A list of Working Papers on the last pages

No. 151, 1985

IS THE SWEDISH WELFARE STATE IN TROUBLE? - a new policy model

by

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December, 1985

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November, 1985

Mancur Olson has often talked about the sclerotic development of economies that have been riding a wave of success for a long time. Herbert Giersch has introduced the term Eurosclerosis. In Olson's 1982 book Sweden was cited as the exception to this rule. During the last ten years or so it has become very popular to entertain thoughts and write books about the impending collapse of the Swedish welfare state (see e.g., Schwartz, 1980). Signs of distress were beginning to show by the middle 70s, which critics were fast to take note of. At last, Sweden was conforming.

On many occasions and in many articles Lester Thurow has sung the praise of industrial policy making. Industrial policy making in various forms and shapes has a long standing tradition in Sweden. The old Swedish policy model that I will explain later had an active labor market policy as its central element. This policy has been gradually abandoned since the late 60s. Swedish industry has to become competitive; it needs government help, such was the argument. We have the new policies of the 70s. When introduced they were announced very much like the programs Thurow has been pushing for.

I will present some evidence on the outcome of the new Swedish policy experience.

Industrial policy and the welfare state are very much related and the old Swedish policy model illustrates just that. The more one believes in the markets, the more infrastructure oriented industrial policy will be and the more insurance and mobility oriented the welfare programs. This is the old Swedish model which had a pronounced individualistic orientation.

The more egalitarian the orientation of the welfare state, the more collective the means resorted to to counter the influences of the market. Selective interferences in the market processes begin to dominate, the purpose often being to achieve short-term policy objectives related to unemployment. When the price system is not allowed to exert its influence on economic structures - and especially so in a small open economy like the Swedish one - industries eventually become less competitive. A potential unemployment problem builds up. This is the background of the <u>new</u> Swedish policy model.

I will structure this paper as follows. There will be a brief presentation (§ 4) of the old, Swedish industrial policy model, as seen in the light of a long history of industrial success and economic growth (§ 7) and an even longer history of a business minded, conservative culture (§ 7). The gradual break up of the old Swedish model, I continue to argue, may have been the result of Olson type forces at work and the building of an ambitious welfare culture that would not adjust to new economic realities (§ 4), of political pressure to enact short term, employment-oriented policies on a basically healthy economy, aggravating rather than relieving the structural problem (§ 5) or an accidental economic political blundering due to a misconceived economic situation.

Whatever the reason, I continue to argue, the damage is done to the economy. The problem is political, not economic or industrial. There are many feasible ways out of the situation, all requiring a short term adjustment with negative social effects and distributional outcomes that no one can predict in any detail. The solutions all require a roll-back of the welfare ambitions of the past. Politicians are reluctant to move. Individuals and households, being very dependent on public transfer income, are caught in a prisoners' dilemma type situation. At the same time the internationally exposed Swedish economy is under world market pressure to adjust on its own, whatever the policy makers do (§ 6).

1. Some Background Evidence on the Swedish Economy

Swedish industry, and hence the Swedish economy has been a superb economic performer (Figures 1A and B). Manufacturing output grew by just above 5 percent per annum on the average for more than one hundred years. This success story appears to have ended abruptly in the 70s. Since 1973/74 manufacturing output has been standing absolutely still (Figure 1C), only to start growing again in 1983 after a very large devaluation of the Swedish krona. It is interesting to note that the four Nordic countries represented in the picture can be placed in two groups:

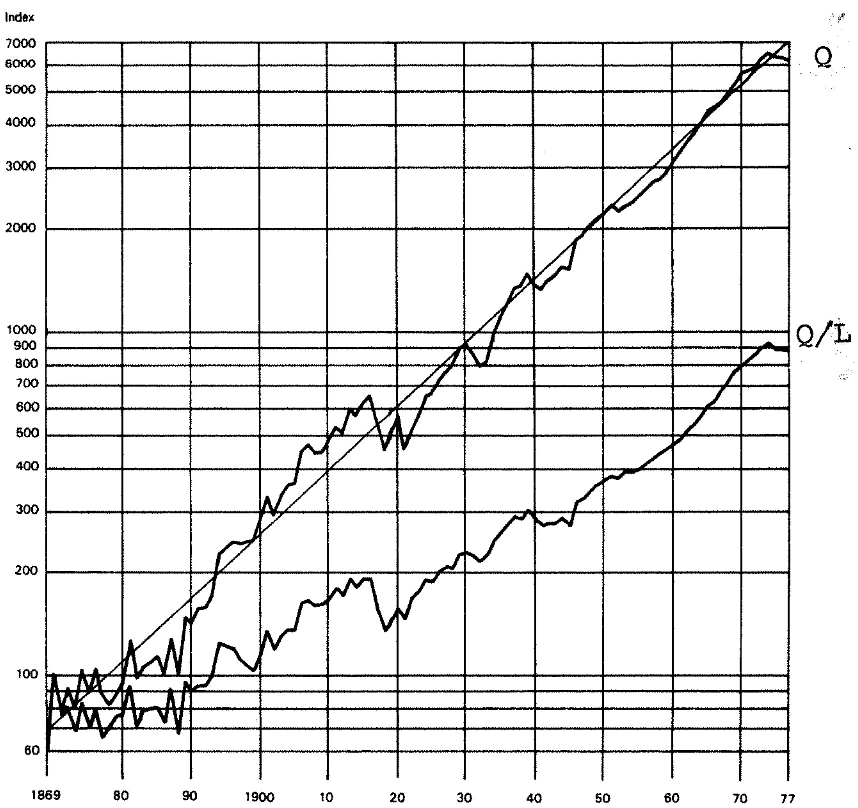
- Sweden and Norway with stagnating manufacturing output, a low level of open unemployment and an extensive industrial policy interference in the manufacturing sector.
- Denmark and Finland with continuing growth in manufacturing output at, or above, the average OECD rate, high open unemployment and virtually no selective industrial policy interference in the market allocation machinery of the economy.

