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Is the Swedish Welfare State in Trouble?

A New Policy Model

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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[1] Sweden was cited as the exception to this rule. But 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.[2] Critics were fast to take note of the signs of distress that began to show by the middle 70s. At last, Sweden was conforming.

On many occasions and in many articles Lester Thurow has praised industrial policy-making. Industrial policy-making in various forms and shapes has a longstanding tradition in Sweden. The *old* Swedish policy model that I will explain later had an active labour market policy as its central element. Since the late 60s this policy has been gradually abandoned. Swedish industry, the argument ran, had to become competitive; it needs government help. So we had the *new* policies of the 70s. When introduced they seemed very much like the programs Thurow has been pushing for.[3] Here, 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 markets, the more infrastructure-oriented industrial policy will be, and the more insurance and mobility-oriented will be the welfare programs. This is the old Swedish model which had a pronounced individualistic orientation.

If, in contrast, the orientation of the welfare state is more egalitarian, then more collective means are chosen to counter the influences of the market. Selective interferences in the economy begin to dominate, the purpose often being to achieve short-term policy ob-

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jectives related to unemployment. When the price system is not allowed to exert its influence on economic structures — especially in a small, open economy like Sweden's — industries eventually become less competitive. A potential unemployment problem builds up. This is the background of the *new* Swedish policy model.

This paper is organized as follows. The old, Swedish industrial policy model is briefly presented in the light of a long history of industrial growth and an even longer history of a business-minded, conservative culture. The gradual break-up of the old Swedish model, I continue to argue, may have been caused by Olson-type forces and the building of a welfare culture that would not adjust to new economic realities, or by political pressure to impose employment-oriented policies on a healthy economy, or by sheer political blundering and failure to understand the changing economy. Whatever the reason, the argument runs, economic damage is done. The problem is political: there are many feasible solutions, but all require a short-term adjustment with negative social effects and unpredictable distributional outcomes. All require a roll-back of the welfare ambitions of the past. Yet politicians are reluctant to move, and individuals and households, dependent on public transfer income, are caught in a situation like the prisoners' dilemma. At the same time whatever the policy-makers do, the internationally exposed Swedish economy is under world market pressure to adjust on its own.

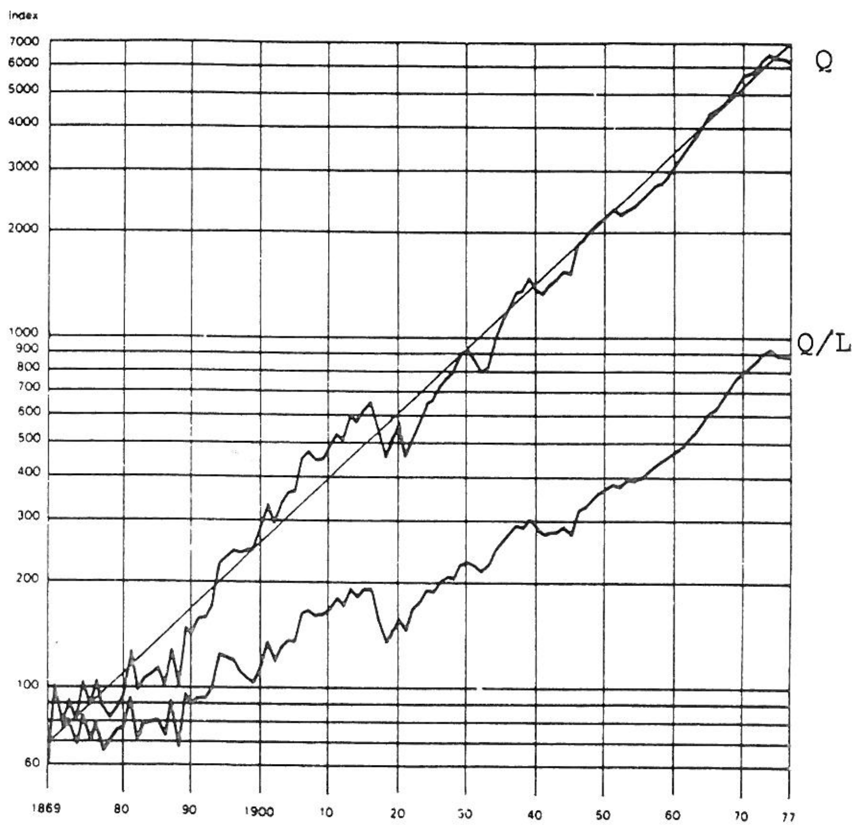
1. Some Background Evidence on the Swedish Economy

Swedish industry has been a superb economic performer (Figure 1). 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. Manufacturing output stagnated after 1973: growth resumed in 1983 only after a large devaluation of the Swedish krona (Figure 2). It is interesting to note that the four Nordic countries represented in Figure 3 can be placed in two groups:

Sweden and *Norway* have weak manufacturing growth, a low level of open unemployment and extensive policy interference in the manufacturing sector.

