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Coping with Budget Deficits in Sweden

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During the late 1970s and early 1980s Sweden's budget deficits grew more rapidly than in probably any other country of Western Europe. Government policy responses developed in three phases. In the late 1970s there was very little action taken to cope with run-away deficits. From 1980 to 1982 a strategy was formulated and partly implemented which heavily emphasized austerity measures through expenditure cuts. From late 1982 a 'mixed' strategy has been pursued which combines less drastic cuts with selected revenue increases. The virtual lack of response in the late 1970s and the turn-about in 1980 may be explained by reference to four major categories of factors: the severity and longevity of the economic crisis itself and the prevailing interpretations of its root causes; the dynamics of public sector growth and the understanding of the processes involved; the ideological and policy predispositions prevalent among policy-makers, economists, major interest groups and the public at large; and, finally, a set of 'organizational' factors mainly associated with the parliamentary situation in Sweden.

Introduction

Sweden was no exception. Following a period of unprecedented economic growth and political stability during the 1950s and 1960s, the 1970s saw a marked destabilization of both economy and polity. Growth rates receded, inflation and unemployment rates increased. Sweden's almost unrivalled political stability largely came to an end. The Social Democrats, who alone or in coalition had formed cabinets since the 1930s, were first severely challenged in the 1973 elections, which resulted in an absolute draw between socialists and non-socialists (175-175) in the *Riksdag*. Then in 1976 the Social Democrats were ousted from power for the first time in 44 years, and since then Sweden has experienced five changes of government; most observers also agree that the political climate in general worsened considerably during the 1970s (e.g. Ruin 1983).

At the interface between economy and polity is the public sector. As most countries of Western Europe, Sweden experienced in the 1970s a severe crisis in the public sector economy as well — a fiscal crisis. This is most clearly illustrated by exploding budget deficits from the late 1970s onwards. There had been a tendency towards growing deficits during the 1950s, but the situation

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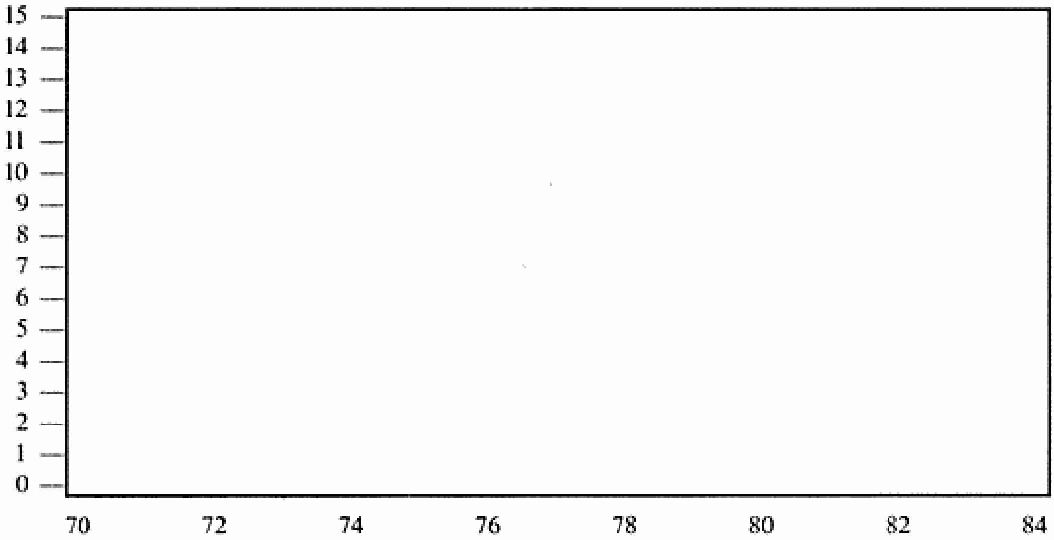
Fig. 1. State Budget Deficits 1970-1984. Percent of GDP.

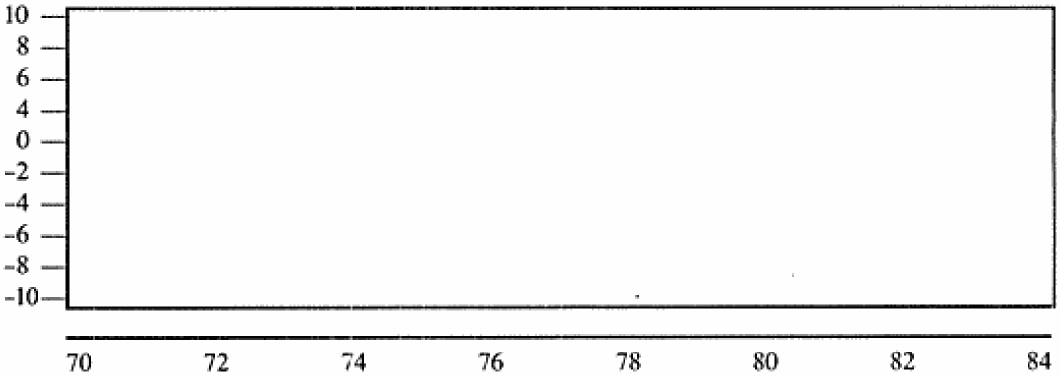


Source: The Swedish Budget 1984-1985, 35.

improved inter alia through accelerated growth and the introduction of a value-added tax in 1960. As shown by Fig. 1 (above), relatively minor increases in state budget deficits occurred in 1971 and 1973, while a noticeable decrease was experienced in 1976. From 1977, however, deficits have exploded to reach a level of about 13 percent of GDP in 1982. In 1983 and 1984 the state budget deficits have decreased to the current level of less than 10 percent of GDP.

Fig. 1 shows the development of *state* budget deficits. In Sweden, as well as elsewhere, considerable political and scholarly debate in recent years has concerned the concept of 'budget deficit' itself. Briefly, the debate has centered on two related issues. First, there is the question of *scope*. Should only the state sector proper be considered relevant, or should the concept include local government and social insurance funds (which, largely by historical accident, are not part of the state budget in Sweden) as well? In theory, most participants in the debate would probably agree that the concept adopted should reflect the nature of the policy problem being discussed (cf. e.g. Lybeck 1982); in practice one frequently resorts to the concept which best fits one's own interests. Second, there is the more complex issue of the *impact* of budget deficits in macroeconomic terms. While most policymakers and economists seem to agree that part of Sweden's huge budget deficits in recent years is rather unproblematic from a policy perspective, another part is not. But there is little agreement with respect to the size and significance of the latter 'structural' deficit. Again, more general considerations largely determine definitions. As a consequence, debates which often seemingly concern technical matters in practice become conflicts over basic political and ideological issues.

Fig. 2. Financial Saving in the Consolidated Public Sector 1970-1984. Percent of GDP.