The Danish situation is particularly interesting. Denmark has long been considered the bankrupt nation of Europe, with its huge foreign debt. A consequence of the large and growing foreign debt, currently reaching almost 35 percent of the GNP on a net basis, has been a steadily growing real interest rate. The domestic (Fisher deflated) real interest rate (see Figure 1D) has been far above the corresponding interest rate in the other Nordic countries and in the U.S. since the middle 60s and investment has been plunging. Nevertheless, and despite a dramatically reduced manufacturing employment, manufacturing output has been expanding with the OECD average, and Denmark is currently endowed with a relatively small, but very sophisticated industry, consisting of mainly small and medium sized firms.

Sweden takes the other extreme position. Interest rates have been kept low through various policy means, investment in manufacturing increased strongly after the 1973/74 oil situation, employment has been kept up, but output has been standing still. If manufacturing output would have expanded at the average OECD-Europe rate since 1973/74, Swedish manufacturing output would have been more than 15 percent larger 1982. In 1984 U.S. manufacturing was still more than 15 percent ahead, while Sweden was only lagging OECD Europe by 5 percent (see Figure 1B).

Apparently the ways resources are allocated and used in an economy matters for the output result.

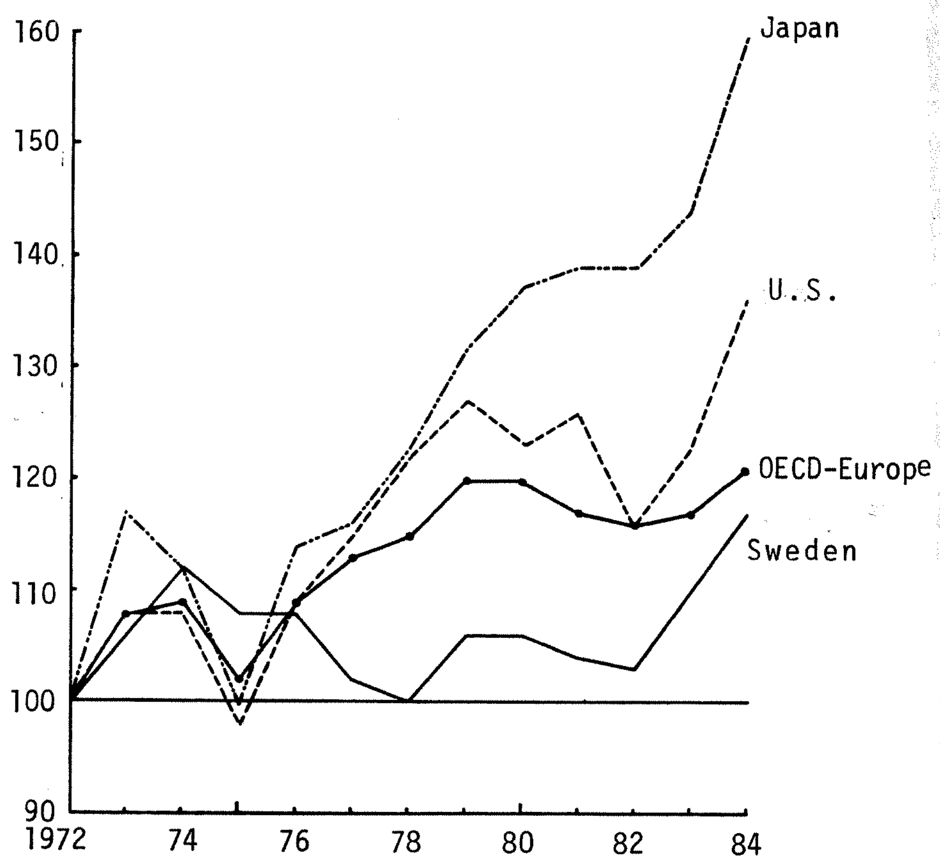
Figure 1A Manufacturing Output (Q) and Manufacturing Output per Employed (Q/L)
Index 1870 = 100



Source: Dahmén-Eliasson (eds.) Industriell Utveckling i Sverige. Teori och verklighet under ett sekel (Industrial Development in Sweden. Theory and reality dureing a century), IUI, Stockholm 1980.

Figure 1B: **Manufacturing Output in the U.S., Japan, OECD Europe and in Sweden, 1972-1984**

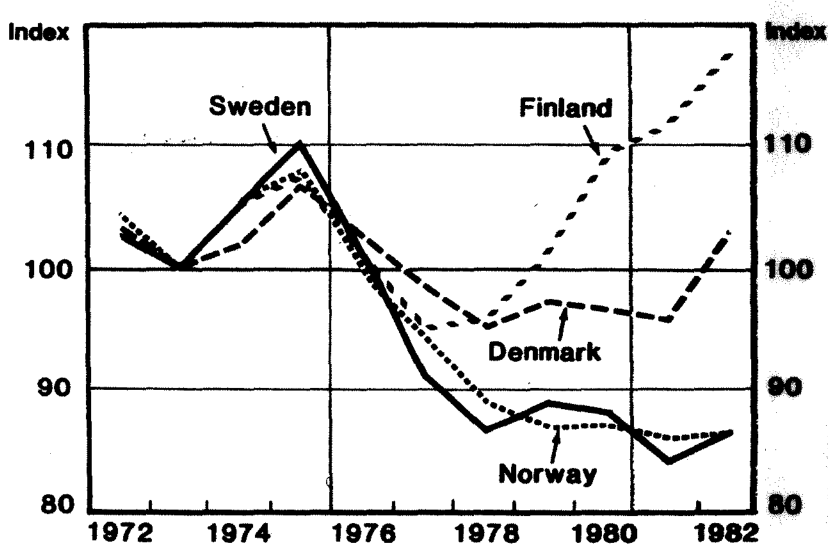
Index 100 = 1972



<u>Source:</u> <u>Who is Responsible for the Long Term Decisions?</u> IUI, Stockholm 1985.

