

Nima Sanandaji

# The Swedish Model Reassessed

AFFLUENCE DESPITE THE WELFARE STATE



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## About the Author

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Nima has previously published six books, covering subjects such as entrepreneurship, women's career opportunities, and innovation within the IT sector. One of these books, as well as several published reports, focuses on Swedish integration policies and entrepreneurship within immigrant groups in Sweden. Nima has also written a number of articles for Swedish newspapers, such as Aftonbladet, Expressen, and Veckans Affärer, and international publications, such as The Wall Street Journal.

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## Preface

In *The Swedish Model Reassessed*, Nima Sanandaji offers a novel historical perspective on the development of the Swedish economy. Contrary to the commonly-held view, he believes the success of Swedish society is not due to the welfare state. Rather, it is a Johnny-come-lately: expansion of public welfare started only around 1970. By 1985, taxes exceeded 50% of GDP, and by the mid 1990's Sweden had dropped from one of the top positions to a mid-level rank in terms of wealth and economic growth.

Sanandaji's key insight is the primacy of the prevailing values. Honesty, frugality, and thrift were part of Swedish culture even before the Reformation, which institutionalized basic virtues. This moral capital, arduously built up over centuries, has sustained Sweden (and the other Nordic countries) through many vicissitudes and supported entrepreneurship, inventiveness, and economic growth. It also brought Swedish emigrants in the United States well above average financial benefits.

The welfare state depends on high taxation, which is made possible by the presence of moral capital. Yet the bureaucratic welfare structure is inexorably eroding the very moral resources which make it feasible. In due course, economic decline is inevitable. This has become apparent in Sweden, and contributed to a political swing after decades of social democratic rule. The new right-of-center administration has already made an appreciable difference.

The present treatise should inspire a closer examination of the long-term interaction between values and economic success. Comparisons between different countries and regions would be illuminating. To measure morality will no doubt be methodologically difficult. Nevertheless, the revelation of the cause and effect mechanisms would be well worth the effort. Democracy itself is built on the basis of morality.

Helsinki, 8 September, 2011

Gustav von Hertzen

Chairman

Libera Foundation



## Introduction

Sweden is often regarded as a country whose policies should be emulated by those in other nations wishing to expand the size of their governments. The reason is that Sweden combines a large public sector with many attractive features, such as low crime rates, high life expectancy, and a high degree of social cohesion.

However, as this report argues, the success of Swedish society is not due to the welfare state, as is often assumed. Rather, it is the result of cultural and demographic factors, as well as a favourable business environment throughout most of Sweden's modern history.

The evidence for this hypothesis comes from three sources. Firstly, Sweden showed even higher rates of growth and had a model society well before the start of the Social Democratic era in 1936.

Secondly, descendants of Swedes who migrated to the United States in the nineteenth century are also today characterized by favourable social outcomes, such as a low poverty rate and high employment, despite not being supervised by a caring welfare state in the US. This indicates that cultural factors such as the Lutheran work ethic have played, and continue to play, an important role in the success of Swedish society.

Thirdly, starting in the 1990s, Sweden has dramatically scaled back the size and scope of government, which was followed by a recovery of the earlier strong growth rate. The period characterized by the most extensive welfare state policies, around 1970–1995, is associated with low growth rates. It is true that Sweden maintains a high standard of living, despite steep taxes, but at the same time, it is wrong to assume that this proves high taxes do not affect the economy.

Affluent Sweden could have been even more affluent with lower tax rates. The combination of high taxes, generous government benefits and a rigid labor market has led to dependency on government handouts among a large sub-section of the population, and has limited the ability of Swedish society to integrate immigrants into the labor market.

Sweden compensates for its tax policy by employing market-friendly reforms in other areas, such as trade openness, personal retirement accounts and choice of schools. Societies can prosper for many different reasons. Undeniably, the success of Swedish society hinges on the free market policies to which the nation is again returning.



## Free market success story

The Swedish economic experience is rarely mentioned as an example of the power of free markets. Yet few other nations demonstrate as clearly the phenomenal economic growth that comes from adopting free-market economic policies. Sweden was an impoverished nation before the 1870s, indicated by massive emigration to the United States around that time. As a capitalist system evolved out of the agrarian society, the country grew richer.

Property rights, free markets, and the rule of law, in combination with large numbers of well-educated engineers and entrepreneurs, created an environment in which Sweden enjoyed an unprecedented period of sustained and rapid economic development. In the hundred years following the market liberalization of the late 19th century, Sweden experienced phenomenal economic development.<sup>1</sup>

Famous Swedish companies like IKEA, Volvo, Tetra Pak, and Alfa Laval were all founded during this period, and were helped by business-friendly economic reforms and low taxes.

An illustration of the vitality of the Swedish free-market model is how well the nation dealt with the Great Depression.

As a trade-dependent nation, Sweden was not only hurt by the global economic depression, but also by the trade barriers other nations put up in a misguided effort to protect their economies from the downturn. From 1930 to 1933, the number of job opportunities available in Sweden decreased by 170 000, a figure which indicates that one sixteenth of all jobs in the economy were lost.<sup>2</sup>

The crisis could have been severe, especially since it occurred at the same time as many young Swedes were entering the labor force. But the Great Depression was short-lived in Sweden. Job creation occurred rapidly in the economy, characterized by free labor markets and low taxes.

