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INGEMAR STÅHL

**A Market Liberal in the Swedish
Welfare State**

Christina and Lars Jonung (eds.)

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**A Market Liberal in the Swedish
Welfare State**

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Ingemar Ståhl – A Market Liberal in the Swedish Welfare State
Christina and Lars Jonung (eds.)

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Preface

This is a book about Ingemar Ståhl, a prominent professor of economics in Sweden. We first met him as graduate students in Lund in the late 1960s. We became friends and eventually colleagues at the department of economics. The friendship soon involved our families. Our contact with Ingemar lasted until his passing in 2014.

To honor Ingemar Ståhl we edited a book in Swedish, published in 2018, where former students and colleagues pay their tribute to him. In addition, the book contains a selection of reprinted articles by him.

Eventually, we decided to also publish a book in English about Ingemar Ståhl, although much shorter than the Swedish version. Our aim with this volume is to present him to an international audience as he made significant contributions to economic policies and public debate in Sweden during the 1960s, 1970s, 1980s and 1990s, worth a wider attention.

We have many debts concerning this volume. We are indebted to all those who contributed to the Swedish edition, to Alan Harkess for skillfully translating from Swedish chapter 1, 3 and 5 and to the Ståhl family for their help. We want to thank Adri De Ridder, Oskar Grevesmühl, Daniel Klein and David Warsh for insightful and constructive comments. We owe a special thanks to Kurt Schuler for adjusting our text to U.S. readers and to Geoffrey Wood for making it more accessible for UK readers. We are also grateful to our friend and publisher Torgny Wadensjö at *Dialogos* for his support.

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Lund in March 2020

Christina and Lars Jonung

Introduction

INGEMAR STÅHL (1938–2014) made important contributions to economics and economic policy in Sweden. He is little known outside of Sweden as he mainly wrote in Swedish. This book gives a broad account of Ståhl's life and works. It is based on our Swedish book, *Ingemar Ståhl – en ekonom för blandekonomin*, published in 2018 by the Swedish publisher *Dialogos*.

The Swedish title means *Ingemar Ståhl – an economist for the mixed economy*. We chose it because one of Ståhl's most prominent papers dealt with the proper economic theory for analyzing the mixed economy, that is, a market economy with a large public sector. However, the term “mixed economy” is little used today in Sweden or elsewhere; instead, the focus has shifted to the welfare state. For this reason, and because Ståhl studied many aspects of the welfare state, we have changed the title for the English version to *Ingemar Ståhl – A Market Liberal in the Swedish Welfare State*.

The English volume is a condensed version of the Swedish one. Chapter 1 is a portrait of Ingemar Ståhl as an economist, describing his engagement over time in many fields, and evaluating his contribution to Swedish economics and economic policies.

Six papers by Ståhl follow, selected to give a flavor of his broad interests. Chapter 2 reflects his work on indexed loans in the 1960s, a source of inspiration for the successful Swedish system for student loans and subsidies designed by him. He also explained why a type of indexed loans for Sweden's housing sector introduced in the 1970s failed.

Chapter 3 contains Ståhl's seminal critique of wage earner funds that were proposed by a study commissioned by Sweden's powerful central trade union confederation in 1975. Here he employed the theory of contracts and transaction costs developed by economists such as Ronald Coase and Armen Alchian to explain the consequences of making trade unions the sole owners of Swedish firms.

In Chapter 4, Ståhl considers the challenges facing an economist who wants to inform politicians and voters about “rational decisions” concerning economic policy. This chapter mirrors his experience as a member of various government commissions, as policy advisor and as a highly active participant in the public debate. He found that the advice of the enlightened economist was often ignored. Here he gives his explanation for this fact.

Chapter 5 is a satirical newspaper article published on New Year’s Eve of 1979. It shows Ståhl as a witty debater, adopting new and unexpected perspectives. The article is a warning that the generous Swedish welfare state may turn into a hard Orwellian version of itself if it tries to combat tax evasion by the registration of all sales and purchases.

In the 1970s and 1980s, the public sector grew rapidly in Sweden, reaching unprecedented levels. Ståhl was fascinated by this process, writing about it in numerous contributions in Swedish. Chapter 6 summarizes his explanation of the driving forces behind the expansion of the welfare state. To him, the Swedish public sector was too big. It might be reduced by a constitutional reform introducing qualified majorities for decisions by the parliament.

Ever since his work in the 1960s for the research institute of the Swedish defense, Ståhl had a deep interest in the Baltic states. They provided the military bases for the Soviet Union that would be used for any military operation against Sweden. Following the collapse of the Soviet empire, he travelled to the Baltics in the early 1990s. Chapter 7 is a report from his journey “through the Estonian economic landscape”, using as his guide the work by Ronald Coase on property rights and transaction costs.

Chapter 7 reflects Ståhl’s interest in property rights, contracts and law and economics. He tried to introduce these concepts in his teaching at the department of economics at Lund University. Eventually, he became so focused on the relationship between economics and law that he spent his last years as professor at the university’s Faculty of Law.

LARS JONUNG

Chapter 1. Ingemar Ståhl 1938–2014. A Portrait

For many decades, Ingemar Ståhl was a well-known economist in Sweden. He introduced new perspectives into economic debate, research and teaching. He made his presence felt in areas as diverse as defense economics, rent controls, energy policy, financial economics, industrial policy, higher education, wage earner funds, environmental economics, law and economics, healthcare economics and taxation.

His intellectual curiosity led him to question prevailing ideas and to put forward new solutions. He found traditional welfare theory too limited to provide an understanding of the political process. Instead, he advocated a public choice perspective, which in his view would provide a more realistic interpretation of the goals of politicians and bureaucrats than that offered by traditional welfare economics. Ståhl also introduced the work of Ronald Coase on contracts and property rights in Sweden by applying it on various policy issues in public debate and by promoting it in his teaching. In his view, the study of economics should start from the study of contracts and property rights.

Ståhl was appointed professor at Lund University at the young age of 33, in 1971. Over more than thirty years, he left his mark in many fields, retiring in 2004. He worked to introduce health economics, environmental economics, human capital, public choice, the economics of contracts and property rights, financial economics and law and economics in the curriculum. He embodied a sense of open academic enquiry. In his view, there were no limits to the use of economic theory. He served as a major source of inspiration and support for doctoral dissertations in new fields of research. He was

consistently on an intellectual move, ending his tenure as professor at the Faculty of Law at Lund University, promoting the subject of law and economics.

As an active participant in public debate for many decades, he provided pungent commentary on a range of issues. He contributed significantly to the shift in Swedish economic policy from interventionist controls to the more market-oriented solutions that characterized the last quarter of the twentieth century. Several of his policy proposals, in particular the system of student finance, remain a part of public policy in Sweden.

The early years

Ståhl grew up on Kungsholmen, an island in central Stockholm, in a middle class family. His father was a judicial expert in the central government, while his mother worked as a prescriptionist in a pharmacy. The family also comprised Ingolf, Ingemar's younger brother.¹ At upper secondary school, Ståhl was interested in almost everything, from science to poetry and social issues. At an early stage, his political interests led him to take an active role in the debates and conferences held by the Social Democratic Party's student association, *Libertas*.

On leaving upper secondary school in 1956, he had a choice between studying medicine or social science. Inspired by Bent Hansen's book *Finanspolitikens ekonomisk teori* (The Economic Theory of Fiscal Policy), he decided on economics. He had already come across this book during his last year at school. Ståhl was "completely fascinated by its apparently fully rational view of economic policy based on an analysis of ends and means and the formulation of preference functions" (Ståhl 1990). Later on in life, his encounters with politicians would lead him far away from the

¹ Like his elder brother, Ingolf Ståhl was also attracted to economics. He was a professor of business administration, specialising in game theory, at the Stockholm School of Economics from 1986-2006.

world of beautiful economic models presented by Bent Hansen.

Ståhl started his compulsory military service immediately after leaving school. He took a bus from central Stockholm to a destination that was kept secret from the rest of his family. It was at the Armed Forces Radio Institute (FRA) on Lovön (an island near Stockholm) where he was to spend several summers as well as part of his academic term time. As a member of the student contingent at FRA, he met Bengt-Christer Ysander – a meeting leading to both a fruitful intellectual collaboration and a lifelong friendship. Moreover, it started a long-lasting contact with the Swedish defense authorities and issues related to military policy.

In the autumn of 1956, Ståhl started his studies at Stockholm University, majoring in economics. Two years later, he had completed his bachelor's degree, which also included statistics, sociology and political science. At that time, economists associated with the Stockholm School of thought that had emerged in the 1930s dominated the Economics Department of Stockholm University. Ståhl attended lectures held by Erik Lundberg, Gunnar Myrdal and Ingvar Svennilson that were largely unconnected to the formal course literature. Instead, the emphasis was on more traditional business cycle theory.

Ståhl found himself both unimpressed and uninspired by these famous figures and their views of macroeconomics. Indeed, later in life, macroeconomic issues remained outside his main fields of academic interest. To get away from Stockholm, and with the support of a Norwegian state scholarship, he decided to spend a year at Oslo University. During this period, his encounters with economists of a more theoretical bent affected his entire approach to the subject of economics. This experience contributed to his focus on resource allocation and microeconomics.

The 1960s – a productive decade

After the completion of his bachelor's degree studies and his time in Oslo, Ståhl faced the choice between a career in academia or

in public administration. He chose both. During the 1960s, Ståhl contributed to no less than seven official government reports or investigations, commonly known by the abbreviation SOU (*Statens offentliga utredningar*). The reports were extensive projects comprising a substantial research input.

Ståhl began his career as an economist at the Central Office of Statistics from 1959–1961. He worked on sampling and methodological problems related to the 1960 census. This was followed by a long period in the planning office of the Research Institute of the Swedish National Defense (FOA), which on paper lasted from 1962 until 1967. However, these five years were also interspersed with several leaves of absence for work on official government investigations as well as for serving as an advisor at the budgetary department of the Ministry of Finance in 1965–1966.

He made his principal contributions in his capacity as assistant secretary to the Indexation Committee (*Värdesäkringskommittén*) in 1959–1964, (SOU 1964:1; SOU 1964:2), as an expert in the 1959 Committee on Social Conditions of Students in 1962–1963 (*Studiesociala utredningen*), (SOU 1963:74), and as a member of the Program Budget Group at the Ministry of Defense in 1966–1969 (SOU 1969:25).

In all of these investigations, Ståhl made major contributions to the final reports. Furthermore, he became a member of the Energy Committee (*Energikommittén*) in 1964, (SOU 1970:13), as well as serving as an expert in three further official government enquiries into defense costs, education and seaports (*Försvarskostnadsutredningen*, SOU 1968:1; *Utbildningsutredningen* [U68], SOU 1973:59; *Hamnutredningen*, SOU 1971:63).

In addition to these assignments, Ståhl worked on a wide range of issues with other economists.² This cooperation is reflected in a number of publications, including a book on rent controls co-written with Ragnar Bentzel and Assar Lindbeck. Ståhl continued to be active within the Social Democratic movement in

² See Jonung and Jonung (2018) for a bibliography of Ståhl's writings. To do him justice, it comprises both published and unpublished work.

the 1960s. It was also there that he met his future wife, Solveig Sandberg.

The Indexation Committee

The Indexation Committee was appointed following the pension reform in 1958 against the background of a rising rate of inflation in Sweden. Its aim was to examine the possibility of introducing index-linked loans in Sweden – a type of loan not available at the time. Guy Arvidsson, as a member of the Committee, together with Kjell-Olof Feldt, secretary of the Committee, offered Ståhl the post of deputy secretary. This was the start of his career as a researcher as well as the beginning of a fruitful collaboration with Arvidsson.

Ståhl quickly got to grips with his new assignment. During 1960 and 1961, he rapidly produced ten or so preparatory studies on index-linked loans, indexation, share yields and real taxation. In this context he produced what was subsequently considered to be his major research achievement, a report entitled “The effects of changes in risk and yields on portfolio composition, consumption and production.” It appeared as a mimeographed working report in December 1961. Three years later it appeared as a FOA document, and shortly afterwards it was presented as a licentiate dissertation at the University of Lund (Ståhl 1964a).

The aim of the report was to generalize traditional microeconomic theory to include decisions made under uncertainty. It focused on the identification of optimal portfolios held by three different types of decision makers: households, companies and “placement companies,” to use Ståhl’s terminology. The latter comprised financial institutions such as banks, insurance companies and foundations. Ståhl studied how their portfolio choice was affected by different types of exogenous changes. The analysis was entirely theoretical, based on optimization and illustrated by geometrical figures.

In the early 1960s this was ground-breaking work. However, it was rapidly superseded by new theories and methods within financial economics and subsequently forgotten. A contributing factor

to this outcome was Ståhl's failure to develop his arguments or publish his results in an academic context. Instead, he continued to make empirical contributions to the work of the Indexation Committee, including a chapter in the final report on how index-linked debt could be used as a means of finance in a housing market characterized by rent control and rent fragmentation. He also studied the pattern of yields in the Swedish stock market. As a result of these analyses, Ståhl became an advocate of basing taxation on real rather than nominal magnitudes and of index-linked loans.

The final report of the Indexation Committee in 1964 did not give rise to a government bill in the Parliament. As Ståhl dryly pointed out, the Minister of Finance, Gunnar Sträng, stuffed the heavy document into the drawers of his writing desk. However, some of the ideas put forward by the committee became sources of inspiration for practical policies in two areas of public lending, namely housing and student finance (Ståhl 1975a). The system of general interest rate subsidies was replaced in 1966 by so-called parity loans.³ However, this change proved to be short-lived. Parity loans were withdrawn as early as 1974 when a return to interest rate subsidies for house loans was made. However, the student finance system became a permanent fixture. Here Ståhl made use of insights into financial economics he had acquired while working on the Indexation Committee.

The government report into student finance

The rapid expansion of higher education in the 1950s provided the impulse for a government report on student finance. The report was set up in 1959 under the leadership of Olof Palme, who worked closely with Prime Minister Tage Erlander, whom he would subsequently replace as prime minister. The main purpose of the report was to examine suitable forms of funding for university studies.

³ The parity loan was an index-linked loan designed for use within the housing sector in Sweden. The rise and fall of the parity loan is described in Ståhl (1975a), included in this volume as Chapter 2.

The debate was dominated by a series of proposals related to student loans, grants and scholarships. Various student organizations as well as the Social Democratic Party and the Swedish Confederation of Professional Associations (SACO) were at the outset in favor of the idea of a student wage. Palme also supported this approach. Studies were a form of work that should be remunerated. However, the work of the committee proceeded at a slow pace.

The Prime Minister, Tage Erlander, had a keen interest in the question of student finance since his time as a student at Lund University in the 1920s. He noted in his biography that “Olof Palme had complained on several occasions that the government report was not making any progress. At that point, a young man, Ingemar Ståhl, who subsequently became professor of economics and a lively contributor to a range of public debates, put forward an overly complicated proposal based on reverse pension insurance” (Erlander 1982, p. 197).

As one of the editors of *Libertas*, the journal of the Social Democratic student association, Ståhl had discussed the principles of student finance in two articles as early as 1961. During the spring of 1962, he provided the new start to the Palme enquiry that Erlander described in his memoirs. According to Olof Ruin, the principal secretary of the committee, “The impulse to fresh thinking in the Committee on Student Finance was provided by a young economist, Ingemar Ståhl. In discussions with the Committee’s secretariat, he launched the idea of an educational fund and an educational insurance along the lines of the ATP pension model” (Ruin 1979, p. 41). After an initial period of doubt regarding this proposal, Palme quickly changed his mind.

As a result, Ståhl was invited to assist the investigation. As many as ten memoranda on study finance, costs of education and the returns to investment in higher education appeared in 1962. His underlying argument was that higher education should be seen as an investment in human capital that could be expected to generate higher personal income, viewed over the recipient’s lifetime. For that reason, a system of student loans could be justified on grounds of both efficiency and equity.

In Ståhl's view, a system of student wages would reinforce differences in income over the life cycle between university graduates and other occupational groups, because university students would benefit from higher salaries later in life. His reasoning was based on human capital theory, developed in the 1950s by American economists largely associated with the Chicago school. He introduced the life-cycle perspective into Swedish economic debate, suggesting it was suitable for the analysis of the long-term distributional effects of economic policies.

The challenge facing Ståhl was to persuade the somewhat skeptical members of the committee of the advantages of his proposal for student loans and the disadvantages of a system of student finance based on student wages and student grants. He cleverly solved this problem in a pedagogical fashion by formulating a number of demands that a system of student finance should meet. On the basis of these criteria, he demonstrated unequivocally that a solution could be found using government loans from what he termed a human capital bank. He recommended that the loans should be interest-free and inflation-neutral by means of indexation to the so called "basic amount" in the social insurance system.

Ståhl's approach carried the day, despite firm opposition from student organizations and SACO. He was responsible for the main chapter, "The system of student financial support," in the committee's final report (SOU 1963:74), as well as for two appendices dealing respectively with the costs, revenues and financing of higher education and with the incomes of university graduates. The latter can be viewed as the first study of the returns to higher education in Sweden.

A quarter of a century later, Ståhl looked back on the system of student financial support that he had designed. He viewed the results as "a triumph for rational political solutions" (Ståhl 1990). At the same time, he noted that Olof Palme's major social policy reform was based on ideas and models drawn from the Chicago School – a school of thought associated with market-oriented economists such as Gary Becker and Milton Friedman. However, Ståhl was not wholly satisfied with the evolution of the system of

student finance. In his view, it should have been developed still more along market lines and should also have taken account of the possible use of tuition fees.

The economics of defense and the Research Institute of the Swedish National Defense

Ståhl worked on defense issues for a long time. He joined the Research Institute of the Swedish National Defense (FOA) in 1962. A year later, his friend Bengt-Christer Ysander became his colleague. Their assignment was to apply economic thinking to defense issues and to provide support to a system analysis group. The introduction of economic analysis proved to be a formidable challenge for the young researchers. It had to encompass marginal concepts and opportunity costs as well as the application of a game theoretical approach where two actors, Sweden and the Soviet Union, sought to optimize their military strategic options. At the same time, it was hoped that their economic reasoning would provide greater flexibility and innovative capacity within a strongly centralised military organization characterized by rigid structures, fixed budgetary frameworks and a “good housekeeping” approach to expenditure.

Ståhl and Ysander started with an ambitious in-service training for themselves involving an extensive study of the US literature on defense economics. An important source of inspiration was the Kennedy administration’s system of program budgeting that had been introduced into the Pentagon. These studies gave rise to a series of memoranda distributed by FOA. Ståhl accounted for at least thirty unpublished documents in addition to those that were published within FOA’s official report series.

The titles reveal the subject matter: input-output analysis for defense; an economic defense budget; estimates of the value of a human life; war games in a network diagram; defense costs in the short and long run; estimated rates of return on military procurement; etc. On one occasion, Ståhl remarked that some of his most interesting writings were classified as military secrets. In those

cases, he was unable to get access to documents that he had written, because he lacked the security clearance required.

The emphasis was on developing a program budgeting system along the lines of the U.S. model. This was a formidable task that required deep and detailed knowledge of the entire Swedish military sector, down to its lowest levels. Program budgeting was interpreted as a reform that “would bring together the different phases of the planning cycle – involving studies and projections, planning and budgeting, implementation and control into an integrated planning, budgeting and accounting system.” This attempt was viewed as an innovation not just in the military environment but in the entire government budgetary process as well (Ståhl 1968).

Over time, the FOA group came under the auspices of the Ministry of Defense. Eventually, Ståhl became one of the main authors of *Planering och programbudgetering inom försvaret* (SOU 1969:25) (Planning and program budgeting of defense spending), also known as the Red Book after the color of its cover. Initially, the Red Book was seen as a promising approach to the reform of the budgetary system for defense expenditures. However, it did not lead to any lasting reforms.

According to the reference letter that Ståhl received when he left FOA, he worked on the development of methodologies for long-term planning and administrative routines, especially program budgeting. However, he was also involved in studies and projects concerning the Swedish nuclear weapons program, which had reached an advanced stage before it was stopped in the 1960s. Late in life, Ståhl expressed the hope that the political correctness that had prevented an open discussion of the Swedish planning for nuclear weapons would be subject to greater openness and research. He placed the blame for this silence on Olof Palme and Alva Myrdal. Because of his classified work, Ståhl was unable to comment on the nuclear program. His reference letter from FOA concluded with the statement that “Owing to his oath of secrecy, Ståhl is unable to provide information regarding the work carried out at FOA.”

Following the completion of the Red Book, Ståhl ended his

formal ties with the military establishment. However, he maintained a strong interest in defense issues and security policy, and not just at a theoretical level. He was an admirable guide for walks over the artillery range at Ravlunda, near the Ståhl family's summer residence. The subjects of the day covered all aspects of tanks: their equipment, crew, weight, speed, firing capacity and caliber. He explained why the Ministry of Defense had chosen the British Centurion tank, the numbers that had been purchased, the types of tanks that should have been ordered and how the operation of armored brigades could be made optimal in terms of cost effectiveness to meet a Soviet invasion of Sweden.

What lessons did Ståhl draw from the long period of time that he spent at FOA? He pointed to the value of introducing a "fairly straightforward forms of economic reasoning while observing that more sophisticated methods were subject to diminishing marginal utility" in an organization that was from the outset unfamiliar with economic thinking (Ståhl 1990). His analytical economic perspective collided with the barriers of traditional prestige among leading military personnel and the prevailing power structures within the military establishment. My interpretation is that Ståhl's experience of working on defense issues inspired him to extend his studies to other parts of the public sector, especially healthcare which in common with defense was not subject to the usual market mechanisms.

Ståhl was able to joke about the similarities between the process of decision making in the health and defense sector. The head of a hospital department and a colonel fulfilled largely the same functions. The differences were expressed by the badge of rank and the uniform: a white coat in contrast to camouflage. In other respects, the structure of incentives was the same. Defense, like healthcare, represented for Ståhl centrally planned sectors where market incentives were replaced by a system of orders from superiors and the allocation of resources was determined by means of political processes. Ståhl also considered that universities could be viewed as a centrally planned sector. However, he emphasized that academic discipline was far behind that of the military since

the commanders, i.e. the professors, had had their powers curbed by both university bureaucrats and the recruits, i.e. the students.