Figure 1C Production in Manufacturing Industry, 1972-82; The Nordic Countries Compared with the OECD

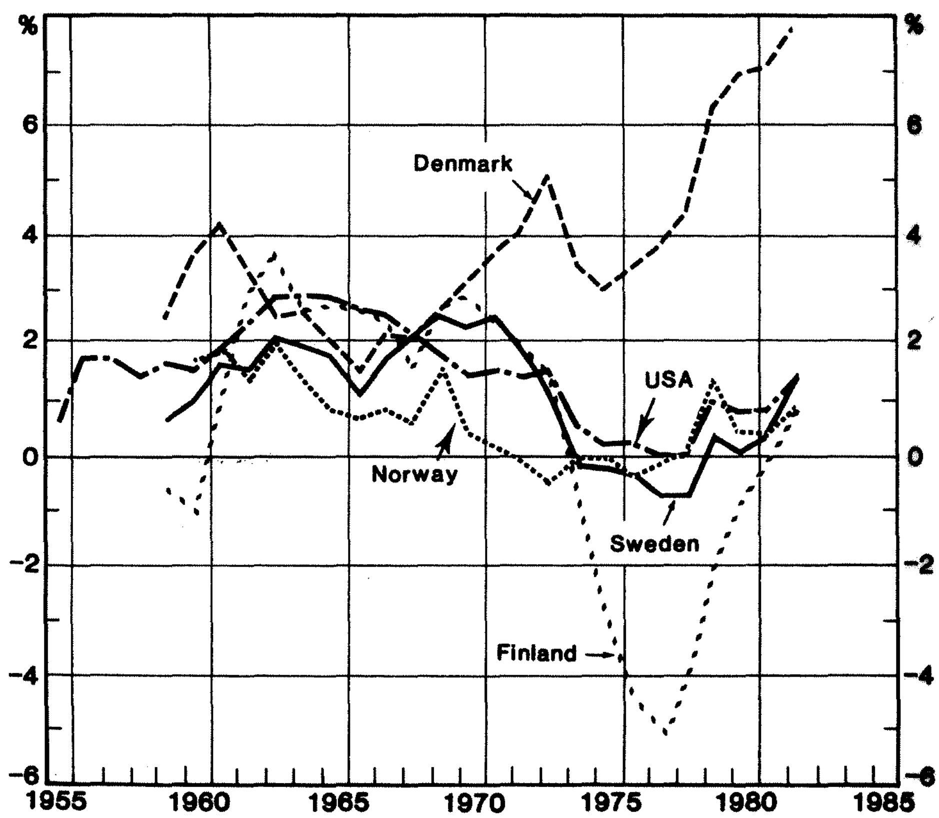
Index OECD = 100



Source: Economic Growth in a Nordic Perspective, IUI etc, Stockholm, Helsinki, Copenhagen, Bergen, 1984.

Figure 1D **Real Interest Rates (Before Taxes) in the Nordic Countries and in the U.S., 1955–82**

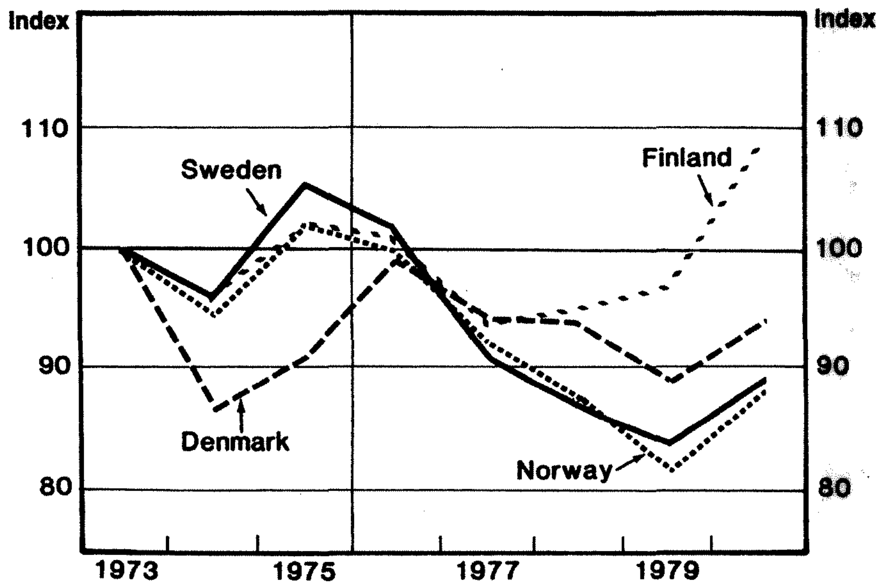
5 year moving average, per cent



Source: Op. cit. Economic Growth in a Nordic Perspective.

Figure 1E Investment in Manufacturing Industry, 1973–80; The Nordic Countries Compared with the OECD

Index OECD = 100



Source: Op. cit. Economic Growth in a Nordic Perspective.

2. Scandinavia's Old Capitalist Tradition

It is a trivial observation from philosophy that the way you look at and approach a problem decides your understanding of the same problem. The nature of one's understanding is, however, not trivial if transformed into policy action. Policies may easily worsen the situation if based on a misconception of dynamic economic processes.

1983 celebrated the 100th year birthday of two great economists that have come to represent two distinctly different theoretical outlooks on the workings of an industrial economy, Lord Keynes and Joseph Schumpeter. The two economists are also representatives of two markedly different ideological or political outlooks that have been very influential in the design of economic policies. Schumpeter emphasized the importance of innovative entrepreneurial qualities in the economic growth process. He also observed that the nature of the capitalist process was not independent of the culture of the country and that the requisite qualities needed for economic growth took a very long time to develop. Even though Keynesian in spirit the early industrial policy practice in Sweden was, however, truly Schumpeterian and appreciative of the importance of industrial knowledge and talent.

Recent years have shown a growing interest in the life and culture of the Scandinavian vikings; not because of their reputation as great warriors, but rather as developers of commerce and industry. Some, and I believe Adam Smith belongs to them, argue that to understand the creation of economic wealth of nations, one has to take a very long-run historic perspective. One argument in that vein is that the cradle of capitalist thought and action really lies in the culture of the Scandinavian vikings (Wax and Wax, 1955). Economic behavior is as much guided by non-economic factors (like the value system of a nation's inhabitants) as it is by prices and profits. The sentiments and attitudes of a nation take a long time to develop and influence.