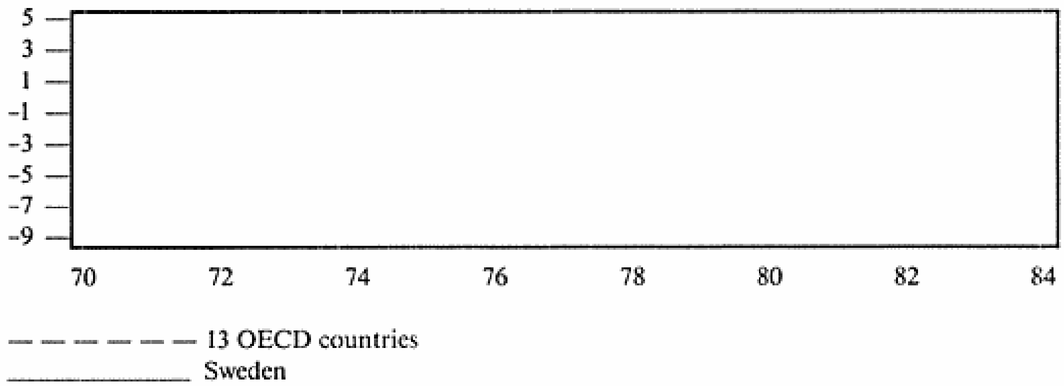
Source: The Swedish Budget 1984-1985, 40.

If we, as many then think is appropriate, adopt a more inclusive concept of budget deficit by adding local government and social insurance funds to the state sector, the result is as shown in Fig. 2.

While the same general pattern appears, the absolute levels of deficits as a percentage of GDP are considerably lower. In fact, a deficit does not occur until 1978 and the maximum deficit experienced during the period — in 1982 — stops at less than 7 percent of GDP.

In terms of the size of its budget deficits, particularly if defined as 'financial saving in the consolidated public sector', as in Fig. 2 above, Sweden does not stand out in international comparison. Countries like Belgium, Denmark and Italy have displayed larger deficits in recent years (Chouraqui & Price 1983,

Fig. 3. Sweden's deficits have grown at a much more rapid rate during the late 1970s and early 1980s than those of other OECD countries.
Financial Saving in the Consolidated Public Sector 1970-1984. Percent of GDP.



Note: The 13 OECD countries are: Austria, Belgium, Canada, Denmark, Federal Republic, France, Italy, Japan, Netherlands, Norway, Sweden, United Kingdom, United States.

Source: Myhrman 1984a, 87 (OECD data)

72). But as may be seen from Fig. 3, Sweden's deficits have grown at a much more rapid rate during the late 1970s and early 1980s than those of other OECD countries.

In sum, then, Sweden's political economy has displayed many signs of crisis in recent years. The severity of the crisis has not been exceptional by international standards. Many comparable countries have experienced much greater difficulties with respect to both economy and polity, though it could be argued that few if any have fared worse in terms of public sector developments.

This paper is about Sweden's efforts to cope with fiscal crisis in general and exploding budget deficits in particular during the late 1970s and early 1980s. The focus is on the perceptions, proposals and performance of key actors in the country's political economy: government officials, political parties, interest groups and professional economists. First, I tell the story of what happened from the early 1970s onwards. Second, an effort is made to explain why it happened. Finally, the concluding section provides a summary and some further reflections on the politics of fiscal crisis in Sweden.

What Happened ...

In telling the story of what happened I have found it useful to divide the years between 1970 and the present into four periods. First, a pre-crisis period encompassing developments until 1976. The signs of the 'stagflation' to come are evident from about 1970 and are met according to a well-established pattern of response: both spending and taxing. The small — at least by later standards — budget deficits are not viewed as problematic by any important actor. Second, a period from 1976 to 1980, characterized by the full onslaught of both economic and political crisis. Spending continues at full speed, revenues cannot keep up, and budget deficits increase radically. Third, a period from 1980 to 1982 when non-socialist governments decide to take action by attacking government spending. Finally, a fourth period from 1982 onwards when the Social Democrats return to power and adopt their 'Third Way' strategy, a budget policy combining more modest expenditure cuts with some tax increases.

Spending and Taxing (Pre-Crisis)

In reprospect it seems evident that signs of 'stagflation' began to show in Sweden already around 1970. A balance of payment crisis — moderate at most in view of later experience — was met by rather drastic austerity measures, primarily aimed at curbing domestic consumption. Inflation reached 7 percent and unemployment rose to levels well above the postwar average. In the Swedish public debate, the Social Democratic government was accused of having produced a 'homemade' recession. The opposition parties talked of 'the lost years'. Most professional economists argued that the finance minister had looked too narrowly at the balance of payment situation and had unnecessarily tried to keep the state budget deficit at a low level.

The recession soon passed, however, seemingly in the manner typical of the 1950s and 1960s. The balance of payment soon displayed a record surplus. Then in late 1973, the international oil crisis erupted, followed, as is well-known, by a severe international recession combined with severe inflation. Most countries met these difficulties by adopting a series of rather drastic deflationary measures. Sweden — together with Norway in particular — embarked upon what was to be called a 'bridging policy', trying to fuel domestic consumption and investment in order to compensate for the fall in international demand. This policy was in Sweden pursued in almost total consensus. All political parties — as we have seen socialists and non-socialists had equal voting power in the *Riksdag* following the 1973 election — all major interest organizations, and virtually all professional economists were in agreement with respect to the basic features of the 'bridging policy'. The Swedish government was praised in enthusiastic terms by the OECD, and advertised as an example for the rest of the member countries to follow.

Nobody — literally nobody — in Sweden seemed to have realized at the time that the country's competitive power was being quickly and dramatically eroded. And few if any key actors seem to have predicted correctly the sluggish future performance of the world economy. In 1973 and 1974 profits skyrocketed in Swedish industry. This, in combination with what must be considered too lenient measures by the government to siphon off these profits, led to wage settlements at a record level in 1974 and 1975. In two years the average wage increases amounted to more than 40 percent. Together with a too highly priced currency this paved the way for a 'cost crisis' of dramatic proportions in late 1976.

But as late as during the election compaign of 1976, most indicators pointed to a healthy development of the economy. Economic policy or public expenditures were not the dominant, or at least not the most controversial, issues in campaign speeches. The three non-socialist parties were in fact, as in earlier campaigns during the 1970s, more expansion-prone than the Social Democrats; the Liberals and the Center Party by proposing additional expenditures, the Conservatives by promising a lower tax burden without matching cuts in public expenditures. The most controversial issues concerned, instead, the alleged 'corruption' of the Social Democrats after their 44 years in power and the question of nuclear energy.

Then in September of 1976 that happened which few in Sweden had in fact expected. The Social Democrats were ousted from power and replaced by a coalition government consisting of the three non-socialist parties. Their time had finally arrived. It would turn out to be much more troublesome than they, or probably anybody, had expected.

