capital abroad, and the flight of capital would make an independent Swedish monetary policy impossible.

Second, if Sweden tries to adopt a fiscal policy more expansive than that of the surrounding world, her disposable income, hence her import, might initially be growing faster than the disposable income of the surrounding world, hence her export. Such a trade deficit would make an independent Swedish fiscal policy impossible.

Third, if Swedish unions try to make the Swedish money wage rate grow faster than that of the surrounding world, Swedish export industries would become unprofitable: their prices would be those of the surrounding world, but their wage

costs would be rising faster. The resulting unemployment and trade deficit would make an independent Swedish wage policy impossible.

Devaluation?

As the Brookings report points out, such frustration could be relieved and the threatening unemployment and trade deficit avoided by devaluing the *krona* by a rate equaling the difference between the growth rates of the Swedish and the foreign money wage rates. Measured in *kronor*, Swedish export prices would then be growing at the rate of world-market prices *plus* the rate of devaluation. The continued profitability of exports would have been secured!

Five times in half a century, i.e., in 1931, 1949, 1977, 1981, and 1982, Sweden devalued her *krona*--each time except 1981 by a rate exceeding the difference between the growth rates of the Swedish and the foreign money wage rates, thus leaving the *krona* undervalued for a while. Export booms developed, but devaluations have problems of their own.

To begin with, because of its foreign-currency denomination foreign debt in *kronor* will rise in proportion to any Swedish devaluation. Second, since Sweden taxes nominal rather than real interest earnings, inflation will distort choices between placements. Third, even under a fully indexed tax system inflation will distort choices: adding uncertainty about domestic inflation to the uncertainty about foreign inflation will make firms less inclined to commit themselves to long-range projects. Fourth, adding uncertainty about public policy to the uncertainty about future prices will do the same.

For such reasons the Swedish comments on the Brookings report are less tolerant of devaluation than was the report itself: domestic inflation over and above the foreign one should be avoided in the first place. But that would require a nonaccommodating public policy leaving the parties of collective bargaining fully responsible for the money wage rate. Such a nonaccommodating policy would become less credible with each new devaluation. The parties will remember the frequency and magnitude of the 1977, 1981 and 1982 devaluations and will count on the government to bail them out. New rounds of domestic inflation will result.

A New Deal?

The massive devaluations of 1981 and 1982 were considered a new deal, and since then Sweden has had tail wind. The international upswing, the lower price of oil, and the lower dollar have lowered inflation to four percent and helped turn the trade deficit into a surplus.

But Sweden is not out of the woods yet. The other deficit, the central-government deficit, was still 5.6 percent of gross national product in 1985. One-third of the competitive edge created by the massive devaluations has already been eaten up by domestic money-wage increases over and above foreign ones. Monetary and fiscal policy declarations are still ambiguous. No tax reform has been enacted.

Conclusion

Among advanced capitalist economies Sweden has the most unionized labor market, the largest public sector, and the most equal disposable-income distribution. We have examined some of the

problems of a modern welfare state:

Wage pressure may generate non-Keynesian unemployment. Keynesian policies applied to non-Keynesian unemployment may generate inflation. Very narrow wage differentials may extinguish the signals a market is trying to send, keep wage earners from heeding them, and generate short-run misallocation. Long-run incentives to acquire skill and education may be destroyed.

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Successive devaluations may offer short-run relief but make long-run stabilization harder.

FOR FURTHER READING

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