Mancur Olson:

How Bright are the Northern Lights?
Some Questions about Sweden

Chapter 1

Why Isn't Sweden Worse Off?

For more than half a century, Sweden has been known the whole world over for a distinctive set of policies and institutions - for the "middle way" between communism and capitalism or the "Swedish model".[1] This Swedish system includes an unusually generous welfare state, but the country also has some other distinctive arrangements that, I shall argue, are no less significant.

Are the distinctive Swedish arrangements really northern lights that nations can use to get a rough sense of direction when they choose economic and social policies? We cannot say until we know how well the distinctive Swedish arrangements are working in comparison with the different arrangements in other countries. Thus to answer our question - "How bright are the northern lights?" - we must first ask, "How is Sweden doing?"

Sweden has, however, *several* distinctive institutions and policies, each of which has a different impact on the country's performance. Some may be lifting Sweden up at the same time that others are dragging it down, so that the overall performance may not reveal the actual value of any one of these distinctive arrangements. The inadequacy of an undifferentiated or monocausal approach becomes clear simply from breaking the familiar question about how Sweden is doing into two separate questions:

1) Why isn't the Swedish economy performing better than it is?
2) Why isn't the Swedish economy performing worse than it is?

Although these questions are obviously parallel, their answers are not. There is a standard, straightforward answer to the first question, but no familiar or obvious answer to the second.

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[1] Erik Lundberg, "The Rise and Fall of the Swedish Model," *Journal of Economic Literature* 23, 1985.

The answer to the first question is so familiar that I shall merely evoke it here: income transfers and the public sector have often been larger in Sweden than in any other noncommunist country, with the government spending and transferring at times more than three fifths of the nation's Gross Domestic Product; tax rates have accordingly been exceptionally high, with large proportions of the population having paid half, or even two-thirds or four-fifths of marginal income in taxes. On top of this, an extraordinarily powerful union, the LO, has often reduced wage differentials, thereby attenuating incentives and discouraging investment in skills. Robert Flanagan, a leading labor economist contributing to the Brookings Institution study of the Swedish economy, said, "When an outside economist first views the Swedish labor market, with its compressed wage differentials, comparatively high marginal tax rates, and numerous government-financed alternatives to work, the first reaction tends to be amazement that the labor market works at all."[2] Thus the standard answer to my first question is not only well known, but emphatic as well.

This makes the second question - why Sweden is not worse off - all the more puzzling. Amazed as he was, Robert Flanagan concluded that Sweden "works." In an important sense, this is surely true. According to the best available measures, Sweden is one of the richer countries in the world, with a real per capita income that is as high as (or a trifle higher) than that of most nations in Western Europe. Why does it not have a lower per-capita income than countries with smaller public sectors, lower tax rates, and no comprehensive union engaged in economy-wide wage leveling?

Why, for example, is per capita income in Sweden about double the level in Ireland? In the countries to which both Irish and Swedes have migrated, their incomes are similar, but there is no question that the Swedish economy is vastly more productive than the Irish.

Similarly, why are per capita incomes now higher in Sweden than in Great Britain? They were for a long time *much* higher in Britain; in 1870 Sweden was a relatively poor country, but Britain then apparently had the highest per capita income in the world.[3] Yet the situation is now reversed, even though, for a very long time, the public sector has been larger, marginal tax rates higher, and union wage-leveling incomparably stronger, in Sweden than in Great Britain.

There is another country that used to have a per capita income substantially in excess of Sweden's but is now way behind. That country is Argentina. Now that Argentina lags so far behind the nations of Western Europe, it is no longer usually compared with them, even though its population is almost entirely of European descent. Yet, in the early decades of our century, Argentina apparently had one of the ten highest per-capita incomes in the entire world, and for a considerable period surely had higher standards of living than Sweden. In the period during which Argentina has fallen behind,

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[2] "Efficiency and Equality in Swedish Labor Markets," in Barry Bosworth and Alice Rivlin, eds., *The Swedish Economy* (Washington, DC: The Brookings Institution, 1987), p. 172.

[3] With the exception of resource rich and recently settled Australia.

its redistributions of income to low-income people and its welfare state have been incomparably smaller than Sweden's; it is even questionable whether Argentina (protectionist and interventionist as its government is) should be described as having a *welfare* state at all.

Many people around the world would say that the Swedish economy has not only outperformed the three economies that have just been discussed, but also been one of the most successful economies anywhere. That is a much stronger conclusion than is required for my argument. To be on the safe side, I take the lowest possible estimate of Sweden's economic achievements. Even then, we must ask why the Swedish economy works or survives at all, why Sweden incontestably remains one of the developed economies, and why it has unquestionably outperformed the three aforementioned comparison economies with less egalitarian policies.

