Lecture I

THE RIGORS OF WELFARE

Social Security and Economic Adjustment in Sweden

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Insuring against the uninsurable

The Swedish welfare state – built and successively expanded during half a century – has arrived at a critical stage. Developments during the seventies have left Sweden with a structural balance-of-payment deficit of some 5–6 percent of GNP, a public budget deficit now at 10–12 percent of GNP and mounting fastly, and an inflation currently running at a rate of 10–12 percent. Industrial stagnation and a low level of private investment are combined with a continuing fast expansion of public expenditure – already channelling more than two-thirds of all income through public budgets, half of which as transfers.

Sweden is certainly not alone in showing this kind of stagnation syndrome and in living as it were on borrowed time and borrowed money. We do, however, seem to have unusual trouble in controlling the situation and we already forsee sharply mounting deficits in the next few years and stern prospects for the whole of next decade. Since Sweden also holds the world record when it comes to relative tax levels and welfare expenditures, it provides a natural testcase for the crucial question concerning if and how a highly developed social security system can make the economy more vulnerable to shocks and changes in economic and social conditions. The following discussion will mainly revolve around this question.

To make the question more clear let us first try to define what we mean by a social security system. In a Swedish context one could roughly discern three different types of social policies and programs: Social insurance, social equalization and social protection.

Social insurance, taken in a narrow sense, aims at insuring the individual against various kinds of actuarial risks – i.e. the risk of becoming sick, of having accidents, of begetting children and of becoming old. It can be viewed partly as a pure risk-insurance, partly as a substitute for a perfect credit market, making it possible for the individual to distribute his life-income in proportion to his needs.

Social equalization aims mainly at a redistribution of life-incomes-from rich to poor. Apart from taxes and transfers equalization of educational chances and of job opportunities could be subsummed under this heading. Although much in the focus of political interest, social equalization in this sense is in fact responsible for only a very minor part of all taxes and transfers in Sweden.

Social protection, finally, aims at protecting the individual from having to bear the brunt of changes in economic, social and environmental conditions. It does this not only by preventive measures and stabilization policies, but also, e.g. by guaranteeing in various ways job security and individual income maintenance. While social insurance compensates for the individual *micro-risks*, social protection is concerned with the *macro-risks*, impinging on the whole economy and marking changes in the external environment and in social conditions. It is in this sense an attempt to "insure the individual against the uninsurable", or at least to ease the adjustment and distribute the adjustment costs more fairly.

During the seventies the ambitions of the Swedish social security system were upgraded in all these three directions. More generous health and pension insurance schemes were introduced at a period when the aging of the population became more marked than ever before. New tax legislation in the early seventies led to a sharp rise in the progressiveness of the income tax, bringing the marginal tax rate for a skilled industrial worker up to some 70 percent. A number of new employment laws combined to make labor, once employed, into a fixed cost for the enterprises, while employment concern in the latter part of the decade led to large-scale nationalization and subsidizing of bankrupt industrial concerns and branches. An even greater job and income security and inoculation against market pressures were accorded to those employed in public service production, whose share of the total labor force rose sharply up to and above a third.

How could these social security measures affect macro-economic flexibility and stability?

Social protection means, almost by definition, that by shielding the individual – and by extension the firms and regions- from "the hidden foot of rivaly and adversity" one is also centralizing part of the responsibility for adjustment and adaptation. If firms facing huge losses due to adverse market trends or to inefficient management are bailed out by public subsidies, if virtual guarantees of local and regional employment are extended by the political establishment, if local public services are shielded both from competition and from full cost accounting by state subsidies – then private mobility of labor and capital will suffer and the decentralized incentives for adaptive ventures and efficiency will shrink. The adjustment formerly forced on the individual and on the private firm by changes say in the world markets or in the own population structure must now partly be undertaken by government. In this sense instability in the small used to be a necessary condition for stability in the large. By guaranteeing stability and security on the individual level you are at the same time inflating the stability problem and the adjustment requirements on a central level.

This can be used as a starting-point for interpreting what happened to Swedish macro-policy during the seventies. It could also explain why we are experiencing so much trouble in getting bakc to a balanced growth path. It should perhaps be pointed out that the interpretation does not necessarily reflect a critical evaluation of the Swedish social security system as such. What it does stress is the fact that welfare policy and social protection involves more than handing out benefits. This "popular" side of welfare policy must always be complemented by a willingness to accept responsibility for the politically less palatable task of making forced adjustment to external changes and of substituting some political risk-taking for private. Only by looking simultaneously at both sides of social security can you realistically assess what security you can offer – the limits of welfare – and what form it should take – the organization of welfare.

From collective to individual security

The building of the welfare state and the increasing dominance of social security for households and firms are reflected in the composition of the public budgets – particularly in the shift of emphasis from collective to individual security.