Rent controls

Ståhl developed an interest in housing policy at an early stage. His interest is shown by his roughly seventy published and unpublished contributions in this field. In 1963, the Research Institute of Industrial Economics (*Industriens Utredningsinstitut, IUI*) published a study entitled *Bostadsbristen – en studie av prisbildningen på bostadsmarknaden* (The housing shortage – a study of price formation on the housing market). This publication was co-authored with Ragnar Bentzel and Assar Lindbeck (Bentzel et al 1963). The study focused on two principal issues: the economic effects of rent controls and the consequences of deregulation of the housing market.

The study was based on a systematic comparison of markets subject to rent control with markets where apartment rents were determined by market forces. The study concluded that the social and distributional objectives of housing policy could be achieved in a rental market where market forces were allowed to operate freely. At the same time, market forces could lead to the elimination of the housing shortage and reduced disparities in setting rents. A transition towards equilibrium price formation could also be designed to make reform socially acceptable.

The three economists demonstrated that the housing shortage could be solved along reasonable political lines. Their book gave rise to a lively debate and became a classic in the literature on rent control in Sweden. The arguments presented in this study still echo in the long, never-ending debate on housing policy in Sweden.

The road to a professorship

The official government reports (SOU) and the Research Institute of the Swedish National Defense (FOA) became Ståhl's university. Here he developed his thoughts and his writings in areas as diverse

as financial economics, index-linked loans, the costs and benefits of higher education, defense economics, security policy, labor market policy, housing policy, planning in the public sector, the pricing of public services such as icebreaking, road transport and infrastructure policy. These areas would form the basis of his future interests.

His output during the 1960s was singularly impressive. Diverse in character, he produced a rapid flow of appendices, chapters in official government reports (SOU), articles in anthologies and journals as well as unpublished memoranda, reports, literature surveys and presentations. The emphasis was on research reports. His work was invariably well-formulated and constructed around the central idea of applying welfare theory to resource allocation in the public sector. It often involved fairly straightforward applications of economic analysis in new areas. In terms of volume, unpublished material predominated. It ranged from brief memoranda to longer manuscripts. He became a familiar figure, not least in public debate. Through this impressive range of work, he established himself as a well-known economist, opening up the road to a professorship.

Ståhl received considerable support from Guy Arvidsson, who was professor of economics at Lund from 1961–1969. Ståhl's licentiate dissertation, entitled *Risk och avkastningsförändringars verkningar på portföljsammansättning, konsumtion och produktion* (The effects of risk and changes in yield on portfolio composition, consumption and production), received the highest mark. On its own, it opened up the opportunity of a lectureship in economics at the University of Umeå in northern Sweden in the spring of 1966. However, Umeå never became a place of residence for Ståhl. In fact, he never even visited Umeå in his capacity as lecturer. In November 1966, he was appointed Assistant Under-Secretary at the Ministry of Defense. A year later in December 1967, he was appointed associate professor (*docent*) at Lund University. In the spring of 1968, he moved to Lund and took up the post of associate professor and senior lecturer. At the same time, he resigned his posts at the University of Umeå and the Ministry of Defense

He now aimed to become a full professor. He applied for a

professorship in business administration at the University of Stockholm but failed to reach the short list. “With regret” one of the referees declared that Ståhl was not considered qualified for the post. When Guy Arvidsson moved to Stockholm in 1969, his chair as professor of economics in Lund became vacant. Ståhl was the only applicant.

All three referees, Guy Arvidsson, Jouko Paunio and Leif Johansen, considered Ståhl qualified for the post. They viewed his work for the Indexation Committee as the most important part of his academic output. Attention was also given to his writings on defense, economics and housing policy.

Arvidsson provided the most positive evaluation, describing Ståhl as an applied economist who had explored new areas with the help of existing theory. He noted that this line of specialization led Ståhl into “contact with decision makers and the general public rather than with the academic fraternity.” It is evident from the evaluations of the other referees that they wished that Ståhl had produced a greater number of academic publications. At the same time, he was praised for his breadth and his capacity to apply economic theory and methodology to new problems. In November 1971, he was appointed professor at Lund at the age of only 33.

In the following year, Ståhl attempted to return to Stockholm. A professorship in labor market policy was vacant at the Swedish Institute for Social Research (SOFI). In support of his application, he referred to the academic year that he had spent in 1970/71 in Paris at the Organization for Economic Co-operation and Development in the directorate responsible for labor issues. He had written a number of papers concerned with labor market policy that were envisaged to be part of a larger publication.

The two academic referees who were economists, professors Erik Lundberg and Lars Werin, supported Ståhl’s candidature. However, Gösta Rehn was appointed to the post due to the strong support that he received from the Social Democratic government. Ståhl appealed against the decision, arguing that the professorship should be divided into two separate ones: Gösta Rehn could take

one as head of SOFI while Ståhl could be in charge of research. However, this proposal did not meet with approval.

From now on, Lund was the home of the Ståhl family. A row house in Lund became the base for him, his wife Solveig and their three children Nils, Pernilla and Ingela for the rest of his life.

The crisis years of the 1970s and 1980s

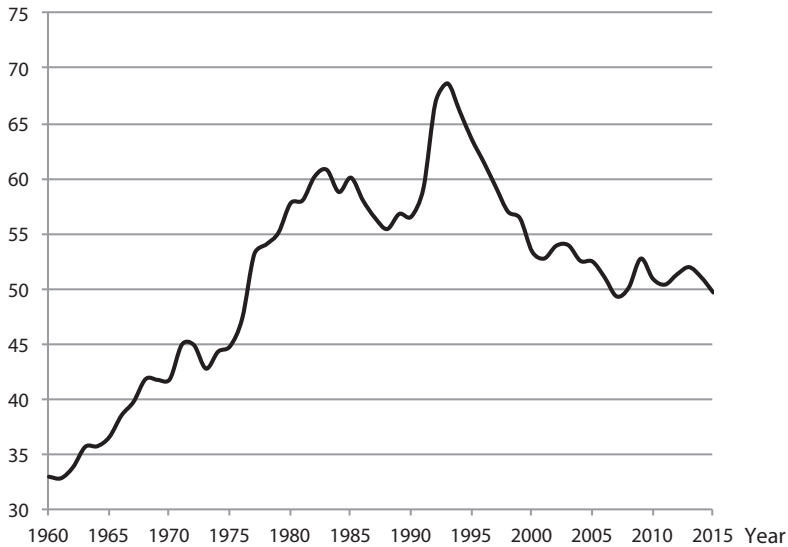
As professor at Lund, Ståhl continued to work on questions that had previously demanded his attention, such as housing, defense and higher education. At the same time, new economic problems emerged during the 1970s and 1980s as a result of the first and second oil crises, OPEC I and OPEC II. This inspired him to take up issues as diverse as energy policy, industrial policy, nuclear power, environmental economics, public sector expansion and taxation. The two oil crises provided a basis for analyses of energy policy. The central argument that Ståhl consistently employed was to allow the market to operate freely in order that it could adjust to the changes in relative prices brought about by the rise in energy prices. He was also in favor of Swedish nuclear plants.

It is difficult to provide a fair and comprehensive account of all of his activities. I have chosen to concentrate on the major issues that concerned him. It was during these years that he participated most actively in public debate.

Public sector and taxation

The large and growing public sector in Sweden, its accompanying high level of taxation and the substantial increases in marginal tax rates fascinated Ståhl. (See Figure 1 and 2, illustrating the growth of public expenditure and marginal rates of taxation in Sweden from 1960–2015). In a long series of articles, he analyzed the driving forces underlying the expansion of the public sector and tried to find a suitable balance between the commitments undertaken by the public sector and the room for maneuver available to the private citizen.

FIGURE 1. Public expenditure as a percentage share of GDP, 1960–2015.



At an early stage, he distinguished between different types of public expenditure commitments (Ståhl 1971). They were divided among a night-watchman state, an infrastructure state, a social state and an interest-group state (Ståhl 1989). The night-watchman state, responsible for the provision of pure public goods and services such as defense and the legal system, accounted for a relatively small share of the budgetary cake. It was rather the social state that was responsible for income transfers over an individual's life cycle and that comprised the largest share of budgetary expenditure.

Ståhl identified the system of tax-financed social insurance as the principal driving force underlying the expansion of the public sector. He was able to pinpoint a number of problems in the social insurance system and argued in favor of more research in this field (Ståhl 1973). He proposed that central government should provide basic social insurance coverage. Citizens could then purchase the level of insurance coverage that they desired. Visible insurance premiums were preferable to concealed taxes and payroll charges. Premiums would allow the level of taxation to be lowered, thereby

increasing individual choice. Ståhl often used the example of third-party motor insurance, compulsory for all vehicle owners although they are able to choose their insurance company and the extent of their insurance coverage.

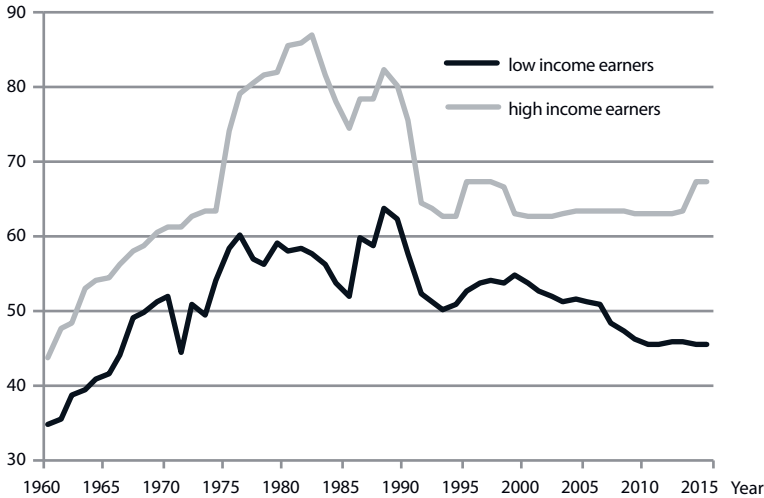
The incentive problems of a high taxation economy concerned Ståhl from an early stage. High marginal tax rates and high average tax levels gave rise to a number of negative effects: lower supply of labor, undeclared employment in the underground economy, increased bartering of goods and services, household and garden work as an alternative to work in the formal labor market, less interest in education, more consumption at work, etc.

Ståhl made frequent use of anecdotes to illustrate his message on taxes for a wider public. This was often a more fruitful form of communication than the formal terminology used by economists. One such example was “The instructive story about a Sunday dinner” where family provider Mr. Jonsson thinks of taking out his wife and two children for a Sunday dinner (Ståhl 1980a). Mr. Jonsson runs a small garage and has a certain experience in working out what he would need to earn to pay for a family dinner that would cost around 200 Swedish kronor. Taking into account all the taxes and charges that he is obliged to pay, he estimates that he would need to earn 2,222 kronor to pay the bill!

Being a rational man, Jonsson decides instead to do the shopping, prepare the dinner and do the washing up. He derives some consolation from the fact that he does not have any children at a day nursery where the charges are income-related. Nor does he have to pay back a student loan, where his repayments would also be income-related. If that were the case, the amount that he would have had to earn would be even higher. Indeed, with a little bad luck, “it would have been completely physically impossible for him to try to slightly increase his standard of living by taking on extra work and at the same time dutifully paying all the taxes and charges that he was required to pay.”⁴

4 In Chapter 5, Ståhl uses satire combined with anecdotal evidence to illustrate how tax evasion is a threat the strengthening of the Swedish welfare state.

FIGURE 2. Marginal rates of taxation for low and high income earners, 1960-2015.



Ståhl drew attention to the arbitrary nature of the Swedish taxation system and stressed the role for fundamental principles of taxation, especially in the fields of housing and capital taxation. In his view, the tax system was the result of a struggle between powerful special interests that had produced dubious distributional effects. He held the work carried out by Knut Wicksell on the theory of public finance in high regard, especially Wicksell's views on constitutional rules for decisions made in parliamentary assemblies. In Ståhl's view, the voluntary principle proposed by Wicksell offered more appropriate guidance for the construction of the tax system than the ability-to-pay principle provided. However, he admitted that Wicksell's proposal of a taxation system based on qualified majority decisions was unrealistic.

Ståhl posed the question: What is the role of the state? His reply was that for many reasons, a smaller state was preferable to high taxation or a social welfare state. He was not only concerned with the efficiency losses incurred by the taxation system. The welfare state had become increasingly "immoral" (Ståhl 1989). It had

reached the end of the line and passed its final station. He was, however, pessimistic about the possibilities of putting the train into reverse. “There is a remarkable tolerance of all of the control systems and abuses of power to which citizens are subject on an everyday basis” (Ståhl 1989). The electorate is grateful for the health-care and pensions that they receive from their “master.”

The welfare state has also damaged the public discourse on the role of government, he thought. Lower marginal rates of tax were treated as a gift to high-income earners. “Solidarity has been put on an equal footing with forced tax contributions for redistribution according to the conditions laid down by the political majority.” Normally concepts such as solidarity assume voluntariness (Ståhl 1989). Ståhl suggested that the debate about the welfare state should be based on moral arguments as well as economic ones.⁵

Stålverk 80 and industrial policy

The 1970s were a decade characterized by unexpected crises in Sweden. The substantial increase in oil prices during 1973 and 1974 (OPEC I) gave rise to serious problems for the Swedish economy. Following a period of domestic fiscal expansion during 1974–76, the Swedish economy found itself confronted with substantially lower economic growth, higher inflation, declining profitability and severe structural crises in many industries. Shipbuilding, steel, forestry and textile production were especially severely affected by the downturn. At the same time, partly as a result of trade union pressure on nominal wage levels, there was a marked loss in Swedish international competitiveness.

The political response to the economic downturn took the form of generous support for companies and branches of industry in crisis. To save jobs, the government took over some companies. Two currency devaluations in 1977 helped to reverse the decline until the second increase in oil prices in 1979 (OPEC II) once

⁵ See also Chapter 6 in this volume for Ståhl’s analysis of the rise of the Swedish welfare state.

again reduced the level of economic activity. Parallel to the crises in industrial sectors suffering from rapidly worsening competitive conditions, the public sector was running large budget deficits and creating growing tax pressure.

The dramatic 1970s created a demand for Ståhl's expertise. He was invited to take part in debates and to participate in projects to find solutions to the new challenges. At the outset, he worked within the framework of traditional welfare theory. However, by the mid-1970s, he had begun to look for new ways to understand the driving forces underlying the behavior of politicians and bureaucrats.

In May 1974, the Swedish parliament decided unanimously to finance a new steelworks in Luleå, *Stålverk 80*. It represented the largest public investment project in Swedish industrial history. The objective, evident from its name, was that the steelworks would be completed by 1980.

The project was led by North Bothnian Steelworks (NJA), part of the government-owned holding company *AB Statsföretag*. It received substantial backing from the Social Democratic government. The government forced through the necessary decisions at a rapid pace. The issue was taken up by the parliamentary committee for business and industry, although its examination was conducted behind closed doors. On the pretext of national security, the government provided the Swedish parliament with only the most meagre information.

In early 1974, the Federation of Swedish Industries (*Industriförbundet*) invited three economists, Erik Ruist, Ingemar Ståhl and Lars Wohlin, to carry out a no-holds-barred assessment of the project. They accepted the offer, arguing that they could bring to the table a different set of views than those put forward by the Department of Industry.

The largest part of their report is taken up by a detailed examination of the project's rate of return, based on an analysis of the entire industrial process from receiving iron ore to producing the final product (Ruist, Ståhl and Wohlin 1975). One conclusion was that the estimated rates of return presented in the government

bills tended to be subject to exaggerated optimism. The authors failed to find any reasonable economic grounds for the project. Nor were they able to identify any social rates of return that were not captured by the traditional measures of the private rate of return.

The three authors emphasized the difference between decision-making in the political sphere compared to the marketplace. The nub of their criticism was that the parliamentary decision to invest in *Stålverk 80* had not been subject to a normal appraisal by the capital market, but had instead been made in a political assembly where the decision-makers, i.e. the members of parliament, had scant personal responsibility for the future outcome of the investment.

The report recommended a more market-based assessment of the project. To ensure profit-oriented managerial control over the project, the steelworks ought to be financed by loans raised on the international capital market without a government guarantee, i.e. the financing of the project should be conducted in the marketplace rather than by means of taxation. The capital market should be used for an assessment of the profitability of the project.

The three economists also recommended that important customers should become part owners to provide a guaranteed market for the output of the new steelworks. In addition, they drew attention to NJA's low level of profitability. NJA had failed to make a profit over the previous ten years. They warned of the danger of trying to solve the problem of low profitability by means of new investments.

Ståhl also discussed the *Stålverk 80* project in the press. The need for reliable rates of return was a central concern. Allowing the public to purchase shares in the NJA would help create a sense of belief in the viability of the project. This would raise the question whether "members of parliament and politicians who had been vocal in their support for the project would also recommend their constituents to invest their savings in NJA shares?" (Ståhl 1975 b). Ståhl considered that this would be the real test of what politicians actually believed less than a year before the election of 1976. He used the idea of a market test in a number of different contexts elsewhere in his work.

The Minister of Industry took the first steps to inaugurate the new steelworks in 1975. Shortly afterwards, however, a rapid fall in the international demand for steel threatened the already unprofitable NJA with even greater losses. When the new center-right government came to power following the election in 1976, *Stålverk 80* was shelved. The huge vacant lot at the entrance to Luleå harbor, known locally as the *Playa Plannja*, stands today as a reminder of this grandiose project.

Throughout the 1970s, against a background of continuing difficulties for Swedish business, Ståhl continued his work on industrial policy. Shipbuilding, steel, and iron ore, together with the textile and clothing industries, were struggling to survive. The political reaction from the new center-right government was a series of emergency measures to save employment in companies, industries and regions. Industrial policy took many forms: grants, loans, credit guarantees, subsidies, financial support for the holding of inventories, additional capital provision to both private and public companies and financial assistance for the employment support measures undertaken by the National Labor Market Board (AMS).

In 1979, Ståhl was once again approached by the Federation of Swedish Industries (*Industriförbundet*). Together with Nils Lundgren, he wrote *Industripolitikens spelregler* (The ground rules of industrial policy), (Lundgren and Ståhl 1981). Their study started with an analysis of the explosion of government assistance to industrial branches and companies that had taken place throughout the 1970s. Viewed from today's perspective, this long list is almost breath-taking. They went on to discuss industrial policy in terms of traditional allocation theory which they found to be inadequate. Instead, they recommended an approach that focused on the actual incentives that confronted politicians and bureaucrats. In their view, this perspective provided a more realistic description of the operation of the political system.

The authors concluded that the rules of operation for the market economy had become much looser. Decisions that had previously fallen on companies had been transferred to parliament and government authorities. This development would probably have

negative consequences in the long run. The authors proposed a package of measures aimed at creating stable ground rules for industrial policy which drew a sharp distinction between decisions made by companies and those taken by authorities and political assemblies. These ground rules would include open financial borders between Sweden and the rest of the world; explicit, time-limited financial support measures; labor market insurance, including redundancy payments; detailed and frank accounts of the loans and grants made by the public sector; the independent standing of public enterprise; and private co-financing as a means of gauging the rates of return on investment in public enterprises.

Finally, the authors stressed the importance of appropriate wage levels. This was an area where unions and employers should accept greater responsibility. It would lead in turn to a reduction in the need for measures of government support. It became subsequently apparent that the improved competitiveness of Swedish industry as a result of the devaluations of the Swedish crown that took place in 1981 and 1982 provided the basis for a rapid recovery in the private sector during the 1980s.

Contracts, property rights and wage earner funds

At the request of the Swedish Trade Union Confederation (LO), Rudolf Meidner put forward a proposal for wage earner funds in August 1975. The essence of this proposal was the gradual transfer of the ownership of companies registered on the Stock Exchange to wage earner funds run by the trade unions. Ultimately these funds would own and control all Swedish companies. This would involve the payment of a given percentage of company net profits into a fund controlled by the trade unions. The analytical framework was obviously inspired by Marxist and socialist ideas.

This proposal gave rise to a long drawn-out, intense political debate on the economic system to be adopted in Sweden and on private compared to public ownership. Economists also became involved in the debate on wage earner funds. One of the first participants was Ståhl.

In November 1975, Ståhl was invited to the Swedish Economic Society (*Nationalekonomiska föreningen*) to open a debate on “Ownership and control in business enterprises” (*Ägande och makt i företagen*).⁶ The discussion took as its point of departure the report by Meidner, who was himself one of the introductory speakers.

Drawing on U.S. research, Ståhl used this opportunity to present a new perspective on business enterprise, based on a contractual approach (Ståhl 1976). From this perspective, a company’s structure and behavior is determined by its contractual relations with its suppliers, customers, employees, company management and financiers, i.e. shareholders and creditors. Contracts regulate the financial relations, the rights and the obligations between the company and the other contractual parties.

The contractual relationship with shareholders takes on a unique role. Shareholders have the right to the earnings that remain once all other claims are met, i.e. they have a claim on residual earnings or profits. At the same time, they guarantee and monitor all of the other contracts which the company has taken on. To enter into a residual contract, the shareholders must have control over the company’s operations, primarily by means of being able to appoint and supervise the company’s management. They require influence over the company to minimize the risk that they otherwise will find themselves without any return on their investment in the shares of the company.

Ståhl was the first to introduce and apply the concepts of contractual relations in Swedish economics. By combining contract-theoretical analysis with his insights into financial economics and taxation, he was able to dissect a number of arguments concerning wage earner funds.

Ståhl emphasized that corporate structure and behavior are determined by the existing set-up of contracts. If a contract is altered for one party, there will be consequences for the incentives and thus for the behavior of other actors. As an owner, the trade union funds would have a weak incentive to run the company efficiently. Ståhl

⁶ This talk is translated and included as Chapter 3 in this volume.

did not hold back in his criticism. In his view, the Meidner proposal would either lead to a Yugoslav worker self-management model or to “a Soviet socialist model where a strong central trade union organization would replace a strong state.” He deplored Meidner’s “vulgar arguments” and in one instance, his use of terminology that “normally belong to the student cafés of the far left.”

Ståhl concluded by presenting an alternative to Meidner’s fund arrangement. His idea was to extend the national supplementary pension scheme (ATP) to include a premium reserve system that comprised numerous funds that invested in shares and allowed individual savers freedom of choice. These funds would contribute to a more efficient form of financial management that would avoid the concentration of political power inherent in the Meidner proposal. Ståhl concluded that a premium reserve system would “combine increased individual security and freedom with increased proliferation of wealth and shareholder influence.”

