Published in the *Wall Street Journal*, July 12, 2010

Lessons from the Swedish Welfare State

New research shows bigger government means slower growth. Our country is a prime example.

Andreas Bergh and Magnus Henrekson

Americans are debating whether to substantially expand the size of their government. As Swedish economists who live in the developed world's largest welfare state, we urge our friends in the New World to look carefully before they leap.

Fifty years ago, Sweden and America spent about the same on their government, a bit under 30% of GDP. This is no longer true. In the years leading up to Sweden's financial crisis in the early 1990s, government spending went as high as 60% of GDP. In America it barely budged, increasing only to about 33%.

While America was maintaining its standing as one of the world's wealthiest nations, Sweden's standing fell. In 1970, Sweden was the fourth richest country in the world on a per-capita basis. By 1993, it had fallen to 17th.

This led us to ask whether Sweden's dramatic increase in the size of government contributed to its sluggish growth. Our research shows that it did.

We surveyed the existing literature looking at the trade-offs between government size and economic growth throughout the world. While results vary, the most recent research, by Diego Romero-Avila in the *European Journal of Political Economy* (2008) and by Andreas Bergh and Martin Karlsson in *Public Choice* (2010) find a negative correlation between government size and economic growth in rich countries.

The weight of the evidence demonstrates that when government spending increases by 10 percentage points of GDP, the annual growth rate drops by 0.5 to 1 percentage point. This may not sound like much, but over 30 years this would result in the loss of trillions of dollars each year in an economy as large as America's.

To put it in personal terms, the average American's per capita income in 2009 was $46,405. A dip of 1% in the economic growth rate (to 2% from 3% for example) would mean an individual income loss of $464 in the first year. Over 30 years, a one percentage point difference in the growth rate translates to roughly $354,000 in lost income per person.

We also investigated the claim that Sweden is proof that big government does not harm the economy. While Sweden has done very well compared to other developed countries in the last 15 years, it has also implemented sweeping pro-market reforms. Examples include a national system of free school choice based on vouchers up through senior year of high school, a fully financially stable public pension system, and comprehensive tax reform that has lowered marginal tax rates tremendously.

Even if Sweden's government still spends some 20% of GDP more than the U.S. on average, the Swedish economy is now much more market oriented and government spending is down by almost 10% of GDP since the early 1990s.

Sweden's recent growth is thus the result of opting for free-market solutions instead of growing government. By comparison, the U.S. already has a relatively free economy, and therefore does not have as much potential for further market-based reform in order to offset the negative growth effects of a larger government.

Also, in Sweden, high personal tax rates encourage people to do work around the house that Americans pay others to do for them. Americans eat out more and hire people to clean their homes, take care of their children, or mow their lawns. Swedes, who have less money to spend after taxes, will do such work themselves. Raising government spending and taxes would cause Americans to behave more like Swedes, hurting the entire U.S. service sector and throwing many—mainly working class Americans—out of a job.

Many Americans argue that the U.S. could safely increase its spending share from roughly 32% of GDP to 37%–38% of GDP. The evidence suggests otherwise. The U.S. needs to acknowledge the trade-off between government size and economic growth. A larger government sector may decrease some economic inequality, but will ultimately leave Americans sharing smaller pieces of a smaller pie.

Mr. Bergh is an associate with the Research Institute of Industrial Economics, Lund University and the Ratio Institute in Stockholm. Mr. Henrekson is the CEO of the Research Institute of Industrial Economics in Stockholm. They are the authors of *Government Size and Implications for Economic Growth* (Washington, DC: AEI Press, 2010).