In the old "guardian state" the main task of government was concerned with collective security, minimizing and insuring against the risk of external or internal assaults on society, by defense and foreign policy, and by the judiciary and other control systems of central administration. Besides these expenditures on collective security – what the economists usually call pure collective goods – another major category of expenditure was investments in roads and in other kinds of infra-structure. In economic jargon the investments were concerned with "semi-collective goods", characterized by a high proportion of fixed cost, long economic life span and large returns to scale, which made them natural candidates for tax financing.

With public budgets dominated by these ambitions and kinds of expenditures, flexibility was needed only to adjust to changes in the national security situation and to long term trends in internal migration and urbanization, etc.

Other kinds of risks, whether arising from changes in the economic conditions or from the vicissitudes of families and enterprises, were born by the individual unit directly affected. It was still the individual firm or the individual household that had to do most of the adjusting, not the public budgets.

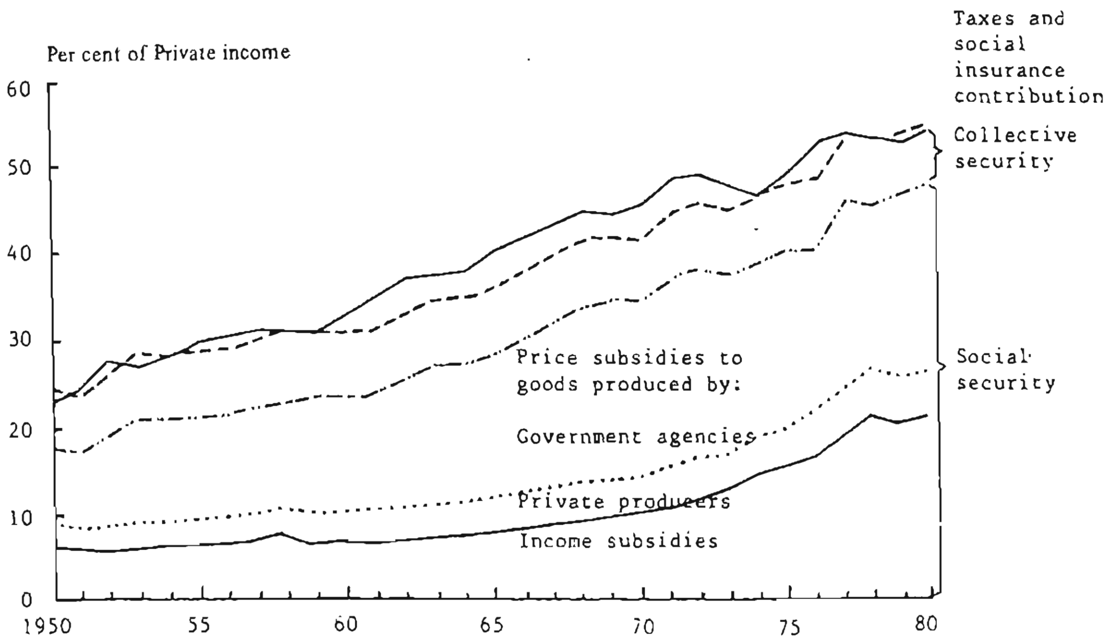
The development over the last half century from the "guardian state" to the "welfare state" has meant a shift of emphasis from collective security to social and individual security. The major and growing part of the public budgets is now aimed at ensuring reasonable standards for the individual household. This fact that much risk-taking has been moved upwards from the individual household – and sometimes also from the individual firm – to government, creates new needs for flexibility in public budgets. Demographic mutations and changes in the economic environment may require drastic changes not only in total public resource use but also in the allocation of resources between different purposes.

How difficult it may be to attain the needed flexibility will i.e. depend on what form has been given the individual standard guarantees. The government can guarantee income by way of transfers to individual households or firms, or it may instead guarantee the availability of certain social services directly by publicly producing the services and distributing them free of charge or heavily subsidized, i. e. as public consumption. Public consumption may for other reasons be a preferred way, but from the point of view of flexibility it certainly has the disadvantage of creating further commitments and adjustment problems for the public budget makers.

Figure 1 shows how the Swedish "welfare strategy" developed during the period 1950–1980 in terms of a simple breakdown of public budgets. All public expenditure of a non-business, non-contractual nature has here been grouped in two main categories: collective security and social security. Under the general heading of collective security all current and investment expenditure for defense and foreign policy, general administration, judiciary system and fire service has been counted. All other expenditures are subsumed under the heading of social security, i. e. are assumed to be mainly concerned with guaranteeing or preserving individual standards.

Social security expenditures have been further broken down into two categories: one is "income subsidies" or direct transfers to households and the remainder is described as "price subsidies". There are, finally, two different kinds of price subsidies.

Figure 1. The Swedish Welfare Strategy – The Use of Taxes 1950–80



Source: Ysander (1979, 1981a).

