EEI BRIEF

No. 2, 2009

Sweden - the Free-Market Powerhouse

by Fabian Wallen

EUROPEAN ENTERPRISE INSTITUTE

Summary

Sweden is one of the most prosperous countries in the world. A century and a half ago, however, living standards in Sweden were comparable to those of Sierra Leone today. A series of early free-market reforms – not least in trade, banking and business regulation – made Sweden one of the fastest-growing economies of the world for decades. The success was reversed in the 1970s, following a massive expansion in government intervention. But during the last two decades, Sweden has once more liberalized, and is again one of Europe's success stories. This EEI BRIEF describes the Swedish recipe for economic and social progress.

Fabian Wallen, Senior Economic Advisor at the Confederation of Swedish Enterprise and Fellow at the European Enterprise Institute

Introduction

Strolling down Avenyn in Gothenburg or Kungsgatan in Stockholm, it is hard to imagine that Sweden some 150 years ago was an extremely poor country. In the end of the 1860's Sweden was struck by three years of extremely bad weather conditions, with harsh winters and dry summers. This had disastrous effects on agricultural production, and since over 70 percent of the population worked in agriculture the economy was thrown into a deep crisis. In 1868 people in London, England, organized a large-scale voluntary collection of funds for the starving population of Sweden.

It is not only its agrarian-based economy that makes Sweden of that time resemble today's poorest countries. Most socio-economic indicators paint the picture of a deeply underdeveloped country. For example, approximately one fifth (17.4 percent) of the children born in the late 1860's would not survive to their first birthday, and the estimated life expectancy at birth was 43 years.

Health indicators for two underdeveloped

	Sweden, 1868	Sierra Leone, 2006
Life expectancy at birth	43	42
Infant mortality rate	17.4	16.5

**The least developed country in the world according to UNDP*

Source: The Human Mortality Database, and Human Development Report 2007/2008, UNDP

This can be compared to the situation in Sierra Leone today, where the infant mortality rate is 16.5 percent and life expectancy 42 years. According to UNDP's Human Development Index, Sierra Leone is estimated to be the world's least developed country.[1] In other words, by today's standards we would refer to Sweden in the late 1860's as a classical case of an underdeveloped country.

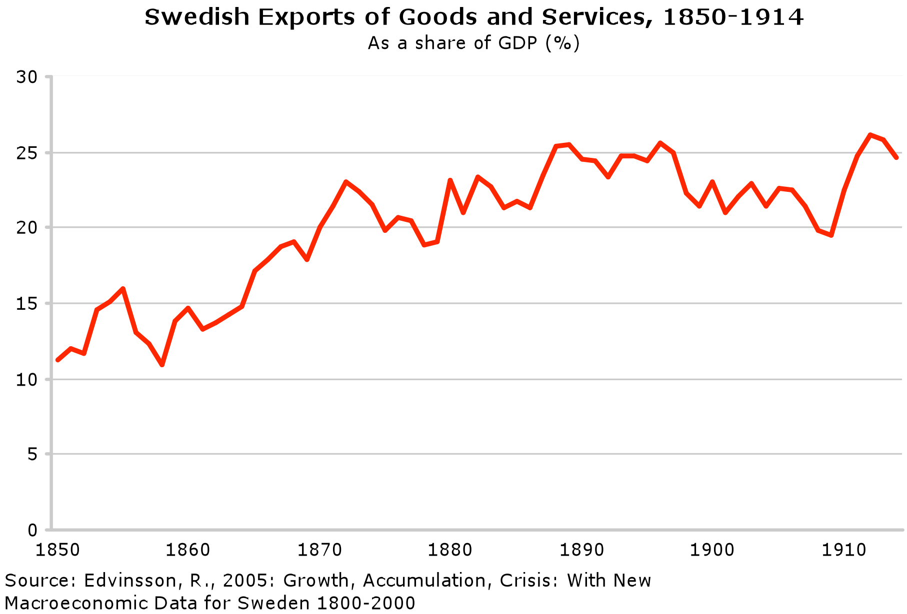
[1] Human Development Report 2007/2008.