I am not going to insist that one needs a 1 000 year lag to explain what is going on today, but business attitudes are certainly an integrated part of Swedish culture. And the current situation in the Swedish economic and political systems certainly cannot be explained without due consideration of a long history of conservative traditions, a business minded culture and a democracy firmly rooted in the private ownership of land by farmers and guaranteed by written and unwritten laws from medieval times. Sweden never developed the continental European feudal political order.

While large scale manufacturing of goods is relatively new in the other Nordic countries, factories for large scale manufacturing of weapons and jewelry from the very early viking age (ca 400 AD) have been uncovered in Sweden. Extensive iron ore and copper mining for exports have been going on for at least one thousand years. The first incorporated company in the world (Stora Kopparberg) has its charter dated in the 13th century. It is currently the 12th largest export company in Sweden. Foreign, direct investment (and the import of new technology) was encouraged by the Swedish kings in the 16th and 17th centuries.Shipbuilding was started on a large scale in the 16th century. In the 17th century, Sweden had a commercial, as well as a naval, fleet comparable to that of Great Britain. Among the 35 largest Swedish manufacturing corporations (ranked in 1981) two thirds started production before the turn of the century (Eliasson, 1984). The ten largest of them employ (together) some 400 thousand people, whereof less than half in Sweden.

Directly and indirectly these firms keep more than 25 per cent of the domestic manufacturing labor force busy. At least seven of the ten companies are the largest producers in the world in their main product lines (vacuum cleaners, hard core metals, ball bearings, dairies, etc.) If we look at the group of large, international Swedish manufacturing corporations the picture looks impressive indeed. Some authors (Pavitt-Soete, 1982) even want to rank Swedish industry in a special class, far removed from all other industrial countries, together with the large industrial nations - the U.S., West Germany and Japan - when it comes to diversity and levels of industrial competence. This, somehow, has to be made an integral part of a story that explains the stagnation of manufacturing output during the last decade.

3. The Old Swedish Industrial Policy Model

The old Swedish industrial policy model, as understood by implicit contracts (and some documents) between the unions, business and the social democratic governments, was one of (1) non-interventions on the part of the central authority in the production process of firms, (2) so-called solidaric wage policies, (3) an active labor market policy to stimulate mobility, (4) a "low interest rate" policy to stimulate growth in manufacturing and (5) redistribution through taxes and public sector growth. This should be observed carefully, since most writers on the Swedish policy model have restricted attention to the active labor market policy part (cf. Lundberg, 1985). The key notions were efficient production through free trade and competitive entry, decentralized production and ownership, efficient structural adjustment through active labor market policies and efficient (equitable) distribution through public sector growth. The objective was to maximize the growth of the total output cake and to appropriate as much as possible of output - through the tax system and public sector growth - for redistribution, but without violating the basic growth premise. This is how the welfare state and industrial policy come together. (Hence, this policy was accompanied by high marginal tax rates and a growing average tax rate, the latter being close to 60 percent of GNP today. What distinguishes Sweden from other countries, however, is that a large part of tax income was simply redistributed back to households again (see Figure 2A).)

The Swedish policy model started from the assumption that a decentralized market organization of the production system is efficient. The competence to manage industrial activities resided among the micro agents in the market and they mattered critically for the success of a business venture. The market forces, hence, should be stimulated through the design of the policy system. Industrial efficiency was not a matter of coordination, but of finding the right business combinations - to use a Schumpeterian expression - that should also receive the investment funds. Bureaucrats were asssumed to lack the competence to manage a business firm. Failure was as common as success, and the abandoning of bad investments should be stimulated. "Creative destruction", to use a Schumpeterian term, was as important as finding the right opportunity. The active labor market policy was there to minimize the social costs of the adjustment. This principle also presumes that inferior firms that find themselves in the wrong market, or are badly managed, should be allowed to go bankrupt or be purchased by somebody else on commercial grounds.

As pointed out earlier, the basic philosophy behind the Swedish policy model was formulated in the early 50s within the Swedish labor union movement. This philosophy formed the backbone of the economic policy of the Social Democrats through most of the 60s. It told that there was no reason to socialize the means of production and to abstain from the benefits of an efficient market organization of the production system for reasons of doctrine.

With a high performance production system ("a capitalist engine" to use Schumpeter's term), ambitions of the policy authorities could be oriented towards the distribution of the total output produced, according to principles that differed from those of the market.

4. The Public Sector - From Infrastructure Provider to a Huge Redistribution Game

For about 100 years, up to the late 60s, the public sector in Sweden consisted mostly of local government bodies. The bulk of local government activity in turn was devoted to the provision of healthy and educated workers for industry who (in this century) did not have to worry about retirement age. Besides health, schooling and retirement funding, the remaining large budget item was transportation (railroads and regular roads, Ysander, 1979). Very little research has been devoted to evaluating the significance for industrial expansion of such infrastructure activities. Were they important in facilitating the "take off" in manufacturing output growth that occurred around the mid-19th century? (See Figure 1A.)

The financing of the growth in public activities as well as of industrial investment was largeley internal, from income generated by exports of iron ore and forest products. All through the 19th century agriculture was an important provider of resources. One could say with a slight exaggeration that war and famine in the world were important resource generators - through agricultural exports - for the early industrialization of Sweden. (Cf. Norway's way of dealing with its oil and gas resources today in Eliasson, 1983, which is not likely to be successful in the long run, if continued).

The major share of public expenditures is still being allocated to the above infrastructure "investments", even though new forms of expenditures for social and egalitarian purposes have been rapidly growing in importance.

My <u>first</u> observation concerns the actual production of these infrastructure services, which as of recently - and schooling in particular - have been exhibiting signs of a deteriorating quality. Schooling, health care, retirement schemes and transportation are almost wholly "socialized" and run through public agencies. The financing of schooling, health care and retirement is basically an "over the life cycle" activity, that can in principle be handled through the market by insurance companies and credit institutions, as it is to a much larger extent in the U.S. and in Switzerland. An important issue in the economics of the welfare state is the relative efficiency of private solutions compared to running this enormous insurance and banking activity large scale through a government bureaucracy.

It may sound surprising, but only a relatively small share of the total tax- take of some 10 percent of Swedish GNP, is really used for truly egalitarian measures, aimed at equalizing the life income among individuals.