In his reply to Ståhl, Meidner noted that “we have very different points of departure and values.” At the same time, he did not entirely reject the proposal for a premium reserve system. However, it did not provide an answer to the problem that LO had asked Meidner to solve.

In his response, Ståhl asked why the trade unions had not demonstrated their capacity to run business concerns owned by them rationally in accordance with their principles. Instead, some of these companies had been sold to private interests. Meidner did not reply to this argument.

In 1984, after many years of political strife, the then Social Democratic government introduced what Meidner’s considered a watered-down version of his proposal for a system of wage earner funds. Following the election of 1991, the new center-right government abolished them. The ATP system was reformed during the 1990s when a premium reserve system was introduced along the lines proposed by Ståhl as an alternative to Meidner’s fund proposal.

Ståhl applied his contract approach in other contexts. Forms of corporate ownership other than joint stock companies in the

Swedish mixed economy, such as producer and consumer cooperatives, could also be analyzed with the help of contract theory to demonstrate why their behavior differed from that of profit-maximizing companies (Ståhl 1979a).

Problems arose when Ståhl tried to make use of contract analysis in public debate. This type of reasoning was new for Swedish opinion. There was no sign of it in the academic textbooks at either the undergraduate or postgraduate level. In addition, it was difficult to integrate contract theory into the neoclassical view of the firm as a “black box” that transformed inputs with the help of labor and capital into output that was subsequently sold in the market. What went on inside the box was not discussed in the courses in economics.

His interest in contractual relations led Ståhl into an analysis of the role of property rights which he considered to be fundamental for an understanding of how a market economy operates. Inspired by the memory of Samuel von Pufendorf, who was appointed by the University of Lund as a professor of law in 1668 and who was one of the first to discuss the relationship between private ownership and the market economy, Ståhl put forward the proposition that “if private ownership had not existed, we would have been forced to invent it” (Ståhl 1984a).

Ståhl was greatly inspired by Ronald Coase, who as early as 1937 had discussed contracts and transaction costs in a classic contribution. Ståhl made reference to this work in his debate with Meidner in 1975. He returned to Coase in an analysis of Estonia following its liberation from Soviet occupation. In an article entitled “A Coasean Journey through Estonia,” Ståhl interpreted Estonia’s history and future with the help of property rights and transaction costs (Ståhl 1993a).⁷ Independent Estonia was confronted with a completely new situation. In the ruins of the collapse of Soviet domination, the country was seeking to re-create the prerequisites for a market economy. This process had to commence with the introduction of private property rights of ownership and contracts.

⁷ This article is reprinted as Chapter 7 in this volume.

Health economics

Ståhl laid the foundations of the subject of health economics in Sweden. As was the case with defense, Ståhl introduced an economic perspective into the field of healthcare, proposing measures that would raise productivity and efficiency in a part of the public sector that was undergoing rapid change. In his numerous studies of health economics, he brought into focus three particular aspects: the level of health expenditures, efficiency and productivity growth.

He called widely cherished views into question. He disagreed with the standard political view of solving the problems of healthcare by providing additional government funding. With the aid of the theory of optimal insurance, he showed that not all healthcare should be financed by taxation. There were gains to be made combining public and private finance. One particular benefit would be to dampen the apparently inescapable growth of public expenditures on healthcare.

According to Ståhl, the efficiency of healthcare production could be improved by greater use of market incentives and by allowing healthcare providers to compete. He recommended methods such as internal pricing, a greater measure of private insurance and private payment, together with a clearer division between clients and service providers. The most radical of his proposals was a voucher system where the patient/private citizen would be able to purchase healthcare services from competing companies (Ståhl 1979b). He viewed the patient as a consumer who would be able to influence healthcare provision by means of informed choice. These proposals were almost considered shocking in the climate of Swedish debate in the late 1970s.

Ståhl also made an innovative contribution to the analysis of the economic effects of new pharmaceutical drugs. He discussed the pricing of new drugs and the role of patents in the behavior of the pharmaceutical industry. He was a dedicated opponent of government ownership of the pharmaceutical industry – a controversial stand at the time (Ståhl 1975c). By the late 1970s, he had completed a draft version of what would be considered as the first textbook in

Sweden on health economics. It was innovative and was moreover written in English. It was finally published in the mid-1980s, the only book by him in English (Ståhl 1986).

Ståhl was a driving force behind the establishment of health economics as a university subject in its own right. At an early stage, he formed a research group at the Department of Economics in Lund. In 1979, this embryo became the Institute for Health Economics (IHE), the first of its kind in Sweden. He was also influential in the establishment of the first professorship in health economics, at the University of Linköping. The same also applied to the program for health research at the Stockholm School of Economics.

Economics of education

The work on the government report on student financial support had provided Ståhl with a detailed knowledge of the economics of education. He developed his thinking through a number of articles, especially in relation to the proposals of the 1968 government report on education, known as *U68*. In a book entitled *U74 – en samhällsekonomisk analys av den högre utbildningen* (*U74 – an economic analysis of higher education*), (Ståhl 1974), he presented an alternative to the centralised administrative solutions offered by the *U68* report, based on market-oriented, decentralized solutions.

Once again, Ståhl used human capital theory to analyse the costs and benefits of higher education. He expanded his analytical framework from the 1960s to include a discussion on how to make the organization of higher education more market-oriented. He examined this theme more closely in Ståhl (1994), viewing universities from a public choice perspective. His analysis explained why no university organized as a private joint stock company had managed to establish itself on the Swedish market for higher education.⁸

⁸ Ståhl involved himself in many different fields during the 1970s. For instance, he contributed to a number of early works on environmental economics. His main role was that of acting as a source of inspiration (Hjalte, Lidgren and Ståhl (1977).

From a naive welfare economist to a realistic political economist

Traditional welfare theory provided the foundations for the early years of Ståhl's work as an economist. This theory may be described briefly in the following manner. In the world of economic models, an efficient market economy under perfect competition operates at a Pareto optimal equilibrium. Given the structure of property rights, it will not be possible for any individual to improve his welfare without lowering the welfare of another.

The market economy in the real world, however, is subject to various market failures that give rise to inefficiencies in the allocation of resources. These originate mainly from external effects, indivisibilities and public goods. In principle, market failures can be eliminated by appropriate economic policy measures. Armed with the theoretical propositions of welfare economics, an economist can demonstrate how economic policy could be formulated in order to correct for different forms of market failure. The economist finds himself in the role of the social engineer who is able to contribute to society's overall economic efficiency and welfare.

Welfare theory has an obvious ideological bias. It provides a scientific motive for political interventions in the private sector. The role of the state is to attempt to reach a Pareto optimal position with the help of the rationally minded economist. For a Social Democratic party, welfare theory could be used as an argument in favor of interventionist policies.

Ståhl was actually the prototype for that type of social engineer throughout the 1960s. However, he became increasingly skeptical about the relevance and use of welfare theory. His optimism turned to pessimism. His experience from meetings with politicians and other decision-makers in the public sector was part of this process. He had come to the conclusion that the sensible advice he and other economists had given had largely fallen on stony ground. This was the case, for example, with the reasoning of the Indexation Committee and with the criticism of rent controls. It also applied to defense policy. It was difficult to influence politicians and the

heads of public authorities by means of economic analysis. They were governed by other objectives than economic efficiency and optimal solutions.⁹

Ståhl often used anecdotes to illustrate the collision between the well-intentioned, good and unselfish advice of economists and the crass reality of politics. Once, following a departmental meeting in Stockholm with the Minister of Housing, Ståhl recollected for his colleagues in Lund that he had presented a detailed account to the minister of the economic advantages of the parity loan system for housing finance. He had completed his presentation by warmly recommending the minister to do his utmost to protect the system. On hearing these words, the minister had replied “That’s all right for you who understands the system!” Ståhl was obviously shaken by this reply. Not long afterwards, the parity loan system was abolished and replaced by interest rate subsidies.

Welfare theory was incomplete, as it lacked an analysis of the political and bureaucratic decision-making processes. He found this missing link in the public choice school of thought, whose main proponents in the 1970s were economists like James Buchanan, Anthony Downs, Gordon Tullock and Mancur Olson. Ståhl became deeply involved in the theory of public choice and transferred it to a Swedish context. In 1977, he produced the first account of the public choice approach available in Swedish. He described it as “the new theory of political economy” (Ståhl 1977).

The central idea underpinning Ståhl’s analysis was that the prevailing economic model for rational decision making in the market economy, based on the concepts of consumers as utility maximizers and companies as profit maximizers, ought to be directly applied to the political system and the public bureaucracy. Politicians and bureaucrats would then also be recognized as utility maximizers. In this sense, it would seem appropriate to describe politicians as vote maximizers, i.e. their objective is to win elections. Analogously,

9 In Chapter 4 in this volume, Ståhl explains how the incentives facing policy-makers and the problems of information in political decision-making make it difficult to implement the “rational” solutions proposed by the economist serving as expert.

bureaucrats seek to maximize the size of their organizations to increase their funding and expand their budgets. On the basis of these assumptions, it was possible to analyze the operation of the mixed economy of Sweden in a more meaningful sense than by using traditional welfare theory. The central question then arose: In whose interest is politics conducted?

According to Ståhl, “a substantial proportion of the interventions into the allocation mechanisms that have occurred in the post-war period in Sweden cannot be justified on welfare grounds” (Ståhl 1977). The regulation of agricultural prices and housing rents fell into this category. Price controls in those sectors destroyed well-functioning markets. Most of the public consumption of education, health and social care was not attributable to external effects, public goods or indivisibilities. They could have been financed by private insurance policies supplementary to the basic security provided by the state. Ståhl concluded that “the benevolent Pareto-optimal dictator who with the help of a large staff of well-qualified economists equalized all the marginal rates of substitution and transformation has never actually existed other than as a hope of welfare economists to expand their labor market” (Ståhl 1977).

Ståhl then went on to examine the use of the assumption of rationality in the study of the political system. He discussed the principle of unanimity, majority decisions, the median voter theorem, horse-trading, the budgetary process, etc. With the help of public choice theory, economists could now analyze political failures where they had only previously envisaged market failures. The political process in the Swedish mixed economy had transferred decisions from the market economy to the public sector. Ståhl concluded with a veritable catalogue of proposed measures and institutional reforms that could curtail political and bureaucratic power.

This entire study can be seen as a research program for the mixed economy, i.e. for the study of political behavior under alternative institutional arrangements, for decisions made within the public bureaucracy and for the patterns of behavior of special interests.

This became his personal agenda for the decades ahead. His main focus was on the effects on the allocation of resources, although he suggested that distribution and stabilization policies should also be brought into a wider analysis of the mixed economy.

The role of the economist would become that of an “eye-opener” who would reveal the political maneuvers underlying economic policy, rather than that of an expert who provides well-honed advice. Ståhl returned repeatedly to this “eye-opening” function. By extension, it offers several pieces of advice on a different level from those that emanate from welfare theory. It is no longer a question of changing taxes and subsidies to correct market failures. The focus should instead be on the analysis and reform of decision-making processes in the public sector and increasing the scope for the market economy. The ultimate objective is to provide individuals with greater power over their own lives.

Public choice was one source of inspiration for Ståhl when he discussed industrial policy and wage earner funds in the 1970s. However, it was not until the 1980s and 1990s that this school of thought came to predominate in his analyses, particularly as the co-author of two books with the words “The power over” included in their titles. Both books were published by SNS, a well-established market-oriented think tank in Stockholm.

The power over the food market

Makten över maten (The power over the agricultural sector) was published in 1984. It was a joint venture among Ingemar Ståhl, Olof Bohlin and Per-Martin Meyerson that offered a systematic public choice interpretation of Swedish agricultural policy. The authors demonstrated how the regulation of agriculture had developed through the cooperation of three principal groups: politicians, special interests and bureaucrats. Together they formed an “iron triangle” that defended the regulatory system that constituted agricultural policy. The benefits from agricultural policy were concentrated among a limited group, while the costs of the policy were spread over the entire population. This made it difficult to

find support for a policy that benefited everyone, ending the regulation of agricultural policy. The winners were easily able to defend their privileges by placing themselves in the middle of the political spectrum. They became an important group of marginal voters who could ally themselves with the political constellations that were best able to safeguard the privileges that farmers obtained from the regulatory system. The long coalition between the Farmers' Party and the Social Democratic Party provides an excellent example of this reasoning.

The book gave rise to a passionate debate in Sweden. The reaction from the farming lobby was extreme. The three authors were subject to a fusillade of criticism. The book could be said to represent a turning-point in agricultural policies. It was certainly an eye-opener. Gradually a few steps were taken towards deregulation. By the early 1990s, this process was completed. A few years later, the regulation of Swedish agriculture took on a new form when the country became a member of the European Union.

The power over the housing market

The same approach as in *Makten över maten* was adopted six years later in *Makten över bostaden* (The power over housing), which Ståhl wrote together with Per-Martin Meyerson and Kurt Wickman. This book examined Swedish housing policy from a public choice perspective (Meyerson, Ståhl and Wickman 1990). There are striking parallels between agricultural and housing policy. The same mechanisms govern the regulatory process. While one special interest (the agricultural lobby) was trying to keep food prices *above* market levels, another special interest (the tenants' organizations) sought to keep housing rents *below* the market price.

Rent controls, stemming from the Second World War, formed the basis of a housing policy where powerful interest groups and public authorities exercised control over the rental market to create and retain their positions of power. The same mechanism worked through the agricultural price controls, secured during the depression of the 1930s.

The authors of *Makten över bostaden* did not initially intend to write a book that would propose solutions. Their primary objective was "to open the eyes of their colleagues, the general public, as well as perhaps the interested parties in the housing market to the procedures and relationships that tend to be ignored in a debate dominated by politicians, bureaucrats and well-organized pressure groups." At the same time, the reader could not avoid ending up with the conclusion that it would be desirable to abolish rent controls.

This was the same conclusion Ståhl had reached with Bentzel and Lindbeck in their book on housing published in 1963, and in the 1976 book *Svensk bostadspolitik* (Swedish housing policy) by Ståhl and his brother-in-law, Nils-Erik Sandberg (Sandberg and Ståhl 1976). The 1976 book concludes with the following sentence: "We have only tried to show that if the goal is to achieve social justice and efficient resource allocation, it is better to work with rather than against the market." This is a credo that reappears in many of Ståhl's writings on the housing market.

Makten över bostaden was a sweeping criticism of half a century of rent controls. The arguments that it presented are still relevant, not least the discussion in the final chapter that examined twelve standard "slogvanized formulations" that are often put forward in the debate on housing policy in Sweden. The authors systematically rejected these opinions, which are still to be found in the current debate on housing issues.

The power over the labor market

As a result of the collapse of the pegged exchange rate of the Swedish currency in November 1992 and the ensuing financial crisis, the center-right government led by Prime Minister Carl Bildt appointed the so-called *Ekonomikommisionen* (Economic Commission), better known as the Lindbeck Commission to set guidelines for future economic policy.

Ståhl provided a chapter on the regulated labor market in Sweden to the report of the Commission (Ståhl 1993b). He adopted the

same public choice approach as in *Makten över maten* and *Makten över bostaden*, arguing that price regulation in the labor market, i.e. of wages, had strong similarities with price controls in the housing and agricultural market. He also contended that the same iron triangle of political parties, special interests and public administrations had taken on a dominant role in the labor market. This iron triangle, consisting of the Social Democratic Party, the trade union movement, government authorities and research organizations closely associated with the labor market, had developed as part of a long historical process that formed an essential and frequently highly respected part of the Swedish model.

Ståhl's analysis dealt with several aspects of the labor market. His point of departure was a comparison between two forms of contract: the individual contractual agreement and the collective employment contract. The individual contractual agreement provides the parties who have entered into the agreement with considerable freedom. This type of contract belongs under civil law. The collective employment contract, or, as it is popularly known, the collective wage agreement, which is regulated under labor law, provides two cartels, the trade unions and the employer organizations, with considerable powers. Swedish legislation favored the collective employment contract over the voluntary agreement on which the individual contract is based. Labor law provides the trade unions with considerable powers since it curtails freedom of contract. It creates and protects monopolies and cartels, thus forming a barrier to free competition.

Ståhl pointed out that an employment contract brings an employer and an employee into "a lifetime relationship." He found it ironic that the Employment Protection Act became law at the same time as the legislation regulating marriage was "liberalized," providing for an immediate annulment with markedly reduced maintenance (Ståhl 1993b, p. 347).

A striking feature of Ståhl's approach to the labor market is his broad perspective. He brings together labor law, collective agreements, conflict measures, social security rules and the design of the tax system. All of these features combine to provide an

“eye-opening” analysis of the rights and powers which had been given to cartel organizations at the cost of individual freedom of contract and free competition.

Where should one start to reform the system? Ståhl provided no facile solutions. He was dealing with the highly praised Swedish model, and it could not easily be replaced by another system. However, he did point to a number of possible approaches that could be adopted: small steps could be taken towards increasing individual freedom in the form of a greater element of voluntary agreements (the voluntary principle) and the “negative right” for individuals and companies to remain outside labor market organizations without being penalized socially or economically.

Ståhl invited his readers “to take part in a mental experiment where one imagines a world where strictly individual contracts are renegotiated when individuals and companies find it advantageous to do so. This imaginary situation could then be compared with the contentious atmosphere surrounding the collective decision-making that characterises contemporary wage bargaining, organized along the lines of military conflict models where armies of ombudsmen confront armies of negotiating executives.” In brief, Ståhl wanted to limit the exclusive power of trade unions to negotiate wage contracts and to create greater opportunities for individual freedom of contract.

What was the reaction of the Lindbeck Commission to Ståhl’s study? The section that dealt with the regulation of the labor market stated in its introduction that the labor market was “one of the most regulated markets in Sweden” (SOU 1993: 16, p. 80). The Commission held more or less the same view as Ståhl, putting forward a number of concrete proposals that would contribute to a liberalization of the labor market. Recommendations along the same lines appeared throughout the report, including for example the proposal to abolish the Swedish Labor Court. However, no major reform of the labor market followed from Ståhl’s recommendations.

The 1990s – a decade of suedosclerosis

In the late 1980s, Sweden was undergoing rapid economic expansion. However, a sharp rise in international interest rates in the early 1990s contributed to a severe financial crisis, followed by several years of negative economic growth. Unemployment, especially in the construction sector, rose dramatically. The commercial banking system was shaken to its foundations and the government intervened with massive financial assistance. The budget deficit reached record heights. Finally, in the autumn of 1992, the Riksbank had to accept a flexible exchange rate. The reverberations of this deep economic crisis were felt throughout the 1990s.

The economic crisis during the first half of the 1990s inspired Ståhl to take on new joint ventures with Kurt Wickman. They wrote five books together from 1992–1997: *Riv bostadspolitiken!* (Demolish housing policy!), (Ståhl and Wickman 1992), followed by *Suedosclerosis – en särskilt elakartad form av eurosclerosis* (Suedosclerosis – a particularly virulent form of eurosclerosis), (Ståhl and Wickman 1993), *Suedosclerosis II* (Ståhl and Wickman 1994), *En miljon utan jobb – Suedosclerosis III* (A million out of work – Suedosclerosis III), (Ståhl and Wickman 1995) and *Ännu mera planekonomi?* (Still more central planning?), (Niklasson, Ståhl and Wickman 1997). The latter four books were part of a series entitled *Marknadsekonomisk årsbok* (The market economy annual survey) published by Timbro, a Stockholm think tank and publishing company.¹⁰

A central theme in their analysis was that the crisis in the Swedish economy was not attributable to a fall in aggregate demand that could be dealt with by traditional Keynesian stabilization policies. Instead, Sweden faced two major disturbances. The first was a real interest rate shock prior to the depression due to a sharp rise in real interest rates in Sweden from the negative levels of the late 1980s.

¹⁰ The concept of eurosclerosis was used widely in the debate on the low rate of economic growth in the 1980s. Stagnation was interpreted as the result of far-reaching state regulation and comprehensive social benefits. Ståhl and Wickman identified a Swedish variant, suedosclerosis, as an explanation of the problems that they found affecting the Swedish economy.

As a result of cross-border financial integration, real rates of interest in Sweden had now reached the same high level as prevailed in global financial markets. The other disturbance was the shock to Swedish industry brought about by the increased competitiveness of low-wage economies in Southeast Asia as well as from countries in Eastern Europe following the collapse of communism.

These changes in the international environment, described by Ståhl and Wickman as “Hayekian,” placed new demands on the Swedish model, mainly through the need to adjust the taxation system, housing policy, social insurance and the labor market. It was now a question of organizing a great retreat from interventionism to deal with the global international competition facing Sweden. Their recommendations were largely based on Ståhl’s earlier analytical work on regulations, controls, incentives and contracts, now adjusted to take account of the crisis years of the 1990s and the new global environment.

Regarding the housing market, they proposed that rent controls should be abolished and replaced by complete freedom of contract. At the same time, interest rate subsidies and housing allowances should also be removed.¹¹ The authors were extremely critical of subsidization. Central government property taxation should be replaced by municipal property taxes. Reforms of labor market legislation should establish greater freedom of contract, partly by means of prohibiting trade union monopoly and providing guarantees for negative freedom of association.¹² Marginal tax rates and the tax burden had to be lowered. Collective savings should be curtailed while private savings could be increased partly by means of the privatization of the ATP supplementary pension system. Finally, the authors advocated a greater scope and understanding for market solutions.

In 1994, they summarized their arguments in a letter to the new Social Democratic Prime Minister, Göran Persson. He expressed

¹¹ Ståhl’s views on housing policy are summarized in Ståhl (2000).

¹² “The ideal labor market would accordingly be regulated by individual contracts” (Ståhl and Wickman 1995, p. 24).

his appreciation and replied that he had a different point of view regarding the measures that could be used to lower unemployment. Above all, legislation could not be used if it would be opposed by the trade unions or the employers' organizations. He also underlined the need to protect a large public sector and a high ratio of taxes to GDP. However, he was not opposed to the idea of a review of the welfare system (Ståhl and Wickman 1995, p. 126).