The major part – called public consumption and related investment in the national accounts – goes to government agencies, producing various types of social services in education, health, social welfare, roads, etc. The rest are subsidies for current or investment expenditures within the private sector, e.g. for housing and food, for public utilities for to ailing industries.

A thick line at the top shows the development of income from taxes and social insurance contributions.[1] All budget items have in the figure been measured as shares of private income.[2]

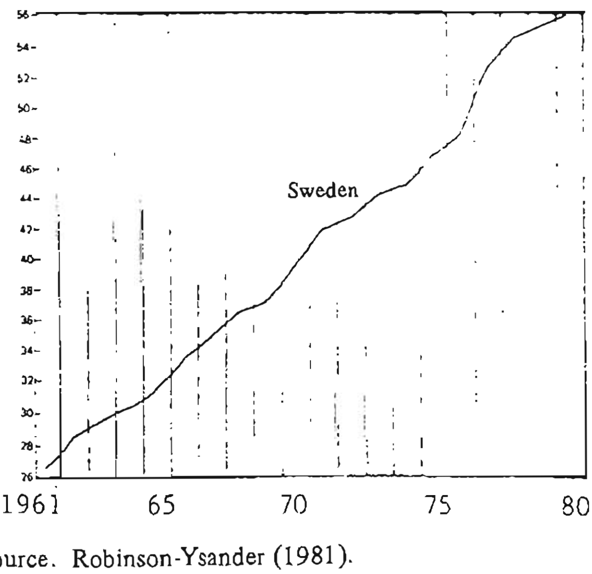
The figure shows a very striking development pattern. The share of income used for collective security has remained more or less constant over the whole period, around 10 per cent. The dramatic expansion of the public budget share has entirely been due to the increase in social security expenditure. This has more than trebled its share during the 30 years. The proportion in social security expenditures of public consumption and related investments as well as of income subsidies has remained fairly unchanged during the period. The share of price subsidies to private producers has expanded at a slower rate than other social security expenditure, in spite of the considerable increase of industrial support measures in late years.

1. The difference between this income and the total expenditure for collective and social security should not be misconstrued as a measure of total budget surplus or deficit. To arrive at a measure of net government financial saving, the surplus or deficit of tax financing, shown in the figure, must be added to the net of government business or contractual transactions, i.e. income from interest on government lending, from operating surpluses, etc., minus the cost of contractual expenditures like interest on government borrowing, etc. Only by then adding to this net financial saving the net of government credit and financial investment transactions do we return to the total budget surplus or deficit, as commonly defined.

2. Private income is here defined as total private factor income less capital depreciation plus income subsidies. It can be viewed as the maximal possible tax-base for an income tax. The use of private income instead of GNP as a common denominator can be justified both by the need to have the measure as invariant as possible for changes in the tax and expenditure structure and by the wish to make possible an interpretation of the shares as "tax burden", "subsidy dependence", etc.

Figure 2. Public Consumption as Percentage of Private Consumption, 1961–80

Current Prices



Source. Robinson-Ysander (1981).

The role played by capital formation in general and infra-structure investment in particular in the Swedish public budget is also diminishing. The GNP share of public capital formation is now less than it used to be 30 years ago.

Compared to other OECD–countries Sweden has tended to rely relatively more on public consumption and less on income subsidies in securing individual standards. The very fast expansion of tax-financed consumption of especially health and educational services is in *figure 2* measured relative to private consumption for the period 1961–80.

The challenges we avoided in the seventies

The viability of the fastly expending welfare system was put to the test during the seventies. In retrospect one can discern several kinds of economic "challenges" that we met with during the decade. At the time we did not fully realize their import or we tried to postpone taking action with the result that they grew into serious structural problems for the eighties. The "challenges" can be discussed under the following three headings: Retarded growth, aging population and world market disturbances.

That we registrated a retarded growth in terms of GNP, relative to the preceeding post-war decades, had many causes.

Increased international competition and adverse price trends in some of our traditional lines of investment goods led to deteriorating terms-of-trade and made a major long-term restructuring of Swedish industry necessary. This was postponed until we were overtaken by acute profitability problems. Since new industrial developments are mainly in the direction of lighter industry-particularly in the field of engineering – the restructuring in itself will contribute to lower registered productivity increase.

An even more decisive cause for retarded GNP-growth in the seventies is the increased employment share of the labor-intensive government services. This share went up from 25 to 35 percent in ten years.

It seems reasonable to assume that the more labor intensive service sectors will always on the average register a lower productivity increase than those prevailing in industry. Given this assumption, even a balanced growth of industrial production and service production will require that successively more people are moved from the industrial sector into the service sectors while the overall rate of productivity increase in the economy will decrease, tending in the long run towards that of the service sector with the least increase in productivity. If we also want to have the consumption of goods and services for each type of household show a balanced growth – not an unnatural norm in a welfare state – then obviously, with an aging population, the shift of labor into service sectors and the decline of the overall productivity increase will be even more rapid, everything else being equal.