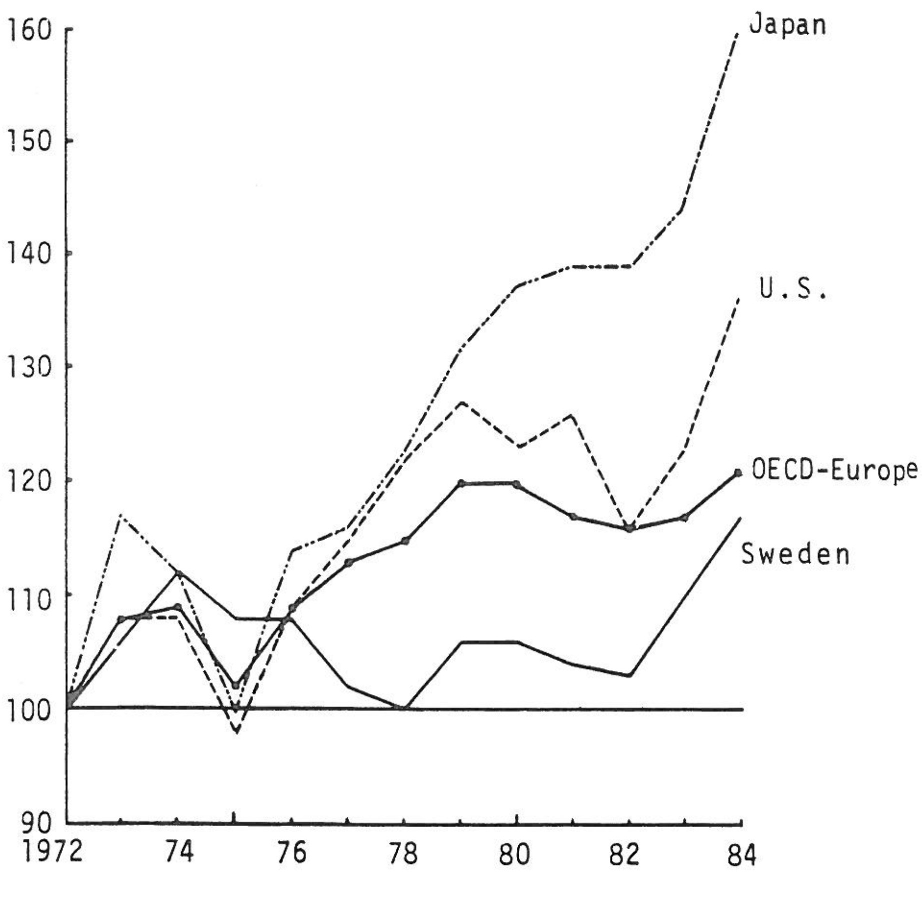
Denmark and *Finland* have continuing growth in manufacturing, at, or above, the average OECD rate, high open unemployment and virtually no selective industrial policy interference in the market allocation machinery.

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



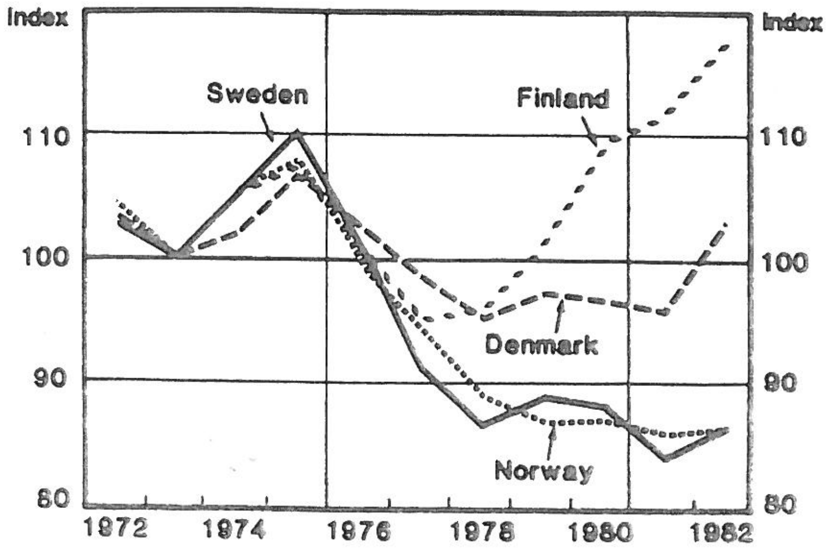
Source: *Industriell Utveckling* [4]