Globalization, reforms and Swedish industrialization

Fuelled by the market-friendly policy changes that took place throughout the second half of the 19th century, with radically reduced trade barriers, a deregulated system of enterprise, liberalization of the banking sector, privatization of forestland, and the introduction of free migration, the Swedish economy began to industrialize at a tremendous speed. At the heart of this process was a strong commitment to entrepreneurship, combined with a self-confident attitude towards global competition. Around half of the 50 largest Swedish companies today were actually founded between 1870 and 1914, for instance Atlas Copco (1873), Ericsson (1876), and SKF (1907), just to name a few.

For a small economy, such as Sweden, the rapid industrialization process would not have been feasible without the possibility of Swedish companies to sell their products on the world market. This is especially illustrative looking at the export share of GDP, which increased from roughly 10 percent in the mid 1800's to around 25 percent by the start of World War I.[2] The telecommunications company Ericsson, which was founded in 1876, reached an export share of 90 percent already by 1900.

It is quite difficult to compare the degree of economic freedom for the industrial countries in the late 19th century, but looking at a couple of important indicators we see that the Swedish economy had indeed emerged as one of the most free-market oriented economies in the world. Tariff rates on industrial goods averaged between 3 and 5 percent around 1875, according to a study by the World Bank. Compared to other industrialized countries, tariffs were only lower in the United Kingdom (where they had practically been eliminated).[3]



[2] Edvinsson, R., 2005: Growth, Accumulation, Crisis: With New Macroeconomic Data for Sweden 1800-2000.

[3] World Development Report 1991: The Challenge of Development, World Bank.

Tariff rates in industrial countries, 1875
Manufactures, percent

United Kingdom	0
Sweden	3-5
Netherlands	3-5
Switzerland	4-6
Germany	4-6
Italy	8-10
Belgium	9-10
France	12-15
Austria	15-20
Denmark	15-20
Spain	15-20
United States	40-50
Average	11-14

Source: World Development Report 1991

Contrary to the situation today, where Sweden is considered a high-tax economy, the Swedish economy of the late 19th century was actually something of a tax paradise. According to a World Bank estimate, government expenditure amounted to approximately 6 percent of the gross national product in 1880, which was markedly lower compared to other industrialized countries. As a matter of fact, in 1960 Sweden was still something of a low tax economy compared to most other West European economies.[4]

Tax revenues as a share of gross domestic product, 1880-2007
Percent of GDP*

	France	Germany	Japan	Sweden	UK	USA
1880	15	10	11	6	10	8
1929	19	31	19	8	24	10
1960	34**	31	18	27	28	27
1980	40	36	25	46	35	26
2000	44	37	27	52	37	30
2007	44	36	28***	48	37	28

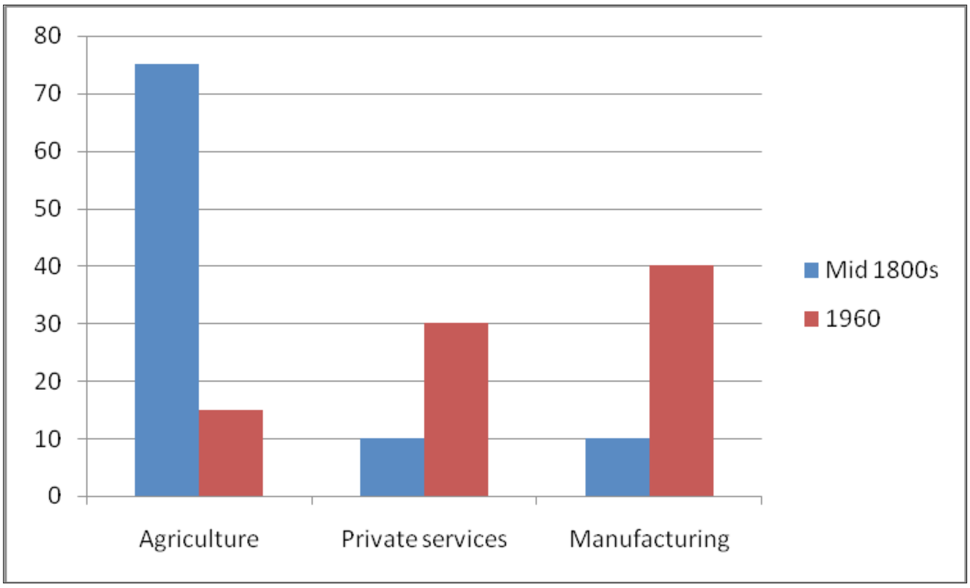
**1880 and 1929 refers to government expenditure share of GNP*
***Refers to 1965*
****Refers to 2006*
Source: World Development Report 1991, and OECD Economic Outlook Database