The growth of recorded GDP will in fact tend to show an even more marked retardation than that which is actually happening in total domestic production. One reason for this could be a relatively expanding "black and grey" sector of the economy i. e. an increasing share of productive activities that goes unrecorded due to illegal tax evasion or because they are performed within the household and never marketed. Another, and less speculative, reason is the accounting conventions used in national accounting and in our definition of GDP. As long as we treat public consumption by definition as a sector with a zero increase in productivity, any growth of public consumption implies that official figures of GDP will show an exaggerated retardation.

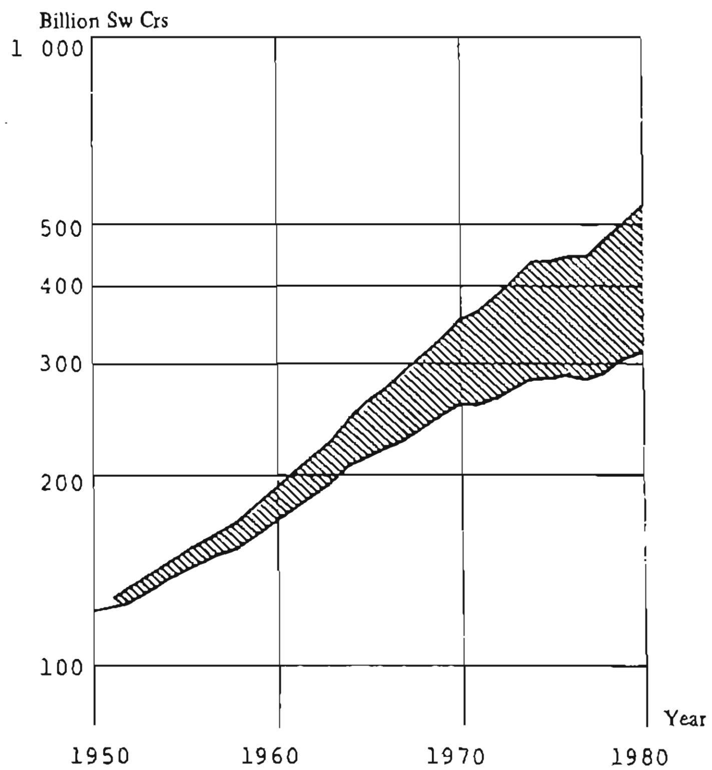
Figure 3 exemplifies this statistical uncertainty as well as the retarded growth. The lower curve shows the actually recorded growth of GDP in Sweden for the period 1950–1980. The upper curve shows how this growth would have been recorded if instead we had used the alternative convention of assuming that the productivity increase in the public sector was the same as that of the private sector.[1] As the figure shows, this alternative assumption would have meant that total production increased five times during the 30 years instead of three times as actually recorded. If we neglect the possibility of an actual decrease in productivity in the public employment it means that we would expect the actual increase of productive capacity to lie somewhere within the shadowed area in the figure. Wherever exactly it lies, it is a reasonable assumption that the retardation of recorded growth of GDP, already noticeable during the first three postwar decades, will continue in the future.

Faced with long-term prospects of retarded growth government has two main options. It may try to expand supply and increase productivity by active investment policies etc. or it can try to adjust consumption increase downwards to the lower growth of supply. During the seventies Swedish policies were not very successful in either direction. Early attempts at a more active and expansive industrial policy were soon swamped by acute structural problems and bailing-out operations, following in the wake of world marked disturbances, and were moreover partly thwarted by a series of regulations and labor market laws increasing social security costs for industry.

Adjusting consumption to available resource growth also proved increasingly difficult, mainly due to the difficulties of raising taxes to keep pace with the welfare service expenditure, which on the average tended to grow twice as fast as GNP during the decade. A steep rise in the progressiveness of the income tax

1. And also that the cost of capital use is the same for the public

Figure 3. Retarded Growth – Swedish GNP 1950–80 under Alternative Assumption



Source: Ysander (1981 a)

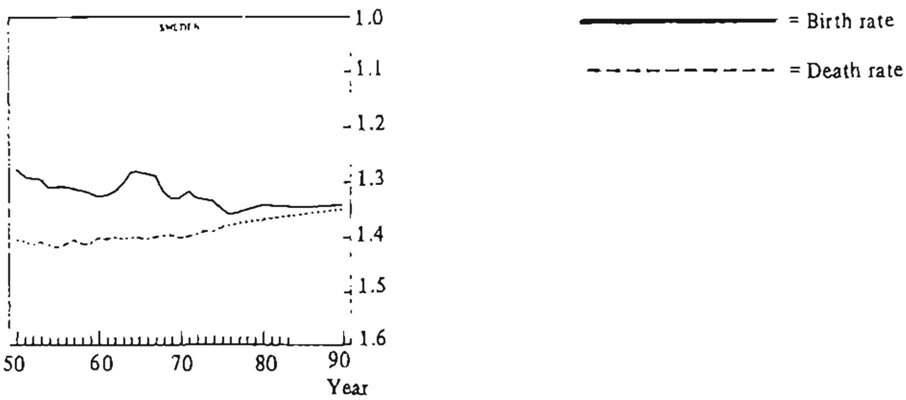
coupled with a doubled inflation rate blew up the distortionary effects of the tax system and made it harder to avoid having tax raises immediately translated into higher inflation rates.