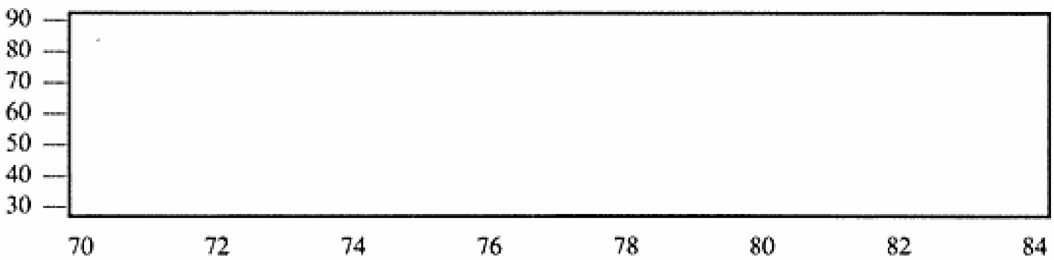
Spending without Taxing (1976-1980)

The Social Democrats talked of a 'laid table'. In their view the new government was presented with a well-ordered economy — to be fine-tuned much as in the 1950s and 1960s. The budget deficit, for example, was smaller than at any time since 1970 (see Fig. 1 above).

It was soon realized by almost everybody, however, that the economic problems were in fact considerable. During the last few months of 1976 signs began to emerge of a major industrial crisis. Captains of major corporations, as well as representatives of entire branches of Swedish industry, began to queue outside the offices of the minister of industry, asking for financial assistance in order to avoid immediate bankruptcy. In the wake of this 'profit crisis' in industry followed rising levels of unemployment and a quickly deteriorating balance of payment situation. The government responded by devaluating the Swedish currency — once in late 1976 and twice during 1977 — and by spending extensively to stave off industrial bankruptcy and unemployment. While the sum total of government subsidies to industry in the period 1970-1975 had amounted to about 9 Bill SEK, during the years 1975-1980 they exceeded 50. Increased government ownership was an important part of the policy; altogether the late 1970s implied by far the most intense period of nationalization of private industry in Swedish history...

These measures were extremely expensive in themselves, but, in addition, the new government adopted a number of costly reforms in other areas. All three parties had come to power equipped with wide-ranging and publicly stated ambitions. The fullfilment of these election promises, implying for the most part new public expenditures but also, to some extent, lower taxes (e.g. an indexation of income taxes adopted by the *Riksdag* in the Fall of 1977), was largely behind the exploding state budget deficit which was shown in Fig. 1 above. In Fig. 4 below it is shown that the exploding state budget deficits resulted from a dramatically widening gap from 1977 onwards between state expenditures and revenues in the form of taxes and charges.

Fig. 4. State expenditures and revenues 1970-1984. Percent of GDP.



———— Expenditures
— — — — — Taxes and charges

Source: Ministry of Finance

The budget deficit was not a major political issue during the late 1970s. In economic policy the three-party coalition was preoccupied with measures to redress the 'cost crisis' and fighting unemployment. Economic policy was not even, however, the foremost issue on the cabinet agenda. Instead the three-party coalition was fighting out a fierce internal battle over nuclear energy. The Center Party stood against the other two parties. The leader of the Center Party, who was also Prime Minister, had made a firm pledge during the election campaign of 1976 that he would not under any circumstances accept that another nuclear reactor in Sweden was put into operation. In fact he did just that in one case — but more stood in line. Finally, in the Fall of 1978, the coalition government could not keep together (for detailed accounts, see Leijonhufvud 1979, and Vedung 1979).

A new government was formed by the Liberal Party, with an extremely weak parliamentary base, only 34 votes out of 349. During its relatively short reign — less than a year — there were obvious signs of economic recovery. The 'cost crisis' was believed to have been at least alleviated. Unemployment rates were down and investments were picking up somewhat. Supported by most Swedish professional economists, the Liberal government presented an expansionist budget in early 1979. The opposition parties, and the Social Democrats in particular, argued that the government was too optimistic and that it tried to conceal major problems like the huge budget deficits.

The pessimists proved to be right, particularly with respect to the development of the international economy. Partly due to 'the second oil crisis' in the Spring of 1979, the world economy soon fell into a recession once more after only a brief period of heightened economic activity. And Sweden's problems were clearly greater than the government, and most other observers, had believed. Neither the economic problems in general, nor the public sector financial crisis in particular, had been alleviated through the aid of international economic recovery.

Meanwhile the nuclear issue had largely been 'pacified' through the Social Democratic proposal in the Spring of 1979 — following the Three Mile Island accident — for a national referendum. The election campaign of 1979 was instead primarily fought over the economic crisis and the Social Democratic proposal for a system of profit sharing, the so-called wage-earner funds. The non-socialist parties were victorious once more, but now by a very narrow margin. They gained a majority in the *Riksdag* of only a single vote, and decided again to form a three-party coalition government.

The new government's first budget was largely the work of the Liberals. The budget deficit continued to grow at a fast rate, despite more explicit warnings about the inherent dangers of such a development. The referendum in March of 1980 resulted in a defeat of the proposal put forward by the Center Party, the Communists and independent anti-nuclear forces, and a victory for that of the Social Democrats, the Liberals and the major labor unions. It implied that Sweden would phase out its nuclear energy program — one of the biggest in the world in per capita terms — but at a slow rate. For the non-socialist government the referendum meant that, finally, it could concentrate fully on coping with the economic crisis. 1980 in fact also turned out to be the year of a major reappraisal in economic and budget policy.

Attacks on Spending (1980-1982)

The first clear sign that perceptions and priorities were finally changing came in the government's so-called complementary budget bill (Government Bill 1979/80:150) in the Spring of 1980. For the first time, an explicit goal was formulated with respect to state budget deficits. The aim of government policy was to reduce the deficit at a rate of one percent of GDP annually during the next few years. It was furthermore stated that the deficit must not be allowed to exceed 60 Bill. SEK in absolute terms. Importantly, the bill also argued that the proposed reduction in the budget deficit would essentially have to be accomplished through expenditure cuts; there was virtually no room whatsoever for tax increases.

The first significant attempt along the lines of the new strategy was made in a special 'cutback bill' (Government Bill 1980/81:20) presented to the *Riksdag* in October of 1980. In a separate budgetary process during the Summer and early Fall a large number of possible budget cuts had been identified, and also a few proposals for limited revenue increases. Those finally included in the cutback bill amounted to an estimated reduction of the state budget deficit of 6.4 Bill. SEK — though the opposition argued that the total would be significantly less. All government ministries were affected, but some more than others; the biggest cuts hit the Ministry of Social Affairs and the Ministry of Housing. The first cutback bill also contained a rather lengthy discussion on the principles of cutback policy in the future. The goal of reducing the state deficit by one percent of GDP each year was restated — although it was already obvious that this would not be accomplished during the fiscal year of 1980/81. The bill also stated explicitly that virtually all expenditure areas must be affected, including social programs.