The market-oriented structure of the Swedish economy – with relatively low taxes, a flexible labour market, and low tariffs on imported goods – resulted in a very high degree of competitiveness for the business community. The dynamic nature of the Swedish economy resulted in dramatic changes on the labour market. Agriculture's share of total employment decreased from around 75 percent in the mid 1800's to around 15 percent in 1960. During the same time period, the share of the labour

[4] Ibid.

force working in the private service sector had increased from around 10 percent to approximately 30 percent, and the share of the labour force working in the industrial sector had increased from around 10 percent to over 40 percent.[5]

Share of total employment in Sweden, percent



Source: Edvinsson, R., 2005: Growth, Accumulation, Crisis: With New Macroeconomic Data for Sweden 1800-2000

Thanks to strong private sector growth, the Swedish economy expanded faster than almost all other economies during this time period. According to the British economist Angus Maddison, the Swedish economy increased by more than 800 percent between 1870 and 1960. Comparing data of GDP per capita between a number of important trading partners, we find that Swedish income levels were markedly lower than those of France and Germany back in 1870, but more than 10 percent higher than the same countries in 1960. The United Kingdom, which had been more than twice as rich as Sweden in 1860, was on par with Sweden in 1960. [6]

Gross Domestic Product per capita, 1870 and 1960
Index Sweden = 100

	France	Germany	Japan	Sweden	UK	USA
1870	113	111	44	100	192	147
1960	87	89	46	100	100	130

Source: The World Economy: Historical Statistics, OECD

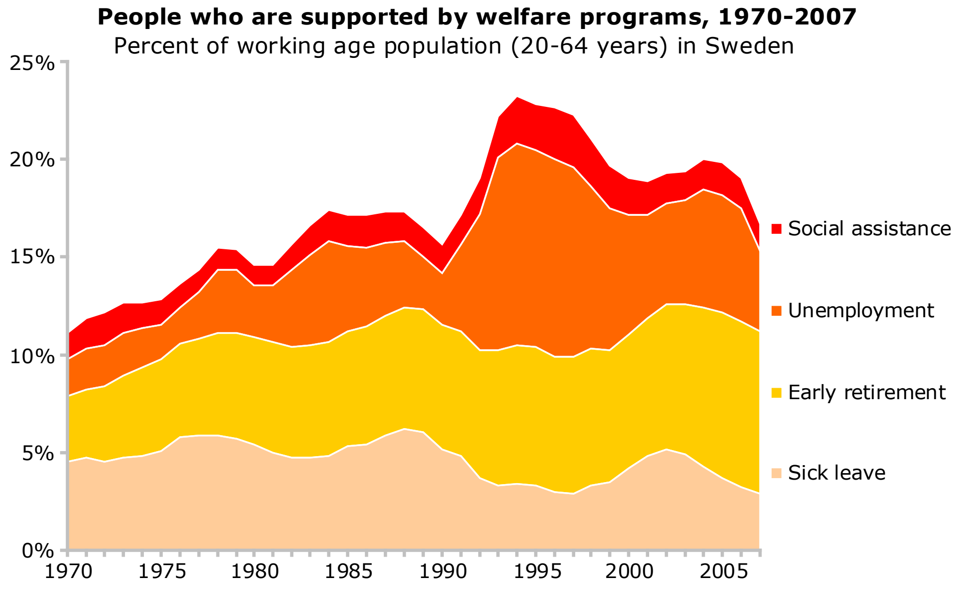
[5] Edvinsson, R., 2005: Growth, Accumulation, Crisis: With New Macroeconomic Data for Sweden 1800-2000.
[6] http://www.ggdc.net/maddison/Historical_Statistics/horizontal-file_09-2008.xls

From having been a poor, agrarian economy in the Northern outskirts of Europe just a couple of generations earlier, Sweden had emerged as one of the richest countries in the world by 1960. The infant mortality rate had been brought down to 1.7 percent, which was only matched by Iceland among all developed countries in the world, and life expectancy had increased to 73 years, which was only matched by Norway and the Netherlands.