The aging population provided another kind of challenge during the seventies. Swedish demographic developments demonstrate in a rather extreme fashion the trends towards decreasing and aging populations, common to most of the highly developed industrial countries. This shows up already in the birth and death rate development, measured in *figure 4*. The gross reproduction rate in Sweden is now down to 0.82 with a projected annual growth rate of 0.1–0.15 for the whole population up to 2000.

The changes in age structure were more drastic during the seventies than they have been before and they happened faster than they can be expected to do before the turn of the century. The share of children went down markedly, but from the point of view of public expenditure, this was more than offset by an upgrading of obligatory schooling and a rapid increase of nursery demand, due to sharply rising participation rates for women. The number of young adults of working-age or higher education age went up while the share of middle-aged people fell off. Most marked, however, were the fast increase of pensioners and particularly of the age-group above 85. Since half of a persons life-consumption of short-term sick care and 90 percent of his consumption of long-term care is done after retirement age, this increase of eldery people implied a steep rise in health and social welfare demand.

This increased demand was met by a service expansion during the seventies even if the concomitant tax bill was not paid up. What we now in retrospect may have reason to regret is the fact that we tended to be both overly generous and overly rigid in carring through the necessary expansion. We have e.g. now been forced to realize that the promises and prospects then offered to pensioners and parents will have to be considerably slimmed to fit into the tighter budgets of the eighties. We were generous then not only with money but also with labor. Measured conventionally in term of hospital patient-day, nursery child-day or school-day etc. the input of work-hours tended to grow annually during the seventies with more

Figure 4. Birth and Death Rate 1950–90



Source: Robinson-Ysander (1981).

than two percent. Whether we call this quality improvement or productivity decrease it steps up costs. Much of the service expansion were moreover carried out according to rather rigid institutional patterns, which makes it more difficult to shift resources around as required in the future by a changing age-structure.

World market disturbances were undoubtedly the dominant economic challenge during the seventies. These disturbances also contributed in making retarded growth and aging population into more acute problems. Much of our present-day difficulties can be traced back to an insufficient or ill-timed policy adjustment to the world market developments during the middle seventies. The 73' energy crises and the concomitant first upsurge of raw material prices released in Sweden extremely high wage increases, which threatened to price us right out of our major export markets for staple goods. Instead of taking immediate corrective action, we tried to hibernate through the following trade slump by inflating domestic demand in the vain hope that trade trends would soon turn. The result, as evidenced by *figure 5*, was that the cost rise pushed down our world market shares and led to an industrial stagnation, that we are still – many years and currency devaluations later – suffering from.

One way of summarizing the outcome of the challenges and policy responses in the seventies is presented in *figure 6*. The figure shows how the increases in production was used in the three post-war decades. We see, that compared to the preceeding decades, there are several distinctive differences in resource use during the seventies. Domestic capital formation, earlier using up between a third and a fourth of new resources, stagnated. Instead local government consumption – education and welfare services – is increased its share to a third. As a result industrial employment fell off while taxes continued to rise steeply – although not steeply enough to pay for public expenditure. An encreased trade surplus volume was accumulated but was still not big enough to cover the deteriorating terms-of-trade or to avoid a growing balance-of-payment deficit at the end of the decade.

These challenges must be faced in the eighties

We have inherited from the seventies a backlog of accumulated adjustment needs. They concern i.e. adjustment in international payments, in public budgets and in the organizational forms and benefit levels of the welfare system.

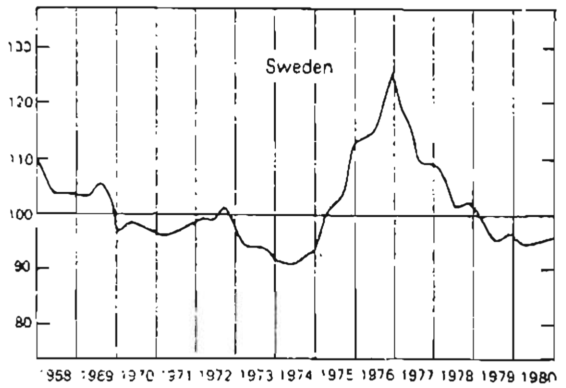
One way to illustrate the scope of our present difficulties is to try to project what it would take to get rid of them over the eighties. One such projection of the Swedish economy over the next twenty years is presented in *Figure 7*. It is based on an econometric model, developed at the Industrial Institute but now also used by the Treasury for medium term planning. It exemplifies the structural changes required to get back to external and public budget balance by 1990. Although based on rather optimistic assumptions as to world trade and domestic productivity developments, it shows how more than half of the retarded growth of resources will have to be devoted to capital formation, partly as investments at home but primarily in the form of increased foreign trade surplus. This implies that even without any increase in real net wages over the decade, the rate of expansion in public consumption must be cut to less than half of its average size during the seventies.