The sclerosis books were pessimistic. Sweden had to be reformed in order to avoid stagnation. Why did things not turn out as badly as the books suggested? The answer is found in favorable international circumstances and the economic policy adopted following the fall of the fixed exchange rate of the Swedish currency in 1992. International economic expansion and the substantial depreciation of the Swedish krona paved the way for a significant upturn in Swedish exports. Economic growth, combined with a tight fiscal policy, helped to eliminate the budget deficit. The Bank of Sweden adopted an inflation targeting policy and kept the rate of inflation at a low and stable level around 2 per cent in the second half of the 1990s. This was accompanied by a fall in international real rates of interest from the levels that had prevailed during the crisis years. The flexible exchange rate following the collapse of the krona undermined the strong position that the trade union movement had held during the fixed exchange rate regime of the 1970s and 1980s. Wage formation became increasingly disciplined partly as a result of increasing competition from low-wage economies as well as a new industrial wage agreement.

The crisis of the 1990s contributed to market-friendly reforms in many areas of economic policy in Sweden. Following the financial deregulation of the 1980s, an increasingly open Swedish economy supported the growth of new companies and entrepreneurship. In short, the welfare state proved capable of reform and adaptation to new global economic conditions.¹³

13 See for example Bergh (2014) for an account of the reforms of the 1990s, in particular chapter 4.

Professor at Lund University

Ståhl became professor at Lund University at a record young age. He had a unique profile. Through his work in central government and in public authorities, he had acquired a deep knowledge of the actual operation of the Swedish economy. He was personally acquainted with many of the key figures in the Swedish government. He had met many of them in the world of student politics. The other professors of economics did not have such a background. They had made their careers from the inside of the academic world.

Ståhl was a breath of fresh air in Lund's economics department. In his most active years, he could conduct a day-long seminar that began when he parked himself in the seminar room, pipe in mouth, for morning coffee. On occasion, this was a long drawn-out affair. Ståhl would read aloud from something that had caught his eye, usually from the morning papers. His favorite newspaper was *Arbetet*, the Social Democratic morning paper from Malmö. He could come up with occasionally hilarious, telling remarks that nearly always had an undertone of humor. This could continue over lunch in the company of a small group who wandered off to a nearby restaurant where they would also meet up with members from other academic disciplines. Lunch became a long debate where the intellectual cuisine was often better than what appeared on the plates.

On their way back to the department, they sometimes stopped to have a look at the stock exchange lists at *Skandinaviska Banken*. It was customary for Ståhl to provide his own comments on the movements of share prices. The seminar finally finished with afternoon coffee at the department before it was time to go home. If the seminar room was empty, he could knock at the door of someone working to test his ideas and trains of thought.

Ståhl usually began his reasoning from the standpoint of an observation or event, frequently in the form of an anecdote. He would then proceed to explain how an economist should analyze what had happened or what should be done. The debate was often lively. His professorial colleague, Bo Södersten, had a standard reply when he

was unable to respond to Ståhl's arguments: "Ingemar! You have an anecdotal world-view!"

Ståhl had a flair for taking initiatives but was less capable of maintaining a presence within any given area. He was always on the move, both mentally and physically. He needed to move on to the next, exciting thing that turned up. He was certainly no empire builder. He made no attempt to surround himself with disciples or a research institute in Lund. The department in Lund became the major exporter of professors of economics within Sweden in the 1980s and 1990s.

Although his thinking and his recommendations were suffused with a sense of rationality and efficiency, along with an awareness of the importance of incentives, Ståhl's academic life was that of a disorganized professor. Unopened letters gathered in piles in his office, while yellow Post-It notes covered the door. He was renowned for his difficulties in meeting deadlines for the submission of manuscripts and for correcting examination papers in time. He liked to accept invitations to public speaking engagements. There were many double bookings.

During the 1980s, Ståhl worked hard to establish financial economics as a new subject in the teaching at the undergraduate level in Lund. At an early stage, the Department of Economics and the Department of Business Administration established cooperation in the field of financial economics. The School of Economics and Management at Lund University became a forerunner in this field in Sweden. Ståhl was heavily involved in undergraduate teaching both in financial economics and microeconomics. His lectures were widely appreciated by the students.

According to him, the undergraduate course in microeconomics ought to start with the concepts of property rights, contracts and transaction costs. During the 1990s, he developed this approach in a manuscript entitled "The institutions of the market place," which he never actually completed for publication (Ståhl 1997). The manuscript was intended to "act as a complement to the basic micro-course in economics". Here the reader is confronted with a different world from that usually encountered in textbooks in

microeconomics. It was both richer and closer to reality. This approach also provided him with a connection to the study of law and economics.

Ståhl's primary role at the graduate level was to act as a source of innovative ideas. The practical role of thesis advisor he usually left to others. The Department of Economics in Lund succeeded in producing a large number of doctoral dissertations considered of path-breaking importance in Sweden, in areas such as law and economics, health economics, labor, taxation, the economics of education and environmental economics. Many of the authors subsequently became professors.

At the turn of the century, Ståhl moved from the Department of Economics to the Faculty of Law. At *Juridicum*, he continued to follow the same pattern as before, taking up a seat in the seminar room. There were both pull and push factors underlying his move. The environment at the Department of Economics had changed. Former colleagues had become researchers or professors outside Lund. The emphasis on mathematics and rigorous presentation had become popular among the younger colleagues. This was not to his liking. He hoped presumably to find a greater response to his interest in institutional economics and law and economics in the Faculty of Law.¹⁴

In the latter part of the 1990s, Ståhl's voice became less prominent in public debate and his research activity began to decline. His health deteriorated and he lost some of his former energy. His involvement and his writing tailed off. When I asked him about this he replied that he had said all that he needed to say. He retired in 2005 and withdrew from economics.

My own experience of Ståhl was that it was both exciting and rewarding to be in his company, although I personally had chosen to involve myself in research far from his fields. He had a humorous twinkle in his eye. He was never far from a joke and laughter. For

¹⁴ Ståhl subsequently received an honorary doctorate in 2001 for his work in law and economics from the Faculty of Law in Lund and a festschrift published in 2005 (Dahlman 2005).

me, he was an inspiring, quick-witted professor who was always prepared to provide a rapid, concise and pertinent analysis. In short, Ståhl made it fun to be an economist. There were many who agreed with me, although others were more critical. They could find him supercilious, domineering and lacking respect. His sharp critical faculties could be difficult to handle.

From a social democrat to a market liberal

Ståhl's fascination for economics ran parallel to a strong interest in political developments. At upper secondary school, he was already active in the Social Democratic movement. He became co-editor of the Social Democratic student association's journal *Libertas* as well as writing articles for the party's own journal, *Tiden*. At an early stage, he got to know the young elite that was rising toward the top of the Social Democratic Party. In that circle, there were two future prime ministers, Olof Palme and Ingvar Carlsson, and a future minister of finance, Kjell-Olof Feldt. This background undoubtedly made it easier for Ståhl to establish contacts with government committees, government departments and authorities during the 1960s, when the Social Democratic Party was the predominant force in Swedish politics.

Ståhl was never a Marxist or a socialist. Not once did he express any approval of the socialist experiments that had been carried out outside of Sweden. The difficulties involved in planning were apparent to him from an early stage. Central planning required so much information that it seemed unrealistic and quite impossible to implement.¹⁵ He could best be described as a social engineer who was ready to improve society by means of rational solutions aimed at increasing overall economic efficiency in society. It was a matter of complementing the market economy and improving the operation of the public sector rather than seeking to replace the market. His proposal in the party journal, *Tiden*, for the creation

¹⁵ See for example Ståhl (1964b and 1979c).

of an institute for structural economics should be seen in that light (Ståhl and Ysander 1965).

On his arrival in Lund, Ståhl was a declared Social Democrat.¹⁶ Gradually, he moved away from the party. Several factors contributed to his reorientation. The Social Democratic Party shifted to the left during the 1970s. He was also influenced by his experience of Social Democratic politicians and policies. He was particularly disappointed by the party's housing policy. He failed to find any support for his ideas, which he considered to be based on rational economic analysis. The wage earner funds issue led him into a critical attack on Rudolf Meidner, a leading economist of the trade union movement. The books on *Stålverk 80* and on the ground rules for industrial policy represented a move to a free-market approach. The debate on nuclear power in Sweden revealed him to be a firm supporter of nuclear power, thus providing support for the line adopted by the conservative party.

His encounter with public choice theory and U.S. economists of more classical liberal and conservative persuasion, some of them associated with the University of Chicago, contributed to Ståhl's shift towards a market liberal standpoint. He had already come across their analysis of human capital and education in his work on a system for student finance. He now wished to introduce these American economists to a Swedish public. He made it possible by writing the preface to Milton and Rose Friedman's book entitled *Frihet att välja* (Free to choose), published in 1980 (Ståhl 1980b). Subsequently, he also wrote the preface to James Buchanan's book *Maktens gränser* (The limits of power), published in 1988 (Ståhl 1988). Ståhl cooperated with Buchanan on the articles to be selected for the book. He was also involved in the publication by Ratio in 1992 of Ronald Coase's book *Företaget, marknaden och lagarna* (The firm, the market and the law). James Buchanan and Mancur Olson visited Lund. Ståhl viewed their work with great sympathy.

As early as 1983, Ståhl became a member of the Mount Pelerin

16 At a very early stage, he pointed out for me the advantages of being a party member in order to advance one's career. I declined this offer.

Society, a group of economists, historians, philosophers, businessmen, politicians and journalists with the aim of spreading the ideas of classical liberalism. He was one of the few Swedish social scientists represented in this organization and was moreover at that time the only Swedish professor of economics in it. Inspired by Knut Wicksell's theory of taxation, Ståhl argued that decision-making in parliament should require a qualified majority, in order to provide the minority with additional powers. This standpoint was in direct conflict with Social Democratic views on taxation and democracy.

In the late 1970s, Ståhl became a columnist of the Stockholm daily newspaper *Svenska Dagbladet* and the business periodical *Affärsvärlden*. He participated in several conferences arranged by SAF (The Swedish Employers' Confederation) and by Ratio and Timbro, two think tanks supported by SAF. He worked as an advisor for them as well as being a member of the board for *Näringslivets fond* (The Swedish Industry and Commerce Foundation). In the mid 1980s, he carried out substantial work for MAS (Market economy alternatives for Sweden). He was the principal contributor to the chapters on healthcare, the housing market, taxation and social policy in the so-called MAS report in 1985 (Thimerdal 1985). This report offered a clear liberal and market-friendly alternative to the Social Democratic program.

Ståhl's market liberal stance became even more pronounced during the 1990s, when he became a contributor to the Market Economy Annual Report published by Timbro. He was also one of the founders of the private City University. He was a board member from 1989–2002 as well as a member of the research institute Ratio's scientific council from 2012–2014.

Ståhl's political journey was far from unique. It followed the same path during the 1970s and 1980s as that of a number of economists who initially shared a Social Democratic orientation, among them Assar Lindbeck, Nils Lundgren and Carl B. Hamilton, joined somewhat later by Bo Södersten.

Ståhl was an early advocate of market solutions, from the start of his career during the 1960s. He was aware at an early stage of the difficulties of central planning and the disadvantages of rent

control. He was also critical of the continuing expansion of the public sector and the negative incentives associated with high levels of taxation. His aim throughout was to extend the scope of the market economy and of the freedom of the individual to make choices. Guy Arvidsson called him a “price enthusiast.” If a political label is to be attached to Ståhl, the epithet “liberal” would be the most suitable. The choice is then available between market liberal, neo-liberal and classical liberal.

The civic role – external commitments

Ståhl was strongly attached to the idea of the civic role of the university professor. He was active in many areas outside Lund University. He wrote articles for the press as well as having a regular newspaper column. He took part in the radio program *Ekonomiska klubben* (The economic club). His experience and knowledge was in high demand. And he satisfied that demand with a prolific supply. He loved to make himself available. He enjoyed public speaking engagements, which provided him with a forum for his eloquence. He was a powerful debater who was able to combine telling replies with rhetorical flourish. At his busiest, his diary would be full of appointments for lectures and speeches. He received invitations from a wide range of organizations: the Swedish Economic Society, Centre for Business and Policy Studies (SNS), Swedish Medical Association, Association of Swedish County Councils, National Association of Homeowners, Swedish Chamber of Commerce, Swedish Employers Association, Timbro, and various local business organizations.

Ståhl became a member of the Royal Swedish Academy of Sciences in 1978 and was a member of the committee that awarded the Nobel Memorial Prize in Economic Sciences from 1981-1994. He was heavily involved in the work of that forum, being a particularly strong advocate of public choice, contract theory and financial economics. Most media attention concerned the prize awarded to John Nash in 1994. Ståhl did not hide his opposition.

In a passionate speech at a plenary meeting of the Academy, he criticized the award to Nash. This led to a serious delay of the customary press conference. Ståhl had raised the objection that the enquiries that had been made into Nash's mental health made it unsuitable to give him the award. He also questioned the originality of Nash's work and its relevance for economics. However, his opposition was in vain. Not long afterwards, he gave up his position on the committee.¹⁷

Over a period of 25 years, Ståhl acted as academic advisor to the Ragnar and Torsten Söderberg foundations as well as being a member of the Ragnar Söderberg foundation. He became deeply involved in the work of these foundations. Following the collapse of the Soviet Union, Ståhl became interested in the Baltic countries. He gave courses in institutional economics, law and economics and financial economics on several occasions at the School of Economics established in Riga, Latvia, with Swedish financial support.

Ingemar Ståhl as an economist

Ståhl was almost certainly born to be an economist. Economic analysis seems to have been in his genetic make-up. He interpreted everything in economic terms. He was able to use economic theory to provide quick, elegant and insightful explanations of his observations of reality. A fallen roof tile lying on the road was probably the result of rent control since it encouraged the property owner to neglect maintenance of the property.

It could perhaps be said that Ståhl did not have to study economics. He actually warned that learning economics could make healthy brains sick. As an example, he chose his experience as an external examiner at Oslo University. It was an important moment for the students. After several years of advanced, demanding studies, they now had to answer questions from professors from other universities.

¹⁷ Nasar (1998) provides a somewhat incomplete account of the events surrounding the award of the prize to John Nash.

Ståhl began his questioning by telling the students that he had taken the tram to the Oslo University, passing a baker's shop that had a sign stating "Today's special offer: bread for seven crowns." Ståhl posed the question: "Why did the bread cost seven crowns?" It became an embarrassing chaos when academically well-trained students were unable to come up with sensible answers. They dug deep into input-output analysis, the labor theory of value, assumptions regarding productivity and other forms of model-based reasoning. Years of higher education were not just a waste of time. In Ståhl's view, they had also damaged healthy brains. He smiled about this unique episode. He was never invited back as an external examiner to Oslo University.

The examination at Oslo illustrates a central feature of Ståhl's approach to knowledge and economics. He chose his example from reality rather than from theory and the world of models. Throughout his working life as an economist, his focus was on concrete questions, which he tried to answer with the help of the most constructive form of analysis. Given the choice between a simple and a difficult explanation, he chose the former. His writings since he became professor contained hardly any theoretical evidence or econometric estimates in support of his reasoning. He was a verbal economist *par excellence*. This approach can be largely explained with reference to his work as an analyst on government reports in the 1960s. He wrote for decision makers, politicians and the general public rather than for a purely academic audience. He continued along that road for the rest of his life.

Almost all assessments of Ståhl as an economist emphasize his inventiveness, ingenuity and relevance. His strength was to stimulate new thought, frequently by adopting surprising approaches. He wrote well and rapidly, although much of his writing remained in his desk drawer. "Stringent analysis, clarity of presentation, capacity to apply theory to practical problems without complicating the theory more than the problem required." These words appear in the formal opinion signed by Guy Arvidsson concerning Ståhl's appointment as associate professor at the University of Lund. This judgement applies to all of Ståhl's work.

Many researchers keep to one field and one type of scientific approach throughout their academic lives. Ståhl did not. He worked in many areas, although his main focus was on resource allocation. He had a thirst for knowledge and a desire to make his presence felt in debates. He was attracted by current problems and finding solutions for them. In spite of his curiosity, he returned to deal with issues that concerned him throughout his life like housing policy and taxation issues.

He did not follow the current road to a professorship based on publishing articles in English in highly ranked peer-reviewed academic journals. Ståhl did not have a single publication in English in an established academic journal, either before or after attaining his professorship. Most of what he wrote was in Swedish. He adapted successfully to the structure of incentives for an academic career in the 1960s. He wrote primarily in response to invitations from external customers – for official government reports, think tanks, organizations, companies and authorities. In this way, he was the product of a bygone period.

The legacy of Ingemar Ståhl

Most of what Ståhl fought for throughout his life has achieved widespread acceptance in public debate and policy in Sweden. This contrasts with the reception that many of his ideas and recommendations received when they were first presented. A central strand in his thinking was that the market economy had suffered at the hands of the Swedish mixed economy. He showed that the expansion of the public sector was not driven by the well-intentioned consideration of public welfare. Instead, it was motivated by the need to use the public purse to protect the interests of privileged groups. He formulated alternatives to prevailing Social Democratic policies based on a positive view of the capacity of the market economy to reflect the wishes and preferences of the citizens.

He wanted to provide individual citizens with greater freedom to change their life situations. Freedom could take many

forms: greater competition in the public sector; deregulation in sectors such as housing, agriculture and the labor market; greater choice for the citizen in areas such as health and education; stable ground rules for both the state and business; a tax system based on uniform principles; and increased scope for freedom of contract.

His role as a public intellectual and his active participation in public debate, together with his numerous proposals for reform, allowed him to exert a considerable influence on the Swedish economic thinking of his time, which initially was characterised by a belief in a strong state, public intervention and control. He helped shift the general state of opinion in Swedish society from skeptical hostility to a more positive view of the role of the market economy during the last quarter of the twentieth century. He was hardly a lone voice in the desert. A number of economists started to argue for a greater acceptance of market solutions. There is a lack of doctrinal analysis of the role played by economists in this process in Sweden. When it is written, Ståhl will appear as an important actor in this course of events.

Ståhl's legacy is also to be found in practical policy. A central part of his intellectual heritage is the system of student financial support. He proposed the idea, developed it and contributed to its implementation.¹⁸ From 1965-2017, 3.1 million Swedish residents received student grants, of whom 2.7 million also took loans. These figures apply to higher education. At the level of the upper secondary school, the comparable figures are 2 million youngsters who received student grants and 1.6 million who took loans. From its introduction in 1965, the system has paid out 191 billion Swedish crowns in grants and 321 billion crowns in loans. These substantial figures have grown out of Ståhl's brief outline, which originally covered only a few pages.¹⁹

Within academia, Ståhl was a pioneer in several fields. He

18 Berggren (2010, p. 328) praises the system of student finance as "one of the most successful reforms in Swedish educational policy."

19 These figures have been made available by CSN (National Board of Student Aid) for the Swedish book on Ståhl (Jonung and Jonung 2018).

introduced health economics as a subject in its own right. He was an early advocate of public choice and contract analysis. As a result of his efforts, financial economics became a part of undergraduate studies in economics at Lund University at an early stage. He encouraged research in new fields.

Ståhl's analyses and ideas have withstood the passage of time. Almost all of the problems that he worked on are still part of the contemporary political debate in Sweden. This applies for instance to issues concerning the tax system, housing policy, agricultural policy, labor market, education and defense. He is a brilliant representative of the tradition in Swedish economics of providing relevant analysis and policy proposals to advance economic and social progress. He deserves to act as a source of inspiration for the current and future generation of economists in Sweden.

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INGEMAR STÅHL

Chapter 2. The Rise and Fall of Index Loans in Sweden

Ingemar Ståhl started his academic career by working on the Indexation Committee, a government commission, in the early 1960s. Created because of the rise of inflation in Sweden in the 1950s, the committee examined the use of indexed loans as a way of adjusting nominal contracts to inflation. Ståhl became a proponent of indexed loans. However, the final report of the committee was not transformed into any legislation. Instead, it was a source of inspiration for two policy experiments, one in housing finance and the other in student finance.

In this chapter, Ståhl describes these two experiments, unique to Sweden. The first introduced so-called parity loans to finance housing. The system of parity loans based on indexation lasted for a few years in the 1970s. However, it proved too difficult to explain and implement indexed housing loans in a framework of nominal taxation and nominal contracts.

The second experiment was Ståhl's design of the Swedish system of student finance of higher education, launched in 1965. Here he introduced an element of indexation in student loans via a redistribution over time of interest payments and amortizations. The student loan system has proved highly successful. It is still running, testifying to the foresight of Ståhl's original work.

This chapter is a reprint of "The Rise and Fall of Index Loans in Sweden", published in Skandinaviska Enskilda Banken Quarterly Review, no. 1, pp. 14–20, 1975.

Periods of sharp inflation not only produce tendencies towards increased money rates of interest, more or less arbitrary redistributions of wealth and greater uncertainty for long-term investments,

but also a discussion on index loans as a means of avoiding some of the effects of inflation. The purpose of this article is not a general discussion of index loans, still less of the overall problem of inflation. Instead, it limits itself to supplementing the accounts given in some recent articles and publications (Robson 1974, Yang 1974, Genberg-Swoboda 1975, and the OECD 1973) by providing a brief summary of the developments of Swedish theory in this sector during the post-war period and of the experiments carried out, particularly in the field of financing of housing and higher education through index type loans. The Swedish investigations and experiments are of particular interest in that they clearly indicate the institutional difficulties which exist and which have received only limited attention in international discussions.

The theoretical discussion on index loans

The inflation that followed the Korean war and the discussion concerning a general retirement pension scheme are essential background factors to the more theoretical interest which began to be devoted to the question of index loans in Sweden during the latter half of the 1950s and the beginning of the 1960s. It is true that some form of index loan would probably have been a necessary prerequisite in order to achieve a completely inflation-proof retirement pension scheme of the more traditional type. But, following the victorious emergence of a system of distribution of the national supplementary-pension-type from the political struggle, interest in just this special aspect also waned. At the same time the annual changes in the price level were stabilised and a dogmatic low-interest policy was systematically abandoned. As a result, more emphasis came to be placed by investigations and discussions on a series of matters of principle.

The starting point was the work carried out by Professor Tord Palander for the 1951 Committee on Full Employment and Monetary Stability and the Swedish life insurance companies.

The report of the Committee was published in an expanded

version in 1957 and supplemented shortly afterwards by a more theoretical analysis of risks (Palander 1957). To a very large degree these writings, like Guy Arvidsson's comments and continued analysis, dealt with the problems which monetary policy faces in a market in which the Government and the Central Bank operate concurrently in a money loan market and an index loan market (Arvidsson 1958, 1959). In retrospect one can well appreciate the fact that this esoteric discussion, which, for politicians and people connected with the capital market, was not all that easy to follow, failed to arouse their immediate enthusiasm.