The increasing role of the government and loss of competitiveness

Throughout history we are reminded that times of economic difficulties can sometimes open up windows of change in a positive way. Even though the economic recessions are clearly not pleasant times for most people, they sometimes may illuminate the need for growth-enhancing economic reforms. This was to a large degree the case of Sweden in the 1860's. However, the opposite can also be true; i.e. long periods of economic enhancements can sometimes result in a growing demand among politicians and the electorate for reforms that are not very good from a competitiveness perspective. This was exactly what happened in Sweden during the 1960's and 1970's.

The welfare state expanded quickly – both in actual size and in generosity – by the introduction of public monopolies on health care, day care, and care for the elderly people, combined with higher benefits for people on sick-leave and unemployment. Added to this, a number of rigid regulations on the labour market were introduced, such as a halt to labour immigration and strict rules concerning hiring and firing. As an effect of these policies, the Swedish labour market was struck by a nasty combination of high wage inflation and stagnation on the private sector labour market. Whereas just over 10 percent of the working age population had been supported by various welfare programs in 1970, the share had increased to well over 20 percent by the mid 1990's. During the same period the share of the labour force being employed by the public sector increased to over 30 percent.



Source: 1970-1998 Commission of Inquiry on Social Insurance (2006), 1999-2007 Statistics Sweden

Due to the significantly increasing role of the government in the economic sphere, tax revenues as a share of GDP increased from less than 30 percent in 1960 to over 50 percent just a couple of decades later. Needless to say, the competitiveness of the Swedish economy was seriously weakened by the increasing tax shares and labour costs. Having been the fourth richest economy among the OECD economies as late as in the early 1970's, Sweden eventually lost positions and became something of a mid-income OECD economy.

During the 1990's and 2000's, a series of important economic reforms were introduced in Sweden. The central bank gained independence, a number of key product and service markets were liberalized (such as the markets for electricity, gas, railways, airlines, TV, etc.), a system of school vouchers was introduced, Sweden joined the European Union, the pension system and the budgetary system were reformed.

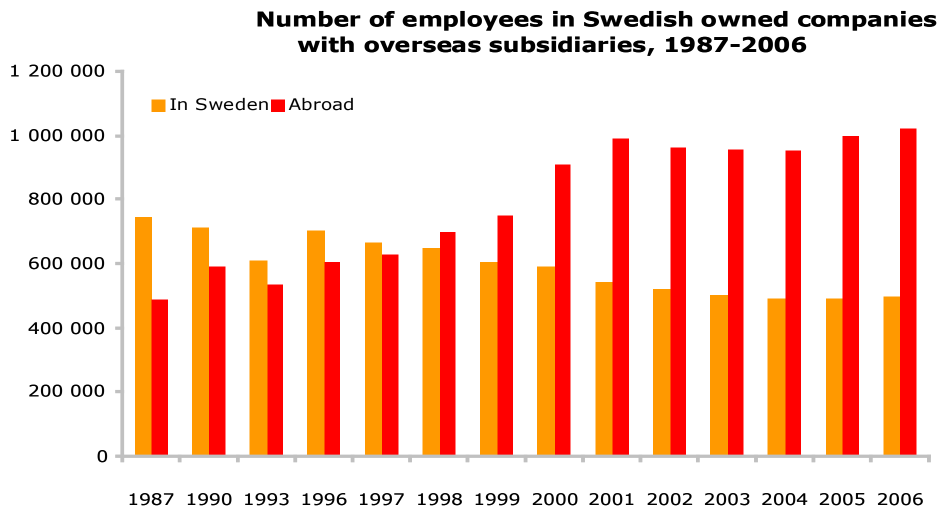
Furthermore, the present government has privatized a number of public companies (for instance the manufacturer of Absolut Vodka), abolished the wealth tax, reduced unemployment benefits, and lowered taxes on labour. These free-market reforms have resulted in a somewhat stronger economic growth during the past decade compared to many other OECD economies. And the share of the working-age population being supported by various welfare programs has been reduced from 23 percent in the mid 1990's to around 17 percent today, which is still too high.