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1 Maddison (1982).

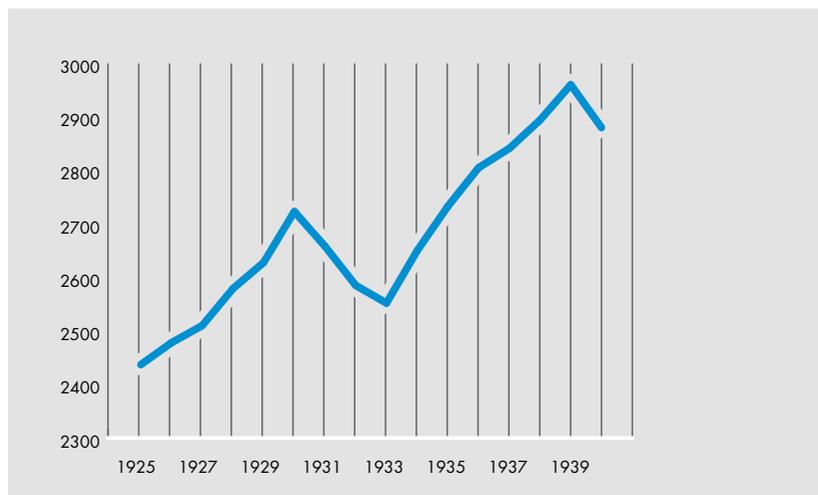
2 Krantz (1997).

As shown in Figure 1, more Swedes were working in 1935 than before the crisis.<sup>3</sup> The reason is that new, innovative businesses were created that replaced many of the jobs that were lost. The economic downturn spurred a structural transition from farming to industry in Sweden. During the crisis years, Nohab Flight engines, today known as Volvo Aero, was born. Shortly after the crisis, Securitas and SAAB were founded.

A new method for creating paper mass was invented, leading to the creation of Sunds Defibrator, today known as Metso Paper – a leading developer of paper industry equipment throughout the world. The successful food company Dafgård was also founded in the 1930s. Yet today, close to a century later, Sweden still relies heavily on many businesses started during or shortly after the Great Depression.<sup>4</sup>

**Figure 1.**  
**Employment in Sweden (thousands)**  
**before and after the Great Depression**

Source: Krantz (1997)



<sup>3</sup> Ibid.

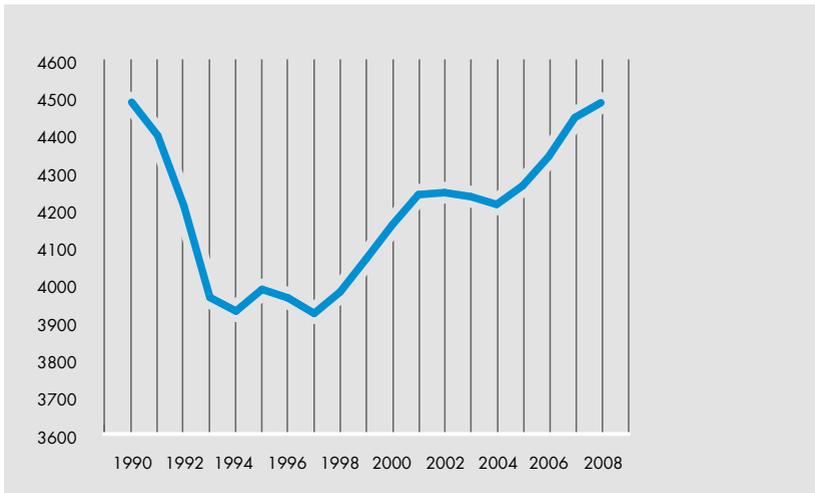
<sup>4</sup> See for example Johnson (2006).

The beginning of the 1990s saw a new crisis hit the Swedish economy. In a time when unemployment was falling in many other countries, it rapidly rose in Sweden. Employment fell by twelve percent between 1990 and 1993. Soon Sweden followed the global trend of strong economic growth. But rates of employment rose only very slowly. In fact, it took until 2008 until it had reached the level it was at before the early 90s – ironically, the same year that a new recession hit Sweden and the world.<sup>5</sup>

Why was the recovery so much slower in the 1990s, compared to the 1930s? As will be discussed in more detail later in this paper, the explanation lies in the policy shift in Sweden at the same time, which brought higher taxes and a rigid labor market that crowded out private sector job creation.

**Figure 2.**  
**Employment in Sweden (thousands)**  
**before and after the 1990s crisis**

Source: Statistics Sweden (2009)



## Capitalism without capitalists

Sweden was a wealthy and entrepreneurial nation in the mid-twentieth century. However, during the late 1960s, policies steered sharply to the left. Not only did the overall tax burden rise (as is discussed further in this report), but the system also discriminated heavily against individuals who owned businesses.

The Swedish economist Magnus Henrekson has shown that the effective marginal tax rate (marginal tax plus the effect of inflation) that was levied on Swedish businesses could be more than 100 percent of the profits. For example, in 1980 a private person who owned a business could pay an effective marginal tax of 137 percent.

