The Swedish Economy Triumph of Social Democracy — or Serendipity?

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In 2016, Sweden came out on top of the Reputation Institute's yearly ranking of 55 countries according to how people viewed them as places to live and work. The same year, Sweden outranked 162 other countries to reach the number-one spot in the Good Country Index, based on its ranking on 35 UN and World Bank criteria ranging from living standards to environmental sustainability.

Now, Sweden doesn't always come in first, but it always does well by just about any important yardstick of social and economic success. In the latest available reports, Sweden placed fifth in the Legatum Institute's Prosperity Index, eighth in the World Bank's Doing Business report, and third in Transparency International's Corruption Perception Index. What makes Sweden perform better by so many criteria? Could other countries find lessons in Sweden's experience that apply across borders?

The good news is that combining research on the causes of prosperity with detailed studies of Sweden's economic and political history offers a fairly convincing answer to the first question. But knowing more about how Sweden became prosperous does not necessarily tell us whether the magic could be bottled for export. In fact, surprising as it may seem to those who see Sweden as the triumph of the modern welfare state, Sweden's success has largely been the result of trial and error, not to mention the beneficiary of the unintended consequences of public policy.

Yes, there are a few lessons to be learned by studying Sweden, just as there are things to be learned from the experiences of any other country. But the lessons from Sweden are not always what one might expect, and in some cases are truly elusive.

In the aftermath of the 2008 global financial crisis, Sweden was described as a rock star of recovery by The Washington Post and a supermodel for other crisis countries by The Economist. But before we scrutinize the Swedish model for insights into economic-crisis management, two things are worth noting.

First, just 25 years ago, things looked very different. Sweden was not a success story but rather the poster child for how not to run an open economy. Indeed, in October 1993, The Economist published an article with the headline "Worse and Worse," lamenting Sweden's humungous budget deficit (13 percent of GDP) and an increasingly unsupportable public debt, along with a rapidly depreciating currency.

Second, it bears emphasizing that, over the years, the example of Sweden has been used to support widely varying ideological positions. Around 1970, Sweden was the fourth- richest country in the world (in terms of per capita income), after Switzerland, the United States and Luxemburg. Social Democrats had been in power since the early 1930s and Sweden was widely touted as proof that socialism – at least the democratic, Swedish version – could work very well. The country had experienced 100 years of remarkably high growth and rising living standards, as well as narrowing gender inequality.

The economic problems that became apparent during the 1970s were initially blamed on factors beyond the little country's control, such as the oil price shocks. A center-right government did take office in 1976, with Social Democrats in opposition for the first time in 44 years. Its mandate, however, was not to push the Swedish economy in a new direction but to deliver what the Social Democrats had been supplying for decades until they slipped – namely, a globally competitive economy and ongoing social reforms.

It did make good on the latter, but failed with the former. It took repeated devaluations of the Swedish currency, the krona, to keep the economy – by necessity of its size and location, a very open economy – competitive. When the Social Democrats returned to power in 1982, yet another devaluation, combined with the global economic recovery of the 1980s, left the general impression that social democracy was back on track. But the fundamental problem of lagging competitiveness had not been solved, and the economic downturn of the early 1990s hit Sweden much harder than other countries.

By now, the debate regarding the Swedish model had shifted. Chronic economic problems (especially slow productivity growth) were now seen as proof that socialism didn't work – not even in Sweden. A new center-right government was elected in 1991, and this time the mandate was to make fundamental changes in the Swedish model, rather than to polish the one that Sweden had long embraced. In some areas the government succeeded; in others it hit a wall of resistance. Simply put, competition and economic freedom increased in many areas of the Swedish economy. But key areas, notably the labor market and the housing market, remained highly regulated.

The winding road Sweden has taken has made it difficult to say whether being more like Sweden involves increasing taxes and government intervention in the economy – or whether it means liberalization, deregulation and welfare-state retrenchment. So, before other countries try too hard to become more like Sweden, it is wise to look back at how Sweden came to be Sweden. The answers may surprise you – they certainly surprise a lot of Swedes.

The Growth of the Forest Economy

A standard explanation (one still taught in Swedish textbooks) of how Sweden grew rich relies on the primacy of exports. Industrialization in other countries, the argument goes, generated demand for Swedish timber. As everyone who has heard of the "oil curse" or "Dutch disease" knows, though, having valuable natural resources to sell is no sure path to growth and prosperity. Swedish scholars – notably Johan Myhrman and Jan Jörnmark – were some of the first to note that institutional reforms, in particular securing the right to private property and the freedom to trade internationally, are pivotal in sustaining growth pretty much everywhere. And while all that timber played a role in Sweden's development, institutional change was the key to the switch to a long-term growth track.