The starting point of the discussion is the equation:

real rate of interest (rate of interest on index loans + the change in the price level) = nominal rate of interest (rate of interest on money loans).

What determines whether index loans are more or less advantageous than money loans for an investor depends on whether the difference in the rate of interest is sufficient to compensate for the change in the price level (plus a possible risk-taking in the event of unexpected inflation). If the rate of inflation were quite certain and, say, 5 per cent per annum, then both borrower as well as lender would be indifferent as between an index loan with a real rate of interest of 3 per cent and a money loan with a nominal rate of interest of 8 per cent. It is probable that many of the popular conceptions of index loans were (and are) associated with the idea that the introduction of index loans must imply a higher rate of interest. In actual fact it is probable that, in a free capital market where both types of loans co-exist, a difference in interest rates between the types of loan which depend on the market's expectations of inflation will be established. One may also say that it is always possible to achieve a certain real interest level (say positive) by allowing the money rate of interest to vary sufficiently with the expected rate of inflation.

The conditions described above must be distinguished from the perhaps mainly politically determined conditions that the real rate of interest on money loans (nominal loans) has for long periods been negative, and that the money rates of interest have not varied

sufficiently to compensate for changes in the rate of inflation. There thus exists a tendency that the real rate of interest, calculated in retrospect, has actually been at its lowest level during years of inflation and high (nominal) rates of interest.

The theoretical discussion came to be concentrated partly on the risk-reducing properties of index loans and partly on the properties of a “double” market. A lender (saver) who is primarily interested in the real value of his assets will experience a smaller degree of uncertainty as to the future value of his assets with index loans than with money loans even if the expected future value may be of the same magnitude. A lender may be prepared to pay a risk premium, i.e., accept a somewhat lower real rate of interest on an index loan than the expected real rate of interest on a money loan (the nominal rate of interest reduced by the rate of inflation). A similar argument may also be applied to a borrower: an index loan provides a greater degree of security as regards the real future commitment than a money loan. One may also claim that financing by means of index loans will result in a more advantageous selection of investment from the viewpoint of the society. If, on the other hand, calculated internal rates of interest, like rates of interest on loans, are nominal and not real, the projects selected will, to a certain degree, also be determined by the investors’ future expectations of inflation. An investor who expects considerable inflation will, in this connection, with the same nominal rate of interest, apply a lower real internal rate of interest than an investor with expectations of moderate future inflation.

In his writings, Professor Palander outlined a monetary policy according to which the Government should endeavor to equalize a possible difference in the rate of interest between the money loan market and the index loan market. By actively reducing this difference the Government could also influence the expectations of inflation to a certain extent. Palander assumed in this connection that the Government must operate in both markets and that a permanent difference in the rate of interest would thereby be interpreted by the public as the Government’s own expectations of inflation. But – as was shown by the continued discussion – it was

scarcely likely that expectations of inflation and the actual trend of inflation can be controlled in this simple manner. Instead, the risk is that, if the Government pursues such an equalizing policy and “inflation is not only expected but occurs, the policy means nothing other than a gigantic topsy-turvy bank under Government control” (Arvidsson, 1958). In the extreme case the policy would, after all, mean that the Government acts as borrower for all index bonds and as lender for all nominal bonds. According to Arvidsson, a better policy would be for the Government to concentrate its policy entirely on the index loan market and leave the (speculative) nominal loan market to its fate.

Contributions by the 1959 Committee on Indexation

When the Committee was appointed in 1959, many of the fundamental problems had already been thoroughly ventilated at the same time as the political interest had cooled off considerably, following the solving of the question of pensions. The lasting contributions of the Committee, which published its report early in 1964 (Swedish Government Official Reports 1964: 1 and 2) without making any really concrete proposals, consisted, if anything, of an investigation of the questions of taxation, housing finance through index loans, as well as a series of institutional conditions.

In its report the Committee pointed out that, when taxing capital income and capital gains, it was necessary to distinguish between nominal- and real-value principles of taxation. The current taxation of interest on money loans is based on purely nominal-value principles. But, without changes in legislation, the nominal-value principle would also be applied to index loans under the Swedish system of taxation: real interest plus index increment being considered to constitute the basis for taxation. Under a taxation system based on real-value principles capital income is to be determined only after the original capital has been calculated with the aid of an index. The principle of real-value taxation can very well be applied to money loans: the interest subject to tax will then be the nominal

rate of interest reduced by the index increment. For a real loan the application will be obvious: tax will be paid on the real interest, while the index increment will be exempt from tax.

The selection of the principle of taxation will obviously affect the determination of the interest rates on the market. If the public demands a zero rate of interest after tax, and the rate of inflation is 6 per cent and the lenders' average marginal rate of tax 60 per cent, then a money rate of interest of 15 per cent with nominal taxation ($15(1-0.6) - 6 = 0$), will be required, but with real-value taxation a rate of only 6 per cent. One of the most important results of the work of the Committee is the fact that strong emphasis was placed on the role played by the principles of taxation. Much of the reduction of the element of uncertainty to which index loans can give rise would be lost if the nominal-value principle of taxation were applied, i.e., the index increment were taxed as interest. But essential advantages would also be achieved merely by adopting the principle of real-value taxation without introducing index loans. As a result of the most recent increases in marginal taxation in Sweden this problem has become more topical than previously.

The adoption of the real-value principle of taxation would have a series of consequences, for instance, on the principles of corporate depreciation methods and accounting. In this connection the Committee devised a real method for depreciation. A lasting impression of the Committee's work is the extensive role played by the various aspects of "money illusion" in the institutional system making up the framework of the capital market: accounting principles, property mortgages, and assessment values are all based on nominal-value principles. It would be extremely difficult to introduce index loans without making amendments to the institutional framework at the same time.

To a large degree the previous discussion has assumed a closed economy without international capital movements. Even though the investigation was never completed, the Committee indicated the problems which would arise if *one* country were to introduce index loans or the real-value principle of taxation in an international context with money loans and nominal-value taxation. In

order to prevent purely speculative capital movements, some tax arrangement would be necessary.

Experiments with practical applications

The Committee's report was circulated to the various parties concerned for referral in the traditional manner, but was never presented as a Bill embodying concrete proposals. One feature of the Committee's work which is of permanent value is, however, that the discussion on index loans was given a more realistic approach as a result of the fact that the research carried out by Palander and Arvidsson was supplemented by an in-depth analysis of institutional problems.

In two fields, however, the views of the Committee did lead to practical policies being adopted, one in the field of housing finance, the other in the field of student finance.

The common feature of these two fields was that, using the Committee's analyses as a basis, emphasis was placed on the problems of liquidity and the redistribution over time of interest payments and repayments which occur in connection with an increase in the rate of inflation and money interest rates. Problems of this kind have, to a large degree, been brought to the fore during the ongoing inflation. Briefly, the argument is that if the real rate of interest is (tolerably) constant, then an increase in the rate of inflation will lead to a corresponding increase in the nominal interest rate. Therefore in an inflationary economy there exists a tendency for the real rate of repayment of a loan to increase as a result of the fact that part of the higher nominal rate of interest can be regarded as compensation for inflation. This leads to increased liquidity demands on the borrower.

For long-term loans with a constant rate of repayment, inflation also means that the real value of the repayments will reach a maximum at the beginning of the life of the loan, before falling off sharply afterwards. This state of affairs creates considerable inconvenience for housing and student finance. In the first place,

the picture is complicated by the fact that the public utility housing enterprises (and the private housing enterprises previously under rent control) have based their annual rents on the actual nominal interest payments and repayments, irrespective of the trend of inflation and the rise in property values. This led to a rental structure with high rents in new housing and low rents in old housing, where the difference in rental levels was due more to the trend of inflation than to differences in standards, i.e. a rental gap emerged.

Parity loans

In order to solve the combined problems of liquidity and the rental gap, the introduction of so called parity loans, the purpose of which was to “simulate” certain properties of index loans, was proposed in 1966. In principle, these loans were money loans, but the payment of the nominal rate of interest was arranged in such a manner that the annuity which determined the rental charged would, in the main, follow the index of building costs. This meant that part of the nominal rate of interest was added to the principal each year; the outstanding debt could, however, never rise more than the index. It may also be said that parity loans were intended to function in such a manner that each year property owners were permitted to increase their nominal borrowing so that a reasonable correlation existed between actual land values and real borrowing. The principle is illustrated in Figure 1.

Student loans

A similar system was introduced for the financing of higher education under the terms of the proposal put forward concerning student loans in 1963 (Swedish Government Official Report 1963: 74). The problem was that the burden of liquidity on traditional-type student loans was relatively heavy at first, at the same time as the income of the graduates in receipt of loans was relatively low

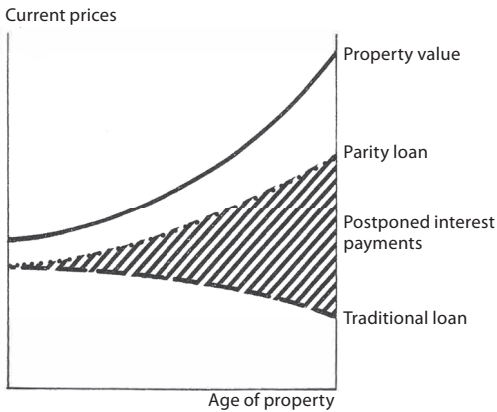


FIGURE 1. Property value and the value of a parity loan and a traditional loan under inflation.

at the start of their career. By introducing a real-value principle and postponing parts of the nominal interest payments – i.e. an extension of the average period of repayment, a better correlation is achieved between the ability to pay and actual payments. The system was linked to the social insurance system, and repayments and interest payments were based on a constant *real* annuity, which meant that the nominal-value increased proportionally with the price index. Formally, this meant that a nominal increase (but never a real increase) in indebtedness occurred as a result of parts of the interest being added to the principal.

Much of the inspiration for these reforms came from the Committee on Indexation, among other things, through personal unions. Guy Arvidsson was a member of the 1966 Housing Policy Committee, and Ingemar Ståhl was attached to the 1963 Committee investigating social measures for students. In the first case it must also be remembered that Alf Johansson, former Director-General of the National Swedish Housing Board, had pursued similar lines of thought with the aim of achieving a rational financing system that avoided a rent gap without extensive general interest subsidies.

The practical result of the Committee's work was thus that, in

two important fields of Government lending, efforts were made to simulate a fundamental feature of index loans, viz., a real fixed rate of repayment and a more even liquidity burden – but maintaining money loans and nominal interest rates. A departure from the real interest assumption, which formed the basis of the financing system (3 per cent for housing finance and nil per cent for student finance) had to be managed by some form of reconciliation procedure or an adjustment of the accepted period of repayment. Experiments with index loans for lenders – apart from the Government – were never carried out. For the sake of completeness it should, however, be mentioned that at the beginning of the 1950s the Swedish Cooperative Union and Wholesale Society issued a loan with a limited index clause. Private index-linked promissory-note loans have probably also occurred on a small scale. As far as taxation is concerned, it may be pointed out that the real-value principle of taxation of capital gains, which was investigated by the Committee, was put into practice.

The abolition of parity loans and index loans

Following the introduction of parity loans, it became possible to abolish the general interest subsidies which had previously been paid out during the early years for each housing property. Interest subsidies were applied to student finance to a very small extent. This was made possible by the fact that the new types of loans solved the problem of liquidity which high nominal rates of interest had created during the first year of the loan. This is a particularly urgent problem today in view of the fact that the high rate of inflation, while creating a high nominal interest level (with an initially heavy liquidity burden), provides actual real rates of interest which are very low – in practice, negative.

But there is no doubt that the introduction of these “simulated” index loans in an otherwise nominal-value environment, created a series of administrative and political problems. As far as housing finance was concerned, the Government mortgage loan had to bear

the whole burden of redistribution of payments over the period, while the remaining loans followed traditional principles. Assessment values and mortgages were still determined on the basis of nominal-value principles. The attempts made on the part of the authorities to explain the features of the systems showed evidence of both half-heartedness and inadequacy.

During 1974 the Riksdag thus decided to abolish in the main both systems and reintroduce general interest subsidies for housing finance and a more refined nominal-value principle for student finance (Swedish Government Bills: 1974: 150 and 1975: 14). It may appear paradoxical that this is taking place just at a time when there is a high level of inflation and the discussion on index loans is being taken up once more. Swedish developments show, however, the difficulties of making a few isolated attempts with index loans in an institutional environment which is strongly characterized by a nominal-value philosophy.

The previous results of the investigations concerning, for example, real taxation of capital income, index-regulated mortgages and a real method for corporate depreciation indicate, however, that these institutional obstacles can be removed. Such institutional changes would probably also facilitate the political problems.

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Chapter 3. Ownership and Control in Business Enterprises

This chapter presents Ingemar Ståhl's critique of the proposal for wage earner funds presented in 1975 by Rudolf Meidner, a well-known trade union economist. The report by Meidner was prepared at the request of the powerful Trade Union Confederation (known in Swedish by its initials, LO). In short, Meidner suggested that the ownership of companies registered on the Swedish stock exchange should be transferred gradually to wage earner funds controlled by the trade unions. If implemented, the proposal would have fundamentally transformed the Swedish economic system, as the labor union movement would ultimately have become the sole owner of Swedish companies. The aim of the proposal, according to Meidner, was to replace old-style capitalists with central trade unions as owners of business.

The Meidner proposal initiated a lively debate that lasted for many years. In November 1975 the Swedish Economic Society invited Ståhl and Meidner to discuss the Meidner plan. On that occasion, Ståhl became the first economist to give a detailed and highly critical analysis of the idea of union controlled funds. While Meidner was inspired by a socialist perspective, Ståhl discussed the effects of wage earner funds using the theory of contracts and transaction costs, a then-new perspective in Swedish public debate.

Ståhl also presented an alternative to Meidner's proposal. He wanted to extend the state pension plan with a premium pension system that invested in shares. Such a system would contribute to a wider distribution of wealth than accomplished by the Meidner plan.

This chapter contains the translation into English of Ståhl's assessment of the Meidner proposal. The original version in Swedish was published in the proceedings of the Swedish Economic Society, 1975-11-20, Ekonomisk Debatt, vol. 4, no. 1, 1976.

Our discussion starts out from the proposal for wage earner funds put forward by Rudolf Meidner in the late summer of 1975 in the form of a report commissioned by LO, the Swedish Confederation of Trade Unions. See Meidner (1975). However, there are strong grounds for an extension of the debate to include the changes in the relationships between employees and enterprises that have already taken place in the form of legislation on board representation, and to include also discussion of the new regulations on employment contracts (the so-called employment security legislation) as well as the growing interest in issues concerning the working environment. In addition, there are further changes in the pipeline regarding legislation on extending rights of consultation in relation to executive decisions in both business organizations and public administration.

Groups that have traditionally exerted a major influence on the decision-making of private firms such as shareholders and to a certain extent, politicians on the boards of public bodies, may well find that their influence will be curtailed at the same time as employees and particularly their trade union representatives may experience a corresponding increase in their influence. However, it is not solely a question of a change or a shift in influence and power: rules of behavior and decisions on the resource allocation within companies may also be affected. Accordingly, this may give rise to changes in the operation of the economic system as a whole.

I would like to begin by raising a slightly polemical question: Why have employees through their trade unions been largely unwilling to take on major shareholdings in companies? If they had done so, they would have been able to exert an influence over company management and overall business strategy. There would hardly have been any practical obstacles for doing so. For example, the total market capitalization value of Volvo is just under SEK 2,500 billion. For 50 000 employees, this was equivalent to a financial investment of SEK 50 000 per employee, i.e. less than the annual wage costs of an employee.

The ownership of Swedish shares would presumably have had a completely different structure if a pension arrangement organized

as premium reserve system had been introduced, funded by investing in equities, instead of the present pension system oriented towards financing in low yield government and housing bonds. It should be remembered in this context that our present pension system based on the concept of national pension insurance funds is a pay-as-you-go system where pensions are paid out of current working incomes. In this type of system, the fund's financial rate of return has little or no effect on either pensions or contributions. In a premium reserve system on the other hand, it is imperative for the survival of the system that the pension investments secure as high a rate of return as possible.

What are the underlying changes that have taken place in the Swedish economy or in the attitudes of trade unionists that could account for the present discussion of wage earner control of the economy, an issue that had previously only attracted a lukewarm response from the trade union movement?

My discussion will largely concentrate on four different areas. *Firstly*, I will briefly present my views on what constitutes a company and the contracts that it has with its employees, production capital, financiers and firm management. It is not a question of introducing new ideas. Rather I wish to present the perspective of the firm as an organization that enters into contractual relations, a view that has emerged during recent years in debates and in some parts of the economics literature. My interest in spending some time considering this perspective is to a considerable extent due to the marked differences between this approach and that followed by Meidner (1975) in his report. In addition, the view that I discuss here presents a different approach to the issues of ownership and control and power in business enterprises than that of Meidner.

Against the background of my different perspective on the business enterprise, I want as a *second* step to take a closer look at some of the arguments that Meidner presents in support of wage earner funds. Following this appraisal of motives, it seems appropriate as a *third* stage to examine the proposed construction of wage earner funds and at the same time to widen the argument to include other proposals of a similar nature that are circulating in the general debate.

Finally, I wish to present some more personal views regarding capital formation and the desire to create a more equitable distribution of wealth. I will also put forward an alternative solution to Meidner’s proposal.

1. The company and its contracts

Starting out from a simple sketch (*Figure 1*), I examine the company as an organization that has entered into a number of contracts with various groups or actors.

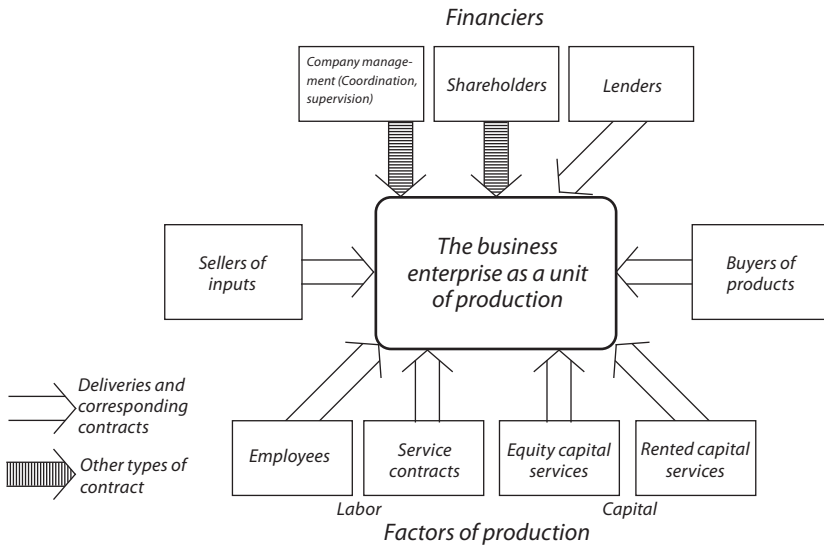


FIGURE 1. The contract structure of the firm.

The company to be discussed is at some distance from the unit of production that features in classical textbook presentations in economics, operating in perfectly competitive markets where the costs of information and of establishing different types of contract are negligible. As we know, significant costs do exist for obtaining and producing information, establishing contacts between buyers and

sellers and determining the various qualities and characteristics of goods and services that have been purchased and sold. The costs involved in initiating and maintaining different types of contracts may also be substantial. This gives rise to a wide range of available solutions for the contractual relationships that business organizations have entered with different actors and factors of production. To a great extent, these solutions seem to be dependent on how well markets operate and the levels of transaction costs that prevail in different markets.¹

It is also important to emphasize that the structure of contracts is determined simultaneously; a change in a contractual relationship on one essential point will have repercussions for other contracts within the company. This will give rise to a process of mutual adjustment that will continue until some type of new equilibrium is established. Consequently, a political decision that changes the content of a contract, for example a wage contract, can also be expected to alter the character of the contracts of other actors.

Products and inputs

Contracts with sellers of inputs and customers of the company's products are perhaps a somewhat less interesting part of the company's contract system. It is probably sufficient to point out that these contracts may give rise to substantial variations in the structure of the firm. An extreme case would be where different units of production are integrated within one and the same company. The relationship or the contract may range from a one-sided or mutual joint ownership supplemented by a long-term contract to different forms of short and long-term contracts. Continuing over a spectrum of alternatives, one arrives at pure exchanges or special intermediaries such as estate agents and wholesalers where agreements are never reached directly between the producing or consuming units. They remain in a relatively anonymous relationship to each other.

1 Alchian and Demsetz (1972), Coase (1937) and Eideim (1975) provide a further discussion of these aspects.

The type of contract that will arise, i.e. the level of vertical integration, will largely depend on how well the markets operate and the level of transaction costs, in a broad sense, that are associated with different types of contracts. A high level of market uncertainty and substantial costs in creating reliable contracts would create obvious incentives for integration.

Production capital

The company's contractual relationship with its actual production capital can be dealt with briefly. The main alternatives are either to own the production capital or to establish a rental contract. The latter, in the form of a rental or leasing agreement, is common in markets where transaction costs are relatively low and where the contract is able to specify clearly the quality of the services provided. Office premises, buildings, vehicle rentals are standard examples of areas where rental contracts are to be preferred to outright ownership.

On the other hand, it would become essential to own the production capital in the event of a rental contract being unable to establish the "resource rights" open to the company. However, the rights of ownership may also be subject to contractual limitations. For example, a supplier or the original manufacturer may have contractual rights of access or influence for a given period that may impinge on the owner's rights of use. In fact, there is a range of contractual solutions from rental contract to complete rights of disposition where all of the resource rights have been transferred to the owning company.

Labor

The contractual relationship with *labor* is one of the central issues in the current debate. A *service contract* is a very simple form of contract that clearly specifies the provision of certain services and corresponding payments for these services. In all other respects, the company's obligations are limited. This type of contract is

most commonly used by companies when they purchase labor services for a limited period of time in an established market, e.g. for consultancy services. Service contracts are generally based on *individual* negotiations.