However, if the business was financed by debt, the tax rate dropped to 58 percent, since the effect of inflation was reversed, and the business could make deductions from the high taxes. The situation was very much different for government owners such as public pension funds, which did not pay taxes, but could make deductions. A public pension fund that invested borrowed money faced an effective marginal tax rate that was minus 83 percent.<sup>6</sup>

Thus, whilst a private, individual owner, who invested her or his own money, actually lost money by making a profit, in effect, the system almost doubled the profits of firms owned by government pension funds. Henrekson drew the conclusion that the tax policies “developed according to the vision of a market economy without individual capitalists and entrepreneurs”.<sup>7</sup>

The sharp left turn in Swedish economic policy did indeed affect entrepreneurship. Sten Axelsson, another Swedish economist, showed that the period between the end of the 19th century and the beginning of the First World War was a golden age for the founding of successful entrepreneurial firms in Sweden.

In 2004, 38 of the 100 businesses with the highest revenues in Sweden were entrepreneurial.<sup>8</sup> A full 21 of these firms, a clear majority, were founded before 1913. Additionally, 15 were founded between 1914 and 1970.

After 1970, the establishment of new firms dropped significantly. Among the 100 firms with the highest revenues in 2004, only two were entrepreneurial firms founded after 1970. If the 100 largest firms are instead ranked according to how

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6 Henrekson (2007). Calculations based on a real profit of 10 percent.

7 Ibid.

8 “Entrepreneurial” is defined as firms that were started from a privately-owned business in Sweden.

**Table 1.**  
**Effective marginal taxes**  
**(including inflation) in Sweden in 1980**

Calculations based on a real profit of 10 percent. Source: Henrekson (2007).

Owner	Debt financed	New mission	Reinvestment
Households (private owners)	58	137	52
Tax exempt owners (such as public pension funds)	-83	-12	11
Insurance companies	-55	38	29

many they employ, the figures change. In that case, none of the largest firms were entrepreneurial and founded after 1970.<sup>9</sup>

How can this dramatic drop in entrepreneurship be explained? Why is Sweden so heavily dependent on firms that in some instances were formed more than one hundred years ago? One reason might be that it takes time for firms to grow large; another, that large firms played a more vital part in the economy in previous times.

These factors alone cannot explain the massive fall in the number of new entrepreneurial firms in Sweden. Clearly, one important factor is the radicalization of Swedish policies to the left, which impaired the development of the private sector. The policy of “capitalism without capitalists” has, coupled with regulation of the labor market and a massive expansion of taxation and the public sector, crowded out private sector job growth in Sweden.

Between 1950 and 2005, the Swedish population grew from seven to nine million, but the net job creation in the private sector was zero. Jobs in the public sector expanded heavily until the end of the 1970s. As it became difficult to further expand the already large public sector, job creation simply stopped.<sup>10</sup>

The inability of the highly-taxed Swedish economy to create new jobs after the 1990s crisis, as mentioned previously in this discussion, is thus closely related to changing policies in Sweden. The move towards higher taxation has also limited economic development in Sweden.

<sup>9</sup> Axelsson (2006).

<sup>10</sup> Bjuggren and Johansson (2009).

## The (hidden) rise in taxation

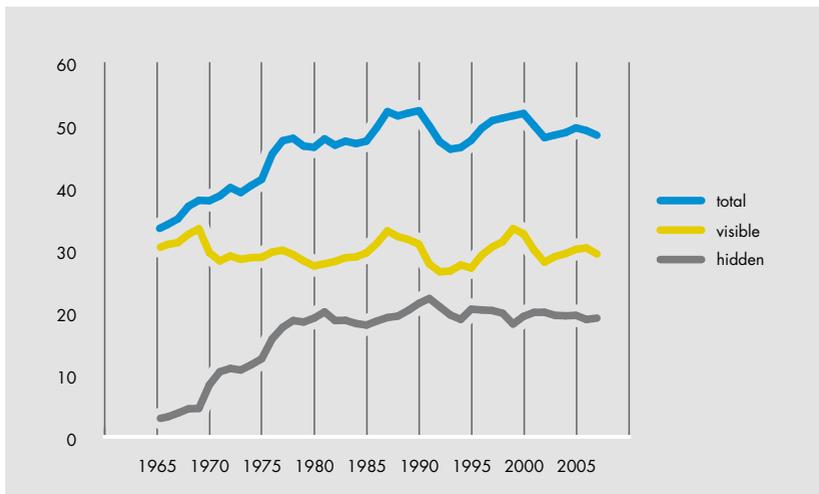
In 1950, the Swedish tax revenues were around 21 percent of GDP. In the next thirty years, taxes increased by almost one percent of GDP annually.<sup>11</sup> How was this massive increase in taxation possible?

One explanation is that many Swedes supported the policies of the leading Social Democratic party, which held power in government over much of the twentieth century. Another possible explanation is that the rise in taxation was effectively hidden from the public.

As the Italian economist Amilcare Puviani predicted in 1903, and Nobel laureate James Buchanan discussed further, it is easier for politicians to raise hidden, indirect taxes rather than visible taxes.<sup>12</sup> Changes in Swedish taxation strongly support this hypothesis. In Figure 3, it is shown that the entire rise in taxes since 1965 can be attributed to the introduction and gradual increase of an indirect sales tax (VAT) and the slow but steady rise of the indirect employer's fees.

