ONE REFORM CAN SAVE THE SWEDISH ECONOMY

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To cut the Gordian Knot constraining the Swedish economy, I suggest repealing the long-standing 'fiscal framework' that currently dictates how the Swedish Parliament conducts fiscal policy.

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There are two words in the Swedish language that are almost impossible to translate. One is 'lagom,' pronounced 'la-gohm.' When you say that something is 'lagom,' you say that it is neither extravagant nor stingy, but most of all, it is not enough for you to be satisfied. When something is 'lagom,' you virtuously give up some of your own wants and needs for the greater good.

The other ultra-Swedish word, 'duktig' (try 'duck-tigg'), is one of the most irritating words in the Swedish language. My fellow economist and Swedish expatriate Axel Leijonhufvud once explained its meaning as follows. A normal fish swims freely in the ocean, and it is up to the fisherman to find it and catch it. A Swedish fish, on the other hand, is 'duktig:' obedient to authorities, showing up wherever the fisherman throws out his net and makes a virtue of it.

These cultural norms are bad for creativity and vigorous debate. They preclude Swedish kids from taking the type of speech-and-debate classes that American high schoolers have access to. But more than that, the 'lagom' and 'duktig' norms have led Swedish elected officials into believing that if only they preserve what already exists, they will be appreciated.

Such anti-innovative cultural norms are the last thing Sweden needs right now. This is painfully visible in the economy. For three decades, the country has been caught up in a protracted economic decline, with stagnant standard of living, rapidly rising household indebtedness, major corporations moving abroad, and others surviving largely thanks to a combination of cheap labor and a tax system that burdens households, not corporations.

The only way that Swedes in general have stayed afloat economically, especially over the past 10-15 years, is by going deeply into debt. They have put up with confiscatory taxes only because they have remained convinced that their welfare state still delivers better benefits than they could get anywhere else on the planet.

It doesn't. Almost 20 years ago, a group of economists at the European Central Bank demonstrated that the Swedish welfare state is the most inefficient in the industrialized world. Its inefficiency is so bad that it could explain most of the pervasive structural problems in the Swedish economy.

There are excellent role models for such reforms: the Kristersson government could go to Hungary and see their conservative welfare state in action.

Fortunately, resistance to new ideas is weakening in Sweden. This is evident in the September election victory for the new center-right government under Prime Minister Ulf Kristersson. He and his four-party coalition won because a growing share of the population are abandoning the culturally imposed norms of compliance and conformity.

It has finally become mainstream to openly discuss and debate key problems in Swedish society. This is abundantly evident in the public discourse over open-borders immigration: as a growing share of Sweden's high taxes has been siphoned off to pay for a train wreck of 'immigrant integration' projects, a large enough segment of voters decided that they had finally had enough.

Hopefully, the same attitude of openness and diversity of opinion will spread to economic policy, and especially to the problematic welfare state. There is hope here: the Kristersson government is built on a policy platform that signals a new attitude in Swedish politics. This administration will no longer be 'lagom' in its expectations; being 'duktig' is no longer a priority either.

The economy is crucial to Prime Minister Kristersson's success.

I have one reform suggestion for him that, if implemented, will cut the Gordian Knot that currently keeps the Swedish economy in a perennial state of under-performance: repeal the long-standing 'fiscal framework' that currently dictates how the Swedish parliament, the Riksdag, may or may not conduct fiscal policy.

The framework in place not only violates established macroeconomic theory, but it also weighs down the economy, keeping it on a growth trajectory that is well below its potential.

The so-called fiscal framework is essentially a Swedish version of the Stability and Growth Pact that is written into the constitution of the European Union. It was put in place by the Riksdag in the mid-1990s and has, since then, forced the Swedish government to design its fiscal policy based on the premise that the government budget is the epicenter of the Swedish economy.

In a backhanded way, this is correct. Government confiscates about half the economy by means of taxes and then spends it through a chronically inefficient welfare state. This does, unfortunately, make government a big player in the economy, but that only reinforces the negative effect that the fiscal framework and its budget-balancing mandate have on the Swedish economy.

Balancing the budget as the overarching goal of fiscal policy has, unfortunately, yet predictably and inevitably, forced the government to ignore pressing macroeconomic problems. As I explain in *Industrial Poverty*, my book about the disastrous European response to the Great Recession of 2009-2012, the fiscal framework delayed the Swedish economic recovery in the late 1990s. It also put the economy on a permanently weaker growth trajectory and left a significant part of the workforce idling.

The fiscal framework forced the government back in the '90s to raise taxes just as the economy slowly got moving again. With no tax increases, economic growth would have been higher. With higher growth, "the Swedish government would have had almost exactly the same tax revenues" as it did with the tax hikes—but "another 4.7 percent of the total workforce" would have been employed (p. 178).

When Kristersson leads Sweden into another economic recession—which is likely already on its way—his government will be bound by the budget-balance-first fiscal framework. This will force it to suppress the economic activity of businesses and households, in order to prioritize government.