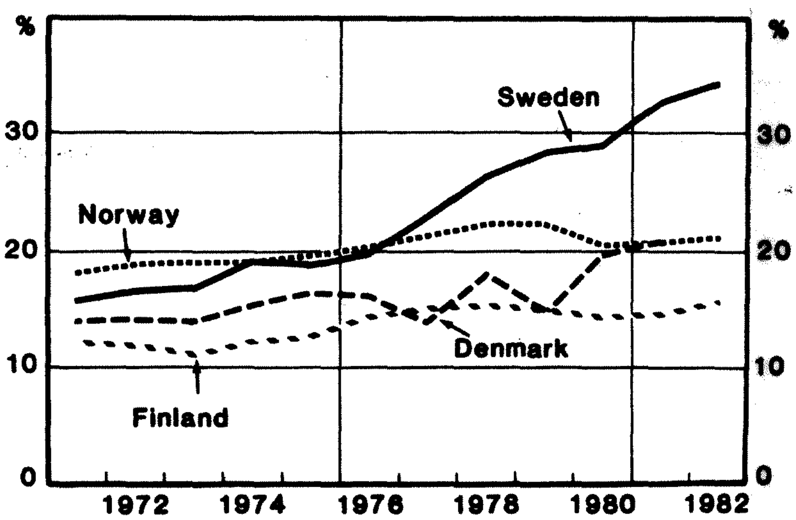
The second observation hence concerns the rapidly growing share of transfers in the government budget - since the late 60s - (see Figures 2A and B) that alienates the compensation from the job effort. This concerns individuals and households as well as firms. The important question is how much this change has affected incentives, and efficiency (see Lindbeck, 1983).

5. The New Industrial Policies - or Socialization Through the Back Door

Even though few observers seemed to know, by the mid-60s Sweden - by the virtue of the old Swedish industrial policy model -had one of the lowest rates of public ownership of industry in the industrial world. Publicly operated manufacturing companies accounted for less than 5 percent of manufacturing employment.

However, to discuss industrial policy making without including the extent of publicly run service production means downplaying the extent, in some countries, of "nationalization policies". It is wrong to argue that there is no private alternative to the service production that occupies the bulk of government activity in, for instance, Europe. In this case, the U.S. and Switzerland distinguish themselves from the rest of the world with much of what (in Sweden) is called public activity, run by private agents. The interesting distinction is between the market and the non- or semi-market sectors of the economy, the latter being the sector over which the Government, through regulation and ownership exercises considerable control, and provides protection from market competiton.

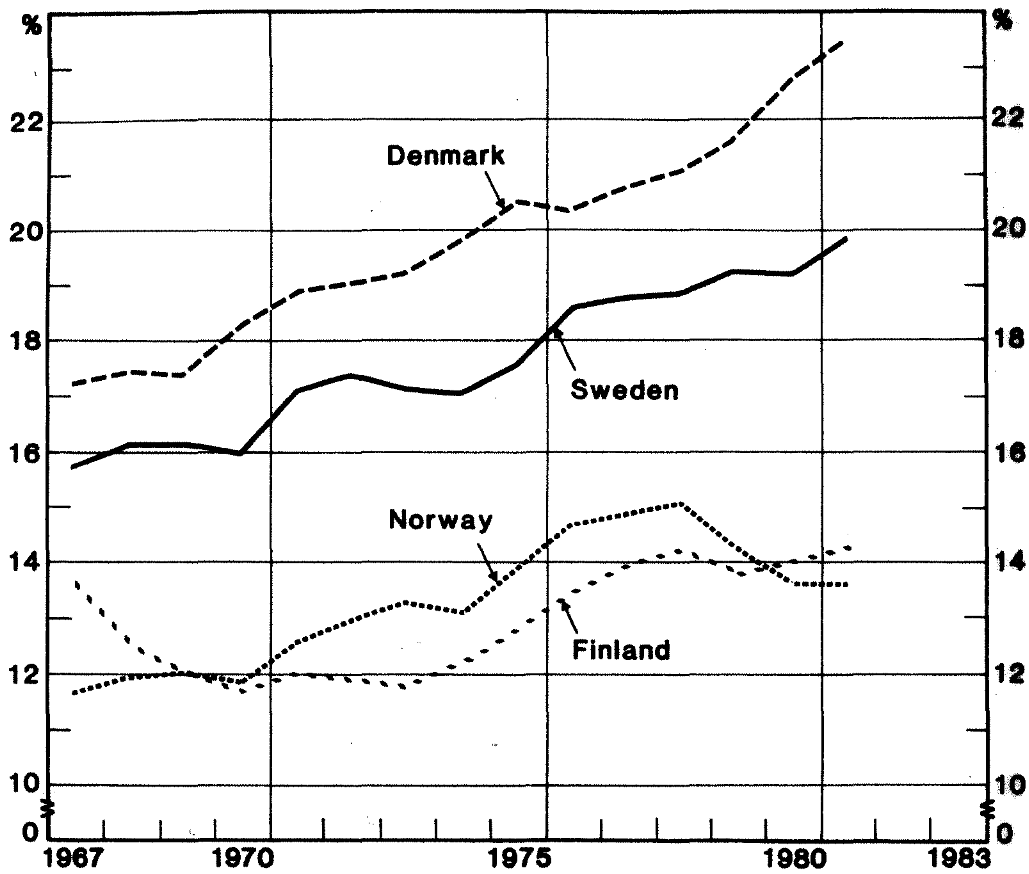
Figure 2A **Transfer Payments to Households in the Nordic Countries, 1971-82**
Per cent of GNP



Source: Op. cit. Economic Growth in a Nordic Perspective.

Figure 2B **The Public Sector in the Nordic Countries, 1967-83**

Per cent of GNP



Source: Op. cit. Economic Growth in a Nordic Perspective.

It was estimated (in Eliasson-Carlsson-Ysander, 1979, p. 105 ff) that in 1977, 22 percent of Swedish goods production came from the non-market sector - up from 14 in 1978 -and of service production between 35 and 42 percent originated in the non-market sector. In 1977 only 32 percent of total consumption was free of price controls or subsidies. Nevertheless, we have to realize that the public sector is not a homogeneous, centrally controlled body. It consists of a large number of reasonably autonomous decision bodies, as autonomous as many firms constrained by a competitive market environment. The difference is that the public decision bodies are governed by different criteria than the market agents, a circumstance that affects their "efficiency".