**Figure 3.**  
**Hidden and visible taxes in Sweden (percentage of GDP)**

Source OECD.



<sup>11</sup> Ekonomifakta

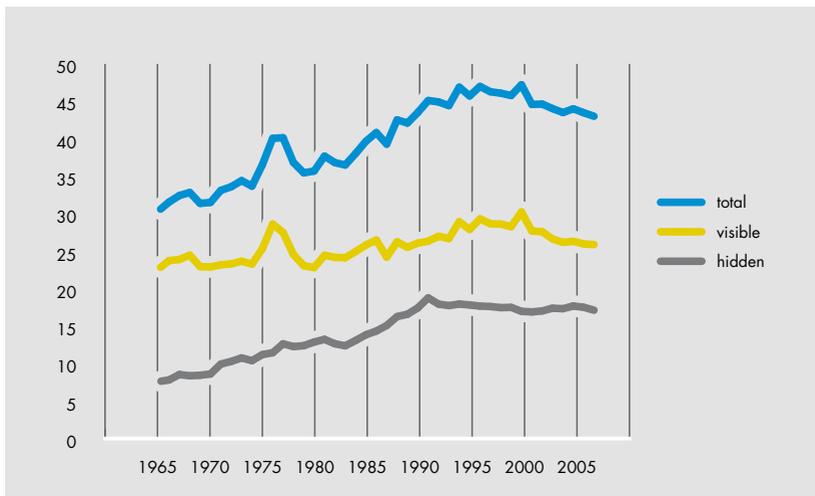
<sup>12</sup> Cited by Baker (1983); Buchanan (1960).

Without this rise in hidden taxation, taxes in Sweden would have remained at around 30 percent of GDP. The reason is that Swedish politicians have not increased visible taxes, since such a rise would probably have been opposed by voters. As will be explained later in this paper, Swedish taxes have lowered significantly during the past few years. One explanation for why they have not decreased even more might be that the total tax burden remains hidden. For example, in a survey conducted in 2003, the Swedish public was asked to estimate the total amount of taxes they paid.

Almost half of the respondents estimated that the total taxes they paid amounted to around 30–35 percent of their income. At the time of the survey, the real tax rate levied on an average income earner (including consumption taxes) was 63 percent.<sup>13</sup> Other more recent studies lend support to the idea that many Swedes are unaware of how much hidden taxes are levied on their incomes.<sup>14</sup>

**Figure 4.**  
**Hidden and visible taxes in Finland (percentage of GDP)**

Source OECD.



13 Sanandaji and Wallace (2004).

14 For example, Larsson (2009).

It should be noted that this rise in hidden taxation is not unique to Sweden. In Figure 4, the total, hidden, and visible taxes in Finland are shown as a percentage of GDP. Just like in Sweden, the rise in total taxation since 1965 is explained almost fully by the rise of hidden taxes. However, the overall level of taxation remains lower in Finland. It has also, as in Sweden, fallen in recent years.

Although many taxes remain hidden in Sweden, they do impact the economy. By hindering entrepreneurship and private sector job growth, the expansion of taxes and public spending lead to slow economic growth in Sweden. As recently as 1975, Sweden was ranked as the fourth-richest nation in the world.

However, rising taxes and an increase in government involvement in the economy led to a slower growth rate. Therefore, Sweden dropped to around the 13th/14th place in the ranking of the richest nations in the mid-1990s.<sup>15</sup> Between 1870 and 1936, the start of the Social Democratic Era, Sweden had the highest growth rate in the industrialized world. Between 1936 and 2008, the growth rate was only ranked number 18 out of 28 industrialized nations.<sup>16</sup>

The growth rate was particularly low in the period from 1970 to 1995, when the development and influence of the welfare state was at its strongest. Swedish growth rates have improved between 1995 and the present, in part because of recovery from the mid-1990s crisis, and arguably in part due to reduced taxes and extensive pro-market reforms.<sup>17</sup>

Those who believe that the high taxes in Sweden are not damaging to the economy should read a new study published by the European Central Bank. This report finds that Sweden is on the tip of the Laffer curve when it comes to average taxes on incomes. This means that increasing taxes on labor would have such a damaging effect on the economy that not even tax revenues are expected to increase.

For capital taxation, Sweden is on the wrong side of the Laffer curve. This means that capital taxes are so damaging that reducing them by only one Swedish krona would stimulate the economy so that more than one krona in additional taxation could be levied (at a lower tax level).<sup>18</sup>

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15 Ekonomifakta

16 Maddison (2010).

17 Ibid.

18 Trabandt and Uhlig (2010).

Several studies from Sweden support the idea that the nation is at, or close to, the tip of the Laffer curve.<sup>19</sup> For instance, one study showed that for each additional Swedish krona levied and spent by the government, the effective loss in the private sector can be up to 3 additional kronor.<sup>20</sup>

Although it is a popular belief that high taxes have not impaired economic development in Sweden, they have been shown by research publications to be so damaging that they even prevent their own intention of increasing public revenue. Besides affecting the level of entrepreneurship and crowding out private sector job creation, the big government policies have also affected the famous Swedish working norms.