Is the Standard Answer to the First Question Wrong?

Some people may suppose that the answer to the second question (why isn't Sweden worse off?) is simply that the standard answer to the first question (why isn't Sweden doing better?) is wrong: the fact that Sweden's per capita income is better than that of some countries with a smaller public sector, lower marginal tax rates, and less egalitarian unionism merely shows that individuals are not very sensitive to incentives and that the distortions in resource allocations that agitate critics of the Swedish welfare state are not, in fact, a significant problem.

I will argue in this essay that the familiar answer to the first question is to a large degree correct, but that limiting and offsetting factors have not been understood. These countervailing considerations not only help to explain why Sweden has a high level of per capita income, but also suggest that a society, with the right policies, can afford a better provision for its least fortunate citizens than those who understand the importance of incentives have realized.

The countervailing considerations that are the main concern of this essay can only be understood if one first appreciates the large element of truth in the familiar argument that Sweden's economic growth is slowed by its high taxes and subsidies and its often egalitarian wage policies. This familiar argument is not merely ideological rhetoric; it is generally accepted by the leading economists on the left and the right alike.

The professional consensus on this point is obscured in part because many economists understandably point out that some welfare state expenditures can increase a society's income. Subsidized education and training for low-income people who (because of capital-rationing or other market failures) would not obtain it by themselves can increase a nation's income. This point may be especially pertinent in countries such as Japan and the United States, where the welfare state is relatively smaller than in Sweden but where unusually large proportions of the population nonetheless receive subsidized higher education. But it does not appear, at least at first glance, that any extra spending on the development of education and skills in Sweden is the main explanation of Sweden's relatively larger welfare state or of its economic achievements.

The professional consensus that very high levels of welfare state transfers reduce a country's income is also obscured because many economists favor income redistributions to the poor even though they believe such redistributions reduce income. There is no inconsistency in this position. A transfer to low-income people may increase total welfare or utility even though it reduces the measured income of the society. This is because, as is now known, the marginal utility of consumption systematically decreases with consumption[4] and people with higher incomes tend to get less utility or satisfaction from marginal consumption than poorer people.[5] Thus, if it is not pushed to the point where the adverse effect on incentives makes the incomes of even the poor lower than they would otherwise be, a redistribution of income can still increase human welfare even if it reduces measured per capita income.

There is also a technical complexity involving "income effects" that leads most observers to underestimate the loss of social efficiency arising from high taxes. Consider a worker who is taxed to pay for transfers to those who cannot work. The tax reduces the reward to the worker from an additional hour of work, but it also lowers his disposable income. Just as the first or "substitution effect" gives the worker a reason to work less, so the latter or income effect implies that he can afford less leisure and this makes him work more. The latter effect at least partially offsets the former effect, and this is one reason why the number of hours individuals work does not usually change dramatically with changes in tax rates.[6]

Unfortunately, high tax rates are harmful to economic efficiency even in those cases where the income effect completely offsets the substitution effect so that the hours worked are unchanged. This last point is perhaps counterintuitive and even some skilled economists need to be reminded of it. The reason why there is a loss of social efficiency from taxes even when they do not change hours of work at all is, in essence, because the taxed individual, though mindful that taxes mean he can afford less leisure, takes no

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[4] Martin J. Bailey, Mancur Olson, and Paul Wonnacott, "The Marginal Utility of Income Does not Increase: Borrowing, Lending, and Friedman-Savage Gambles," *American Economic Review*, vol. 7 (3) (June 1980), pp. 372-79.

[5] See my "Why Some Welfare-State Redistribution to the Poor Is a Great Idea," in *Public Choice and Liberty, Essays in Honour of Gordon Tullock*, ed. Charles K. Rowley (Oxford: Basil Blackwell, 1986).

[6] The impact of a tax increase on hours work also depends on other things, such as the uses to which the tax proceeds are put. If the tax receipts are mainly given as transfers to the same people who pay them, or if they are used to make leisure activities more attractive, this can lead to a far greater reduction in work than otherwise. See, for example, Assar Lindbeck, 'Tax Effects vs. Budget Effects on Labor Supply," *Economic Inquiry* vol. XX No.4, October 1982, pp. 473-89, James Gwartney and Richard Stroup, "Labor Supply and Tax Rates: A Correction of the Record," *American Economic Review*, June 1983, 73, 446-51, Cecil E. Bohanon and T. Norman Van Cott, "Labor Supply and Tax Rates: 'Comment'", and Firouz Gahvari, "Comment," in *American Economic Review*, Vol. 76, No. l, March 1986, pp. 277-283.

account of the gain to those who benefit from the extra taxes he would pay if he worked more (as is shown in the footnote).[7] Since the loss of efficiency from higher taxes, even when large, is not directly observable from the total number of hours of work done, it is often under-estimated.