Even if we include the public sector, Sweden was not particularly socialized in the early 50s when compared with other industrial countries. Today, however, the public sector is significantly larger than the manufacturing industry if measured by employment (30 percent of the labor force compared to 22 percent). Again, this is not the largest share among the industrialized countries. The distinguishing feature is the extent of transfer payments, and the change of direction of these payments during the 70s.

a) A dual economy

If one looks at the share of output in the Swedish economy today, that is protected from direct competitive pressure from foreign and domestic firms, it is large by international standards. To this sector - protected from market competition - belongs almost the entire public sector. This does not imply that the Swedish people do not demand the services produced in the public sector. On the contrary. Demand for health care, education and retirement schemes tends to increase with the level of economic wealth in all countries. This is well known from international comparisons. There is, however, a concern about who runs the production of such services and how they are priced and financed. Is production less efficient if organized under a centralized authority within the public sector, production being effectively shielded from outside competition, than if organized on a more decentralized basis? Private and more efficient solutions with a higher price and a smaller tax subsidy may exist that do not necessarily violate the ambitions concerning welfare and distribution set by Swedish Governments during the 70s. Labor market policy is a good example. Labor market agencies are run by the public sector (The Labor Market Board). This is a standard feature of welfare societies. However, they are not always monopoly institutions. In Sweden, private labor agency activity on commercial grounds is prohibited, and the Labor Market Authority and its employee organizations keenly watch, and object to proposals and legislation aiming at undermining that monopoly position and introducing competition. Competition in the service production currently monopolized by the public sector is potentially very beneficial for the entire society. But it implies tougher standards for both the producers of these services and their employees. It is paradoxical to observe that the total labor market program, and the industrial subsidy program together during the second half of the 70s drawing more than 6 percent of GNP in resources, rather than lowering unemployment appears to have increased open unemployment at each targeted inflation rate (see Schager, 1985 and Eliasson et al., 1985). On the margin, the enormous, at least 3 percent of GNP per year labor market policy program of the 70s even appears to have been welfare reducing (see Björklund-Moffitt, 1983) It is also interesting - in passing - to note that public employees make up a significantly larger share of elected politicians than their share of the labor force (Isacsson, 1978) and for the first time in history clients of the public sector (public employees, retired people, people on welfare, etc.) were in majority in the 1985 electorate (Zetterberg, 1985).

The potential social benefit foregone by the dominant public control of service production is that a major share of income distribution policies in Sweden, and probably in other countries as well, involves a reshuffling of benefits over the life cycle of the individual rather than between life incomes of different individuals. This makes public financing alternatives based on individually based insurance principles adequate and efficient alternatives.

Moreover, a de-teriorating macroeconomic situation is not a good basis for ambitious welfare and distributional policies. During the postwar period international competition directed towards Swedish goods production has increased strongly.

Financial systems of the industrial countries, including Sweden have become increasingly integrated and efficient through the growth of an international credit system. This means, among other things, that the international interest rate has become a norm for investment calculations throughout the world, and also in Sweden.

The rapid growth of the public sector, sheltered from both domestic and foreign competition and coupled with the full employment policy has forced up wages throughout the system. This has reduced the relative size of manufacturing. Hence, this export-oriented industry sector has had to absorb a growing structural adjustment burden that relates to the entire economy. The conflict between distributional ambitions and growth has finally led to an economic impasse in the early 80s, the solution of which may be critical for the future success of the Swedish economic system.

b) How to make public production more market oriented?

Guaranteed output and employment levels in public production pose part of the problem of insufficient market price guidance of the economy. Well into the 70s the demand for labor largely determined the level of employment in private industry. The Swedish policy model involved helping labor to move through labor market policies to jobs where they were most needed and obtained the largest marginal product in a market sense. Thus, employment in the agricultural sector was reduced from more than 600,000 employed in 1950 to just above 200,000 at the end of the 70s. This corresponded to closing down a major shipyard every second or third month for more than 30 years, a labor migration on a scale far larger than the more modest adjustments necessary within industry today.

The so-called "solidaric" wage policy on the part of unions - combined with a highly progressive income tax and rising payroll taxes - increased the speed of structural change. Those industries that were unable to maintain profitability through higher prices or increased labor productivity were simply forced to fade away.

Despite the hardening international competition for a relatively shrinking export sector the adjustment burden was shared fairly equally between labor (unemployment, job change) and capital owners (losses) until the mid-70s.

The 70s signifies a break with this tradition in so far as labor began to be increasingly protected by legislation from being forced to move. Probably as important, however, were the extremely erroneous expectations about future labor needs, and the ability to pay high wages, on the part of firm managers during the first round of extreme inflation in 1973/75. Add a new mood of "social responsibility" among business leaders when it comes to laying off workers and it is easy to see that almost the entire adjustment forced on the Swedish economy during the past oil crisis years has been absorbed by business profits, especially in the export sector.

An implicit "employment guarantee" of the Swedish type suggests that exaggerated wage demands on the part of wage and salary earners involve smaller risks than before of losing a job. While the total adjustment pressure on the economic structure has increased, the sector that has to make the adjustment has shrunk relatively. In addition, the relatively growing non-market sector, controlled by public authorities, means that diversity of structurers, demonstrated to be important for macroeconomic stability (Eliasson, 1984b) has decreased. The supreme generators of diversity in an economy are innovative, competitive entry and exit of production establishments. Within the public sector entry is normally restricted or forbidden, and political bodies are notoriously bad in shutting down commercially impossible activities. As a consequence, new elements of instability and tension have crept into the Swedish economic system.

c) Socialization through the back door?