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<sup>19</sup> See for example Holmlund and Söderström (2007); Pirttilä and Selin (2011).  
<sup>20</sup> Hansson (2009).

## The work ethic and dependence on government benefits

How was it possible for Sweden to experience such phenomenal growth after the introduction of a free market economic model? One explanation is that Sweden had an abundance of natural resources; another is that the nation was not directly involved in either of the World Wars, which tore up other industrialized nations in Europe.

One should, however, also look at the institutional frameworks in Sweden, especially the culture related to work and entrepreneurship. Before the introduction of property rights and free enterprise, Sweden was a poor nation, but still gifted, with a strong Protestant work ethic.

For a long time, the religious, cultural, and economic systems in Sweden fostered strong norms related to work and responsibility.<sup>21</sup> These norms were important for the success of the Swedish free market system. Socialist politicians also saw them, coupled with the fact that Sweden was a uniquely homogeneous society, as the optimal starting point for an expanding welfare state.

Since the norms relating to work and responsibility were so hard, Swedish citizens did not usually try to avoid taxes or misuse generous public support systems. Also, the “one-solution-fits-all” systems of the welfare state are typically less disruptive in a strongly homogeneous social environment, since most of the population has similar norms, preferences, and income levels.<sup>22</sup>

Thus, these strong social norms opened the way for a massive expansion of government. But as Swedes became accustomed to a system of high taxes and generous government benefits, the norms gradually declined. In the World Value Survey of 1981–84, almost 82 percent of Swedes responded that “claiming government benefits to which you are not entitled is never justifiable”. Sweden was still a nation with very strong morals related to public benefits.

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21 Ibid.

22 For example, it is difficult to introduce a system of social security that is generous to the middle class if the income level varies significantly between the middle class and those with the lowest incomes. If the benefit level is high enough to be generous to middle class individuals, it might be above what those with low incomes can earn, due to their lower productivity. In a homogeneous system, with less initial spread of income to begin with, a system can be designed that, to a large degree, feels generous to the middle class, whilst not reducing the incentives of low income earners as much as it would in a heterogeneous society.

As the population adjusted their norms to the higher tax regime, the number who held this view dropped steadily in further surveys. In the survey of 1999–2004, only 55 percent of Swedish respondents believed that it was never right to claim benefits to which they were not entitled.<sup>23</sup>

**Table 2.**  
**Benefit morale in Sweden**

1981–1984	1989–1993	1994–1999	1999–2004	2005–2008
0.815	0.745	0.579	0.553	0.610

Proportion of answers agreeing to “claiming government benefits to which you are not entitled is never justifiable”. Source: Heinemann (2007) with the latest World Value Survey data for 2005–2008 added.

This deterioration of norms supports Swedish scholar Assar Lindbeck’s theory on self-destructive welfare state dynamics, in which the welfare system erodes norms relating to work and responsibility.<sup>24</sup> Change in the work ethic is related to a rising dependence on welfare state institutions.

Since the beginning of the 1990s, approximately one fifth of the Swedish population at working age has been supported by unemployment benefits, sick leave benefits and early retirement benefits. Among others, Jan Edling, former economist at the labor union LO, which has close ties to the Social Democratic party, has discussed this high hidden unemployment, and its connection to the over-utilization of welfare systems.<sup>25</sup>

Recently, Swedish policies have shifted strongly to the center-right, and a long-term social democratic hegemony has become a situation where the Social Democrats are in deep crisis. One likely explanation is that the Swedish electorate wishes to again strengthen the work ethic and responsibility norms that were eroded during the high tax regime.

<sup>23</sup> Heinemann (2007).

<sup>24</sup> Lindbeck (1995).

<sup>25</sup> Edling (2010), Swedish Enterprise Institute (2006), Herin, Jakobsson and Rydeman (2006).

Both government policy and the public debate in Sweden have focused on reducing the overutilization of welfare services in recent years. As shown in Table 2, this is correlated with an upward swing in benefit morale. Although Swedish society has been known for a strong work ethic and norms of responsibility, it has not been resistant to the fact that high taxes and generous welfare programs diminish the incentive to work hard, and instead create an incentive to overuse the welfare system.

The combination of high taxes, generous benefits, and a rigid labor market has clearly affected the integration of the foreign-born into Swedish society.

## Failing integration policies

Sweden used to be very good at integrating immigrants. In 1950, the rate of employment for the foreign-born was 20 percent higher than that for the average citizen. This figure dropped by 50 percentage points in as many years. In 2000, the rate of employment was 30 percent lower for the foreign-born.<sup>26</sup> In 1968, foreign citizens living in Sweden had 22 percent higher income from work, compared to those born in Sweden. In 1999, foreign citizens had 45 percent lower incomes.<sup>27</sup>

While racism decreased significantly as time passed, the situation of those born abroad in the labor market had worsened dramatically. A government study showed that in 1978, foreign-born residents from outside the Nordic nations had a rate of employment that was only seven percent lower than that of ethnic Swedes. In 1995, the gap had expanded to 52 percent.<sup>28</sup>

Why did this drastic shift occur? One reason is that Sweden shifted from labor immigration to refugee immigration. However, it is important to remember that the nations from which labor immigrants came to Sweden after the Second World War – such as Greece and Turkey – were relatively impoverished at the time.