An *employment contract* has, not least after the latest changes in Swedish labor law, a markedly different form. The duration of the contract is not determined. A mutual agreement to end the contract is subject to certain legal provisions regarding for instance “first in – last out” procedures. There is also a marked shift from “payment by results” to one based on a specific time period. A partial explanation is that the “fair” measurements of work performance that are essential for the determination of piece rates have become increasingly difficult to determine as a result of the organization of production. It may also be attributable to changes in attitudes and values in the labor force associated with rising incomes and higher marginal rates of taxation.

The increased interest in regulating the *negotiation procedures* with regards to the allocation of work assignments and the company’s internal organization is a result of the strikingly “open” nature of the employment contract. Indeed, it resembles to some extent, a form of option contract for continued employment where work assignments and salary could be subject to either one-sided determination or joint negotiations.

This so-called “paragraph 32” problem has naturally become more pressing as a result of the changes that have taken place in employment security legislation.² The more permanent the employment contract tends to become, the less mobility there will be in the labor market. This will in turn present a threat to a wage earner who seeks to leave a company and secure a different employment contract. This strategy would increasingly lack credibility since if one cannot vote with one’s feet, all that is left is to stay and negotiate.

² Editors’ note: Paragraph 32 refers to a paragraph in the collective wage agreement that gave the employer the sole right to lead and direct the work within the company and to hire and fire workers. This paragraph was challenged by the union movement in the 1970s.

In a labor market characterized by employment security and rules of seniority, it is possible that the negotiating position of wage earners has been eroded. The new regulations that offer greater scope for negotiations on questions of work management and the company's internal organization may be seen as an attempt at compensation. Legislation concerning employee representation on company boards may also be viewed in this perspective: it is understandable that employees would wish to obtain increased insight into the company in order to monitor and protect their contracts. Employment contracts are after all open in character and their final outcome will depend on the way in which the company is managed. A bankruptcy or cut-backs in production constitute a greater problem than was previously the case given all the regulations on seniority that are a consequence of employment security legislation. Similarly, the termination of an employment contract will inevitably present difficulties in finding a new contract of comparable value.

The increased interest in what I would term the pure *consumption aspects* of work follows a somewhat parallel development: improvements in working environment in a broad sense, the opportunities for further education and the pure leisure consumption of company-owned recreation facilities and holiday accommodation are obviously activities that become prioritized when incomes and marginal rates of taxation rise. The construction of the tax system makes it currently very expensive to provide cash benefits. On the other hand, consumption benefits in kind are tax deductible for the company and are not subject to tax for the recipient. The distribution of these "tax benefits" between the company and their employees may provide a substantial basis for negotiations between the interested parties.

A striking difference between "service contracts" and "employment contracts" is that the former is based on individual negotiations while the latter is subject to negotiations between employee organizations and company management or the employer organization. The decision-making of employee organizations is largely based on the majority principle. It is often argued that the

majority principle is especially democratic. However, this cannot be said to apply in all circumstances: individual negotiations may also offer an individual the right of veto while the majority principle encounters difficulties in providing sufficient protection for minorities. Hence, it is uncertain what the majority of employees would consider to be a suitable balance between the demands of work and the rewards in the form of cash payments or improved work conditions. The increased opportunity to negotiate on the actual content of employment contracts has markedly increased the influence of *organizations* and consequently the role played by political processes in the market economy.

I raise this issue simply to draw attention to the fact that obviously controversial matters regarding internal democracy in the trade union movement and the problems concerning minority protection should perhaps attract greater interest in the general debate than is presently the case. Internal forms of decision-making are not solely of theoretical interest to political scientists since we are rapidly entering into an economy based on negotiations and meetings.

We should also bear in mind that “real” democratic decisions that require perfect information for all of the concerned parties, compromises and respect for minorities are presumably a most demanding form of decision-making in terms of the resources required. In all political contexts, the idea of “mass meetings” or other forms of direct democracy have lost ground to the more efficient solutions provided by representative democracy. The attempt to achieve greater employee participation may consequently give rise to a trade-off between influence and efficiency, at least after a certain point when further participation is achieved at the cost of lower efficiency and ultimately lower wages.

Financiers and management

I have deliberately saved the most interesting aspect until the end: the contractual relations with *financiers and management*. A neo-classical formulation would suggest that with given prices for labor, inputs and products, a surplus would accrue over a certain

period of time to the owners of capital in the form of a residual or quasi-rent. If the company's previous estimates on the returns on investments prove to be correct, it would be sufficient, on average over an economic cycle, to ensure a reasonable rate of return on capital including depreciation. If these estimates are not borne out, both gains and losses on capital will occur. As a result of the actual construction of the contract, it will be the rate of return on capital that will normally have to deal with all the setbacks and uncertainty. In a market economy, marginal investments in new production capital will be expanded to the point where their expected return will just cover depreciation and the demands of savers, i.e. the expected returns that savers will require to postpone immediate consumption and thereby create available real resources for investments.

I wish to emphasize here the *uncertain and residual character of the returns to capital*. This will have consequences for both the financing and its distribution between debt and equity. Some lenders prefer relatively predictable amortization payments and returns. Other lenders are prepared to accept a higher expected but more uncertain return. This has led to the establishment of two principally different types of contracts in the capital market: on the one hand, traditional (promissory notes, bonds and debentures) and on the other, stocks or profit sharing certificates.

Consequently, shareholders should be viewed as a group of financiers who are prepared to accept a large part of the risk involved and thereby *protect* and guarantee the completion of all the other contracts. Naturally this is facilitated by the extremely open construction of the share certificate which only guarantees a share of net profit once all the other contractual claims have been met. This protection is sufficient provided that there are no exceptional variations that are large enough to endanger the contracts concerning employment, loan and delivery of inputs. Consequently, the normal variations are borne entirely by the shareholder while the other contracts will only be subject to risk when the company suffers a more dramatic reversal of its fortunes.

Hence it is the construction of a contract where a group is

prepared to accept the residual result once all other contractual obligations have been met that provides the other contracts with a degree of security. This conclusion is naturally self-evident. However, the current debate on the role of the shareholder tends to forget these more obvious aspects. Another obvious conclusion may be drawn: every company that is subject to some degree of risk will need to have a contractual partner that is prepared to take on this uncertainty and accept a return that is determined by the residual. It would seem reasonable to try to limit this uncertainty to a specific party rather than spread the risk over all of the company's contracts.

Share ownership and influence

The role played by the shareholder also creates special incentives. It would appear completely reasonable that the party who accepts the most open contract with the company must also be provided with opportunities to exert influence in order to safeguard in some way his/her claims on the company. This may be most simply arranged by allowing this group of financiers the right to appoint the company's board of management and set a framework for the relationship between the company's executive structure and its contractual partners. Hence, it is the construction of the share contract that will have direct consequences for the right to appoint the board of the firm and have an insight into other contracts. Other contractual relationships that have a higher degree of security, e.g. regarding lenders, will have to accept far less insight and influence into the company's affairs.

New factors will emerge when a share contract or profit-sharing claim trades on a stock exchange. A discontented shareholder may try to influence the operations of the company directly or sell his/her shares to others who have either greater influence or have a more positive assessment of the company. In exceptional cases, this process may go so far that practically all of the company's shares change hands, resulting in a new ownership structure that has a greater opportunity to manage the company. A well-functioning

stock market will also be able to capitalize these changes in a company's expected net profits and thereby strengthen the incentives of shareholders to react to the new situation.

A company that systematically reinvests, i.e. plows back, its profits and offers only a low dividend still provides the shareholder with a number of alternatives. If the shareholder believes that his investments will contribute to a positive outcome, he can accept the policy by retaining his shares; if he does not accept the policy, he can sell the shares. A well-functioning stock market is consequently an important part of the entire system.

The low proportion of new rights offerings on the Swedish stock market does not provide per se a clear indication that the stock market is an inadequate source of financing. All that can be said with any degree of certainty is that a sufficient number of shareholders are prepared to forgo a dividend and allow the company to reinvest profits that would otherwise have been available for a dividend payment in the belief that such a strategy would be advantageous compared to alternative investments. This attitude may be influenced by the taxation of shares and companies. Nevertheless, a functioning stock market will offer dissatisfied shareholders the opportunity to sell rather than to voice their opposition at the company's annual general meeting.

I have decided deliberately to emphasize the financing role of the shareholder. Together with the open character of the share contract, the shareholder would thereby gain a predominant influence in relation to the appointment of board members and to drawing up the principle guidelines for the company's operations. This influence may be exercised passively by the small shareholder who chooses to retain his/her shares and accept the decisions of the board. Accordingly the power of a person such as Marcus Wallenberg does not need to be associated with the wealth of his family or his foundations, even with the help of a conspiratorial model based on the ownership of Chinese boxes. It is sufficient that Marcus Wallenberg's presence on the company board provides a sufficient guarantee for the passive shareholder that the shares will provide dividends and retain their value. It will not be profitable to

sell them or to organize an opposition group at the Annual General Meeting. Indeed, it is somewhat surprising that the representatives of the political system have not sufficiently understood this type of “representative power” since it is a widespread occurrence in the political world that particular individuals symbolize and represent a particular form of political status. The position of power held by Gunnar Sträng, the longstanding Minister of Finance in the Social Democratic government, is in principle the same phenomenon. He has acted as a guarantor in political elections for a certain type of stable policy.

Naturally, the role of the shareholder could change substantially if another party had secured sufficient influence in the company to affect the scope for dividend payments or if profits were earmarked for another group leaving shareholders to run the risk of only being able to share losses. In the Swedish economy, there are examples of companies where the suppliers of inputs exert a decisive influence, for instance in the case of agricultural and forestry cooperatives. In good years, suppliers may acquire a share of company profits through higher prices or different types of bonus. It is obviously very difficult to combine this type of “open” or profit-related supplier contract with that of a normal shareholder role: the shareholder runs a continual risk that his contract will be made redundant and that he will be unable to secure sufficient influence to protect his/her own claims on the company. It is quite logical that this type of company does not have private shareholders. The financing of equity capital in these companies is taken on by the producer cooperatives. As a result, they become both suppliers and shareholders. Simple observations would suggest that these companies prefer to distribute their profits in the form of higher prices rather than as dividends.

Consumer cooperatives provide a somewhat similar picture. If the members decide to prioritize lower prices, it will be difficult to reconcile this goal with shareholder financing of the company’s equity capital. Reference can also be made to the contract structure of the Yugoslavian model of so-called worker self-management where the financiers have drawn up closed contracts that guarantee

interest payments and amortization while the residuals will be distributed in various ways as payments to the employees.

I wish here to point to the theoretical and practical difficulties for traditional financing that arise when a standard shareholding model is undermined by another contractual party who exerts a decisive influence and is able to gain access to profits through other contracts than just the pure contract for financing. This means that large parts of the discussion concerning a gradual take-over of share ownership on behalf of the employees become completely unrealistic. Even a minimal ownership by unions would be able to exert considerable influence. A considerable proportion of a company's dispositions could be blocked at the level of a ten per cent ownership. The use of shareholder through further equity to raise capital could become less attractive and traditional financiers would look for other types of contract.

2. Motives for wage earner funds

In the above, I have described companies as organizations which have contractual relations that provide both payments and influence to various parties. This set of contracts should be considered as a holistic solution where each party finds an optimal relationship between, on the one hand the level of economic return and associated risks and, on the other hand, a corresponding level of influence. The form of contract is dependent on the form of all other contracts. A standard example is a traditional lender whose interest in direct insight and influence is in inverse proportion to the borrower's financial solvency or his equity capital. It is not unreasonable to expect that some kind of equilibrium will be established in the long run. Another conclusion to be drawn from this reasoning is that there will obviously be substantial variations in the optimal degree of insight between different companies dependent on the perceived stability of the employment contract. It is conceivable that the demands for uniform legislation to be applied to all companies will fail to provide sufficient flexibility in this context.

The solidaristic wage policy

Meidner raises three different types of argument in support of the creation of wage earner funds. The first and most provocative point is the hypothesis that the solidaristic wage policy creates “excess profits” as a result of employees in profitable companies demanding less than they are entitled to.³ An obvious corollary, which is not mentioned in the Meidner report, is that the solidaristic wage policy must give rise to corresponding losses in other companies. Generally speaking, it is assumed that the unrealized wage demands that accrue to the shareholders are equivalent to the losses made in other companies. It is also assumed that the average distribution between labor and production capital is largely independent of the success of the solidaristic wage policy.

A serious discussion of the solidaristic wage policy is also made more difficult by the lack of an explicit theory of wage formation. If we assume that labor is paid according to its marginal productivity and that wage drift adjusts to some extent for the inflexible wage levels that resulted from the collective bargaining process, there is no *prima facie* case to believe that there is a close relationship between “unrealized wage demands” and company profits. A high level of profits in the forestry industry in 1974 was presumably unrelated to the labor force receiving wages below their marginal productivity. The profit levels might simply be explained with reference to a lack of production capacity at a given point of the cycle, which resulted in the creation of large quasi-rents. The lower profit levels in 1975 may in a similar way be explained with reference to the large production capacity in the industry in relation to demand. I would not wish to reject the argument that a lack of

³ Editors' note: The Swedish trade unions, inspired by the work of the trade union economists Gösta Rehn and Rudolf Meidner in the 1950s, pursued a “solidaristic wage policy” in the sense that wage increases were held back among the most profitable firms while wages were raised in less profitable firms. The purpose was to establish greater equality among wage earners. Profits became in this way “excessive” in sectors of high profitability, a problem that Meidner tried to solve by his proposal for wage earner funds.

wage adjustment temporarily may improve profit levels. However, profit levels may also deteriorate symmetrically. It is likely that growing employment security has increasingly made labor a fixed cost for companies. As a result, profit levels will become more variable which would tend to support the argument that the risk premium for shareholders should be raised.

Even if one, for my part most unwillingly, accepts the Meidner contention that the solidaristic wage policy gives rise to unilateral increases in wealth for shareholders, the problem remains that this effect of the solidaristic wage policy hardly can be expressed as a part of the return on equity capital.

A power station with an enormously high capital input per employee would according to the Meidner model be treated in the same way as an engineering industry with a high degree of labor input. If it was decided to transfer company profits, in some way due to the solidaristic wage policy, it would have to be done on the basis of *the total sum of wages* rather than the size of the *equity*.

If the solidaristic wage policy is considered to be a high priority on grounds of internal unity within the trade unions, it seems natural that the Swedish trade union movement collectively applies some form of taxation where the aim is to achieve equilibrium wage levels and a system of direct transfers from high to low wage earners. Another factor that strikes at the Meidner argument is that it is practically completely impossible to determine empirically the difference between market-based wages and wages determined by collective wage agreements based on the principle of solidarity.

The tax system and low rates of interest

Meidner's *second* argument is that companies are able to use the design of the *tax system* – rules of depreciation, appropriations to particular funds etc. – to accumulate capital. Subsidies in the form of industrial development grants etc. may also be included. *Consumers* also contribute to profits “by paying the prices that the company charges for its products” according to Meidner (1975, p. 23). I do

not want to get involved in a dispute about price formation theory but one might regret that Meidner repeats such vulgar arguments in a widely distributed work. For those readers who are unused to economic analysis, these arguments are most likely to lead to confusion. In relation to the tax system, Meidner's arguments have considerably more relevance. Through its generous depreciation allowances and double taxation of profits, the tax system does indeed encourage the retention of profits within companies. However, in the long run, share prices will be determined by the payment of dividends rather than the net asset value. Consequently, it is also likely that the entire profit created by the tax system does not end up in the hands of the shareholders. It is highly possible that share values systematically underestimate net asset values. As a result, we get a system subject to anonymous ownership.

It is naturally a sensitive issue that Meidner raises regarding the Swedish tax system. The high degree of self-financing to which he refers may lead to a distorted choice of investments or strange amalgamations of companies in conglomerates where some of them are responsible for ideas and others for finance. However, this problem cannot be dealt with by means of wage earner funds. Indeed, the Meidner proposal would actually tend to increase the degree of self-financing.

It would seem more natural to work with less generous depreciation regulations and appropriations to internal funds if one wishes to achieve greater mobility of financial capital. Similarly, a more consistent use of tax relief on dividends from right offerings would also be an effective means of reducing the effects of double taxation.

Meidner is also completely justified in pointing out that companies pay extremely low real rates of interest on borrowed capital in credit markets where nominal rates of interest hardly cover inflation. However, this type of increase in financial wealth, the leverage effects of high lending, has hardly any connection with the question of wage earner funds. If complaints are to be made, it should come from small savers and insurance policy holders who are forced by current credit policy to lend at extremely low real rates of interest. A rational consequence of this situation would be

to support arguments for a higher real interest rate or possibly to create small-saver funds rather than wage earner funds.

Wealth and power

The third group of arguments in support of wage earner funds in Meidner's report concerns problems such as a more widespread distribution of wealth and power in society. Firstly, the formulations used by Meidner to suggest that shareholders and the owners of the physical means of production can be treated as being identical is an argument with which I disagree.

I have from the outset tried to play down the role of the shareholder by treating him as a financier who has clearly defined tasks in the company. Here I have support from company law, which has established strictly defined regulations in relation to the role of the shareholder. It is clearly stated that the shareholder is only entitled to make a claim concerning the profits of the company. A serious discussion of wage earner funds requires that one avoids describing reality by the use of a terminology that belongs to the cafés of the left-wing student movement.

I have tried in the above to put forward the argument that the distribution of power in a company may be viewed as an equilibrium solution in relation to the overall contract structure of the company. At this juncture, I do not wish to develop these arguments any further. However, I would like to consider some aspects of the argument concerning a more equal distribution of wealth. In the case of Sweden, companies exhibit a significant ownership concentration. Excluding a rapidly disappearing number of large family asset holdings, these major shareholders are however mainly institutional investors, foundations or insurance companies who in turn represent a large number of co-owners or interest groups. It is completely misleading to treat a life insurance company as a single owner while at the same time arguing that a Trade Union Confederation fund represents a diversity of ownership.

Firstly, insurance companies and unit trusts have an indirect veto principle which allows them to cancel the contract. They are

therefore able to use a hyper democratic rule compared to that used by the majority group in a series of representative votes that characterize the trade union organizations. Secondly, the welfare of the individual is dependent on how well the unit trust or insurance company manages its investments. In the anonymous and collective wage earner fund that Meidner discusses, there are not any connections to the welfare of the individual. It is my contention that share ownership, direct or indirect, has nowadays a substantially wider distribution than is generally assumed to be the case. Hence it is a matter of urgency to obtain a more secure empirical basis for these matters.

At the same time, it is necessary to point out that an excessively wide distribution of ownership may lead to potential efficiency losses. The role of the shareholder in the capitalist economy assumes some form of commitment to the need to control and monitor the company's management. The incentive for these types of activities will be reduced if many small shareholders have portfolios that are diversified throughout the entire list of stocks on the stock exchange. Poor results in a company will not lead to essential counter measures. Problems may also be found in passive funds that seek to avoid making portfolio changes or fail to take an active part in the appointment or dismissal of top management. Nor can problems of this type be solved by means of centralized public ownership or through a wage earner fund run by the trade unions.

A record loss of SEK 200m. in NJA (Norrbottnen Ironworks) would amount to SKR 50 for each taxpayer.⁴ Few people would think it worth their while to write angry letters to the newspapers to protect such a small sum of money. Small private economic returns substantially reduce the shareholder's interest in monitoring. I cannot come to any other conclusion than that problems of this type will become grotesquely enlarged in a centralized wage earner fund. The only alternative, in terms of finding active shareholders who have their own incentives, would be to strengthen

⁴ Editors' note: NJA was a government owned company, known for running substantial losses in the mid-1970s.

local representation among employees. However, that would take us close to the Yugoslav system of locally owned worker enterprises, a system that is emphatically rejected by Meidner.

3. The Meidner proposal

Wage earner funds

The actual proposal put forward by Meidner specifies that in principle a certain percentage of the net profit of a company shall be paid into the wage earner fund of the trade union organizations. This fund will in turn have to purchase new offerings of shares of the company. The wage earner fund can take the form of a single central fund or a series of branch or regional funds that take on the actual ownership role. It is envisaged that the fund will be monitored by a number of board members who are usually experts in the field and are appointed by local trade union organizations. Trade union members will not receive individual share certificates. Any returns from the holdings of shares will be allocated to new right offerings as well as research and development and education.

There is no reason in the present context to discuss the innumerable technical problems raised by this proposal. How should cooperative enterprises in agriculture and forestry or the branch companies of foreign owned enterprises be amalgamated into this system? There would seem to be very special reasons that would make it unsuitable for these companies to have an external owner. The decisive influence in these cases would appear to come from the suppliers of inputs.

The proposal may be interpreted as an increase in company taxation. However, this increase is paid directly into the fund rather than via central government. The primary effect of this procedure is to lower the return on previous share ownership which will exert downward pressure on share prices and possibly increase the difference between net asset values (after taking account of financial indebtedness) and share prices. This means that continuing

acquisitions by the wage earner fund would benefit from higher share prices. A company must guarantee an increased pre-tax return on new rights offerings in order to maintain the same structure of returns as before. Financing through debt will consequently appear to be a cheaper option.

At the same time, the company will receive an increase in its equity capital from the wage earner fund. However, from the perspective of previous shareholders, this may be offset by changes in the preferred distribution of dividends and retained net profits, partly as a result of the uncertainties that arise from the intentions of the new owners. In extreme cases, the former owners may completely change their contractual relations, for example through a sizable increase in preference shares and an equivalent decrease in the value of ordinary shares. It is presumably very difficult to discuss the net effect of all these changes. Mechanical extrapolations would appear to be of little value.

I would suggest that the reactions of the former shareholders will be largely dependent on the expressed intentions of the new owners. In the long run, the wage earner fund is planned to form a majority. However, long before that happens, the fund will take on a predominant influence. As I have previously emphasized, the picture is complicated since the new group has also the task of negotiating the employment contract. In a transitional period, it is possible that the new group may prefer to exert influence over company management through more attractive employment contracts than by means of dividends.

According to Meidner, a strong centralism would be able to counteract these tendencies. However, this may give rise in turn to the creation of a latent conflict between central and local organizations in the trade union movement. It is not enough to refer to the "solidarity" that has always characterized trade union work. Studies of how organizations that have followed the principles of representative democracy based on majority decisions without reference to developed party political affiliations may offer a more realistic interpretation of the problems of power and conflict.