If such a very restrictive policy were consistently carried out simultaneously with an industrial expansion, the foreign debt would reach a maximum of almost one quarter of GNP in 1990, as shown by *figure 8*.

Making up for the adjustments we failed to do in the seventies will, however, not be enough – although that by itself appears a pretty grim task. We must also be ready to face again challenges of a similar kind to those we encountered in the seventies.

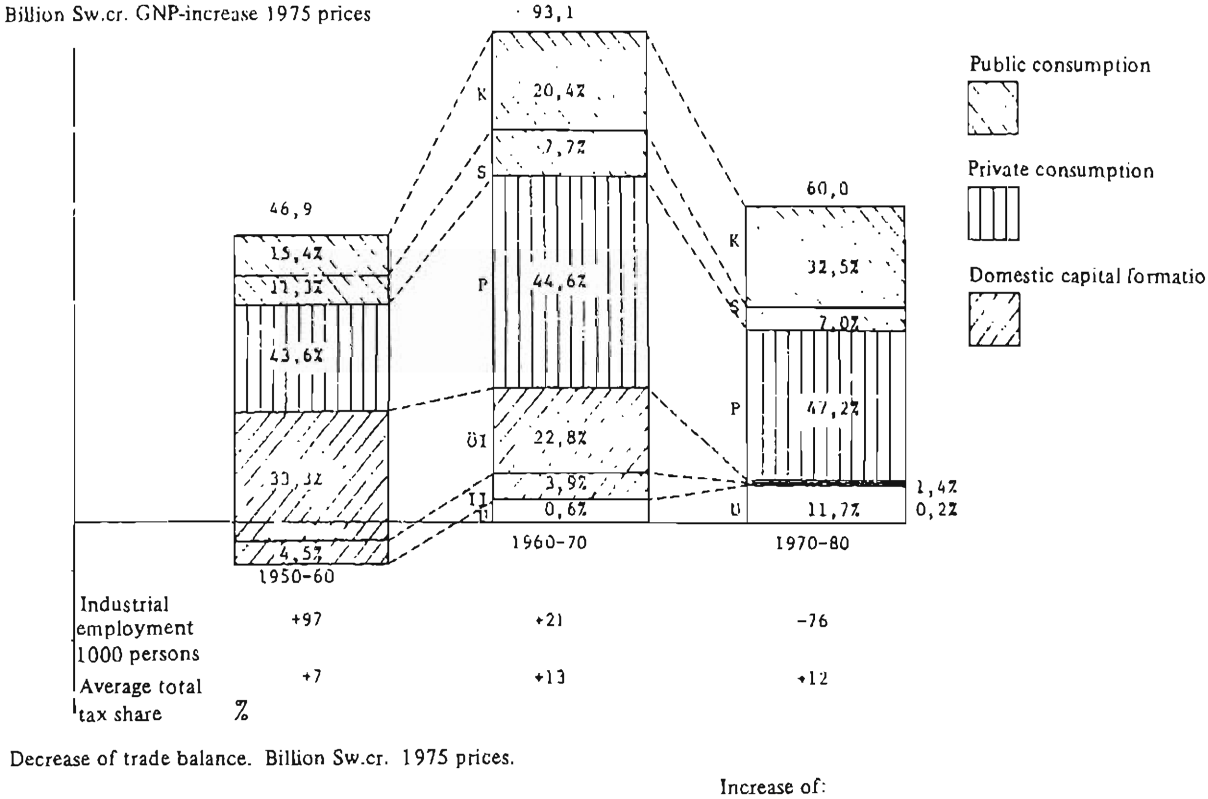
Even without an acute industrial stagnation, retarded GNP-growth will continue

Figure 5. Unit Labor Cost in Manufacturing, 1968–80



Source: Robinson-Ysander (1981).