GDP per head, current PPPs

1970	1990	1997	2007
1 Switzerland	**1** Luxembourg	**1** Luxembourg	**1** Luxembourg
2 Luxembourg	**2** Switzerland	**2** United States	**2** Norway
3 United States	**3** United States	**3** Switzerland	**3** United States
4 Sweden	**4** Iceland	**4** Norway	**4** Ireland
5 Australia	**5** Canada	**5** Iceland	**5** Switzerland
6 Canada	**6** Austria	**6** Denmark	**6** Netherlands
7 Denmark	***7 Sweden***	**7** Austria	**7** Canada
8 New Zealand	**8** Japan	**8** Canada	**8** Australia
9 Netherlands	**9** Belgium	**9** Japan	**9** Austria
10 Belgium	**10** Denmark	**10** Netherlands	***10 Sweden***
11 Austria	**11** Germany	**11** Belgium	**11** Denmark
12 Germany	**12** Norway	**12** Germany	12 Iceland
13 Iceland	**13** Finland	13 Australia	13 United Kingdom
14 France	**14** Netherlands	***14 Sweden***	14 Belgium
15 United Kingdom	**15** Italy	**15** Italy	**15** Finland
16 Italy	**16** France	**16** United Kingdom	**16** Germany
17 Finland	**17** Australia	**17** Ireland	**17** Japan
18 Japan	**18** United Kingdom	**18** France	**18** France
19 Norway	**19** New Zealand	**19** Finland	**19** Spain
20 Greece	**20** Spain	**20** New Zealand	**20** Italy

Source: OECD

Nevertheless, the external circumstances have changed during the past 15-20 years. Most importantly, a number of countries in Central- and Eastern Europe and Asia have made a swift transformation from centrally planned economies to highly competitive market economies. In most of these countries taxes are much lower than in Sweden, labour markets are much more flexible, and labour costs much lower. As a result, Swedish companies are to an increasing extent relocating production abroad, either indirectly through growing imports of input goods or directly through heavy investments abroad. During the past twenty years, the number of people employed in Swedish-owned multinational companies abroad has increased from less than half a million to over one million. Simultaneously, the number of people employed within the same companies in Sweden has decreased from around 750 000 to less than half a million.



Source: The Swedish Institute for Growth Policy Studies (ITPS)

Concluding Remarks

In light of these changes, it is of utmost importance that the Swedish reform process is not being put to a halt. Welfare benefits must be further reduced in order to strengthen the incentives to work. Taxes must be brought down and flattened in order to stimulate work efforts and education. The labour market must be liberalized in order to reinforce dynamism and flexibility. And the welfare sector, which is currently heavily monopolized by the public sector, must be opened up for private entrepreneurs. A more general theme for the reform strategy ought to be to make the welfare state more heterogeneous and selective rather than homogenous and universal.

With the world economy currently struggling with a financial crisis, the Swedish economy is standing at a crossroads. The choice of not continuing on the successful path of reforms could result in a vicious circle, with decreasing employment and an increasing share of the population being supported by welfare programs, and as a consequence increasing tax shares and a further loss of competitiveness. The choice of embracing free-market reforms such as the ones described above, on the other hand, would most likely result in a virtuous circle, with incomes and living standards increasing steadily, employment growing dynamically, and, as a consequence, great opportunities for further tax cuts. Looking at Sweden's path from underdevelopment to modernization, it should not be a difficult choice to make.

The positive experience of free-market reforms in Sweden could serve as an inspiring guide to other European economies. Many countries, not least within the European Union, are currently struggling with stagnating growth, high unemployment, and rigid state monopolies. At the same time, the negative experience of labour market regulations, increasing tax rates and a rapidly increasing public sector in Sweden could equally serve as an example for other European countries of what not to do. Strong long-term economic growth, sustainable employment growth, and improving living standards are ultimately a result of a dynamic, profitable and competitive private sector.

EUROPEAN ENTERPRISE INSTITUTE

EEI BRIEF is a publications series with quick facts and arguments on hot topics. Editor is Johnny Munkhammar.