Figure 2: Manufacturing Output in the U.S., Japan, OECD Europe and in Sweden, 1972-1984
Index 100 = 1972



Source: *Att rätt värdera 90-talet*[5]

Figure 3: Production in Manufacturing Industry, 1972-82; The Nordic Countries Compared with the OECD
Index OECD = 100



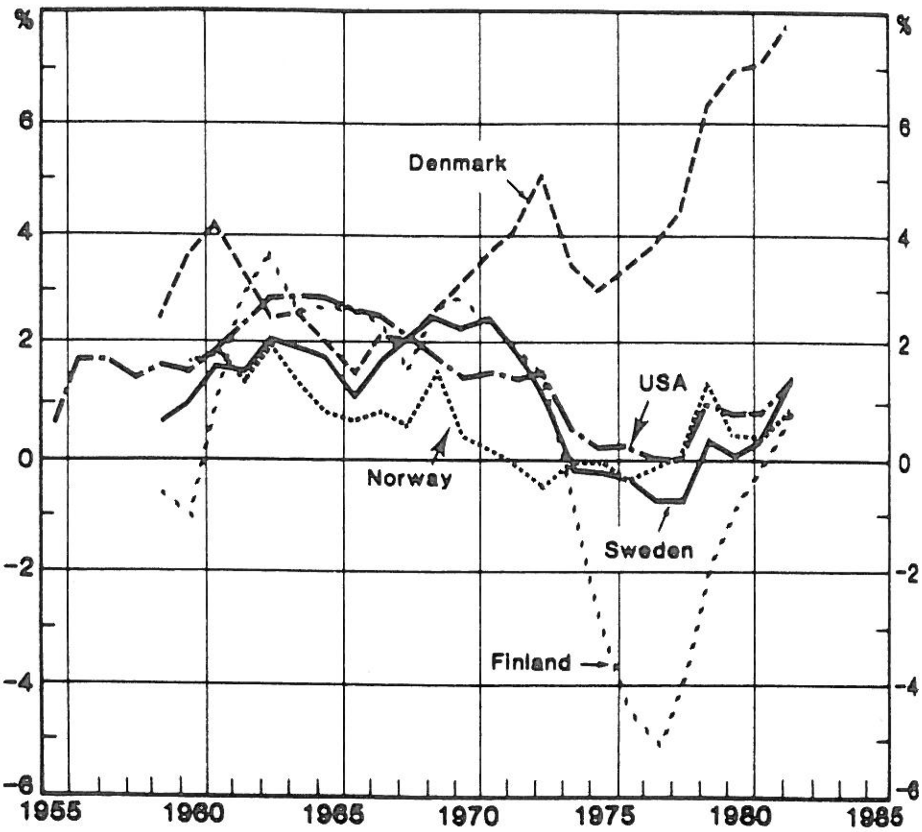
Source: *Economic Growth*[6]

The Danish situation is particularly interesting. Denmark has long been considered the bankrupt nation of Europe, with its huge foreign debt. A consequence of this growing debt, (currently reaching almost 35 percent of the GNP on a net basis), has been rising real interest rates. The domestic (Fisher deflated) real interest rate has been far above those in the other Nordic countries and the United States since the mid-60s, and investment has been plunging (Figures 4 and 5). Nevertheless, manufacturing output has been expanding with the OECD average, despite dramatically reduced employment in the sector, and Denmark is currently endowed with a relatively small, but very sophisticated industry, consisting mainly of small and medium-sized firms.

Sweden takes the other extreme position. Interest rates have been kept low, investment in manufacturing increased strongly after the 1973/74 oil situation, and employment has been maintained; but output has been standing still. If manufacturing output had expanded since 1973-74 at the average OECD-Europe rate, it would have been more than 15 percent larger than it was in 1982. Although Sweden was only lagging OECD Europe by 5 percent in 1984, United States manufacturing was still more than 15 percent ahead (Figure 2).