In short, the second question of why Sweden is not doing worse than it is cannot be dismissed simply by claiming that the standard answer to the first question is wrong. The large Swedish welfare system may be morally appropriate and on balance desirable, but that does not change the fact that this system, together with wage-leveling, is making Sweden's *measured* economic performance less good than it would otherwise be. If we leave aside some interesting technical questions that are of no special pertinence here, this conclusion does not require much more than the finding that individuals and firms respond to changes in incentives in the ways that economic theory predicts.[8] Sweden's relatively high per capita income, and its far faster growth during the period it has followed the "middle way" than less egalitarian countries like Argentina, Britain, and Ireland, is an anomaly that cries out for explanation.

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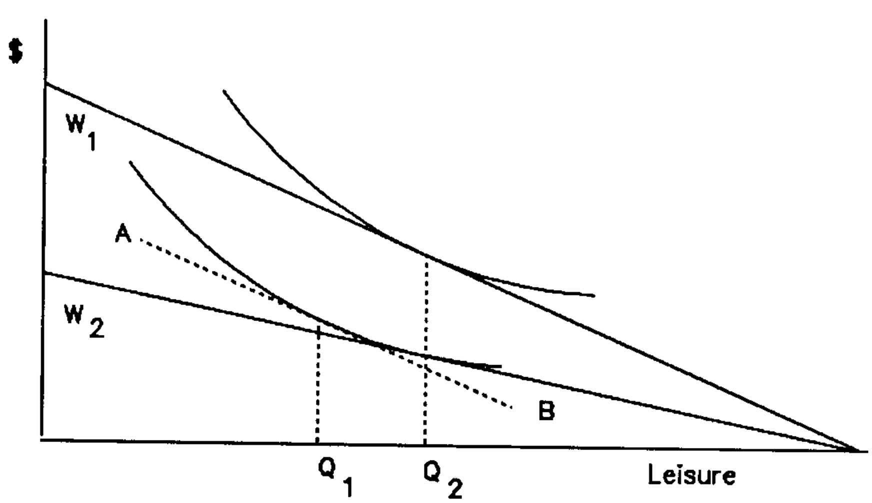
[7] Suppose an individual, with preferences between money income and leisure given by the indifference curves below, is confronted with a (proportional) income tax such that his post-tax wage rate falls from W_1 to W_2, and that none of the proceeds of the tax receipts are devoted to the consumption of the individual who pays the taxes. In the case depicted the reduction in the individual's post-tax income reduces the amount of leisure he chooses to consume by just enough to offset the reduction in the amount of work he chooses to do because the reward to him of an extra hour of work is decreased. But the adverse effect on economic efficiency is still there. When we take into account the value to others of the extra taxes this individual would pay if he worked more, we see that the total social value of his work can be depicted as the slope of line AB, parallel to W_1, so that, if the individual had an incentive to take account of the value of his tax payments to others, he would now take only Q_1 rather than Q_2 hours of leisure.



[8] The important qualifications in the theory of the "second best," for example, will be ignored here.

Are Time Lags the Answer?

A comparison with the United States in recent years suggests a possible explanation. Although the American standard of consumption has remained high since 1980, it is by no means an adequate basis for judging the country's economic performance in this period. As is well known, the United States since the beginning of the Reagan administration has run large deficits in its government budget and in the current account of its balance of payments. When the debt to overseas borrowers is repaid, consumption will have to be lower than it would otherwise be. Therefore, the level of consumption leads to an overstatement of the current performance of the American economy.

Surely the Swedes have not yet received the full bill for their extravagances either. As Swedish critics of the country's welfare state have pointed out, habits of behavior do not change overnight, so that when incentives change their full impacts come with lags, which are a pervasive feature of economic life. Thus there can be no doubt that lags are relevant in answering our second question. A subsidiary theme of this book will be that the shape or functional form of the relationship between tax and subsidy levels and economic performance makes the "lag" explanation more significant for Sweden than it would otherwise be.