But as developments following the first cutback bill illustrated, agreeing to a first round of cuts and to general goals and rather vague principles was one thing, identifying further specific cuts in government expenditures quite another. Inside the Cabinet, the Conservatives headed by their party leader, who was also Minister of Economic Affairs, pressed hard to persuade their Liberal and Center Party colleagues to pursue the new austerity policy more forcefully (Bohman 1983). Little in this direction was, however, accomplished during the last stages of preparing the regular Budget Bill.

When the bill was presented in early January of 1981, it was immediately recognized by most observers, friends and foes of the government alike, as very 'weak'. Signs of a currency crisis began to appear, something which both the Conservatives and the Social Democrats had issued warnings about. It was obvious that the government would have to act. For the Conservatives such action was long overdue, but a similar conviction now spread to the Liberal leadership in particular. Hardly more than a week after the presentation of the Budget Bill, the Liberals produced their 'Ullsten Plan', named after the Liberal leader, proposing among other things expenditure cuts, measures to stimulate investment and a tax reform.

Constant Conservative pressure, the Liberal initiative — in fact prepared since late December — and the prospects of a major currency crisis, incited the Cabinet as a whole to act. In early February, less than a month after the regular Budget Bill, the three-party government presented an 'economic action program'. Apart from renewed pledges to attack public expenditures — new proposals would be put forward in the 'complementary budget bill' during the Spring — the document also contained a proposal for tax reform. More specifically the government pledged to reduce the marginal rates of income tax; a proposal would be formulated and presented to the *Riksdag* in the late Spring of 1981, following consultations with the Social Democrats and the major interest organizations.

Nobody could know at the time, of course, that the battles over tax reform would break up the three-party coalition government in the early Summer. In brief (for inside stories, see Westerberg 1983a and Bohman 1983), the Liberals and the Center Party struck a deal with the Social Democrats with respect to the specifics of income tax reform, a deal which the Conservatives chose not to accept. The deeper motives of the key actors will probably never be revealed; as so often they were probably a mixture of both policy concerns and political tactics. All parties were convinced — to a varying degree — that the marginal tax rates were detrimental to Sweden's economic development, but all parties were also beginning to form their forces in view of the 1982 election.

The 'complementary budget bill' presented to the *Riksdag* in March of 1981 had proposed public expenditure cuts amounting to about 12 Bill. SEK, but the specific proposals were few (Government Bill 1981/82:30). Instead the *Riksdag* was asked to authorize the level of cuts proposed and was promised detailed proposals later. The new two-party coalition formed during the Summer had agreed with the Conservatives — now outside the government — on the main features of budget policy. A first step towards implementing it came in the form of a second separate 'cutback bill' presented in September. The total saving in public expenditures was estimated at 4 Bill. SEK, spread across eight different ministries. In general the bill once more illustrated that the thrust of the policy outlined in 1980 stood firm: budget deficits should be reduced through less spending; more taxing was no workable alternative.

In the regular Budget Bill of January 1982 expenditure cuts amounting to nearly 10 Bill. SEK in savings during the coming fiscal year were proposed, again involving all central ministries. The opposition parties, both Conservatives and Social Democrats, argued that the total net effect of the proposals would be considerably less. The former proposed many more and more drastic cuts; the latter vividly attacked some of the specific proposals as being particularly unfair and unjustified. In particular the Social Democrats protested against proposed cuts in four social policy areas: old age pensions, health insurance, unemployment benefits and the state support to local governments' operation of child care facilities. In general the Social Democrats also argued that government policy was too single-mindedly aimed at expenditures, too willingly discarding the use of taxes in budget policy.

During the election campaign of 1982 the Social Democrats pledged to restore benefits in all four areas mentioned above. The non-socialist parties once more concentrated their attacks on the Social Democratic proposal for wage-earner funds, this time assisted by a massive campaign launched by private industry. Still, the non-socialists lost their overall majority among the voters. The Social Democrats could return to power after six years in opposition. Their recipe for solving the economic crisis in general and coping with budget deficits in particular was now to be tested against reality.

'The Third Way' (1982-)

All through the six years in opposition the Social Democrats had attacked the various non-socialist governments for their allegedly irresponsible budget policy. Every year they had produced alternative proposals which promised a better balance between expenditures and revenues in the state budget. But the differences had not been dramatic, especially not with respect to expenditures. According to government spokesmen, the Social Democratic budget proposals were a mixture of unrealistic cuts and greatly increased taxes and charges, mainly aimed at an already crisis-ridden industry.

It was of course only to be expected that the Social Democrats would find it hard, much harder than the non-socialist parties, to reorient themselves in the new economic context. Their ideology, and their practical politics, were closely intertwined with the seemingly inexorable growth of the public sector. Their budget proposals while in office had contained almost endless lists of costly reform projects. But they had always also insisted on 'responsible' financing, even to a point where the opposition parties, and professional economists in particular, talked of the Social Democratic finance minister's obsession with budgetary balance. It is a moot point — which I will pick up later — whether the Social Democrats would have allowed the budget deficit to explode the way it did during the late 1970s and early 1980s.

Slowly, however, the Social Democrats while in opposition began to formulate their own strategy to cope with budget deficits and economic crisis in general. It was a painful process — in fact it is not yet concluded — referred to in the media as 'The War of the Roses' (alluding of course to the party symbol of the Social Democrats). 'Spenders' stood against 'cutters'. The former were mostly drawn from the labor unions — particularly those of the public sector which launched their own campaigns and even formed a coordinating committee in defense of public sector growth — including economists associated with the union movement, and, generally the Party's leftist groups. The Social Democratic press was split down the middle. The 'cutters', by contrast, have been in a majority position in the national leadership of the Party, and have since about 1980 been heavily supported by virtually all professional economists with social democratic leanings.

During 1981 a working group within the party, including among others the future finance and deputy prime ministers, published a comprehensive 'crisis program' outlining the Party's strategy to cope with economic crisis. The program was adopted in all essentials by the Social Democratic party congress in the Fall of 1981. It was in many ways a vague document — a vagueness reflecting a genuine uncertainty about the Party's future course in economic policy, the substantial disagreements over such a course and the fact that the Social Democrats were in opposition. But, more importantly, the document signified that the dominant forces within the Party's leadership had now rallied behind an economic strategy which would probably have been inconceivable only a few years earlier. What would soon be christened 'the Third Way' implied that the need for considerable austerity in public sector expansion was clearly recognized. In concrete terms, the program stated that the state sector would be allowed to grow very little or not at all while the local and county government sectors had to stop at a growth rate of about 2 percent i.e. one percentage point more than had been proposed by the Liberal-Center coalition government. But in contrast with the latter or, rather, all three non-socialist parties, the Social Democrats were prepared to improve public sector finance through selected tax increases. The program was presented as a combination of austerity and expansion, the latter strategically aimed at improving economic growth and employment in the industrial sector.