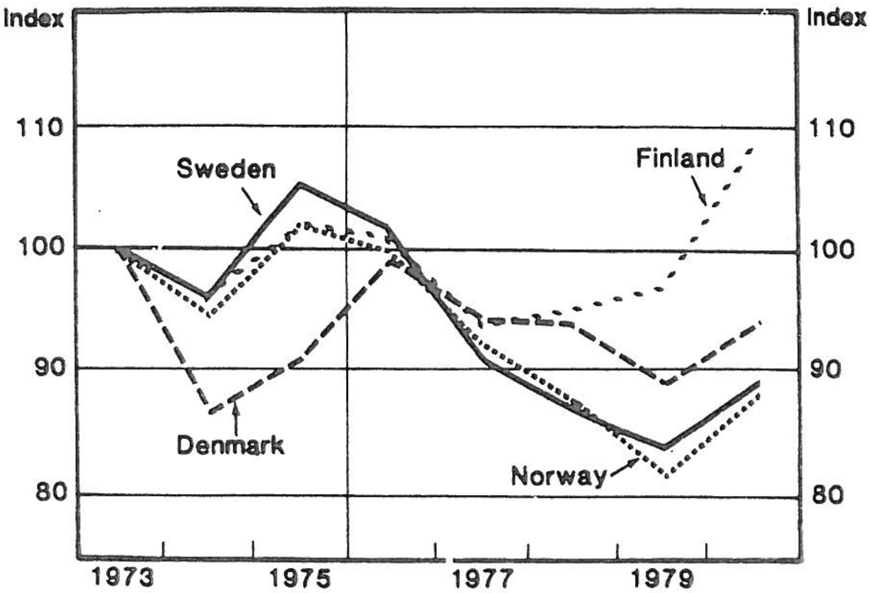
Apparently resource allocation and use in an economy affects the output result.

Figure 4: Real Interest Rates (Before Taxes) in the Nordic Countries and in the U.S., 1955-82
5 year moving average, per cent



Source: *Economic Growth*, p. 28.

Figure 5: Investment in Manufacturing Industry, 1973-80; The Nordic Countries Compared with the OECD
Index OECD = 100



Source: *Economic Growth*, p. 18.

2. Scandinavia's Old Capitalist Tradition

It is a trivial observation from philosophy that the way one approaches a problem determines one's understanding of it. 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.

The year 1983 marked the 100th birthday of two great economists, Lord Keynes and Joseph Schumpeter who have come to represent two distinct theoretical outlooks on the workings of an industrial economy. The two economists also represent two markedly different ideological or political outlooks that have been very influential in the design of economic policies. Schumpeter emphasized innovative entrepreneurial qualities in the economic growth process.

He also observed that the nature of the capitalist process was not independent of a nation's culture, and that the qualities needed for economic growth took a very long time to develop. In Sweden, the early industrial policy had Keynesian aspects, but was fundamentally Schumpeterian in its appreciation of industrial knowledge and talent.

Recent years have brought 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, like Adam Smith, have argued that understanding the development of the economic wealth of nations, requires a very long-run historic perspective; others maintain that economic behaviour is as much guided by non-economic factors like the value system of a nation's inhabitants as it is by prices and profits. In this vein run arguments that the cradle of capitalist thought and action really lies in the culture of the Scandinavian vikings.[7]

I am not going to insist that events of 1,000 years ago explain what is going on today, but entrepreneurial attitudes are certainly an integral part of Swedish culture. And the current situation in the Swedish economic and political systems 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 manufacturing weapons and jewelry which date from the very early viking age (ca 400 AD) have been uncovered in Sweden. Extensive mining of iron ore and copper for exports has 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. In the 16th and 17th centuries, Swedish kings encouraged foreign, direct investment and the import of new technology. 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. Of the 35 largest Swedish manufacturing corporations in 1981, two-thirds started production before the turn of the century.[8] The ten largest of them together employ some 400,000 people worldwide.

Directly and indirectly these firms keep more than 25 percent of the domestic manufacturing labour 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[9] even want to place Swedish industry in a special class, removed from all other industrial countries and together with the largest industrial nations — the U.S., West Germany and Japan — when it comes to diversity and levels of industrial competence. This, somehow, has to be incorporated into 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 incarnated in formal and informal agreements between the unions, business and the social democratic governments, included the following: (1) non-intervention on the part of the central authority in the production process of firms, (2) so-called solidaric wage policies, (3) an active labour market policy to stimulate mobility, (4) a low interest rate policy to stimulate growth in manufacturing and (5) re-distribution through taxes and public sector growth. The full extent of this should be understood, since most writers on the Swedish policy model have restricted attention to the active labour market policy part.[10] The key notions were efficient production through free trade and competitive entry, decentralized production and ownership, efficient structural adjustment through active labour market policies and efficient (equitable) distribution through public sector growth. The objective was to maximize the growth of total output and to appropriate as much as possible of output — through the tax system and public sector growth — for re-distribution, *but without violating the basic growth premise*. This is how the welfare state and industrial policy came together.