Yet, even if Sweden is overcome by an economic catastrophe before the ink is dry on this little book, we should still be puzzled about why the lags are so long. The impacts of changes in macroeconomic policies, in investment incentives, in exchange rates, and in tariff levels normally show up within a few quarters or a few years. Sweden has been famous for its "middle way" for more than half a century. Most of the lags that are evident in economics are not even a tenth as long as that. When we are comparing economic performance of different countries, it is the *relative* size of the public sector that is most relevant. If we take the period since 1951 (when national income statistics first came to be generally available) as a whole, both government consumption and total government outlays as a percentage of national income have been larger on average in Sweden than in any other country in the Organization for Economic Cooperation and Development.[9] No doubt *some* of the effects of a general change in the pattern will show up only after generations have passed, but the main effects of most changes in economic policy show up within a few years, so we still have a scientific puzzle.

[9] Total government outlays are defined as government consumption + social security transfers + subsidies + interest on public debt + gross capital formation + purchases of land and intangibles. Over much of the 1951-87 period, social security transfers have been less in Sweden than in several other Western countries.

Is Swedish Culture the Explanation?

There is a tendency to "explain" each country's performance by referring to allegedly unique traits of its people. Every culture and every people have some obviously distinctive characteristics, so it is always easy to claim that these characteristics account for a country's performance. But after sustained examination these claims usually turn out to be pseudo-explanations. Although references to national character are as common on one side of the political spectrum as the other, my experience suggests that, where our second question is concerned, this tendency is likely to take what might be called a "conservative-chauvinistic" form. Sweden's economic performance is as good as it is, some say, because the disincentives of the uniquely large welfare state and the egalitarian LO are countervailed by Swedish or Nordic cultural tendencies to work harder, to save more, and to be more enterprising than most other peoples would be if confronted with similarly oppressive incentives. Being of Nordic descent myself, I understand that this type of argument can have an emotional appeal. But it cannot survive careful examination.

How can favorable cultural traits, which surely do not change quickly, also explain the relatively low incomes in Sweden and in Scandinavia in the mid-nineteenth century and for some time before that? Those who oppose a large welfare state also need to explain how a superior national character could be consistent with what they regard as uniquely bad national decisions on this matter. And how can enduring national characteristics explain why so many countries - such as Argentina, Britain, Germany, and Japan - had extraordinarily good economic performance in some periods and extremely poor economic performance in others? All that we know about relative economic performance indicates that ad hoc cultural and racial explanations normally do not prove useful in the long run. We can be confident that we have found valid explanations only when we have parsimonious and general theories that explain performance in a wide variety of settings.[10]

Government Size and Economic Growth in the West

The same puzzle of why, in spite of the distortion of incentives from high taxes and welfare state subsidies, Sweden still has a high per-capita income is evident, in a less extreme form, in most of the other countries with relatively large welfare states. The data on the developed democracies in general show that, in the years since World War

[10] See Chapter 1, on "The Standards Satisfactory Answers Must Meet," in my *Rise and Decline of Nations* (New Haven, Conn. and London: Yale University Press, 1982), or in the Swedish translation published by Ratio in 1984.

II, the countries with relatively large welfare states have tended to grow about as rapidly as those with less egalitarian policies. To be sure, as later parts of this book will demonstrate, different types of government expenditures can have very different effects, so we cannot solve the puzzle simply by looking at the relative sizes of government outlays and rates of economic growth in different countries. In addition, definitive empirical findings about the relation between the size of the public sector and the rate of economic growth would require not only more data than now exist, but also a full scale econometric study rather than the merely illustrative and descriptive display of data that is offered here.