Also, many of the refugees who have come to Sweden from nations such as Chile, Iran, and Iraq are from the educated elite and middle class, seeking a better life abroad. To give an illustrative example, a privileged group of well-educated Iraqi citizens fled from Saddam Hussein's reign to Sweden at the end of the 1980s and the beginning of the 1990s.

Of those Iraqis that stayed in Sweden between 1987 and 1991, they were 2.3 times as likely to have a higher education of more than three years, compared to native Swedes. So, how well did this highly-educated group do in the Swedish labor market? In 1995, only 13 percent of the women and 23 percent of the men from the group were employed.<sup>29</sup>

Another Swedish research study has calculated the incomes of immigrants to Sweden from Iran and Turkey. Between 1993 and 2000, the income from work for the average Iranian immigrant was only 61 percent, and for the average Turkish immigrant 74 percent, of the average income of a native Swede.<sup>30</sup>

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26 Ekberg and Hammarstedt (2002).

27 *Ibid.*

28 Ekberg (1997).

29 Rooth (1999).

30 SCB and Arbetslivsinstitutet (2002).

According to the US Census for 2000, those born in Iran had an income that was 136 percent of the average for native-born residents, compared to 114 percent for those born in Turkey.<sup>31</sup> Clearly, similar groups of immigrants had very different opportunities in the US compared to Sweden.

In 2004, when the Swedish economy was performing strongly, the employment rate among immigrants from non-Western nations in Sweden was only 48 percent. It should be noted that this definition in Swedish statistics also includes some people that do not hold a regular occupation, such as those participating in publicly-financed labor market programs.<sup>32</sup>

Dependence on government welfare was nine times as high for non-Western immigrants compared to those born in Sweden the same year.<sup>33</sup> That Sweden has gone from being a nation which successfully integrated the foreign-born into the labor market, to one where many immigrants are trapped in long-term dependency on government handouts, is not only linked to changes in immigration policy, but also to general economic policy.

The expansion of the Swedish welfare state since the mid-twentieth century has created a situation where the incentive to work has reduced, whilst the incentive to live off government handouts has increased. At the same time, regulations and labor union domination impede entry into the labor market.<sup>34</sup>

There is no doubt that a generous welfare system initially helps many immigrant families, cushioning the transition to a new country. However, as long-term dependency grows, it can easily transform into social poverty. The fact that social problems exist among immigrants to Sweden is not a coincidence.

If favorable outcomes were solely the result of the Swedish welfare system, integration would be very successful, since good outcomes would simply be transmitted through the system. But such is not the case. The reasons why Sweden has favorable social outcomes also have a lot to do with demographic and cultural factors that existed before the rise of the high-tax welfare state.

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31 US Census 2000.

32 Sanandaji (2009).

33 SCB (2004).

34 Sanandaji (2009).

## Impressive social outcomes even before welfare state expansion

It is important to realize that many of the differences between Sweden and the US in terms of social outcomes existed already before the rise of the welfare state. In 1950, long before the high-tax welfare state, Swedes lived 2.6 years longer than Americans. Today the difference is 2.7 years.

A comparison of historical rates of income inequality in Sweden, The United States, Canada, France and Netherlands shows interesting results. Already by 1920, well before the existence of a welfare state, Sweden was among those with the lowest levels of inequality within this group of countries.<sup>35</sup>

One important reason why Sweden performs well on many social metrics has its roots in history and sociology: Sweden and other Nordic nations have, for hundreds of years, benefited from sound institutions, such as a strong Lutheran work ethic, a homogeneous population, and high levels of trust, civic participation, and cooperation.

These cultural phenomena do not disappear when Swedes cross the Atlantic and emigrate to America. On the contrary, they appear to bloom fully. The 4.4 million or so Americans with Swedish origins are considerably richer than the average American, as are other immigrant groups from Scandinavia.

If Americans with Swedish ancestry were to form their own country, their per capita GDP would be \$56 900, more than \$10 000 above the earnings of the average American. This is far above the Swedish GDP, at \$36 600 per capita. Swedes living in the US are thus approximately 53 percent more wealthy than Swedes (excluding immigrants) in their native country.<sup>36</sup>

It should be noted that those Swedes who emigrated to the US, predominately in the nineteenth century, were anything but the elite. Rather, it was often those escaping poverty and famine. The success of this group shows the value of norms and institutions, which to some degree have been hindered, to create “social good” by the economic policies implemented in Sweden.

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35 Roine and Waldenstrom (2008).

36 OECD (2009); US Census database.

According to data from the Bureau of Labor Statistics, Americans with Swedish ancestry do not have significantly higher test-scores than other European immigrant groups, and score no higher than Swedes in Sweden, which confirms that immigrant Swedes were not a “selected” elite group.<sup>37</sup>

A Scandinavian economist once said to Milton Friedman: “In Scandinavia, we have no poverty.” Milton Friedman replied: “That’s interesting, because in America, among Scandinavians, we have no poverty, either.”<sup>38</sup> Indeed, the poverty rate for Americans with Swedish ancestry is only 6.7 percent, half the U.S. average.<sup>39</sup> Economists Geranda Notten and Chris de Neubourg calculated the poverty rate in Sweden using the American poverty threshold, finding it to be an identical 6.7 percent.<sup>40</sup>

This points us towards the conclusion that what makes Sweden uniquely successful is not the welfare state, as is commonly assumed. Rather than being the cause of Sweden’s social strengths, the high-tax welfare state might have been made possible by the hard-won Swedish stock of social capital.