As a consequence also many large corporations for the first time have come close to bankruptcy. The government has stepped in with subsidies to prevent large, concentrated shutdowns. (Shipbuilding is the prime example.) A number of industrial companies have been "taken over" by the government in recent years for the same reason. It has become increasingly difficult politically to allow large, inferior production plants to die. Labor will of course interpret this as a "local" job holding insurance, and managers and capital owners will (probably) interpret the relief from market pressure as a political insurance of their assets. Unpleasant internal reorganizations will be postponed and political pressure will build up for a public take-over of control of decisions regarding when and where to invest, since the government is anyhow footing the bill. The employee or wage earners funds (see below) become a natural socialist conclusion to such a development, if nothing steps in to break it. Perhaps this is part of the dismal vision of the future semi-planned economy that Joseph Schumpeter once had for the efficient capitalistic system. Some of the West European industrial countries are already close to this scenario. The process began in Sweden by the government making individual business firms responsible for employment in their firms[1], a task earlier vested in the central government. This has in turn made the government step in and take over managerial responsibility in a growing number of companies - an absurd mismatch of competence and task.

Schumpeter viewed capitalism, individualism and democracy as interlinked concepts. Those who worried about the future of the

[1] Note, that this is something entirely different from the employment policies of large Japanese firms.

market economy had equally good reasons to worry about the future of individual freedom and democratic processes - or in short, about the future of western industrial society.

d) The political discount rate is high

The 70s began in Sweden with pompous political fanfares about the need for government intervention in industry to make it behave and perform better. The Swedish state-operated company (Statsföretag AB) was created with the declared ambition to set a good example of socialized business and do everything at least as well as the best private companies, but also to take a social responsibility (see Eliasson-Ysander, 1981). The Department of Industry was formed and drew extensive plans of (inter alia) a gigantic standard steel plant in the underindustrialized north ("Steel Works 80"). The plant was never built, to the relief of later governments, but preparatory work on the site only, almost wrecked the finances of the northern city of Luleå - the host city for the proposed steel plant.

The ultimate industrial policy ambition was vested in the joint push by the social-democratic party and the central blue-collar union (the LO) for collectively (read union) controlled "employee funds" that would eventually take over control in private industry (Meyerson, 1982). When returning to power in 1982, the social-democrates, pushed by the unions, reluctantly forced a legislation of a watered down version of these funds through a marginally willing parliament. The three bourgeois parties pledged to throw the funds out when they returned to power. The economic situation of the country was now very different from what it had been, when the political push for these funds had begun.

The early ambitions of Swedish industrial policy making aimed at improving business performance, within the firms and within industries, a kind of attention that did not please business leaders and that created a new kind of tension between unions, government and business that was not there during the many years of the old Swedish policy model. During the later employee funds phase of the political process the state of tension worsened considerably. (In the early 60s business leaders and union leaders travelled the U.S. to praise the Swedish model. They shook hands and smiled in front of TV cameras. In October, 1983, business owners and executives marched the street of Stockholm to protest the "employee funds".) A gradual take over of control in the private sector was the obvious ambition. It was strongly resisted by industry and referred to as an unwarranted change of political economic system. It was hailed as a step towards economic democracy by the promoters. A critical political question is: Will the employee funds be thrown out? Is the watered down version legislated potent enough to eventually, if not thrown out, lead to a government-union take over of industry (read socialization), or will it rather be a costly vehicle for wasteful disposal of investment resources?

As it happens, current industrial policy practice - the new policy model - as practiced through the 70s, and that has accounted for the bulk of policy expenditures has turned out to be something entirely different from what went on during the old policy regime. Outcomes are very different from the pompous words that accompanied these policies.

Post 1973-74 policies mark the change of policy regime. Policies all turned very short-term towards protecting employment whereever employment was threatened. One could say that the political discount rate was raised very much, and significantly shortened the horizon within which politicians were concerend about what happened. The allocation effects from policies have in fact been disastrous, and the industrial subsidy program may alone explain the stagnation in aggregate manufacturing output after 1974 (Eliasson 1982, 1983, 1984c, Carlsson 1983). For some years value added in the Swedish shipyards was negative and steel plate was being destroyed there with the highest paid labor in Swedish manufacturing. In 1980, 3 percent of GNP was devoted to labor market policies and 3 percent of GNP to direct subsidizing of industries (see Eliasson-Holmlund-Stafford, 1981). The extent of this activity is enough to tell that something had gone seriously wrong in the policy machinery and that the effects would be large for years to come.

These policies were being carried out by a bourgeois government, but in agreement with the social democratic opposition. Was it all an unfortunate accident, due to a misunderstanding of how a dynamic industrial economy works? Is this policy story an illustration of the shortcomings of the democratic process in advanced economies when it comes to take really difficult political decisions? Or could it possibly be a smart bourgeois scheme to block once and for all, further socialization ambitions on the part of future social democratic governments. Huge public and external debts (see Figure 3) will prevent further "experimentation" with the Swedish economy for years to come.

e) Privatization through the back door?

The ultimate irony of the excessive welfare state may still be waiting around the corner. My assessment of the economic situation of Sweden over the past three or so years has been that policy making is much more difficult than we ever envisioned. The intended welfare effects derived from overly simple models were perhaps observed for several years, especially the growth effects from expansive - and inflationary (!!!) - demand policies. But no commonly accepted policy models included the possible reversal of these effects due to the disorganization of the price system that followed from inflation, and a constant full, or excess capacity operation (see Eliasson-Sharefkin-Ysander, 1983). The dynamics of price/quantity interaction has always been a weak spot in economic theory, and the additional consequences for prices on wealth objects of rigid non-adjusting real structures and disorderly price behavior have so far never been understood or predicted. The emerging evidence is that while income distributions in a cross section sense may have been made more even, the effects on the more appropriate welfare distribution, lifetime consumption capacity are probably insignificant, and they may currently be reversing for the worse, due to the increased spread of the wealth distributions caused by taxes and the disorganized price system in combination (see Eliasson,1985). If the ultimate outcome of the enormous redistributional gamble of some overly ambitious welfare states turns out to be a return to pre-policy wealth distributions and economic stagnation, someone else has played the game back at us, and far more skilfully, the market.