In recent years, the framework has been relaxed somewhat, but it still burdens the Swedish economy with its government-first fundamental principle. While this has led Sweden to have one of the lowest government debt ratios in the industrialized world, it has also held the economy back and lowered growth rates in such key variables as private consumption and household income.

Swedish families have responded by going deep into debt. Figure 1 explains the main consequence in terms of a perennially rising ratio of household debt to disposable income:

Figure 1

Source of raw data: *Statistics Sweden*

This is a depressing view of household finances in Sweden. The upside of it is that the center-right coalition that now governs the country has a history of being a bit more lenient in enforcing the fiscal framework. Consequently, during their reign from 2006-2014 there was a little bit of a trend break in household indebtedness.

No economy can sustain over time with households so deeply in debt. It does not matter if the liabilities are dominated by mortgages or unsecured debt; all loans must eventually be paid back (or else banks will fail). The deeper they are in debt, the more painful it will be when interest rates rise.

The only remedy is that the expansion of private indebtedness in the 2000s and early 2010s injected enough consumer spending into the economy to keep the Swedish labor market in relatively good shape. However, as an indicator of what structural problem the indebtedness constitutes, Sweden is rapidly losing its position as a jobs-for-all economy. Figure 2 reports raw data for the employment rate in Sweden. It compares to similar rates in Hungary, one of Europe's absolutely strongest economies, and in the EU as a whole:

Figure 2

Source: *Eurostat*

While the Hungarian economy has continued to churn out jobs at EU-leading rates, the Swedish economy has fallen below the EU average. Youth employment numbers are equally disappointing, putting Sweden below the EU average since the first quarter of 2019, and below Hungary since 2016.

Part of the problem in Sweden is high immigration. According to labor-market data from Statistics Sweden, in five of the ten years between 2010-2019, the workforce grew faster than employment. Adjusted for a one-year anomaly, the number of new jobs created in the economy was just about equal to the number of people entering the workforce.

It is also worth noting that the closer the Swedish economy got to the end of the 2010s, the more it struggled to keep producing new jobs for every new person added to the workforce.

This labor-market creation trend is, again, in part tied to rising household debt: a comparison of the growth of household debt to private consumption shows that the annual increase in debt pays for a relatively constant proportion of household spending. When households can no longer afford to increase their indebtedness, private consumption declines.

The weaker jobs creation, which continued through and after the pandemic, is a sign of this very problem. But frailty in private consumption is not the only macroeconomic fallout from the Swedish government's fixation with balancing its enormous budget every year.

In the past decade, business investments have barely stayed ahead of the EU average. According to Eurostat national accounts, in the past five years, business investments have grown by 2.9% per year in Sweden and 2.6% in the EU.

This is more than a little troubling for a country that used to be an industrial world leader. By contrast, in Hungary, investments grew by 8.8% per year in the same period. Furthermore, since 2013—the first year when the economic policies of Viktor Orbán's government really kicked in—business investments in Hungary have grown at 6.8% per year, adjusted for inflation.

This is twice the Swedish rate.

While still ranked 7th by the most recent Eurostat numbers, the Swedes are barely ahead of Poland and Croatia but far behind countries like Greece, Italy, Slovenia, and Hungary.

With the recent slowdown, Sweden is in a transition for the worse—a point reinforced by the decline in the employment rate. When business investments taper off, a larger share of the capital formation that still happens is aimed merely at maintaining productive capacity. Inevitably, this means fewer new jobs for the economy as a whole.

Faced with weakening capital formation and unhealthy levels of household debt, the new center-right Swedish government simply must do all it can to structurally change the role of government in the economy. To do this, it must do away with the budget-balancing straitjacket that currently forces them to rank the needs of government above the needs of the taxpaying sector.

Once that is done, the Kristersson administration can start working on permanently lowering the very high Swedish taxes. Table 1 reports the average tax burden for the past four quarters as share of GDP for all EU member states (T/Y). It also reports the balance in the government budget, as share of total government spending (D/G):

Table 1

Source: *Eurostat*

Prime Minister Kristersson ought to take a careful look at the right column of Table 1. The number for Sweden says that for every 100 kronas that government spends, it takes in 102.3 kronas in taxes.

This over-taxation is economically harmful. The original idea with relentless focus on a budget surplus was to keep interest rates down and financial markets calm. However, given how weak the Swedish krona is today, and looking at how the Swedish central bank is now being pressured to raise interest rates, the original motives for the Swedish version of the Stability and Growth Pact are irrelevant.

Once the fiscal framework is gone, Prime Minister Kristersson can start implementing structural reforms to the Swedish welfare state. These reforms would fit neatly into the policy platform that his government is built on; all he has to do is extend those reforms in a distinctly conservative direction. That will require structural reforms that may cause temporary budget deficits, but with a significantly smaller government at the other end of the reforms, taxes will be lower—and the private sector will prosper as a result.