It was well before the welfare state, when hard work paid off, that a culture with a strong Protestant work ethic developed. As discussed previously in this paper, the modern system has eroded some of this norm.<sup>41</sup> The Swedish welfare state does create some social good, for example, by providing relatively generous social security nets. Yet it is clearly not the only reason for the low poverty rate and long life expectancy in the nation.

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37 Bureau of Labor Statistics.

38 Quoted among others by Kotkin (2009).

39 US Census 2006–2008

40 Notten, Geranda and Chris de Neubourg (2007). Note that the Swedish figures also include poor immigrants.

41 Some of the facts and arguments in this chapter appeared in a column David Brooks published in The New York Times on 3 May, 2010. It should be noted that the author of this paper co-authored an article with the same statistics and arguments in The New Geography on the day prior to the publication of Mr. Brooks’ article. The articles are included in the footnotes.

## Free-market Sweden?

When Sweden is used as an example in policy debates, not only the successes but also the limitations are often exaggerated. It is important to realize that Sweden is not a socialist nation at heart. Taxes are high and the labor market is rigid, but policymakers have sought to compensate for this lack of economic freedom with economic liberalizations in other parts of the economy.

Five dimensions of economic freedom are included in the Economic Freedom Index developed by the Frasier Institute: size of government; legal structure and security of property rights; access to sound money; freedom to exchange with foreigners; and lastly, regulation of credit, labor, and business.

A study found that between 1970 and 2004, Sweden and other Nordic nations scored poorly on the first dimension: size of government. However, on the other four dimensions, the Nordic nations had much higher scores than other groups of industrialized nations.<sup>42</sup>

Since the beginning of the 1990s, Sweden has implemented a number of free market reforms which, in some cases, even surpass the US system. School vouchers were successfully introduced, creating competition within the frame of public financing. Similar systems are increasingly being implemented in other public programs as well, such as health care and elderly care. Another example is that the pension system has been partially privatized, giving citizens some control over their mandated retirement savings.<sup>43</sup>

In Figure 5, the overall scores from the Economic Freedom Index published by The Heritage Foundation and The Wall Street Journal are shown for the US, Sweden, and Finland over the period 1994 to 2009. Although Sweden still ranks below the US, it is clear that the country has caught up most of the gap that existed in the mid-1990s. Finland has, interestingly, even surpassed Sweden. This illustrates that Sweden is not alone among the Nordic nations to move towards greater level of economic freedom.

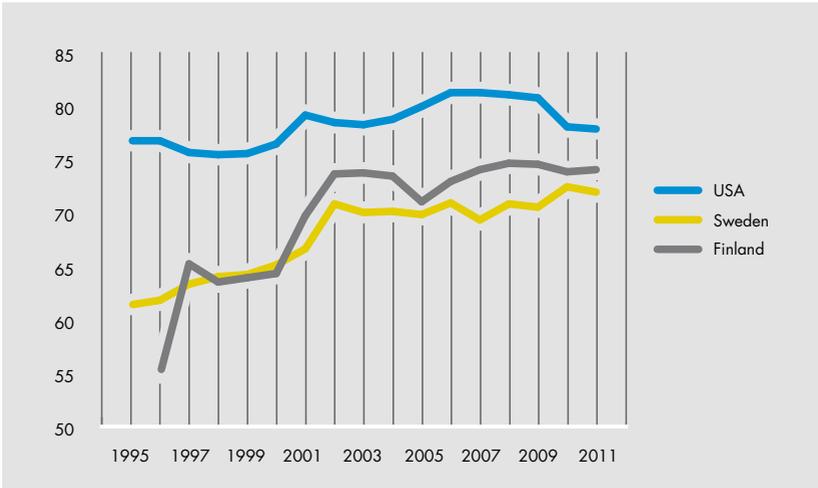
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<sup>42</sup> Bergh and Henrekson (2010).

<sup>43</sup> See for example: Freeman, Richard B, Birgitta Swedenborg and Robert H Topel (2010).

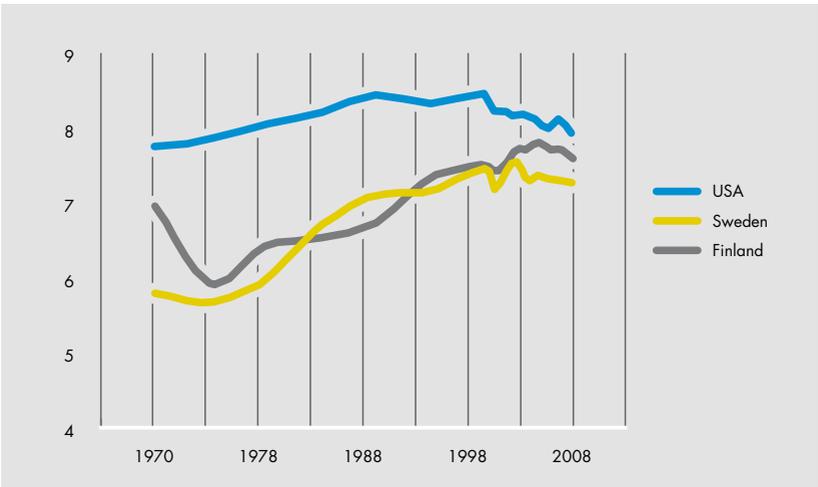
**Figure 5.**  
**Heritage/WSJ economic freedom index overall score**

Source: Heritage Foundation and Wall Street Journal Index of Economic Freedom.