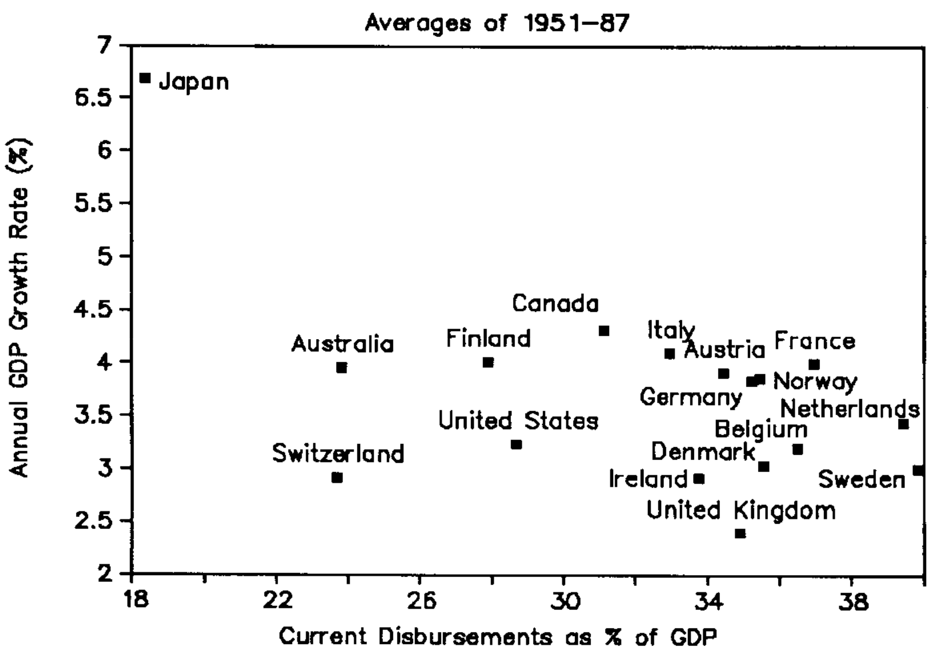
Still, it is instructive to examine the data displayed in Figure 1 and in Table 1. These data reveal that, when we take all the years since 1951 to 1987 together, there is at least no clear association between the percentage of a nation's resources spent or transferred by government and its rate of economic growth. Any association there may be is not strong enough be conspicuous. In the 1950s, as Figure 2 and Table 2 reveal, there was, if anything, a faint tendency for the countries with larger welfare states to grow faster. In this decade, Sweden, though well above average in total government disbursements as a percentage of GDP, was by no means the leader. The most notable country was West Germany, which was then undergoing an economic miracle and had, at the same time, one of the very highest levels of social security transfers and also one of the highest percentages of total government disbursements. These facts must surely alert us to the likelihood that something besides the disincentives of the welfare state has a big impact on rates of economic growth. The ideological arguments that focus exclusively on the size of welfare state redistributions to the poor are, at best, incomplete.

The data also reveal that there is definitely no general or lasting tendency for nations with larger public sectors to grow any faster than other countries. Indeed, the one country that has all along devoted the smallest proportion of its resources to government - Japan - grew almost as rapidly as West Germany during the 1950s, and much more rapidly than any other developed country over the postwar period as a whole.

If we compare historical periods in which the roles of government were quite different, we get the same mixed picture. In the last half of the nineteenth century, almost all countries came closer to having laissez-faire policies than at any time before or since. This was also a time of unprecedented economic progress, so this period clearly supports the view that laissez-faire improves economic performance. The period from 1945 to 1970 offers quite a contrast. During these years all of the developed democracies greatly expanded their welfare states and the public sectors became far larger than ever before. Yet this was also a time of extraordinary economic growth, surpassing even the glorious last half of the nineteenth century. This period is, accordingly, evidence supporting the view that big government favors economic growth. But the pattern changed again in the 1970s and 80s: the welfare state grew still larger and at the same time economic performance turned sour.

Thus the historical record for the developed democracies as a whole, like the comparison across the developed democracies since World War II, produces no regular pattern: in some countries and in some periods a relatively large public sector is associated with poor economic performance, but in other countries and periods we observe exactly the opposite.

Figure 1



Unfortunately, the ideological and partisan debates have so obscured judgment that some scholars have nonetheless been tempted to draw unjustified conclusions from the experience of individual countries, or from data such as that presented in Figures 1 or 2, or from one or the other of the historical periods mentioned above. This type of mistake is made on both the left and the right. Some scholars of the former persuasion conclude from data or information such as I have set out that a government that aggressively intervenes in the market is favorable to, or at least not harmful to, economic growth. Some advocates on the right can find in the same sources allegedly clear evidence of the pernicious effect of a large welfare state on economic growth. Statistical results are in these situations sensitive to variations in specification and to the inclusion or exclusion of particular countries. Japan is particularly important; it is such an outlier that it can reverse the results in a regression equation. Although the data on Japan clearly favor the rightist view - that a smaller government yields faster growth - this one country's rapid postwar growth obviously could be due to other reasons, so regressions that are not statistically significant unless Japan is included are unreliable.

Table 1: Average Government Size and GDP Growth, 1951-87 (percent)