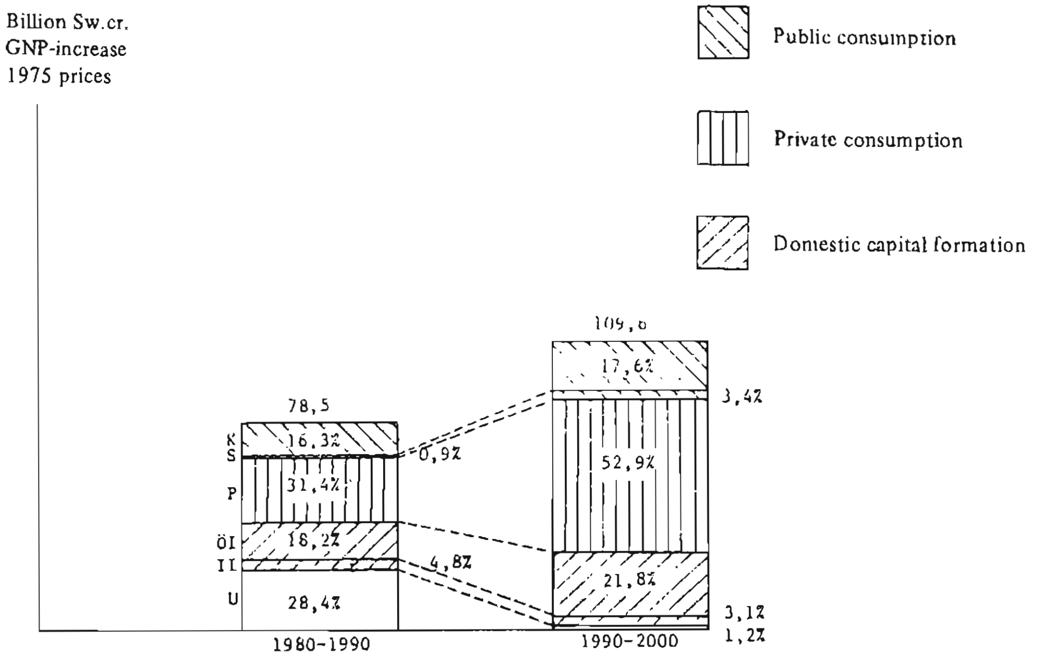
Figure 6. The Use of GNP-increase 1950–60, 1960–70, 1970–80



Source: Ysander (1980).

Increase of:
U = Balance of trade
II = Industrial investment
ÖI = Other investment
P = Private consumption
S = Central government consumption
K = Local government consumption

Figure 7. The Use of GNP-increase 1980–90, 1990–2000



Industrial employment 1000 persons	−35	−136
Average total tax share %	+4	–

Assumptions:
Structural
Change: Productivity change Gross production/hour 80/90 90/1000

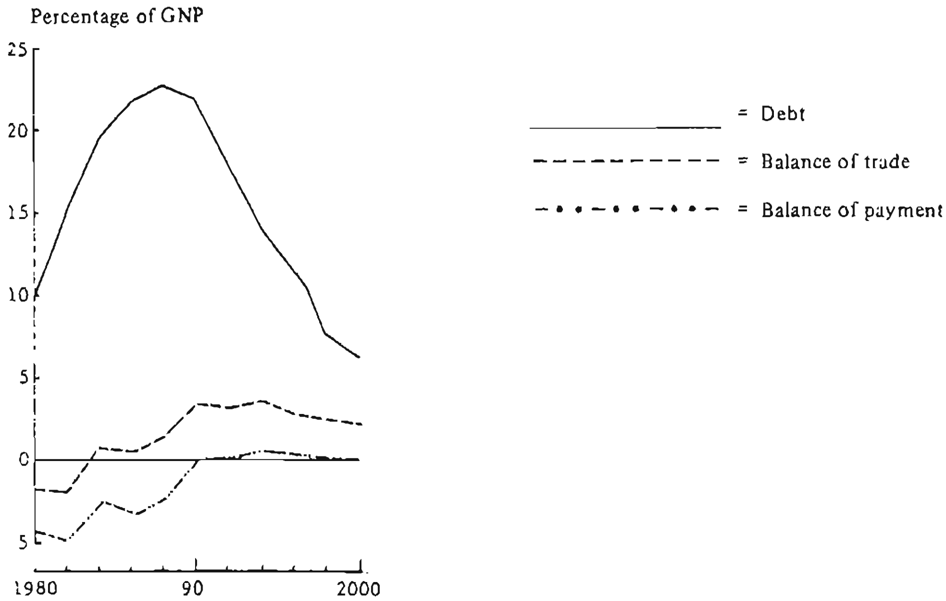
Manufacturing	4,1	4,1
Total private production	3,5	3,4

Balance of payment: 0–1990 and 2000
Real net wages: 1981–90 – unchanged
1991–2000 – 3%annual invrease.