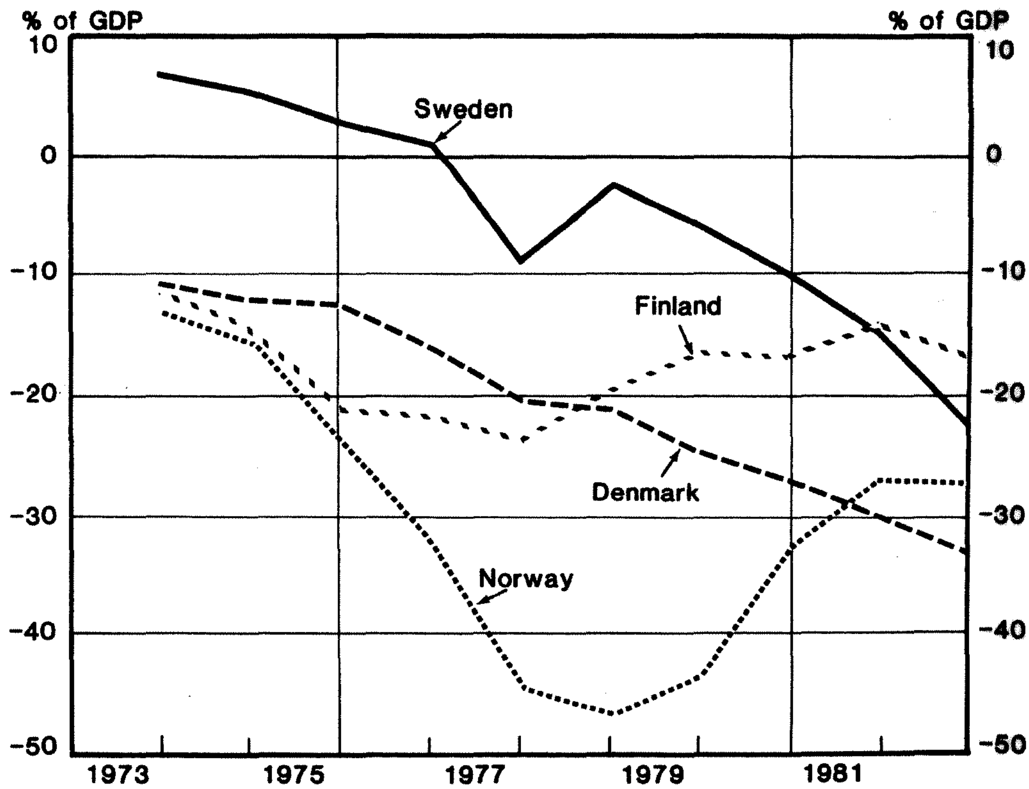
6. The Prisoner's Dilemma

Sweden closed the 70s with a large and growing foreign debt, a large and growing public debt and an output growth rate in manufacturing knocked down to zero. During the past decade income earners had delivered all increases in gross income to the public sector in the form of higher taxes. They had received some increases in disposable income back in the form of government transfers. Hence, practically all disposable income increaes during the 70s for the majority of Swedish income earners appeared to originate in public budgets.

The massive industrial rescue program to avoid immediate increases in open unemployment was an important part of the story. Taxes and subsidies together with inflation had significantly distorted the domestic price system (see for instance Södersten-Lindberg, 1983) and the efficiency of the investment allocation machinery.

Full employment, measured the conventional way in labor force surveys, had been a key vaiable in Swedish economic policies for decades. For the first time in post-war history it was threatened by the turn of economic events. In retrospect it appears as if the moving force behind this turn of events has been just policy making to prevent open unemployment.

Figure 3 **Net Foreign Assets in Sweden, Norway, Finland and Denmark, 1973-82**
in per cent of GDP



Source: Op. cit. Economic Growth in a Nordic Perspective, p. 39.

The extreme openness of the Swedish economy makes its internal markets very sensitive to developments in world markets. Emerging imbalances will have to be corrected sooner or later by explicit policy action or by endogenous responses from the economy. Policy makers are beginning to realize that they have devoted too much attention, and public resources to extensive welfare programs while neglecting the important task of the central political authority in a mixed economy, being the guardian of the rules of the market game. Their policies even seem to be back-firing on the distribution side.

Empirical evidence is telling a very distinct story. The current malaise of the Swedish economy has nothing to do with lack of potential economic or technical competitiveness on the part of private industry. The problem is entirely political, and resides in the non-market, Government controlled parts of the production system and in the inability of politicians as representatives of the electorate to take a long-term view on the economic adjustment problem (Eliasson et al., 1985, 1985b).

There is only a longer term solution to the Swedish policy problem, preceded by short-term structural adjustments in the economy, connected with some roll-backs on the welfare agenda. These adjustments will necessarily be accompanied by a temporary increase in open unemployment and some distress on the part of income earners working in distressed industries and in the public sector (see Economic Growth in a Nordic Perspective, IUI, 1984). There is the crucial issue of minimizing the transitional problems by skilled macro policy management. Skilled policy management appears to be significant for a successful roll-back of the welfare agenda, cutting down on transfers to households and industries, and taxes and allowing after-tax incomes to widen significantly.

The assessment agreed on today by most observers is that the Swedish economy won't be able to carry the current welfare burden much longer. A roll back of welfare would release incentives and pave the way for a more prosperous society later on. There are, however, two critical questions that are left unanswered:

- how long will the adjustment period be?
- who will benefit and who will gain in the end? (The equity issue)

Nobody can provide an answer to these two questions. There is a prisoner's dilemma type of hitch. The income and benefit distribution will probably change but most will probably be better off, if rational macro policy decisions can be taken. The political process is, however, not well designed for difficult and important policy questions like this. I would, nevertheless, venture the assessment that the Swedish production system would respond quite speedily to tough adjustment policies of the kind I have suggested, due to an efficient, sophisticated and well adjusted manufacturing sector - the healthy, not subsidized part. I do not believe the Swedes have to worry about a repetition of the British experience from similar policies.

Hence, rational policy making means a return to the old, Swedish industrial policy model. If the political process manages to achieve that, and to weather the transitional period of adjustment there is no cause for alarm. The industrial base of Sweden could hardly be better - only larger. And the industrial base certainly could have been larger if the government had abstained from carrying out structure conserving industrial policies. There has been a "lost decade". A significant volume of material output has been lost for good. We may call this loss the costs for a learning experience. The Danes are going through the same adjustment process now. The Swedes can learn from their experience. If the Swedes, however, cannot make it, economic and political prospects look dismal.

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