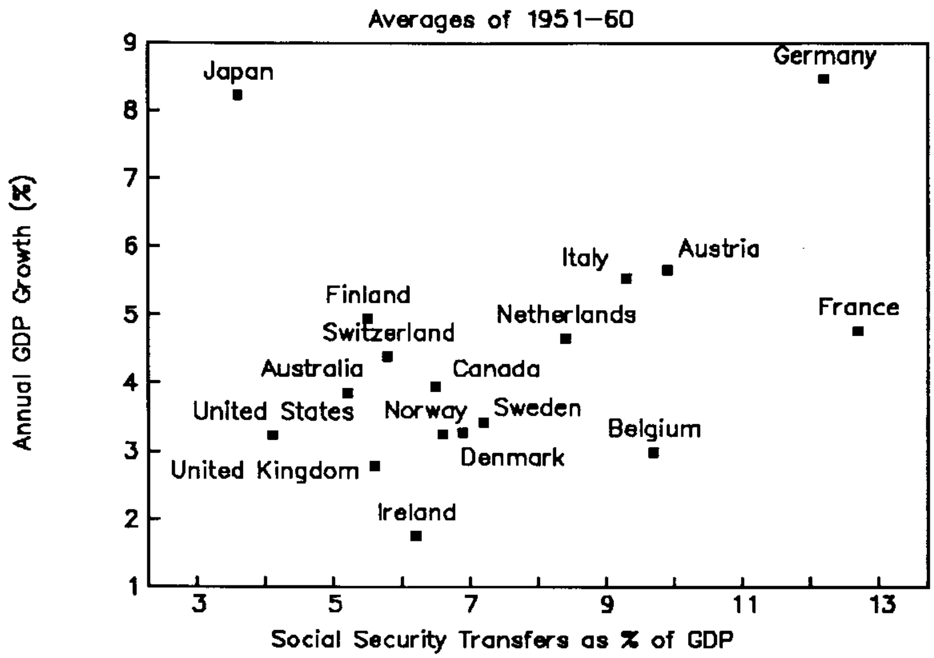
	Annual GDP Growth	Government consumption	Social Security Transfers	Government Expenditure	Current Disbursement	Total outlays (1960-87)
Australia	3.96a	14.2	6.6b	20.8	23.8b	29.8
Austria	3.91	15.2	15.3	30.5	34.5	44.0
Belgium	3.20d	14.5e	15.3e	29.7e	36.5e	42.2
Canada	4.32	17.1	8.4	25.5	31.1	37.1
Denmark	3.03	19.4	11.1	30.5	35.6	44.3
Finland	4.01	15.3	7.5	22.7	27.9	34.3
France	4.00	16.3	17.9	34.2	37.0	42.7
Ireland	2.92	15.3	9.2b	24.5	33.8b	41.8c
Italy	4.10f	13.4	12.7	26.1	33.0	39.8
Japan	6.69e	9.1f	6.4f	15.5f	18.4f	25.3g
Netherlands	3.44	15.5	18.6h	34.1	39.4	48.9
Norway	3.85f	16.4	11.0	27.5	35.5	42.5
Sweden	3.00	21.5	12.0	33.5	39.8	49.3
Switzerland	2.92	11.5	9.1	20.7	23.7	25.0
United Kingdom	2.40	18.8	8.8b	27.6	34.9b	41.0c
United States	3.24	18.0	7.5	25.5	28.7	32.0
West Germany	3.84	16.8	14.2	30.9	35.2	42.6

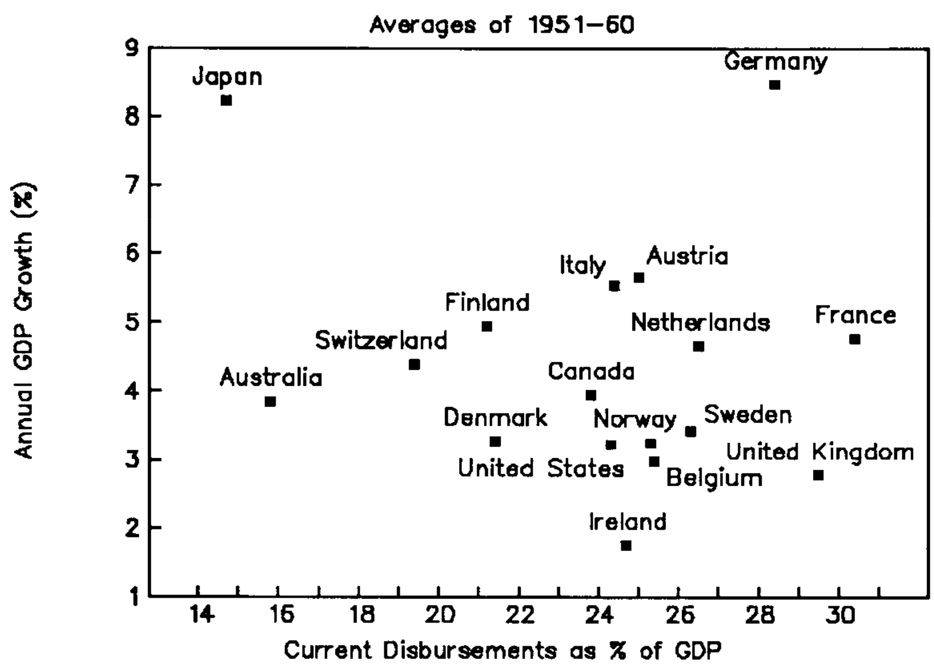
Note: Government consumption = government final consumption expenditure for goods and services. Social security = social security benefits for sickness, old age, family allowances, etc. + social assistance grants and unfunded employee welfare benefits paid by general government. Government expenditure = government consumption + social security transfers. Current disbursement = government expenditure + interest on public debt + subsidies. Total outlays = current disbursement + gross capital formation + purchases of land and intangibles. All data calculated and rounded. For average annual GDP growth rates, geometric averages are used.