The choice would appear to be between a locally based worker

management model of the Yugoslav type or a complete Soviet socialist model adjusted to take account of the strong central trade union organization that would take on the role of the centralized state. It would also have to act as the countervailing negotiating party in discussions with local union organizations. In the first case, there are all the efficiency problems that are well-known from the theory of worker management companies: a substantial reluctance to expand if a potentially profitable marginal increase in production would lower the average wage and profit share of the existing work force. Strict seniority rules could be applied to recruitment: new employees would receive a lower share of profits than existing employees and a strict hierarchy could be maintained between employees. It is also probable that the employees would have a higher risk aversion than the previous shareholders, not least because the labor contract and the share of profits applies to the same company with a markedly limited risk spread.

In the second case, a central fund would certainly offer a diversity of risks. However, the lack of a strong link between the results of the fund and the welfare of its members would provide a weak incentive to exercise the traditional shareholder function. It is conceivable that over a long transitional period that this type of central fund may act fairly passively and rely on the former owner interest in the company and its own capacity to restrain the demands of local union organizations. However, little has been achieved in terms of influence or a wider spread of wealth.

The trade unions may consider the trade-offs in the present wage contract to be unsuitable. For example, they may wish to have a different balance between production and consumption activities in the workplace or a different type of leadership in relation to work. There are obviously other ways of achieving these changes without having to take the difficult road via the purchase of shares. The current distribution of power is not as asymmetric as the Meidner report tends to conclude. In a labor market close to full employment, the relationship between employer and employee is fairly symmetrical, particularly when there is a well organized employee side. The trade union movement has been able to establish collective

wage agreements and a system of financial contributions to the Social Democratic Party. Together with the common ideological ground that it shares with the governing Social Democratic Party, it has great opportunities to influence the political decision-making process. Central union representatives are current members of a majority of the boards of public administrative organizations. They represent the principal standpoints of the trade union movement rather than just acting as representatives of their members. It is hard to imagine any other organizations in Swedish life that have become as influential as the trade unions. A further extension of the powers of their central organizations to include an increasingly predominant wage earner fund can hardly be seen as a move to reduce the concentration of power in Swedish society.

There is a risk that an increase in employee influence in the management of the firm would be used primarily to protect existing employment contracts, i.e. the security of particular companies and particular jobs. The difficulties of the political system in being able to withstand the threats of local and regional unemployment may be systematically exploited. There would be a tendency towards a gradual shift from an economy that has a policy of full employment at the macro level, complemented by a labor market policy that seeks to stimulate labor mobility, to one of an economy characterized by a lower level of structural change and an illusion of security through the protection of existing employment.

Profit sharing and worker control

Other ideas circulating in the political debate such as proposals in favor of profit sharing and limited individual funds have obvious drawbacks. There is perhaps a kind of idealistic belief that a profit sharing system would lead to higher levels of productivity since the employees would be rewarded for having been conscientious employees during the past year. These ideas are presumably based on fairly muddled thinking about human behavior. If an employee in a company with 50 000 employees makes a special effort to try to earn an extra profit share, he can at best hope to earn 1/50 000 of

that special effort. The social control that is required for individuals to work for the collective can only be applied in very small groups. Even in this case, they are unlikely to avoid serious difficulties with for example, shirking.

The same argument may naturally be used against idealistic preconceptions about worker managed companies that are free to release a productivity potential that is repressed by capitalist enterprises. If instead of a wage, workers share the company's profits, there would be a tendency towards avoiding work discipline. The collective wage agreement stipulates a certain degree of work performance together with supervision from the side of management. If all that remains is a pure partnership, each individual will have all the benefits of using up fewer resources through avoiding work at the same time as he bears only $1/n$ th of the share of the costs where n represents the number of owners. What may work in a small consultancy or a family business with a strong degree of mutual control could become a catastrophe in a large enterprise in the absence of important parts of a capitalist company's forms of distributing and monitoring work performance.

An equally obvious disadvantage would occur if the profits of the company employees are invested in the shares of the company without any differentiation of risk. The issue of shares to employees will naturally quite quickly give rise to selling: this is not so much a question of not wishing to save or to accumulate capital but rather of just following the advice of stock market analysts who would warn small savers against holding a few shares in their own company.

It is probably advisable not to have any illusions about the possibilities of a widely spread distribution of individual share ownership. It is in the nature of the share contract that there is considerable uncertainty. The correlation between shares of different companies is also relatively high which suggests that shares are best suited to large portfolios that offer a certain amount of risk spread and considerable opportunities to gather relevant information.

4. A brief outline of an alternative proposal

I have argued that the implementation of Meidner's proposal would lead to a highly striking concentration of power instead of the opposite. The collective ownership of wage earner funds would give rise to a loss of welfare since no one would be able to obtain the personal security provided by individual wealth. It is debatable whether the shift in power that the proposal would bring about would solve the problems associated with the increasingly open character of wage contracts and the consequent demands for insight into the company and for increased opportunities for negotiation. Nor is there overwhelming clarity in the connections between macroeconomic issues such as the solidaristic wage policy and the desire for increased capital formation on the one hand and a wage earner fund on the other.

My presentation may have appeared up to now strikingly negative both in terms of its criticism of the Meidner proposal and in its analysis of the power and contract structure of Swedish companies. Consequently, I would like to conclude with a brief outline of a proposal that at least on certain points would achieve the same objectives as recommended by Meidner. However, in contrast to his plan, my proposal aims at a widespread distribution of wealth and influence. Moreover, it also opens up possible opportunities to increase capital formation on an entirely voluntary basis.

There are in principle two main reasons for building up a fortune during one's lifetime. The first reason is that even relatively limited individual financial assets offer the individual substantial freedom in terms of choice in the labor market, in education and in consumption. At the same time, the individual will have a greater opportunity to deal with different types of uncertainty. The other reason concerns the distribution of consumption and income over the life cycle. Savings in the form of a pension insurance in a growing economy will become the principal component of the wealth of individuals.

As a result of the rapid rate of economic development that has taken place during the years following the ATP pension reform

of 1960, the income levels of large groups of the population have already exceeded or will during the next decade soon reach the ceiling in the state pension system. This will inevitably lead to growing demands for additional types of pension above the state pension (ATP) ceiling as well as other forms of improvements such as a lower age of retirement. There are major objections to extending the ATP-system above this level. The construction of the ATP-system is awkward which makes it difficult to establish stable relationships between the payment of fees and the receipt of benefits. Many will almost certainly experience the basic construction of the ATP-system as appearing distinctly unjust. However, it is accepted in the absence of anything better. The re-distributive character of the system would seem to suggest that at present fee levels, the actuarial value of the system's benefits will outweigh the net value of fees, i.e. each generation assumes that the payments of its own pensions will require a systematic taxation of future generations.

If one wishes to increase capital formation in society on the basis of voluntary and individual decisions, it should be possible to view the present ATP-system as the base for a future extension largely founded on a premium reserve system. This type of development could comprise a number of different funds, foundations or existing insurance companies that would be increasingly able to invest their assets in shares. If individuals were allowed to freely choose between different funds, this would provide a clear incentive for the funds to represent the interests of their clients. This would also help to widen the distribution of shareholder influence compared with a situation where all of the shares end up in the same central wage earner fund. It is also probable that relatively anonymous funds of this type would mainly concentrate their interests on the returns of the fund which would help to minimize the risk for purely political maneuvers. A system along the lines of this outlined proposal would also be able in the long run to deal with individual short-term borrowing on pension rights than is currently not the case with the strictly bureaucratic procedures followed by the ATP-system.

With the aid of this brief outline, I have tried to show that there are practical, feasible alternatives to centralized wage earner funds that are able to combine increased individual security and freedom with a broader distribution of wealth and shareholder influence.

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Chapter 4. Problems of Information in Economic Policy

Ingemar Ståhl started his career by working with no fewer than six different government commissions in the 1960s. All resulted in policy recommendations. Implementing the recommendations was challenging, however. The political system did not accept the “rational” solutions that the economists had proposed. He learned this lesson both from his active involvement in public debate and from his role as policy advisor in many capacities.

In this chapter, employing the economics of information to support his arguments, Ståhl discusses to what extent better information to policy-makers and voters could increase their acceptance of policy measures recommended by economists serving as experts. He stresses the differences between decision-making in free markets and in the political system. Collective political decisions are much more complicated and costly from an informational point of view than private decisions in markets.

Ståhl’s message is that the politicization of many issues, moving decisions from the market to the political system, creates problems of information that do not emerge in market transactions.

In Ståhl’s opinion, there is a risk of a Gresham’s law of information in public discourse: simple but faulty messages drive out complex and more correct analysis. At the end of this chapter, he endorses the role of independent university-based economists in offering policy advice. Their participation would contribute to pluralism in Swedish society.

This chapter is a reprint of “Problems of information in economic policy”, published in Skandinaviska Enskilda Banken Quarterly Review, no. 1-2, pp. 33-41, 1979.

Economists often believe that economic policy would be “better” if politicians and voters were more well informed. Economic policy decisions that can frequently be regarded as “economically irrational” have become a source of (easily enough explained) irritation among economic experts. This applies to stabilization policy as well as resource allocation policy. Several approaches are used in this paper to discuss the extent to which an increase in information to political, administrative and organizational decision-makers could result in what experts would regard as more rational decisions.

The first aspect to be considered is the fact that collective, political decisions make greater demands on the dissemination and processing of information as compared to traditional market decisions. An important element in this context is that political decision-making lacks the capacity to deal with a large number of issues simultaneously. Possibilities of forming public opinion effectively also appear to be highly limited; the general political debate cannot handle more than a few issues at a time. Then, too, these issues should be chosen in such a way that the capacity for political decision-making is not devoted to matters where simple market decisions, that require less information, could provide the same or better results.

Another aspect concerns the complexity often inherent in economic information. Not only do economists use complicated language, but the nature of their messages may be such that they contradict everyday economic knowledge or conflict with values or concepts espoused by political parties or organizations. Perhaps insufficient information does not pose the primary problem in many instances, but rather the fact that the information is contrary to other aims or values.

Closely related to these issues is a third aspect – the motives (incentives) which guide individuals and organizations in assimilating and disseminating information. In all collective decision-making, the private individual’s incentives are often small; each individual has only one vote among the millions of votes in the collective. Even if an individual improves the status of his own information, he can hardly expect to alter a collective decision. In order to

understand the information problems associated with economic policy, it seems fitting to make a systematic survey of the incentives that govern individuals, firms, organizations – and why not even economic experts.

Market and political decision-making

Perhaps one of the most important results of modern economic research on the properties of a decentralized market economy is the emphasis on how only a minimum of information is required in order for a market economy to function effectively with respect to resource utilization. The consumer does not have to do much more than keep track of his own values and technical possibilities and the market prices of the products he wants to buy. The same applies to producers whose primary information requirements are also limited to their own technology and market prices. The information a household or firm needs concerning other households and firms is to a large extent transmitted through the price system. Prices signal the relative scarcity of different resources and commodities and price fluctuations serve as indications of changes in demand, supply and technological conditions. A well-functioning price system also provides the necessary degree of coordination between consumers and producers (Hurwicz, 1960). In a reasonably stable environment, satisfactory information about future prices can be obtained on the basis of current prices and price trends.

Thus there is no need for any kind of central coordinating or planning authority. Specific problems of coordination may arise when several, relatively large producers intend to increase capacity simultaneously. But this can be handled rather easily via direct negotiations between the firms involved, so that temporary over- or underinvestments are avoided and the increase in capacity is evenly distributed over time.

A good example of increased information requirements when an area becomes politicized is the energy issue in Swedish politics. An energy committee was appointed in the mid-1960s. The

committee submitted a 120 page report in 1970 (SOU 1970:13). The report strongly emphasized the market as the central instrument of resource allocation, while government policy was limited to environmental measures, development and military preparedness. There were competent state agencies in each of these three areas. Typical of the situation at that time was the fact that energy had not become a *topical political issue* of any particular importance. The average politician's and, to an even larger extent, the political citizen's information requirements were highly restricted. By devoting about six hours (20 pages/hour) to the report, everyone could be reasonably convinced that there were no major problems of a primarily political nature which required extensive *political* decisions, but that problems in the sector predominantly called for market decisions (and relatively routine administrative corrections, such as in regard to oil stores). The report and proposed measures were circulated for comment and debated in the Swedish Parliament. These procedures, which *de facto* served as the basis for large-scale investments in the light water reactor program in Sweden, went by almost unnoticed; none of the political parties wanted to politicize the issues and no pressure groups emerged. To all intents and purposes, the private citizen's or firm's choice still constituted a market decision as to how many KWh of electricity at approximately 5 öre/KWh or how many tons of oil at about 100 SKr/ton the consumer was prepared to buy.

This somewhat idyllic situation may be compared with more recent developments, where many decisions have been elevated to the highest central level in the country and the government has had to make decisions concerning a large number of issues, many of which are highly technical in nature. The amount of information required – or in any case produced – is almost unprecedented. Next to the slender volume from 1970 on my bookshelf are parts of the Energy Commission's report (SOU 1978:17) and printed appendices. All this material has been circulated for comment and responsible politicians, organizations and last but not least private citizens are supposed to form an opinion about it. The volume itself is approximately 10,000 pages long. Reports available from various expert

groups would comprise an additional volume of at least the same size. A person with a reading rate of 20 pages/hour would have no difficulty spending a year's working time going through the material, supplemented by some economic or technical literature.

Now that energy policy has become a topical issue on the political agenda, cabinet ministers, chambers of commerce, industrial organizations, executives, politicians, researchers and interested voters have to devote time – in some instances a great deal of their time – to detailed technical and economic questions. These are the same questions that were previously solved with skillful capability by experts who, in an economy based on efficient division of labor, had unique competence in these matters.

My attitude might easily be interpreted to imply that I would recommend extreme expert domination. But nothing could be more erroneous. *First of all*, there are many corrective mechanisms in a market economy. If firms cannot produce solutions that are at least as good as their competitors' or manufacture products that are acceptable to consumers, they are severely punished on the market. It is also relatively easy to establish corrective administrative institutions – such as the nature conservation agency and environmental concessions – that can function as a countervailing power against solutions which infringe on the rights or safety of others.

Second, technical and economic questions are not transformed into topical political issues free of charge. "There is nothing such as a free lunch" is a motto often found in the lunchrooms of economic institutions. A simple and pertinent travesty would be: "There is nothing such as free information".

As a matter of fact, the process of politicizing an issue and establishing it on the political agenda may be very costly. Using the energy issue as a case in point, the first component – but not the predominant one in the final accounts – consists of outright investigatory costs. This does not mean generating unique and new knowledge, but to a large extent compiling knowledge that is stored at different levels of expertise for new and restructured authorities. Our *investigatory capacity is limited* and the costs for society of the

economic research on energy policy were not composed solely of consulting fees. The size of these costs left no room for detailed analyses (and discussions) of other urgent problems. The second cost component refers to the *blocked decisions and uncertainty* which arise in the political process. Industrial capacity is not utilized and future, offensive investments are postponed.

The *third* – and perhaps most important – aspect is that the *total capacity for political decision-making and information processing is a limited resource*. This probably applies to all levels of society. The Cabinet, government offices and Parliament all have highly limited decision-making capacity in terms of active information gathering and processing, and formulating and executing decisions. The massive concentration on energy issues has superseded other matters. In this sense, the extreme politization of energy issues has had a high opportunity cost.

The economic crisis (wholly predictable at an early stage) following wage negotiations in 1975 never became a principal issue in the 1976 elections. Journalistic accounts of the deliberations preceding the forming of the coalition government indicate that the alternatives for necessary economic policy measures were assigned obscure and negligible status as compared to the fueling of the second nuclear reactor at Barsebäck or decisions concerning provisional legislation for nuclear energy.

The mass media – as a significant channel of information – also have a limited capacity for supplying information. It is not particularly reckless to contend that even in the mass media, the energy and nuclear power debate displaced other important issues. The possibilities of creating public opinion are restricted; there is not enough leeway in the political system for more than a few *topical issues* at a time. Whenever one issue is at the forefront, what other issues does it automatically supersede?

Examples of such issues may include: awareness of the monetary crisis was appreciably delayed due to the insufficient capacity of decision-making authorities and in the dissemination of information; industrial policy had been approved without any penetrating public analysis or discussion; the rapid growth of the public sector,

tax increases and the budget deficit have all occurred without ever becoming predominating issues on the political agenda. In other words, many important issues – determined on the basis of collective decision-making and for which different ways of forming public opinion and disseminating information are necessary – will be suppressed or delayed, perhaps wholly inoptimally in the long run, because of the large amount of attention devoted to energy issues in Swedish politics for several years.

If my hypothesis about the considerable limitations of the capacity in political decision-making and public opinion formation is correct, then there is good reason to have a gravely pessimistic attitude toward future development. We are evolving into a society where more and more decisions are transferred from markets to political (and in many instances combined with administrative) authorities. The political decision-making system cannot handle more than a few issues where there is profound insight and knowledge at all levels in the political system. At the same time, knowledge is an important prerequisite for political decision-making, particularly in terms of the ability to make a comprehensive survey of entire systems and the way they function.

By means of a market decision, I choose to heat my home in the most comfortable and economic way, given current prices of electricity and oil. My consumer reaction is registered by firms that adapt their supply according to proven economic rules. This kind of decision sequence requires much less information than a referendum in which I have to form an opinion as to how many and what kinds of power plants there should be or the total quantity of energy that should be consumed in the country. In the latter case, I would in principle be expected to peruse extremely complex investigatory material. Thus, when decisions are brought into the sphere of politics, there is in fact a high risk that the decisions will be based on very incomplete information on the part of the voters and perhaps even their representatives.

My preliminary conclusion is that the increase in the number of decisions which have become politicized in the Swedish economy has led to a very large gap between the level of information

required in a formal sense and the real level of information. But I am not sure that the solution would be a continuous increase in the level of information in order to bridge the gap. It might be more worthwhile to arrive at solutions (or in some cases revert back to previous decision-making processes) that require less information. Collective political decisions could then be reserved for areas where the necessity for collective decisions is the greatest. What I have said here is relevant not only to political decision-making but also efforts to “democratize” working life in a formal sense. For the time being – in the private as well as the public sector – we are in the midst of a delicate balancing act between increased information to and involvement on the part of all employees on one hand and losses in terms of decreased specialization and less efficient division of labor with respect to knowledge, information processing and decisions.

We seem to be switching to organizational forms where the individual reacts by raising his voice and protesting (*voice*) instead of walking out (*exit*). The consumer’s ultimate expression of dissatisfaction with a seller or product is simply to refrain from buying; he exits from the informal organization inherent in the buyer-seller relationship. A dissatisfied employee changes jobs. A patient who is displeased with a doctor or medical insurance firm chooses another doctor or insurance company. But the exit reaction is gradually becoming more difficult to implement; we want citizens to voice their reaction to the energy issue; if a dissatisfied employee changes jobs he loses all his seniority privileges guaranteed by employment security legislation and has to negotiate instead; the displeased county hospital patient simply has no choice whatsoever. And if someone would also like to react on an individual basis, he is confronted with the nearly impossible task of arousing collective opinion where he himself comprises only an *n*’th of the total. He will have to wait until either his particular problem becomes a topical political issue or some kind of organized collective develops.

Complex messages

There is extensive minimum wage legislation in many countries. Some of the consequences of the solidaristic wage policy pursued in Swedish society are fully equivalent to such legislation – for example regarding the comparatively slight wage differentiation between youth and more experienced manpower. Economists, with their educational background in price theory, always seem somewhat surprised about the existence of such legislation or wage policy; it is always better to have a low-paid job than none at all. But this conclusion is not as immediate in the eyes of public opinion as it perhaps appears to economic experts.

It is probably quite easy – in the name of “fairness” – to argue in favor of higher *incomes* for those who are worse off. An apparently simple means of achieving this goal is to raise the wages of those who are paid the least. It is relatively easy to convey this kind of message. A much more complex message would involve proposing a system of say, negative income tax, i.e. a subsidy to low-income earners that would gradually be reduced as their incomes rise.

There is in all likelihood an adequate majority in support of the notion that those who become unemployed due to an erroneous wage rate policy or a distorted exchange rate policy should not have to bear the entire burden alone, but that collective responsibility should be achieved in some way. The introduction of unemployment insurance or labor market measures implemented by public authorities are simple instruments which demand a minimum of political argumentation. Nor is it difficult to argue that the level of compensation should be high enough to allow an unemployed person to maintain the consumption standard he would have had if he had been able to keep his job.

A much more complex – and unpleasant – message is conveyed by claiming that there is a straightforward tendency for high unemployment compensation to lead to a rise in unemployment. The individual’s search costs are much lower and his incentives to change occupations or geographical location are reduced. At the same time, individuals with a high probability of future

unemployment are persuaded to enter the labor market. An extensive international discussion is now in progress regarding what is known as induced unemployment, i.e. generated by high levels of unemployment compensation (Grubel & Walker, 1978). But it is interesting to note that this discussion has had hardly any effect on the Swedish debate concerning a proposal for compulsory unemployment insurance or the structure of overall labor market policy.

In Sweden, we have had – and will probably continue to have – a public discussion of wage earner funds based on same kind of profit sharing. It seems fairly reasonable to implement a reform which would reduce the concentration of wealth and give employees a share in company profits. Expressed in this way, the message is simple and straightforward. The criticism raised by professional economists has concentrated on the *changes in the economic system* that would occur in an economy with wage earner funds. The main factors under discussion have been how firms' incentives would be influenced, how investments should be selected and how innovations and new establishment would be affected. Obviously, these are extremely complicated issues as compared to the simplified arguments in favor of wealth equalization.

Economists' messages are often both complex and discomforting. They are complex in the sense that they require the use of relations and concepts which do not coincide with "everyday economic" conceptions (or outlook on the world). Economists think and argue in patterns or "models", their language is much more complex than normal, everyday economic expressions. Their messages are discomforting in the sense that economists continually emphasize the necessity of making a choice in situations where resources are limited. We have to say: this or that, but not both.

The political system is forced to make use of strong simplifications. It takes time to disseminate information, communication capacity is limited and the recipients lack the complex patterns or models required to comprehend the messages. Thus, situations often arise where central decision-makers in the political sphere or in organizations have all the necessary information but lack the opportunity – owing to their limited capacity to form public

opinion – to disseminate the information to voters or members. An increase in decision-makers' knowledge of economics would not solve the problem.