Perhaps the most interesting aspect is how the process was triggered. Often, it was foreign entrepreneurs rather than Swedes who saw the potential value in the Swedish forest. Meanwhile, the Swedish state moved to define and protect private property rights because the government saw this as a step to expanding the tax base. In other words, the development of taxation and private property rights did not only coincide, but were in fact two sides of the same coin.

On a superficial level, then, Sweden is yet another country that illustrates how well-functioning private property rights are a vital prerequisite to economic development. But the subtle aspect to Sweden's export-led development story is that it's impossible to identify either the market or the government as the primary driver.

The Impoverished Sophisticate

Sweden around 1850 has been described as an impoverished sophisticate because the average education level was high compared to incomes. Having a highly educated population arguably contributed significantly to economic growth. But why was educational attainment high in Sweden to begin with?

Historians point to the early introduction of mass public education, with the adoption of the 1842 Elementary School Act. The law, which stipulated that every parish must have at least one school, is often mentioned by contemporary politicians as a shining example of Sweden's long commitment to investment in human capital. The policy implication is seemingly clear: political decisions promoted growth early on by mandating public education. That may well be the case. But before jumping to that conclusion it is worth considering the analysis offered by the economic historian Thor Berger of Lund University.

Berger argues that the education law looks good in history books, but largely provided the potential without the substance. The law came with meager funding and no minimum requirement of attendance. Interestingly, the rural poor (who were very poor, indeed) were apparently opposed to state intervention in primary education because they feared having to pay higher taxes to finance it.

The question then remains why, in the latter half of the 19th century, Swedes attained an average level of schooling that was much higher than could be expected, given the country's modest level of economic development. According to Berger, the answer lies in local elites, which pressed the case for investment in primary schooling in rural areas.

Just why this rural upper class acted as it did is hard to say. Maybe it wanted to shape the minds of the masses in an era of growing fear of class warfare; maybe the goal had something to do with the tenets of Lutheran church. Most strikingly, Berger shows that the positive influence of local elites on school spending was weaker in places in which suffrage had been extended beyond landowners and the middle class. Many voters, it seems, preferred instead to spend tax money on poverty relief.

In short, education promoted economic development in Sweden, but democracy at the time did not promote education. Knowing more about what actually happened in Sweden hardly leads to clearer recommendations for other countries.

The World's first Universal Pension System

Other aspects of Sweden's rise as the global leader of social democracy also resist easy interpretation. In 2013, Sweden celebrated the 100th anniversary of its pension insurance system, which is acknowledged to be the world's first universal system, providing cash to everyone reaching age 67 as well as to anyone who became disabled.

The keyword here is universal. Other countries had pension systems earlier. But the Swedish system was unique in that it covered the entire population and also served as poverty relief. The universal nature of many components of the social safety net is still a core feature of the Swedish welfare state, defended by many on ideological grounds. But the chain of events that led Sweden to introduce tax-funded universal pensions has an important non-ideological component that is often ignored: the demographic dislocation caused by mass Swedish emigration to the United States that peaked between 1870 and 1900.

The social-policy expert Per Gunnar Edebalk of Lund University notes that the Swedish population at the turn of the 20th century was, on average, very old. Sweden had 165 persons age 65 years or older for every 1,000 persons ages 20 to 65. Comparable figures for Great Britain were 88 and for Germany 96. This coincided with the emigration of almost one million Swedes – more than one-fifth of the entire population – to the United States.

The migrants' primary motives were to escape poverty and to seek better opportunities. And because they were typically young adults, an immediate result was a lack of familial support for the impoverished elderly back in Sweden. Doing nothing about that would have placed an enormous burden on municipal poverty relief – then the last resort of the destitute – and so municipalities turned to the central government. More or less by chance, that need coincided with the introduction of the reporting and taxation of individual incomes in Sweden, which gave the government an adequate source of revenue to meet increased demand for relief. And so, the Swedish welfare state was born.

Gender Equality

One of the most celebrated aspects of Sweden's social democracy is the high degree of gender equality, both in general and in the labor market. And that claim is not hollow: among all OECD countries, Finland and Sweden are at the very top when it comes to female labor force participation relative to males.

Swedish social planners rarely fail to point out that tax-financed child care has been critical to easing the way to female labor force participation. But this seems less the cause than the effect of a collective determination to promote gender equality. It doesn't explain why Swedes, who were seemingly as attached to the male-breadwinner model as others, so readily adopted a dual-earner household model while other European countries lagged behind.

There really is a puzzle here. Sweden only adopted universal suffrage in 1921, years after the rest of Scandinavia. Yet, a few decades later, the country was a front-runner in female labor force participation and gender equality. The answer suggested by those who have looked closely at the issue may come as a surprise: economic growth.