Upon coming to power in September of 1982, the Social Democratic leadership had prepared a shock treatment for the Swedish economy. In fact everybody could see the problems ahead already during the election campaign: whatever the outcome of the elections, the Swedish currency would be in trouble. The Social Democrats decided to make a virtue out of necessity. A devaluation would be needed — then why not transform this defensive weapon into an important means for economic recovery? After all, economic historians had shown that a key reason behind the successful Social Democratic crisis policy in the 1930s had been a favourable exchange rate due to de facto devaluations. Devaluations at the level of 20 or even 25 percent were now discussed among the top leadership and their economic advisers. The decision finally reached was to devaluate the Swedish *Krona* by 16 percent in relation to major foreign currencies.

In fact, devaluation had become a regular feature of Swedish economic policy since the mid-1970s. The most recent one — the fourth since 1976, amounting to about 10 percent — had occurred in late 1981, less than a year before the 1982 election. Essentially, however, the advantages brought about by these devaluations had soon been lost. Now the Social Democratic government made it a key feature of their economic policy to follow up the decision to devaluate. In particular, no interest group or sector in Swedish society would be allowed to compensate for the inevitable cost increases which would accompany the devaluation. In other words, the Swedish people would have to accept a substantial lowering — at least 4 or 5 percent — of their material standard of living in order to make Swedish industry more competitive. In order to counteract some of the negative impacts — from the Social Democratic point of view — on income distribution, a number of tax increases were also proposed that were particularly aimed at the relatively wealthy sections of the population.

A special bill outlining the new economic policy was presented to the *Riksdag* in early November (Government Bill 1982/83:50). A number of separate bills also dealt with the election promises. It was estimated that the additional expenditures added up to 7 Bill. SEK. These expenditures would be covered almost in full by increased taxes, particularly an increase in the Swedish V.A.T. and the various measures aimed at taxing the rich. However, new expenditures were also decided in order to boost employment and industrial investments. All in all, the various measures meant that the state budget deficit would increase by at least 10 Bill. SEK.

The regular Budget Bill of January 1983 contained few surprises. It confirmed and elaborated on certain aspects of the 'Third Way' strategy. But it was important in the sense that it clearly showed the extent to which Social Democratic policy did in fact represent a continuation of the last non-socialist government's expenditure policy. With the exception of the areas already indicated, there was little room for additional spending. Many interest groups and individuals who had expected a reversal of the former government's expenditure policy, and who had supported the Social Democrats for that reason, were now greatly disappointed.

The 'complementary budget bill' of March 1983 (1982/83:150) may be characterized in similar terms, i.e. it contained few concrete proposals but dealt extensively with the basics of government strategy. In particular, it emphasized, more than heretofore, the importance of inflation fighting. To be sure, a low inflation rate was stressed as a means to economic growth and full employment, but this could not conceal the fact that inflation was now accorded a priority position which was essentially novel to Social Democratic economic thinking. The bill declared that the government's goal was an inflation rate of 4 percent at the end of 1984 — to be contrasted with an estimated current rate of about 10 percent. The importance accorded this goal was illustrated by the government's determination to keep the compensation rate in public programs at 4 percent; virtually nobody could expect a higher rate of compensation. A key element of this strategy was a 'deindexation' of public programs.

Meanwhile the Social Democratic government was beginning to realize that the situation required additional measures with respect to government spending. Projections made during the Spring of 1983 pointed to a state budget deficit close to 120 Bill. SEK during 1985 — the year of the next election. This could simply not be tolerated in the view of a majority among the Social Democratic leadership. Intense discussions produced a near-consensus that savings would have to be found in the order of some 12 or 13 Bill. SEK for each of the two following years. In the early Summer an extra budget process was initiated aimed at finding possible cutbacks in the domain of every minister. The results were presented in a separate 'cutback bill' in October of 1983 (Government Bill 1983/84:40). Originally such a bill had not been envisaged. In fact a majority opinion was for long that the new government should abstain from such a course of action and thus disassociate itself from the image of ad hoc decision-making characterizing the former non-socialist governments. But that line of argument had to succumb to the necessity of implementing some of the proposed measures as quickly as possible.

The suggested cutbacks covered, as in earlier instances, all central ministries. But the specific areas had been carefully selected from a tactical point of view; the fact that the Social Democrats were in a minority position was clearly reflected in the bill, and so, with only a slight exaggeration, the proposed cutbacks hit just those expenditure areas where the non-socialist parties were in disagreement. Altogether the proposals would cut expenditures by about 5 and increase revenues by about 2 Bill. SEK. i.e. they would reduce the state budget deficit by some 7 Bill. SEK. During the subsequent parliamentary deliberations it turned out that the net savings would be less, not least because of internal opposition to some of the proposed cutbacks on the part of some Social Democratic MPs.

In the Budget Bill of January 1984, the Social Democratic government could display at least a partly well-founded optimism concerning the state of the Swedish economy. Most indicators pointed in the right direction, though the extent of the improvement could be disputed. The non-socialist parties argued that it was all due to the current international recovery, and that government policy was in fact detrimental to Swedish economic recovery. In particular they demanded more drastic cutbacks in the state budget; the government's ambition to keep the deficit at the same nominal level during 1984/1985 as the year before, i.e. reduce it by the rate of inflation, was viewed as far from enough.

That the 'Third Way' is actually a rather narrow path has, however, been confirmed by recent developments. The wage settlements in the labor market during the Spring have clearly exceeded the levels recommended by the government. The government response has included a special 'crisis package' last April containing measures like a temporary freeze of prices and profits, a round of negotiations between government and labour market organizations, and a firm pledge by the government to keep the inflation rate at 4 percent. In late June, however, the government was forced to admit that it had adjusted its expectations; the inflation rate is now predicted to run close to 6 percent in late 1984. In a more hopeful vein, from the government's point of view, the labour market organizations have promised to settle for wage agreements at 5 percent or lower for 1985.

... And Why

Our account of what has happened in the politics of Swedish economic and budget policy in recent years has by necessity simplified matters greatly. Still the story is sufficiently complex to defy simple explanations. In turning from the what to the why we must, however, simplify even further. I have thus found it reasonable to focus on two separate but related explanatory tasks. First, we must ask in company with the Swedish budget minister of the period 1976-1980, why there was such a 'long road to economic realism' (Mundebo 1983). More specifically, why were the exploding budget deficits largely ignored for several years before effective action was even contemplated? Second, we proceed from inaction to action. Why did the turnabout occur in 1980? What caused government policy-makers then to begin to view large budget deficits as a key problem and to start formulating a strategy to cope?

'The Long Road to Economic Realism'

Why did the non-socialist governments of the late 1970s refrain from taking actions to reduce the exploding budget deficits? The short answer is that they would not and they could not. The long answer involves a number of factors which contributed to the particular blend of inability and unwillingness which resulted in government inaction.

Let us start with the macroeconomic context. Sweden's relatively small and extremely open economy is largely at the mercy of international developments.