**Figure 6.**  
**Frasier economic freedom index overall score**

Chain-linked summary score index. Source: Frasier Institute (2010).



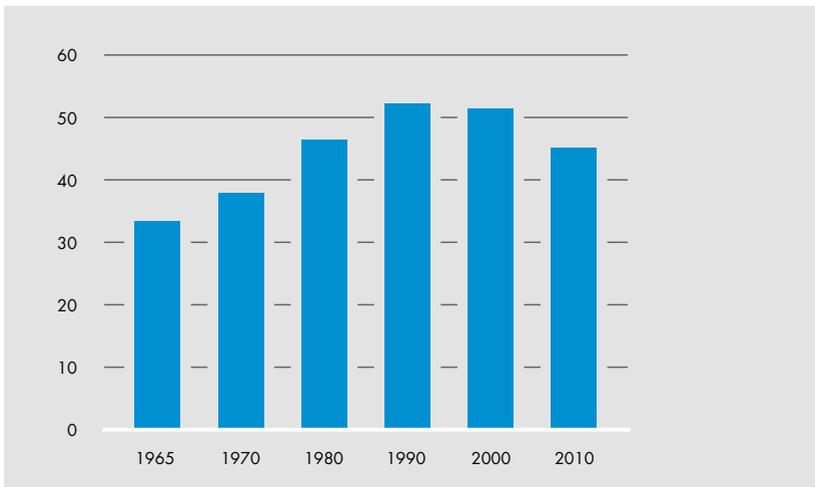
In Figure 6, the average scores are shown for the Economic Freedom of the World Index published by the Frasier Institute. This index shows that a very wide gap existed in 1975 in terms of economic freedom between Sweden and Finland on the one hand and the US on the other. In 2008, the gap was much narrower, particularly between Finland and the US.

Lastly, the center-right government that took office in 2006, and was re-elected in 2010, has implemented stepwise and rather large tax reductions. As is shown in Figure 7, the tax burden has begun to fall. It is quite likely that this fall will continue, given research previously cited in this paper, which shows that the high taxes are still very damaging to the economy, and the current political development where support for the Social Democrats is at its lowest level for one hundred years.

Sweden is not abandoning the idea of a welfare state, but has taken and is continuing to take steps in order to increase economic liberty and reduce the size of government.

**Figure 7.**  
**Tax revenues as percentage of GDP**

Source OECD and Swedish Government (2010). "Budgetpropositionen för 2011 - Bilaga 2".





## Conclusions

The Swedish model is often dramatized in the public policy debate, described as either a social democratic utopia or a failed socialist experiment. These views are far from the truth. Sweden is a successful country in terms of low poverty rate and long life expectancy. However, these factors have much to do with Swedish culture that existed already when taxes were still relatively low.

As Milton Friedman has previously noted, the millions of US residents of Swedish descent also have a low poverty rate. As is shown in this report, they combine this with a living standard that is over 50 percent better compared to Swedes living in Sweden. The transformation of Sweden from an impoverished agrarian society to a modern industrialized nation is a rarely mentioned, but quite significant, example of the role of free markets.

One should remember that the golden age of Swedish entrepreneurship, where one successful firm after another was founded in the small country and gained international renown, occurred during a time where taxes and the scope of government were quite limited. Sweden shifted to radicalized social democratic policies in the 1960s, 1970s, and the 1980s.

However, this transformation was not successful, as it led to long-term diminished entrepreneurial growth, lagging behind in terms of wealth compared to other industrialized nations, and an erosion of previously strong work and benefit norms. The move towards high taxes, relatively generous government benefits, and a regulated labor market, is related to the situation in which Swedish society has had difficulty integrating even highly-educated immigrants, and where a fifth of the population of working age are supported by various forms of government handouts.

It is, however, important to remember that Sweden, like other Nordic nations, has compensated for these policies by improving economic liberty in other fields. Some reforms, such as the partial privatization of the mandatory pensions system and voucher systems in schools and health care surpass what has been possible to implement in most developed nations.

Swedish society is not necessarily moving away from the idea of a welfare state, but continuous reforms are implemented towards economic liberty within the scope of welfare. The rise of government has been stopped and even reversed in recent years. The nation is again returning to the free market policies which served it so well in the past.

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What should other nations learn from the Swedish model? The success of Swedish society is not linked to the welfare state as is often assumed. Rather, it is the result of cultural and demographic factors, as well as a favorable business environment, throughout most of Sweden's modern history.

The combination of very high taxes, rigid labor markets, and generous handouts constrain entrepreneurship and wealth creation in Sweden. The nation would be even more affluent with a free market-oriented policy. Sweden is now moving closer to its free market roots, reducing taxes considerably, and rising in indices of economic freedom.

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