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. Bureaucrats were assumed to lack the competence to manage a business firm. Market forces, therefore, should be stimulated through 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 receive investment funds. 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. Creative destruction, to use another Schumpeterian term, was as important as finding the right opportunity. The active labour market policy was in place to minimize the social costs of the adjustment. Under the reign of the old policy model there was no place to complain about the hardship suffered when having to change job or move because of market competition. The absence of a Department of Industry or similar industrial policy agencies until the 70s signifies an attitude of society in this respect. This was part of the old Swedish policy model and defines its perhaps most important characteristic: a means of indoctrination to make people accept the rules of the market game.

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

With a high-performance production system — a "capitalist engine" — the public authorities' ambitions 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. Most local government activity concerned the provision of healthy and educated workers for industry. Besides health, schooling and retirement funding, the remaining large budget item was transportation.[11] 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? In any case, the major share of public expenditures is still being allocated to these infrastructure "investments," even though new forms of expenditures for social and egalitarian purposes have been rapidly growing in importance.

My *first* observation concerns the actual production of these infrastructure services, which recently have been exhibiting signs of a deteriorating quality. Schooling, health care, retirement schemes and transportation are almost wholly "socialized" and run through public agencies. But financing education, health, and pensions is basically a matter of transfers over the life-cycle, which can in principle be handled through the market by insurance companies and credit institutions, as it is to a much larger extent in the United States and in Switzerland. An important issue in the economics of the welfare state is the relative efficiency of private solutions compared to running these enormous insurance and banking activities through a government bureaucracy. It may sound surprising, but only a relatively small share of the total tax take of some 10 percent of the Swedish GNP, is used for truly egalitarian measures, aimed at equalizing the life income among individuals.

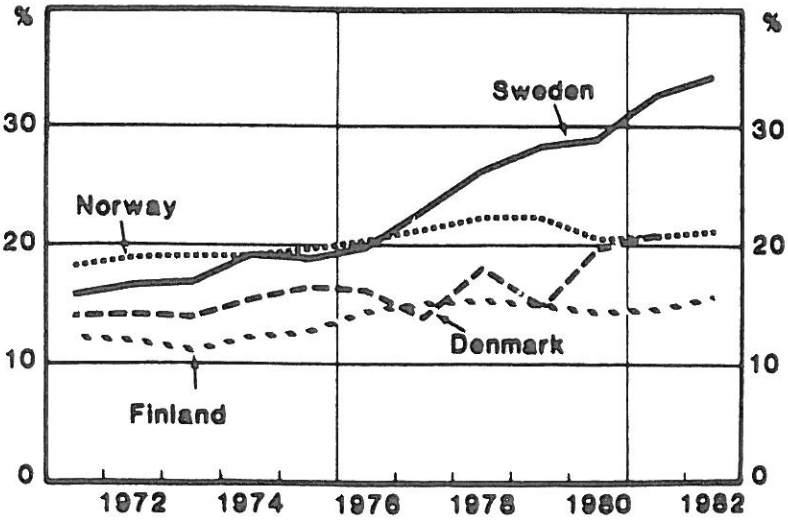
The *second* observation concerns the rapidly growing share of transfers in the government budget (see Figures 6 and 7). This concerns individuals and households as well as firms, and it separates compensation from job effort. It is interesting to note that for the first time in history clients of the public sector — public employees, retired people, those on welfare and so on, were a majority of the 1985 electorate.[12] The important question, though, is how much this growth in transfers has affected incentives, and efficiency.[13]

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

Even though few observers seemed to realize it, under the old industrial-policy model Sweden in the mid-60s had one of the lowest rates of industrial public ownership in the OECD. Publicly operated manufacturing companies accounted for less than 5 percent of manufacturing employment.

However, to discuss industrial policy without including the publicly run service sector means downplaying the extent of "nationalization policies." There are private alternatives to the service production that accounts for most government activity in many countries.