To be sure nobody would deny that the economic crisis of recent years has partly been of our own making — although the debate is still raging about the extent to which this has been so. But the fact remains that our domestic economic situation is largely determined by forces that Swedish policy-makers can influence only marginally or not at all. It borders on the trivial but needs to be noted, then, that government inaction during the late 1970s was partly predicated on false expectations — wishful thinking that is — about international developments. This was particularly evident in 1978 and 1979, when the Liberal one-party government acted on the expectations that clear signs of international recovery implied the beginning of a more lasting upturn.

Even more important, dominant macroeconomic thinking tended to belittle the importance of budget deficits. We were all still more or less faithful Keynesians. A generation of policy-makers had been brought up in this tradition. Professional economists kept lecturing to politicians and the public about the necessity to put public finances in the context of the economy as a whole, and they deplored some policymakers' concern with balancing the state budget. This lecturing went on almost unabated until about 1980 (cf. below; also Murray 1982).

Turning to the public sector specifically, I would argue that in no other Western country were the dominant political forces more favourably disposed towards public sector growth than in Sweden. To be sure there were nuances in expected directions with Communists more expansion-prone and Conservatives less so. But, importantly, the differences were very small between the Social Democrats on one hand and the Liberals and the Center Party on the other. And during the late 1960s and early 1970s the two latter clearly moved to the left, arguing for at least the same rate of public expansion as the Social Democratic government. The result may be gauged from international statistics; no other OECD country, with the possible exception of Denmark, allowed its public sector to expand faster than Sweden (cf. Premfors 1982). This virtually unrivaled expansion was during the 1970s supported by the vast majority among both policy-makers and public. The Liberals and the Center Party acceded to power in 1976 with no intentions to reverse the trends. In addition, they were both firmly wedded to a policy of full employment and, the Center Party in particular, regional justice. When economic crisis hit Sweden with full force in 1977, they were both disposed toward solving problems of unemployment and industrial crisis through government spending. It was simply inconceivable for both paties at the time to watch major industries, and with them entire geographical areas, go bankrupt almost overnight.

But this willingness to spend in many areas was combined with a lack of ability to control totals in budget policy. This was, I will argue, due to a number of different political and organizational factors. First, there was little of both understanding and control of what may be termed 'automated growth'. It has been estimated that as much as 80 or 85 percent of the Swedish state budget during the late 1970s consisted of programs which 'automatically' required funding out of the public purse, i.e. in order to cut expenditures earlier decisions had to be altered (cf SOU 1979:61). To put it in the language of budget theory, the base line of this year's spending was not that of last year, but for more than four-fifths of the budget the higher levels already decided upon for this year. (The importance of such mandatory or 'uncontrollable' expenditures in shaping the character of budgetary outcomes is now beginning to attract scholarly interest; cf Downs & Rocke 1984.)

Second, the fact that the new government formed in 1976 was a coalition government probably inhibited forceful action. The evidence is legion concerning major and minor conflicts among the three parties throughout the late 1970s (see, for example, Rydén 1983 and Bohman 1983). The inevitable conflicts between 'spending ministers' and cabinet members responsible for overall government policy were attenuated by the fact that they represented different parties; party loyalty and discipline could not be as effectively invoked as in a singleparty government. The most dramatic conflict, already mentioned above, during the first two years of non-socialist rule concerned the use of nuclear energy. The conflict was so divisive that it must have taken considerable time and energy off other policy concerns. The almost day-to-day accounts that have been published testify to this (Leijonhufvud 1979; Vedung 1979).

Third, partly inspired by earlier discussions among economists and partly motivated by considerations in the bargaining process before the cabinet was formed, the coalition parties in 1976 decided to split the Ministry of Finance into a Ministry of Economic affairs and a Budget Ministry. The critics of the old arrangement had argued that macroeconomic policy was being unduly influenced by budget considerations. Now the Conservatives were given the Ministry of Economic Affairs while the more spendthrift Liberals were allowed to name the budget minister. The split itself and the party political division of responsibility with respect to the two new Ministries were probably detrimental to efforts to cope with exploding deficits.

When the Liberals formed their single-party government in late 1978 the budget minister of the three-party coalition became responsible for both the Budget Ministry and the Ministry of Economic Affairs. These developments — a singleparty government and the new ministerial arrangement — may well in principle have been conducive to a more forceful budget policy, but this was counteracted by at least two other factors. First, the extremely weak parliamentary base of the new government. The Liberals were, at least initially, intent on seeking parliamentary support both to the left and right — hardly a strategy that paved the way for expenditure restraint. Second, the Liberals took over less than a year before the 1979 elections. As mentioned above, many economic indicators pointed then toward an end of the recession. The result was, it has been argued, a Liberal 'election budget'. A recent study of 'politico-economic interaction' in Sweden between 1970 and 1982 shows that the Liberal minority government of 1978-1979 is the only instance when the evidence points toward a conscious manipulation of the economy for political purposes (Lybeck 1983).

Fourth, in the Swedish debate on 'the long road to economic realism' what may be termed 'the skill factor' has also been advanced as a possible partial explanation of government inaction. The argument is that the new ministers acceding to power in 1976, with no experience whatsoever of cabinet-level work, were simply slow learners. Stories are told, for example, about their not even finding the way to their respective Ministries ... There may well be more than a grain of truth in such observations; they are of course disputed by the ministers themselves (e.g. Mundebo 1983). But the evidence is so far no more than anecdotal.

Fifth, turning for a moment to the revenue side of the budget, it could well be argued that the observation about a lack of both willingness and ability to cope is equally valid here. The rapidly expanding public sector in Sweden has also led to the highest rate of taxation among OECD countries. Signs of a 'creeping tax revolt' have been present since at least the early 1970s, putting pressure on especially the Conservative and Liberal Parties. So the willingness to avoid tax increases was strong in the late 1970s. But there was also a lack of understanding about the revenue side of the budget leading generally to too optimistic calculations about the revenues that various taxes and charges would produce. The concept of 'cannibalism' has later been launched to describe the mechanism at work. Simply but, it is argued that new and/or higher taxes and charges tend to erode the base of existing ones. The importance of this factor for the exploding budget deficits in the late 1970s is very difficult to estimate, but many observers are prepared to argue that it was at least of some significance.

Finally, some Social Democrats have argued (Åberg 1982) that the non-socialist governments of the late 1970s — chiefly inspired by the Conservatives — consciously pursued a policy of exploding budget deficits in order to pave the way for future drastic cuts in public expenditures. Such a 'conspiracy theory' can hardly be substantiated. It appears as simply untrue with respect to the Liberals and the Center Party. As for the Conservatives, an obvious problem with this allegation is that a huge budget deficit may both motivate expenditure cuts and, if not tax increases, at least not be conducive to large tax cuts — an equally attractive goal for the Swedish Conservatives.