Source: Ysander (1980)

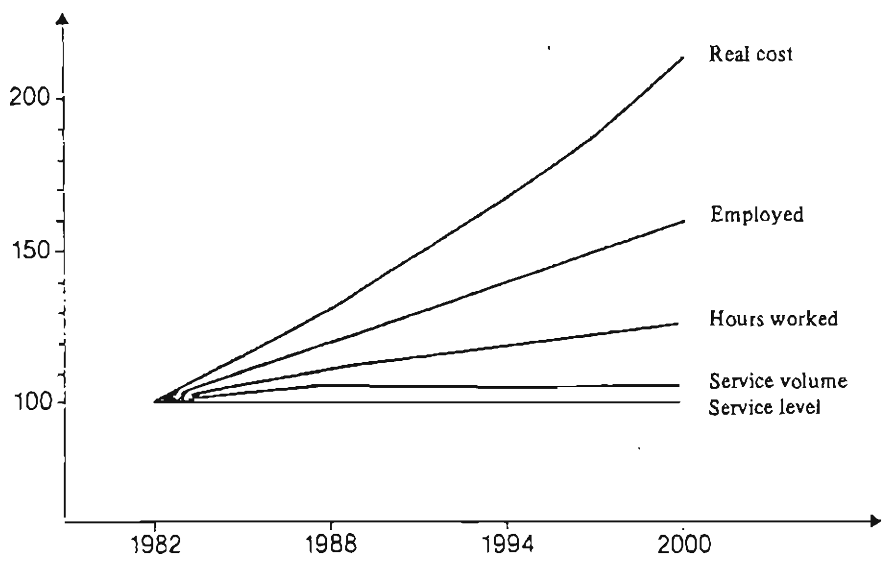
Increase of:
U = Balance of trade
II = Industrial investment
ÖI = Other investment
P = Private consumption
S = Central government consumption
K = Local government consumption

Figure 8. Development of Foreign Debt, Balance of Trade and Payment 1980–2000



Source: Nordström–Ysander (1980)

Figure 9. Projected Development of Cost for Welfare Services at Constant Service Levels



Source: Lagergren (1981)

to require new adjustments in household planning and in public spending habits. Although the changes in population structure will be less marked than during the seventies, reallocation of resources will again be required, something which can probably only be accomplished by radically changing some institutional patterns. The welfare services will also have to become more stingy both with money and labor.

This last point is illustrated by the projection for welfare service costs (health services, nurseries, social welfare services etc.), shown in *figure 9*. The projection is based on the assumption that service levels, in term of days of care per client or age group, are to be kept constant. The aging of the population will imply a certain but limited increase of total service volume. What really makes the cost explode is, however, the expected increase in labor cost, due to more labor-intensive care, successively shortened workday and a wage rise following that of industrial workers. Although the projection assumes a considerable increase in efficiency compared to the seventies, it would, if realized, mean that the share of GNP devote to welfare services went up from 13 to 20, almost eliminating any chance of increased private standards before the turn of the century. In view of these rather frightening prospects there has even been suggestions in the public debate about some kind of obligatory "welfare-draft" to complement the professional welfare workers.

Also in the eighties world market disturbances may require quick and drastic adjustments to avoid sliding anew into stagnation and structural problems.

It has, e. g., been calculated that a rapid – three year – adjustment to an oil price shock of the same magnitude as the one in 1973, would in Sweden require a downward shift of 3 percent of per capita consumption over the three years and an 8 percent cut in real wages during the first years. (Ysander 1981b).

The art of adjusting

We started out above with the contention that improved social security – and particularly what we termed "social protection" – requires increased capability of central adjustment to avoid economic instability. Our brief review of Swedish developments and prospects seem to indicate that the Swedish politicians have not yet learned the art of creating flexibility. So much of our economic problems indeed seem to stem from this lack of flexibility, that one is tempted to say that the present "crises" in the welfare state is not fundamentally economic in the sense that economic remedies are lacking or poorly understood. It is rather a political crises due to ambitions and promises of social security not being sufficiently matched by a political willingness and capability to shoulder the correspondingly increased responsibility for keeping the economy flexible and continually adjusting it to external developments.

There are unfortunately many reasons to assume that the transition of political tasks from collective to social security naturally tends to change the roles and rules of public decision-making in the direction of more rigidity. Compared to the old more hierachial type of government the welfare state can be expected to have interest groups and voter organizations more directly involved in the budgetary process, competing with claims and trying to extract binding commitments. The welfare system will usually also imply both a decentralization of public spending and an increased government involvement in the production of welfare services, both of which will tend to make central adjustment and resource-shifting more difficult.

How then can you counteract these tendencies towards rigidity? The Swedish debate is right now full of suggestions, especially concerning ways to introduce more flexibility into public expenditure. The proposed measures range from privatization and "sunset legislation" to flexible design of government programs, contracts and careers and increased use of pricing and internal competition in government services.

Any radical remodelling of the institutional pattern of the welfare state must, however, rest on an understanding and acceptance both by the voters and by the decision-makers of the need for flexibility as a condition for making the social security system economically viable.

Whether such an acceptance of the "rigors of welfare" can be gained in time and become effective in the present Swedish political environment of nicely balanced blocs – that is perhaps the crucial question for the eighties.

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