a.1956-87. b.1951-86. c.1960-86.
d.1954-87. e.1953-87. f.1952-87.
g. Average of 1968-87
h. Average of 1951-59 and 1968-87

Sources.
1. OECD, OECD National Accounts Statistics, 1950-68.
2. OECD, Economic Outlook, Historical Statistics, 1989.
3. United Nations, Yearbook of National Accounts Statistics, 1957,1964

Figure 2





I do *not*, however, want to go so far as to conclude that there is *no* causal relationship between the role of government and economic growth. My point is rather that the foregoing data and historical facts do not, by themselves, allow us to come to any definitive conclusion yet about the size or even the direction of the influence of the welfare state on economic growth. Any statistical analysis that considers only the variables in Figures 1 and 2 and thus omits many other factors besides the role of government that affect the rate of economic growth, can do little more than raise questions. This problem of "omitted variables" and other difficulties of "specification" indicate that the results of statistical tests on only the foregoing data are likely to be spurious. To underline the point that the variables that have been presented here are not sufficient to allow a properly specified statistical test, I do not even report the results of the regressions that I have run on the foregoing data - that might obscure the mainly heuristic purpose of the foregoing tables.

Table 2: Average Government Size and GDP Growth, 1951-60 (percent)

	Annual GDP Growth	Government consumption	Social Security Transfers	Government Expenditure	Current disbursement
Australia	3.85a	10.0	5.2	15.2	15.8
Austria	5.66	12.7	9.9	22.6	25.0
Belgium	2.99b	12.0c	9.7c	21.7c	25.4c
Canada	3.95	14.2	6.5	20.7	23.8
Denmark	3.28	12.6	6.9	19.5	21.4
Finland	4.94	12.0	5.5	17.4	21.2
France	4.77	14.1	12.7	26.8	30.4
Ireland	1.75	12.5	6.2	18.7	24.7
Italy	5.54d	11.9	9.3	21.2	24.4
Japan	8.23c	10.0d	3.6d	13.6d	14.7d
Netherlands	4.66	14.1	8.4	22.5	26.5
Norway	3.25d	13.1	6.6	19.7	25.3
Sweden	3.42	16.5	7.2	23.6	26.3
Switzerland	4.3	11.1	5.8	16.8	19.4
United Kingdom	2.78	17.4	5.6	23.1	29.5
United States	3.23	18.2	4.1	22.3	24.3
West Germany	8.47	3.7	12.2	25.9	28.4

Note: For definitions and sources, see Table 1.

a. 1956-60. b. 1954-60. c. 1953-60. d. 1952-60.

This said, we must also remember that, if causal relationships are overwhelmingly strong, there is usually little need to worry about omitted variables and other misspecifications. If we test whether being in a plane crash reduces life expectancy, we will probably get the qualitatively correct answer even if we don't take into account whether the dead had been cigarette smokers or not. Thus we can be pretty sure that the effect of the size of the welfare state on economic growth, even though it is the crux of modern ideological debate, is evidently not large enough to overwhelm other factors that affect economic growth in the developed democracies.

When we go beyond the advanced democracies and include evidence from the developing nations, we find that the data are poorer. They are also more difficult to interpret, since the level of development of a country constrains or influences the share of the government in GDP. It is nonetheless interesting that the data on the developed and developing nations together also do not reveal any clear tendency for the size or growth of government to be associated with economic performance. Some studies, such as Daniel Landau's,[11] find that a relatively larger public sector makes for slower economic growth. Other studies, such as those of Richard Rubinson[12] and Rati Ram,[13] find that a relatively larger size of the government generates faster economic growth. When different specifications lead to exactly opposing results, we may suspect that there is really no compelling pattern in the data. That is also what we find from a glance at the data I have displayed in Figure 3, which compare government size and growth for 121 developing and developed non-communist countries.