Figure 6: Transfer Payments to Households in the Nordic Countries, 1971-82
Per cent of GNP



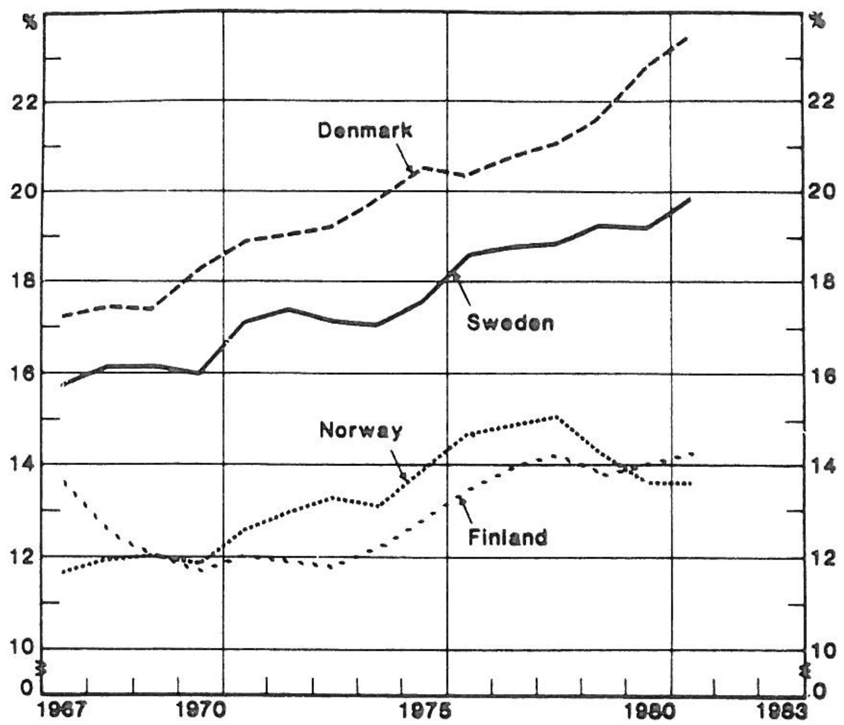
Source: *Economic Growth*, p. 33.

The interesting distinction is between the market and the non- or semi-market sectors of the economy (the latter being the one over which the Government exercises considerable control through regulation and ownership, providing protection from market competition).

It was estimated that in 1977, 22 percent of Swedish goods production came from the non-market sector, and of service production between 35 and 42 percent originated in the non-market sector.[14] Only 32 percent of the total consumption was free of price controls or subsidies. Nevertheless, one has to realize that the public sector is not a homogeneous, centrally controlled body. It consists of a great many reasonably autonomous decision bodies, as autonomous as many firms constrained by a competitive market environment. The difference is that the public 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

Figure 7: The Public Sector in the Nordic Countries, 1967-83
Per cent of GNP



Source: *Economic Growth*, p. 34.

than the manufacturing industry if measured by employment (30 percent of the labour 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 in direction of these payments during the 70s.

a) A dual economy

If one looks at the total share of Swedish output that is now protected from the direct competitive pressure of foreign and domestic firms, it is large by international standards. This protected sector includes 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. There must, however, be concern about who runs the production, pricing and financing of such services. Is production less efficient if organized under a centralized authority within the public sector, shielded from outside competition, than if organized on a more decentralized basis? More efficient private solutions, with a higher price and a smaller tax subsidy, may exist, and they need not violate the ambitions concerning welfare and distribution set by Swedish Governments during the 70s.

Labour market policy is a good example. Labour market agencies are run by the public sector in Sweden. This is a standard feature of welfare societies. However, they are not always monopoly institutions. In Sweden, private labour agency activity on commercial grounds is prohibited, and the Labour Market Authority and its employee organizations keenly watch, objecting to proposals and legislation which might undermine that monopoly position and introduce 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 service agencies and their employees. It is paradoxical to observe that the total labour market program, which along with the industrial subsidy program drew more than 6 percent of the GNP in the late 70s, rather than lowering unemployment, appears to have increased open unemployment at each targeted inflation rate.[15] On the margin, the enormous — at least 3 percent of the GNP per year — labour market policy program of the 70s even appears to have been welfare reducing.[16]

The potential social benefit foregone by the public control of service production arises from the fact that a major share of income distribution policies in Sweden involves a *reshuffling of benefits over the life-cycle of the individual rather than between life incomes of different individuals*. This makes financing alternatives based on individually based insurance principles adequate and efficient.

Moreover, a deteriorating macroeconomic situation is not a good basis for ambitious welfare and distributional policies. During the postwar period international competition faced by Swedish goods production has increased strongly. But 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, the 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 labour largely determined the level of employment in private industry: Swedish labour market policies involved helping workers move to jobs where they were most needed and obtained the largest marginal product. Thus, employment in the agricultural sector was reduced from more than 600,000 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 labour 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 unable to maintain profitability through higher prices or increased 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 labour (unemployment, job change) and capital (losses) until the mid-70s.