To see why growth mattered, note first that tax-financed child care was initially not popular in Sweden. Male politicians resisted the proposed intervention because they worried that it would undermine women's incentives to cater to household needs. This resistance only eroded after World War II, when buoyant economic growth generated demand for labor that only women could supply from the domestic population. Indeed, the radical expansion of tax-financed child care was only adopted in 1963. But once the reform was in place, the work force adapted rapidly: Children who grew up in Sweden during the 1970s or later have never known a time when it was normal for women to stay home.

These days, many Swedes worry about the low levels of labor force participation among immigrant women in Sweden and stress that gender equality has economic benefits. As true as that may be, the forgotten lesson from Sweden is that economic growth drove the change in cultural norms, not the other way around.

The Swedish Experiments, 1970-1995

The examples above are mostly cases in which historical accidents worked out favorably for Sweden. But, as more recent reform initiatives suggest, Sweden's fortunes have not always been protected by prescient social and economic planning – or by good luck.

In the 1970s, several well-intended political reforms backfired. The desire to increase income equality through high marginal tax rates and generous welfare benefits weakened work incentives and created strong incentives for tax avoidance. Indeed, in the 1970s and 1980s, many wealthy Swedes – notably Bjorn Borg – left the country to avoid the taxman.

Meanwhile, the desire to tame the business cycle and minimize unemployment led to the subsidization of noncompetitive industries. The unions' desire to drive wages ahead of productivity growth led to inflation, while efforts to restore Sweden's competitiveness through repeated currency devaluations led to both a lower living standard and investment-sapping uncertainty.

Perhaps most important, the mix of subsidies and devaluations sent the signal that firms in trouble could turn to the government for help, rather than be forced to innovate in order to stay competitive. When that happens, economies inevitably pay a price.

The problematic period in Sweden – roughly from 1970 to 1995 – is one of the most useful periods in Sweden's history when it comes to lessons for other countries. Those who want to learn more about the Sweden that seemingly could do no right should look to Assar Lindbeck's out-of-print book, The Swedish Experiment. Or check out his article with the same name in the Journal of Economic Literature, which is alive and well in the American Economic Association's digital archive.

What Now?

After the crisis of the early 1990s, the Swedish economy recovered smartly. In many ways, Sweden learned from its mistakes and took measures to avoid large budget deficits and inflationary wage pressures. By the mid-1990s, these changes were institutionalized – and strikingly, often with support from Social Democrats as well as the right-wing parties. Prominent examples include a tax reform that lowered marginal rates substantially and a pension reform that balanced the risks between pensioners and taxpayers by automatically adjusting payments to demographic and economic conditions.

But things are not all fine and dandy. In fact, the mood in Sweden seems more pessimistic than usual about the country's future. And the news regarding Sweden's pole position in the Good Country Index and the Reputation Institute's rankings didn't make much fizz in Sweden. Doing better than most other countries is not really enough if your country is doing worse than it was five years ago. And according to recent polls, that's where Swedes think they stand.

There are many reasons for the current pessimism, two of which deserve mention here. First, the reform wave that contributed to Sweden's recovery after the crisis of the early 1990s left the labor market more or less untouched, and thus still highly regulated. High minimum wages and relatively low demand for workers with little education pose few obstacles for the majority of Swedes, who share language, community and a solid educational background. But they represent a serious hurdle for the large numbers of recently arrived refugees. And thrusting low-skilled immigrants into an unforgiving labor market – and backing it up with the very expensive services of a universal welfare state – amounts to an ongoing test of Swedes' tolerance and flexibility that many are unhappy to be participating in.

A second issue weighing down the public mood is the troubling development in Sweden's once widely admired primary and secondary education system. In a nutshell, the skills of students have been decreasing for decades, even as their grades have increased.

This problem nicely underscores the importance of unintended consequences in driving Sweden's social and economic change. The education system has undergone a series of reforms, many of which have interacted in unforeseen ways. First, primary and secondary education were decentralized, with authority devolving from the central government to municipalities – as well as to parents who, thanks to a voucher system, get the last word on where their children go to school. Second, grading criteria, once rigidly dictated by the center, were made more flexible.

These changes gave schools both ample opportunity and strong incentives to inflate grades – the better to please parents (who now had a choice about where to send the kids), and to give their students improved access to universities whose admissions policies remained tightly tied to metrics of success in secondary school. Adding to concerns about declines in the quality of education, new teaching methods that de-emphasized the teacher's role in the classroom in favor of group work and free exploration became all the rage.

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Sweden's modern economic and social history offers sufficient room for interpretation for observers to draw the conclusions that best fit their preconceptions. What I can say with some confidence is this: first, a combination of culture and luck (never forget the latter) has made Sweden the envy of outsiders, and for good reason. Second, there's no guarantee the luck will hold. The Swedish experiment is just that – an experiment in which the best-laid plans of social engineers and men oft go astray.

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