The Turn-About in 1980

1980 and early 1981 marked a period of reappraisal in government economic policy in Sweden. As told above, an explicit goal was for the first time established for a systematic and successive reduction of state budget deficits. This was to be accomplished through expenditure cuts. All major spending areas would have to bear part of the burden. A first 'cutback bill' appeared in October of 1980. Another round of significant cuts was announced in early 1981.

In trying to account for this turn-about in government policy, I will, again, start with general economic developments and perceptions surrounding them. The rapid passing of the international recovery of 1978/79, greatly aided by the 'second oil crisis' of 1979, proved conclusively to many Swedish policy-makers and professional economists that the roots of economic crisis went deeper than had earlier been realized. There is evidence that this was an interpretation that was widely shared by actors in many or most other OECD countries; from about 1980 'austerity measures' signify economic policy virtually everywhere (cf. e.g. Braun & Keman 1984). The subsequent reorientation in macroeconomic thinking was particularly dramatic among professional economists, both in Sweden and internationally. A Swedish economist has recently made the following observations (Siven 1984):

> In the early 1970s Swedish professional economists, with very few exceptions, were Keynesians. They were trained to analyze stabilization problems in terms of a relatively simple macro model of a small open economy. They discussed the Phillips curve as a policy option model but were convinced that under the present currency system inflation was largely imported. They had no clear understanding of the importance of the political mechanism for economic policy formation. Public-choice thinking was not introduced (until 1977). The late 1970s implied that they (more or less rapidly) both abandoned Keynesian analysis and arrived at a deeper understanding of the peculiarities of the Swedish crisis.

It has been discussed whether they were becoming outright monetarists, supply-siders or just some kind of neo-Keynesians (e.g. Persson-Tanimura 1981; also Ashford 1984). Be that as it may — the important observation here is that a marked 'paradigm shift' did occur. Mainstream economists in Sweden, who in the earlier postwar period had legitimized traditional Keynesian economic policies, now supported a quite different set of policies. From about 1980 they forcefully advocated drastic cuts in government spending, lower taxes in order to provide incentives in economic life and, generally, a restoration of markets in Sweden as a panacea for solving the economic crisis. The public sector now — to paraphrase a well-known slogan — was increasingly viewed as a problem rather than a solution. Budget deficits became a chief concern among economists. Extensive lists of the evil impacts that large deficits would produce were published, although it was obvious that theory lagged considerably behind conviction.

Theory-based or not, the conviction about the importance of budget deficits also spread among government policy-makers in 1980. Some under-secretaries of state seem to have been particularly instrumental at this stage (Siven 1984; also Westerberg & Westerberg 1983). For example, they were engaged in producing projections of government spending — exercises which illustrated that a substantial part of current budget deficits was 'structural' rather than conjunctural in nature. A similar 'horror scenario' was included in the governments' long-term economic plan of 1980 (LU 80). The media in Sweden immediately caught on, some of them with headlines predicting Sweden's imminent bankruptcy — unless drastic action was taken.

Furthermore, at least two 'political-organizational' factors were conducive to the turn-about in economic policy in 1980 and early 1981. One concerned the cabinet agenda. As told above, the nuclear energy issue had greatly dominated the internal conflicts within the first non-socialist coalition government, and had finally brought it down. Through the referendum in March of 1980, this troublesome issue was largely taken off the second three-party coalition's agenda. The conflicts within the new cabinet were legion — but at least they now centered on economic policy. The difficult task of formulating a coherent strategy in this key area could finally begin.

A second important event was the resolution of the intraparty dispute over economic policy among the Liberals in late 1980. The Liberals were acutely aware that they were slipping substantially in opinion polls. Within the Party the neoliberals were gaining strength, and they had an unequivocal interpretation of the major reason behind the troublesome situation: the Party had during the 1970s gone too far to the left, and was now losing to the Conservatives. Discussions in late December of 1980 resulted in a mandate for the leadership to pursue the new austerity policy with full force and thus incite government action. The Liberal initiative, I would argue, finally tipped the balance among the non-socialist parties, and so within the three-party government. They finally agreed on the main features of a policy of how to cope with budget deficits. The ironical fact that the coalition soon broke up did not change this.

Concluding Discussion

During the late 1970s and early 1980s, Sweden — probably at a more rapid rate than any other OECD nation — developed huge budget deficits. Government policy towards these developments may be said to have occurred in three phases. Until 1980 little was in fact done to cope. From 1980 to 1982 a strategy was formulated and partly implemented which heavily emphasized cuts in public spending. From late 1982 onwards a 'mixed' strategy has been pursued which combines less drastic cuts with selected revenue increases.

The lack of both willingness and ability to cope during the late 1970s was probably due to several factors as discussed above. Mistaken predictions about macroeconomic developments; the dominating views among professional economists; ideological predispositions among policy-makers and public; signs of a 'creeping' tax revolt; poor understanding of the nature of public sector growth; the character of parliamentary government — first an extremely conflict-ridden three-party coalition, then an extremely weak single-party government; the dividing-up of the old Ministry of Finance; perhaps also a lack of skills due to inexperience — all these factors, I have argued, contributed to government inaction.

The fundamental turn-about which occurred in 1980 should, I believe, essentially be interpreted as a process of 'saturation'. Macroeconomic developments showed that both the international and the Swedish crises were more long-lasting and profound than had been realized so far, and projections of public expenditures and budget deficits provided 'horror scenarios' which demanded action. Furthermore, the 'revolution' in macroeconomics finally reached the Swedish economic profession — supporting and legitimizing the new economic policy. Within the three-party coalition, the 'resolution' of the nuclear energy issue and the Liberals' decision to back an economic strategy so far endorsed only by the Conservatives were both crucial events paving the way for the turn-about.

In order to elaborate somewhat on the argument presented so far, I will pose two related and 'counterfactual' questions. First, we ask if a Social Democratic government during the period 1976-1980 would have 'managed better' than the non-socialist ones that were actually in power. Second, we pose the same question with respect to the period between late 1982 and the present: Would Sweden's budget deficits have been smaller if the non-socialist parties had been victorious in 1982? These questions can obviously not be definitely answered — but this should not, I believe, prevent us from learning by trying.

According to many Swedish observers today — in particular Conservative commentators but also many economists (e.g. Siven 1984) — the period 1976-1980 is best described as a continuation of Social Democratic policy by non-socialist governments. As should be evident from our story above, this statement is at least partly true. The Liberals and the Center Party were before 1980 committed to public sector growth in general and to specific goals such as full employment and regional justice in much the same manner as the Social Democrats. They responded to crisis by spending more — as I believe the Social Democrats would have done.

However, there are at least three factors which I think support the hypothesis that the Social Democrats would not have allowed budget deficits to explode in the manner they did during the late 1970s. First, although it may seem improbable at first, an individual may have made a difference. The Social Democratic finance minister during almost two decades, Gunnar Sträng, had a unique position in Swedish political life in general and within the Social

Democratic Party in particular. Equally important he ran his 'household' according to a simple principle: expenditures had to be met by revenues. Budget deficits must be kept as small as possible. Through the years he largely withstood all the intense 'lecturing' mentioned above from Swedish economists. Of course, we cannot be sure how he would have behaved when economic crisis finally hit Sweden in 1977 — or if his unique authority would have remained intact. But according to a very prominent — and non-socialist — economist in Sweden, a Social Democratic government with Sträng as finance minister would not have tolerated the huge budget deficits that actually developed during the late 1970s (Lundberg 1981).