The 70s marked a break with this tradition, as labour began to be increasingly protected by legislation from being forced to move. Equally important, probably, were the erroneous expectations about future labour 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 cost forced on the Swedish economy during recent years has been absorbed by business profits, especially in the export sector.

An implicit "employment guarantee" of the Swedish type suggests that making exaggerated wage demands involves 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, since the non-market sector, controlled by public authorities, has grown relatively, the diversity of structures, demonstrated to be important for macroeconomic stability,[17] has decreased. The supreme generators of diversity in an economy are innovative, competitive entry of superior, and exit of inferior production establishments. Within the public sector entry is normally restricted or forbidden, and political bodies are notoriously bad in shutting down commercially impractical activities. As a consequence, new elements of instability and tension have crept into the Swedish economic system.

c) Socialization through the back door?

For the first time, many large corporations 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. Labour 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.

Eventually, political pressure will build up for public control of decisions regarding when and where to invest, since the government is footing the bill anyway. 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. 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. This has in turn led to the government stepping in to 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 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 of setting a good example of socialized business, doing everything at least as well as the best private companies, but also assuming a social responsibility.[18] The Department of Industry was formed, and it drew up extensive plans, including those for a gigantic standard steel plant in the underindustrialized north ("Steel Works 80"). The plant was never built, to the relief of later governments, but just the preparatory work on the site almost wrecked the finances of the proposed host city of Luleå.

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.[19] Returning to power in 1982, the social-democrats, pushed by the unions, reluctantly forced 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 very different from what it had been when the political push for these funds began.

The early ambitions of Swedish industrial policy-making aimed at improving business performance within the firms and industries. This new kind of attention did not please business leaders, and created a tension between unions, government and business that had not existed during the many years of the old Swedish policy model. During the later phase of the political process the state of tension worsened considerably. (In the early 60s business leaders and union leaders travelled the United States to praise the Swedish model, shaking hands and smiling in front of TV cameras. In October, 1983, business owners and executives marched the streets of Stockholm to protest the employee funds.) A gradual take over of control in the private sector was the obvious ambition. Hailed by its promoters as a step towards economic democracy, it was strongly resisted by industry as representing an unwarranted change of the politico-economic system. A critical political question now is whether the employee funds will be thrown out. Is the watered-down version potent enough to lead eventually to a government-union takeover of industry (read socialization)? Or will it rather be a costly vehicle for wasteful disposal of investment resources?

The new policy model as practiced through the 70s has turned out to be entirely different from the old policy regime. Outcomes are also very different from the pompous intentions that accompanied these policies.

As the policy regime shifted after 1973-74, policies all turned very short-term, aiming to protect employment wherever it was threatened. One could say that the political discount rate was raised very much, so the time horizon within which politicians operated was dramatically shortened. The allocation effects of these policies have in fact been disastrous, and the industrial subsidy program alone may explain the stagnation in aggregate manufacturing output after 1974.[20] For some years, for instance, value added in the Swedish shipyards was negative: steel plate was being destroyed by the highest paid labour in Swedish manufacturing. In 1980, almost 3 percent of the GNP was devoted to labour market policies[21] and 3 percent to direct subsidizing of industries. The extent of this activity is enough to show that something had gone seriously wrong in the policy machinery. The effects would be large for years to come.

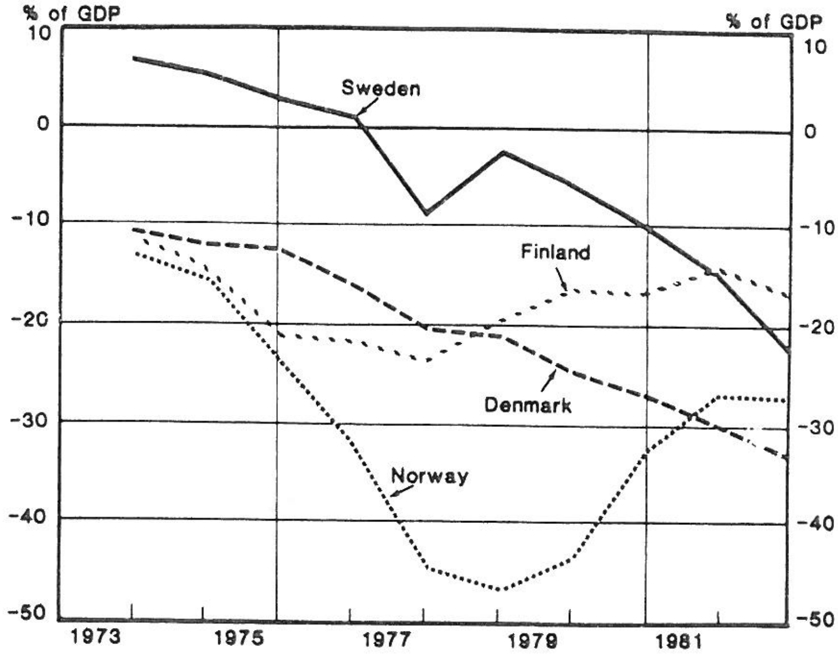
These policies were being carried out by a bourgeois government, but with the agreement of the social democratic opposition. Was it all an unfortunate accident, due to a misunderstanding of how a dynamic industrial economy works? Or does this policy story illustrate the shortcomings of the democratic process in advanced economies when it comes to take really difficult political decisions? Or could it possibly be a clever 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 8) 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 lie ahead. My assessment of the economic situation of Sweden over the past three years or so has been that policy-making is much more difficult than was ever envisioned. The intended welfare effects derived from overly simple models were perhaps realized for several years, especially the growth effects from expansive — and inflationary — demand policies. But no commonly accepted policy models foresaw the possible reversal of these effects due to the disorganization of the price system that followed from inflation and from constant operation at full or excess capacity.[22]