The data in the three Figures in this chapter, the conflicting conclusions of the prior studies of government size and economic growth, and the broad historical facts that have been set out here are nonetheless suggestive. Since we know from the observation of the behavior of individuals that high levels of welfare spending and taxation have adverse effects on incentives, why doesn't the size of the welfare state show up in comparisons a cross countries and historical periods? This question underlines the need for an answer to my second question about why Sweden, in spite of the large distortions of incentives due to the huge welfare state and to LO wage-leveling policies, is not worse off; the puzzle about Sweden is also evident, in a less extreme form, in the comparisons of different countries and historical periods. Similarly, we know that all the Soviet-type economies - the ones where, in principle, the state runs everything - have failed miserably. Though it is wildly wrong to suppose that large welfare states are inherently semi-Soviet, the collapse of the Soviet-type societies nonetheless does raise our second question in a more casual and perhaps intuitive way. Why isn't the Sweden of the "middle way" - the society with the relatively largest public sector in the noncommunist world - also "mid-way" in per capita income between the Soviet-type

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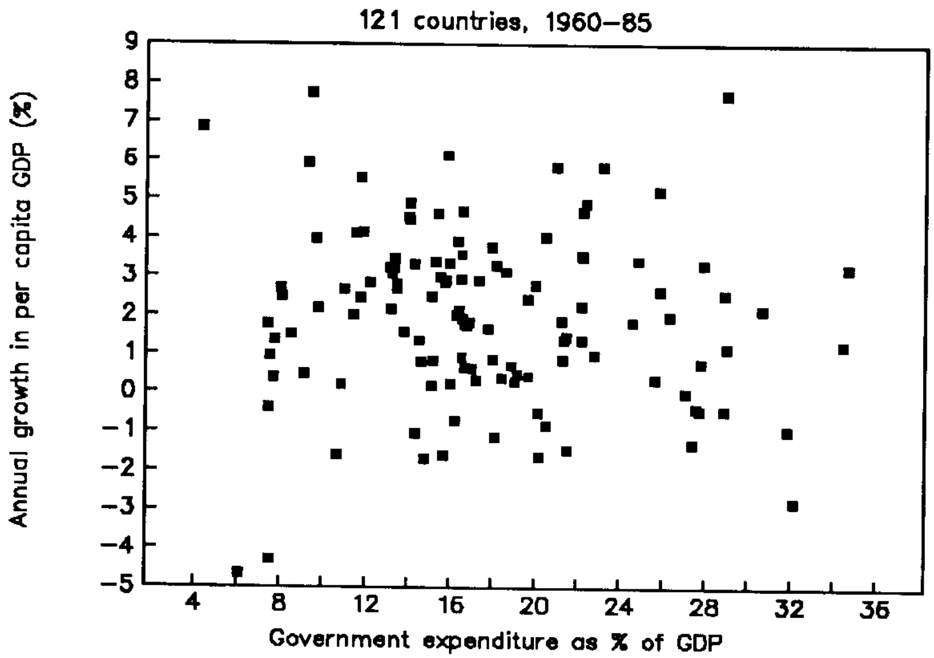
[11] "Government Expenditure and Economic Growth: A Cross-country Study," *Southern Economic Journal* (1983), pp. 783-92.

[12] "Dependency, Government Revenue, and Economic Growth, 1955-70," *Studies in Comparative Institutional Development*, 12 (Summer 1977), pp. 3-28.

[13] "Government Size and Economic Growth: A New Framework and Some Evidence from Cross-Section and Time-Series Data," *American Economic Review* 76 (1986), pp. 191-203.

countries and the developed economies with the relatively smallest public sectors?

Figure 3



I shall try in later chapters to provide a conceptual framework that helps resolve these puzzles. The foregoing data and historical facts have helped us see that we must search for some factors that both of the familiar ideologies omit. They have also shown us that the effects of a larger welfare state on economic growth, important as they must be, are by no means sufficient to overwhelm other factors.

The Route to an Answer to the Second Question

The next task is to contrast the inconclusive aggregate data about the welfare state and economic growth with some other salient facts about economic performance, and especially about international trade in manufactures by small countries such as Sweden. As we shall see, the other facts form a strong, clear pattern. This striking pattern suggests that competitive markets open to international competition are the main source of economic dynamism and that protectionism and most other forms of government regulation in such markets have monstrously harmful impacts on economic growth. The striking pattern we shall find in the next chapter stands in sharp contrast to the aggregate facts on the size of government expenditures and transfers and economic growth that we have seen in this chapter, both for Sweden and for the rest of the world.

The contrast between these dramatic results and the ambiguous aggregate data on the size of the welfare state and economic growth will, as we shall see, help us discover some new ideas. With the aid of these ideas, we will be able to find an answer to our second question, about why Sweden, given the undoubted distortions in incentives from its uniquely large welfare state, is not performing worse than it is.