Second, it seems obvious that a Social Democratic government — with or without Sträng as finance minister — would have resorted to increased taxes as a means to cope with budget deficits. This should, for example, be evident from their alternative budget proposals. Although this may have resulted in less revenues than hoped for (cf. the argument about 'cannibalism' above), it would at least in the short run and to some extent have reduced the rapidly widening gap between expenditures and incomes.

Third, and finally, a Social Democratic one-party government would obviously not have been affected by all the 'organizational' problems mentioned earlier. It would have formed a team rather than three warring factions as was the case with the first three-party government. Nor would a Social Democratic government have been torn apart by an internal battle over the nuclear energy issue. Obviously it would have experienced difficulties as all governments in a period of economic crisis, but its effectiveness — considering also the 'skill factor' discussed above — would in all probability have been greater. It may well have pursued the wrong policies — but it would have been better at it.

By contrast, many observers — in particular those on the left wing of the political spectrum — argue that the period 1980-1984 has been characterized by quite consistent 'rightist' policies pursued by non-socialist and Social Democratic governments alike. Again, there seems to be a lot of truth in such a statement. Although I have mainly pointed to the differences between the austerity policy of the period 1980-1982 and the 'Third Way' strategy of the last few years, there is plenty of evidence pointing to similarities as well. A closer look at the detailed means of 'cutback management' in recent years will reveal that most measures adopted since about 1978 have either been decided unanimously or were accepted by the Social Democrats after the fact. This has been true, for example, of general cutback measures such as the '2 percent rule' which briefly implies that most central government agencies have been forced each year to accept a reduction in funding amounting to 2 percent. It has also been true of a whole series of measures aimed at improving the basis for budgetary decision-making (for an extended list and a discussion, see Premfors 1982). The point here is that there is more continuity in budget policy means than in the highly politicized discussions of ends and overall strategies.

Keeping these observations about continuity in mind, would a non-socialist victory in 1982 have made a difference with respect to recent budget deficits? My answer to this second counter-factual question is that — all things considered — it would have resulted in a more rapid reduction of budget deficits, but, as in the period 1976-1980, the differences would not have been dramatic. To put it briefly, my argument is that the non-socialist parties would have implemented cuts that were greater than those actually implemented by the Social Democratic government, and that Social Democratic revenue increases would not have made up for the difference. This 'guesstimate' is based on the actual proposals by the non-socialist parties in opposition, and an estimate of the sincerity and capability of their present leaders in pursuing these proposals for expenditure cuts. Of special significance in the latter respect is the new leadership in the Liberal Party. Their new party leader, elected in 1983, is a very convinced adherent of the 'revolution in macroeconomics', a true believer in less government and more market. In a pamphlet published shortly before his election he advocated truly drastic cuts in government spending (Westerberg 1983b). And the Conservatives have almost completely been taken over by quite extreme neo-liberals advocating massive privatization of the public sector in Sweden. By contrast, many in the Center Party are obviously not at ease when confronted with such ideas, but they still advocate a three-party coalition following a non-socialist victory in the 1985 elections. Such a victory would provide, I argue, a stable majority within the coalition in favour of a quite forceful reduction of budget deficits via expenditure cuts.

In sum, this exercise in counter-factual reasoning points to the following conclusions: In the period 1976-1980 a Social Democratic government would have meant smaller budget deficits; in the period 1982-1984 a non-socialist government would have meant the same. The resolution of this seemingly paradoxical statement is, I contend, to be found in the preceding analysis of Swedish budget politics and policy.

In the so-called long-term economic plan (LU 84), an expert report published in early 1984, a systematic reduction of deficits is listed as one of five key objectives in Sweden's future economic policy. The overall goal should be, the report argues, a state budget deficit of between 40 and 50 Bill. SEK in 1990 — which means about half of the current level. Savings will have to be found in the order of 6 to 8 Bill. SEK each year. The room for increased taxes is said to be very limited; the goal must largely be reached through limitations on spending:

> The recommended increase in public expenditures represents a very dramatic break in historical trends. Total government spending, which has increased by 5 percent on average during the period 1970-1983 is presumed to increase by only 1 or 2 percent a year (until 1990).

The recommended level of future budget deficits is arrived at through the postulation of a specified goal for Sweden's balance-of-payment situation and complex (and highly uncertain) projections of savings and investments in the rest of the economy. The report seems aware of the quite shaky theoretical underpinnings of its argument and recommendations. The state of the art is summarized as follows:

> In sum, it may be concluded here that there is no clear relationship between a budget deficit on one hand and economic growth and inflation on the other. The impacts (of budget deficits) depend, among other things, on the degree of capacity utilization in the economy, the ways in which the deficits are financed, and the size and permanence of the deficits.

However, this does not prevent the report from arguing that:

> ... large structural deficits create structural imbalances in the economy. The budget deficits tend to 'crowd out' activities in the private sector and to produce balance-of-payment difficulties.

Swedish economists are now increasingly at work trying to sort out the theoretical and policy problems associated with large budget deficits (see e.g. Lybeck 1983, Persson 1983, Werin 1983, Myhrman 1984a and 1984b). In both respects, the issues involved are extremely complex: the impacts of budget deficits 'are simply related to all macro problems that face government economic policy' (Myhrman 1984b).

It seems safe to predict that budget deficits will continue to occupy the center stage of Swedish politics for some considerable time. Even if some degree of consensus is reached at a theoretical level — which I doubt — the politics of budget deficits is much more. Basically it involves the key issue of the size and nature of government. Furthermore, to agree on the appropriate level of government spending is one thing, finding and implementing specific cuts quite another. The present minister of finance, Kjell-Olof Feldt, has recently reflected on the current politics of budget policy in Sweden (Feldt 1984):

> Budget policy affects the economy both positively and negatively and to formulate it implies precarious choices between goals that are often contradictory. The political opposition can afford the luxury to focus entirely upon the budget deficit, using their eloquence to demand forceful actions. A government — a Social Democratic government in particular — has to take into account the impact of the budget on employment, inflation, growth and income distribution. Many and complex factors have to be traded off in order to find the appropriate balance.

In sum, budget policy 'is far from an exact science'. Within the Swedish labor movement, the 'expansionists' are pushing hard in the opposite direction, playing down the importance of large budget deficits. In and out of government there is also the immense pressure excerted by sectoral interests, pushing for expansion in their own area and disregarding totals. The outcomes of Swedish budget policy — and so the size of future budget deficits — will largely be determined by the outcomes of the struggle among these opposing forces.

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