The dynamics of price/quantity interaction has always been a weak spot in economic theory, and the additional consequences for wealth creation of rigid, non-adjusting real structures and disorderly

Figure 8: Net Foreign Assets in Sweden, Norway, Finland and Denmark, 1973-82
In per cent of GDP



Source: *Economic Growth*, p. 39.

price behaviour have so far never been understood or predicted. The emerging evidence is that while income distributions in a cross sectional sense may have been made more even, the effects on the more appropriate welfare distribution, lifetime consumption capacity, are probably insignificant. Indeed they may have reversed this for the worse, through the combined effect of the disorganized price system and the widening spread of wealth distribution caused by taxes.[23] 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, then the game will have been played back at us, and more skilfully, by market forces.

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 preceding 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 increases for most Swedish income earners in the 70s 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 and the efficiency of the investment allocation machinery.[24]

Full employment, as measured conventionally through labour force surveys, was a key variable in Swedish economic policies for decades. For the first time in post-war history it was threatened by the turn of economic events, and in retrospect it appears that the moving force behind this policy shift has been the desire to prevent open unemployment.

But the extreme openness of the Swedish economy makes its internal markets very sensitive to developments in world markets. Emerging imbalances must be corrected sooner or later by explicit policy action or by endigenous responses from the economy. Policy makers are beginning to realize that they have devoted too many resources to extensive welfare programs while neglecting their most vital task in a mixed economy: acting as the guardian of the rules of the market game. Even on the distribution side, their policies seem to be back-firing.

Empirical evidence is telling a very clear story. Sweden's current economic malaise has nothing to do with a lack of potential economic or technical competitiveness on the part of private industry. The problem is entirely political, residing 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 of the economic adjustment problem.[25]

There is only a longer term solution to the Swedish policy problem. It requires 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 losses on the part of income earners working in distressed industries and in the public sector.[26] The transitional problems must be minimized by macro policy management. Skilled policy management is essential for successfully rolling back the welfare agenda, cutting transfers to households and industries, and reducing taxes to allow after-tax incomes to widen significantly.

Most observers today agree that the Swedish economy cannot carry the current welfare burden much longer. A roll-back of welfare would restore incentives and pave the way for a more prosperous society later on. There are, however, two critical questions that are left unanswered: (1) *how long* will the adjustment period be? (2) *who will benefit* in the end?

No one can provide an answer to these questions. This is a prisoner's-dilemma type of problem. The income and benefit distribution will change but most will probably be better off, if rational macro-policy decisions can be taken. I would venture the assessment that the Swedish production system would respond quite speedily to tough adjustment policies of the kind suggested, due to an efficient, sophisticated and well adjusted private manufacturing sector. I do not believe the Swedes have to worry about replicating the British experience of similar policies. The political process, however, is not well designed for difficult policy questions like this.

Nevertheless, rational policy making means a return to the old Swedish industrial policy model. If the political process can achieve that, and can 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. Sweden has had a "lost decade." A significant volume of material output has been lost for good. We may call this loss the costs of a learning experience. Now the Danes are going through the same adjustment process, and Sweden can learn from their experience. If the Swedes, however, cannot make it, then economic and political prospects look dismal.

Notes

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[6] *Economic Growth in a Nordic Perspective* (Stockholm, Helsinki, Copenhagen, Bergen: IUI, ETLA, *et al.*, 1984), p. 14.

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[26] See *Economic Growth*, p. 49.

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