The importance of incentives

Economic information is to a large extent generated through political agencies and institutions, trade organizations and administrative authorities, each with their own incentives. In order to arrive at a more thorough picture of the generation of information, we would have to go back to the fundamental motives that guide different institutions (Ståhl, 1977). We would also have to derive some kind of mass media theory and study the motives and filtering processes in this area. In addition to all this, we would require some kind of comprehensive survey of the private individual's incentives and possibilities of assimilating complex information.

In regard to information gathering on an individual level, it can easily be verified that proficiency in learning and knowledge of a complex and problem-oriented nature are extremely poor (Gagne, 1970 and Marton *et al.*, 1977). Learning researchers know a great deal about how mice can be taught to choose the correct path in a labyrinth by alternating food and electric shocks. We also know that individuals can learn rapidly and, in particular, forget meaningless syllables. If there is anything an economist might be able to utilize from this area of learning research, it would be the emphasis on the importance of incentives in the learning process. And this is sufficient in order to draw some preliminary conclusions.

We may ask: as an individual in a collective composed of several million people, what are my incentives for voluntarily learning about complex socio-economic relationships, when my only means of influencing the result is the single vote assigned to me? In a market situation, I have certain incentives for keeping track of prices so that I can make comparisons. Up to a certain level of relatively simple information gathering and learning, I can improve my own position by making better and cheaper purchases. But there is also

an upper limit, above which further information gathering is not worth while to the individual.

The small stockholder is a good example. In the long run, he can hardly expect to “beat the market” by devoting considerable time and resources to information gathering; he can make random choices or delegate them to funds or investment companies with economies of scale with respect to gathering and processing information.

Incentives are even weaker in political decision situations. What interest – aside from pedantic curiosity – do most voters have in finding out how the Swedish International Development Authority distributes grants among countries? What voter could improve his position by trying to understand the implications of university reforms?

Objections such as these may also be taken a step further; does an individual have any interest whatsoever in participating in the political decision-making process on a national level? The probable explanation for the high percentage of voters who in fact participate in Swedish elections is that every individual expects everyone else to vote. Other reasons may be the even distribution between political blocs and the subsequent counterbalancing of seats on a national level. In other words, each voter may feel that his vote is important and decisive. But even the social solidarity constituted by this kind of collective action is probably a scarce resource which should not be consumed unnecessarily by campaigns for turning off lights in empty rooms. Thus, I would like to argue that lack of incentive places very strong limitations on the possibility of arousing the average citizen's interest in socio-economic issues. Of course, everyone may be desperately aware that such issues are important to them personally, but at the same time citizens are equally convinced that they can hardly do anything as individuals. In turn, these fundamental characteristics imply that only a small number of “topical issues” can be transformed into issues about which an individual is really prepared to absorb information in order to form his own opinion.

The importance of the world outlook

Modern learning theory strongly emphasizes the role of different structures or patterns in our outlook on the world and our possibilities of interpreting data. *Figure 1* illustrates a division between “data” and “structures”. “Patterns” or “models” may be used as synonyms for the later group of concepts. Conclusions or actions are generated by interpreting data on the basis of the individual’s world outlook (“Model”).

In order to understand the design of the schedule in *Figure 1*, we may return to the simple example of minimum wage legislation. A proposal for such legislation may be interpreted as new data. An individual whose general attitude towards income equalization is favorable – but who otherwise has an unclear “model” of the relation between wage-setting mechanisms and the rate of employment – may spontaneously exhibit a positive reaction. An individual with another outlook on the world or a more complex “model” including a relation between the demand for labor and wage levels – is likely to find the proposal problematical. But a skeptical attitude is not wholly uncomplicated.

Assume that the proposal is brought before the public with considerable emphasis by a political party with which the individual sympathizes. The party’s representatives show no signs of skepticism. How can the individual determine whether it might not be his own outlook on the world that is wrong? Or – even if he is correct about his misgivings regarding the risks for increased unemployment – perhaps he has disregarded other aspects of the problem in his own analysis? Is it really plausible that the party leaders do not have a more comprehensive view than he does as a lone individual?

An experienced executive or researcher in economics may be so convinced that his outlook on the world is correct that he would venture to start a debate. But there is no guarantee that this would improve the situation. Suspicions may be aroused that it is the critics’ political sympathies and not their more comprehensive knowledge that cause them to have a more negative attitude.

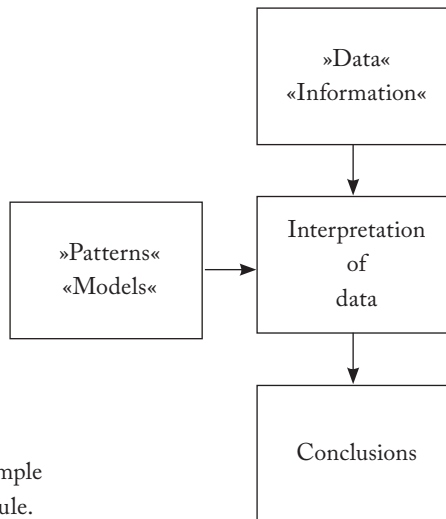


FIGURE 1. A simple decision schedule.

It has become popular in economic theory to distinguish between adaptive expectations and rational expectations. In the first instance, the individual is assumed to react on the basis of a very primitive model. If inflation is 10% one year, it is expected to continue the following year at approximately the same rate. In the second case, the individual is assumed to have a more or less complex model at his disposal in order to make a forecast. This would amount to an econometric model in this extreme case – and somewhere inbetween we would find a world outlook which had perhaps never been formalized but which could take circumstances other than historical developments into account. However, experiments in learning with respect to economic theory indicate that even on an academic level, it is very difficult to teach students about complex patterns and that the students often resort to rather mechanical memorizing without any profound comprehension. It should also be kept in mind that the learning of complex information such as economic structures requires abundant resources. As compared to medical information for example, this kind of economic information is also of very limited value in the everyday life of most citizens.

By tradition, unemployment figures attract considerable attention in the Swedish economy. Figures are published on a monthly basis and commented on in the mass media. These data are familiar to the average citizens and can even be inserted into a highly primitive world outlook where a low rate of unemployment is probably often interpreted as an indication that economic policy has not failed too disastrously. Developments during the last few years reveal the need to search for more complex “data” and more complex “structures” in order to make correct interpretations of economic events. Politicians are probably correct in regarding unemployment data as an important component in the private individual’s evaluation of the economic situation. This is why efforts are made to keep the unemployment which is registered openly at a low level and, in turn, to depress a traditional crisis indicator. But the 1975–1977 recession, combined with high domestic costs and structural changes, obviously made itself felt as evidenced by stock accumulation, overcapacity and low profits. Suddenly, a whole series of new crisis indicators emerged. But of course, these events were difficult to interpret because the new situation required a more complex structure or model.

The interesting question – which we will never be able to answer – is whether economic policy could have been formulated in a more rational way if the level of information had been higher. But, as I pointed out earlier, most of the decision-making capacity and public opinion were already engaged in the energy issue. Awareness of the crisis was inhibited and delayed to some extent by the suppression of traditional crisis signals. But even if there had been an entirely correct world outlook on the central political level, say during the fall of 1976, the discrepancy between this outlook and that of the general public might still have been large enough for a devaluation policy to fail (for instance due to the pronounced demands for compensatory wage increases during 1977, brought about by an early devaluation).

It does not suffice to have well-informed politicians as long as the discrepancy between the central decision-making level and the voter/member level is excessively large. The central wage

negotiations in Sweden in 1975 and 1977 may be interpreted on the basis of this pattern. Regardless of how well-informed the union leaders were – that is, even if their expectations had been correct in regard to the implications of high nominal wage increases in Sweden, in conjunction with fixed exchange rates and a decrease in the inflation rate in West Germany – it would still have been difficult to sway the opinion of union members (who had adaptive expectations based on high rates of inflation and wage hikes) in favor of exceedingly moderate nominal wage increases. It was not until 1978, when the crisis signals had become sufficiently conspicuous that more balanced wage negotiations could be pursued, based on a gradual rapprochement of world outlook and expectations.

Gresham's law and information

Similar processes, whereby information is filtered out, followed by gradual adaptation, certainly exist in firms. Various kinds of organizations may exhibit strong tendencies to filter out disturbing information which does not coincide with their current objectives. There is an obvious connection between this phenomenon and our previous discussion of discomfiting and complex messages. Therefore, in a well-organized society as in Sweden, it is not surprising that economists who enter into the public debate encounter massive resistance from different organizations or well-established views and opinions. Support in some instances is limited to statements made by passive sympathizers who find it reassuring that someone expresses what they think, although cannot, or would not dare, say so in public.

Perhaps there is a risk that we are up against a parallel to Gresham's law in the area of public opinion with respect to the dissemination of economic information. Simple and sometimes erroneous messages may tend to displace complex and more correct information. I have already pointed out the overabundance of messages, the limitations on capacity and the problem of securing involvement in issues where individuals cannot utilize information

to improve or affect their own position (except through collective action). Another aspect concerns the difficulty of providing the mass media with impartial information, in competition with different kinds of organizations. It should also be kept in mind that in order to survive and retain the support of their members, organizations are always anxious to convey their messages via the mass media.

Thus, in a thoroughly well-organized economy, it is imperative that we maintain a group of qualified economists who are independent from organizations and political parties. Universities have an important task with respect to preserving pluralism in Swedish society. But unfortunately, I am not at all convinced that the increased political control of universities and research grants will create sufficiently favorable conditions.

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Chapter 5. It Will Soon Be 1984 ...

On New Year's Eve in 1979, Ingemar Ståhl published a satirical newspaper article in which he presented a far-reaching plan to strengthen the foundations of the welfare state. Observing that tax evasion posed a growing threat to the tax base necessary to fund the Swedish welfare state, he proposed that every transaction in the Swedish economy, along with the identities of the buyer and the seller, should be registered electronically in a new national transaction registration system run by the tax authorities. In this way, cash would be taken out of circulation.

The benefits of a cashless economy would be many, he argued. Tax evasion and black markets would be prevented. Socially irresponsible consumption patterns and criminal activities such as the use of drugs and illicit distilling of alcohol could be identified and curtailed. The transition to a cashless economy could be rapid, since most of the payments and surveillance technologies were already in place. The plan could be in operation well before the year of 1984.

By publishing his proposal on New Year's Eve, Ståhl acted in the Swedish tradition of offering an end-of-year, crystal ball account of what the future might hold. He wanted to warn, in a light-hearted way, that the well-intentioned and generous welfare state could turn into an Orwellian nightmare.

The article was originally published as "Snart är det 1984..." in Svenska Dagbladet on December 31, 1979. The use of boldface is as in the original article. The translation here is also reprinted in the March 2020 issue of Econ Journal Watch with an afterword underlining that Ståhl's plan preceded by several decades the present discussion about the "curse of cash" and the movement towards a cashless society.

It is clearly evident from recent developments that government authorities in many respects have failed to gain full control over

the citizens of our country. This is especially notable in relation to the problems that have arisen from the spread of so-called grey and black markets and the associated increase in the number of transactions that have evaded taxation.

This is not just an efficiency problem in the sense that citizens – partly influenced by the tax evasion propaganda from the right-wing bourgeoisie and the ruthless attacks on society's ambitions to construct a soft and long-term planned People's Home (*folkhem*)¹ – are indulging in activities of dubious economic benefits to society as a whole. It also presents a sizeable problem of social justice, equity, and possibly even of gender equality.

Trusting the tax authorities

It is above all a question of creating trustworthy relations between citizens and tax inspectors. The latter should form a group with whom citizens should be able to discuss their economic problems and seek advice with great openness and trust.

It is of particular importance that the tax inspectors will have the opportunity to both explain and to persuade less solidaristic citizens – undoubtedly a diminishing group – of the necessity of surrendering most of their income to a society which by means of long term solidaristic planning has a greater capacity to achieve an efficient and equitable use of that income than would have been possible if individuals had been left to use it for themselves.

However, the Swedish tax system has an obvious flaw or perhaps just a blemish. This relates to the failure to register substantial numbers of transactions. Accordingly it is still possible for an individual to conduct a transaction in the black economy without

¹ Editors' note: The term *folkhem*, the people's home, is a metaphor for the Swedish welfare state, prominent in the ideology of the Social Democratic Party since the interwar years. Core elements include ambitious social protection and policies to reduce inequality, a government-run pension system, universal health services and free access to higher education.

it reaching the eyes and ears of our society.² A few very simple steps could be introduced to deal with this obvious anomaly. It is a question of making minor administrative adjustments to the existing system rather than introducing a series of new measures.

We all have a personal identification number

Each citizen in Sweden is assigned a personal identification number (*personnummer*) by the tax authorities. Sweden has gained substantial international respect for the leading role that it has played in this field.³ All registered companies already have their own organization number (*organisationsnummer*). It is in fact only non-profit organizations, foundations and public authorities that are not required to have an organization number. At most, there are around 100,000 legal persons that do not possess such numbers for identification. It would hardly be a major administrative exercise to put an end to this anomalous situation.

The central principle underlying the proposal that I will outline here, which has undoubtedly occurred to numerous responsible citizens, is that every transaction should be recorded, specifying the seller, the buyer and the nature of the transaction together with the weight and value of the transaction.

Hence it is a matter of providing a computer record of for example, my personal identification number (38 06 02-0859), the organization number of the local supermarket (56 78 34-8215) and a code that denotes the nature of the transaction (commodity group

2 Editors' note: In public debate in Sweden, the term "society" (*sambället*) is often used as a synonym for the state or the government. Ståhl adopts this usage here although as an economist he was keen to make a clear distinction between society and government.

3 Editors' note: Sweden introduced in 1947 a system of personal identification numbers covering every citizen. It was the first country in the world to do so. This measure was due to a change in the system of taxation. The Social Security numbers used in the United States are similar to the Swedish system of personal identification numbers although they do not cover every US citizen.

1106, plain bread, weight 0.8 kilo, value 4.20 SEK).⁴ All of this information is currently available.

To simplify matters, it will be advantageous if every citizen is provided with a citizen debit card based on his/her personal identification number.⁵ When used for purchasing, the citizen's personal identification number will be scanned automatically. On grounds of rationalization, most of the cash registers in the supermarkets will be equipped with computers and automatic scanners by 1984.

Once a month, large transaction units like major shops will submit electronic data to the national transaction register of the National Tax Board (*Riksskatteverket*). Smaller transaction units will not have to meet these monthly requirements. It will be sufficient for them to hand in manual lists once a quarter. Normally sellers have the **legal responsibility for registering transactions**. Compulsory registration of transactions is already the case for financial institutions such as commercial banks and to some extent the tax authorities make use of this opportunity.

The registration department of the National Tax Board will consequently be able to carry out monthly computer calculations that will provide information on the expenditures, incomes and changes in net balances for every natural and legal person in Sweden.

Free Saturday sweets!

Naturally this will involve a relatively large volume of computer data. However, it does not seem to be overwhelming or unmanageable, not least since there are numerous advantages, as we shall see below. In total, it may be estimated that between 30 and 40 billion transactions are carried out by natural persons (ten transactions

4 Editors' note: The personal identification number of Ingemar Ståhl reveals that he is a male person born on June 2, 1938 in the city of Stockholm.

5 Editors' note: Ståhl proposes here the idea of *medborgarköpkort*, literally a citizen purchasing card. Today, this would amount to a debit card issued to every citizen.

per day per citizen) and approximately the same number by legal persons. It would seem appropriate that small purchases such as evening newspapers and Saturday sweets that cost less than ten crowns would not have to be registered.

As a result of this change, which is actually nothing other than the rationalization of an existing system, the tax authorities will gain a complete overview of not just the incomes of individuals but also of their expenditures and changes in their holdings of assets.

It will be practically impossible to make purchases in the black market economy since income and expenditure have to balance, allowing for changes in net wealth. In the same way, a stricter control of the value added taxation will also be enforced.

A new form of taxation

The system also opens up the opportunity for a whole range of new theoretically interesting forms of taxation. A progressive expenditure tax becomes a practical possibility.⁶ The purchase of foreign currency or indeed all types of purchases abroad could become subject to value added taxation in Sweden. Capital gains taxation could be made more stringent and be extended to include personal goods and belongings.

It also raises the possibility of working with designated tax rates as part of the foreign exchange rate policy where taxes on imports and exports can be levied and changed to contribute to current account balance.

Purchases made by foreigners in Sweden need not give rise to any problems. The individual seller would in principle take note of the purchaser's passport number which would automatically harmonize with the national transaction register. Many foreigners will almost certainly be so fascinated by this rational Swedish system that they will apply for temporary citizen debit cards.

⁶ Editors' note: A progressive expenditure tax, that is a tax on consumption, was the subject of debate in Sweden in the second half of the 1970s.

A certain amount of leakage due to minor cash purchases would, however, have to be accepted. The expenditure deficit due to such purchases could be made managed by means of a tax-free allowance, for example equivalent to the purchase of a newspaper once a day or a bar of chocolate once a week.

Higher quality of life

The benefits of the proposed system will, however, not just be a matter of improvements to the tax system. There will also be a whole range of positive effects that will be disseminated throughout society. First and foremost, there is the widespread sense of satisfaction, tantamount to an **increase in the quality of life**, arising from the improved cooperation between public authorities and citizens. These improvements will in turn help society to fulfill its objectives in relation to social justice and the idea of the Swedish *folkhem*.

Another equally notable effect is that the periodic reports from the national transaction register will allow citizens to improve their economic planning. **In the long run, it is conceivable that further improvements in the quality of life could be achieved by allowing the National Board for Consumer Policies (*Konsumentsverket*) to carry out statistical analyses of the data in the national transaction register in order to identify those individuals who could be said to have inappropriate “consumption profiles” from a social standpoint.**

This could give rise to extensive outreach and preventive programs. In many cases, a conversation between the household and the National Board for Consumer Policies or the local municipal consumer board should be sufficient. In more deviant and problematical cases, society may have to intervene with more intensive consumer care measures.

Submission of a consumption plan

After some experience of the system, it would seem appropriate that each household every year submits a **consumption plan**. Once the plan has been approved by the National Board for Consumer Policies (*Konsumentverket*) – following the possible intervention of a consumer adviser or the municipal consumer planning board – the plan can be implemented. Automatic comparisons between outcomes as registered in the national transaction register and the approved consumption plans will indicate at an early stage where discrepancies arise and where appropriate measures should be taken. It is obvious that the national transaction register provides markedly increased opportunities to further the long-term planning of consumption and by extension, also of production.

It is also possible to improve consumer planning in particular designated areas. For example, the National Board of Health and Welfare (*Socialstyrelsen*) has for a long time taken responsibility for the Swedish population's consumption of bread. The Board has nevertheless lacked the technical means to carry out comprehensive follow-up studies. The national transaction register will be able to deal with this shortcoming. Consequently, there will be no difficulty in attaching a separate code to bread transactions and presenting them separately. Then it will be possible to monitor whether the consumption goal of six to eight slices of bread per day is actually being fulfilled.⁷

The proposed system is also able to ensure that consumers who over- or under-consume will be automatically requested to consult their district healthcare center, where they will be examined and advised by a team of specialists. (The composition of the team in the particular case in question comprises a specialist in primary care, a specialist in metabolic disorders, a medical welfare counsellor, a

⁷ Editors' note: In 1976, the marketing organization of the Swedish bakery association (*Brödinstitutet*) launched a campaign based on the slogan "The National Board of Health and Welfare wants us to eat 6-8 slices of bread a day". The campaign gave rise to a heated debate about the involvement of the state in the life of citizens.

dietary specialist, a district nurse and a trade union representative from the Municipal Workers Union (*Kommunalarbetarförbundet*).

The state-run pharmacies in Sweden are already in the process of introducing this type of transaction register. The possibilities of expansion into new areas will allow us to rapidly obtain information about the various side effects of consumption.

In the same way that the 1970s became the decade of the working environment, the 1980s could under the influence of the measures recommended here become a decade characterized by issues related to the consumption environment.

Solving the mystery of milk

The national transaction register opens up unimagined opportunities for research in the social and behavioral sciences. We will be able to compare consumption patterns in different groups and regions. Who drinks milk and why? This question will finally be answered.

The costly, time-consuming compilation of much of our official statistics could be replaced by simple, routine data processing in the national transaction register.

Deductions from the National Supplementary Pension System (ATP)

Tax evasion and property crime will at last become much easier to deal with as a result of the proposed system of a national transaction register. In principle, three types of crime are feasible: an expenditure deficit, an expenditure surplus and non-registered transactions. An expenditure deficit may arise from consumption abroad or black market purchases (thereby avoiding the payment of value added tax or at worst using non-taxed labor).

The submission of a travel plan backed up by appropriate documentation should help to deal with the problem of foreign

consumption. Swedish tax could thereby be levied immediately. The presumption made in relation to other types of non-recorded consumption is that they are a criminal offense. In this context, a tax surcharge can be automatically imposed electronically. The charge could be deducted from the individual's capital holdings or ultimately from his or her supplementary pension (*ATP*).⁸

A recorded expenditure surplus arises when an individual has received untaxed foreign income or is in receipt of so-called black income. In this case, a Swedish tax or a tax surcharge will be imposed in the same way as with an expenditure deficit. The only difference will be that the relevant taxes will take the form of payroll charges and income tax.

More police, of course!

Transactions not recorded with the national register are obviously a serious crime. They arise principally when individuals exchange goods or services without a registered payment. Once such trade is discovered, it would have to be punished severely. It is anticipated that this would lead to a certain increase in police surveillance, opening of correspondence and the tapping of telephones. Home visits carried out by specially selected supervisors from the transactions register might also be used.

It must be emphasized, however, that these control measures will not affect honest, loyal citizens. They are solely directed at actual or suspected tax evaders. There is no reason why this type of measures, which are in the interest of society as a whole, should not be compatible with the principles of a state governed by law. It is not the aim of the legal system to protect criminals who sabotage the institutional foundations of society.

⁸ Editors' note: The ATP pension was introduced in 1960 as a part of the state-run pension system.

Cash is criminal evidence

As a result of the steady expansion of electronic surveillance systems, it can be expected that cashless transactions will increasingly become the norm. The purchase of newspapers, sweets and chocolate will continue to exist as exceptions in the little “free circle” outside the transaction registration system. This will also mean that a large cash holding in itself will give rise to suspicion of criminal acts or of criminal intentions. A solidaristic behavior by the citizens will quickly reveal any cash rich saboteurs of the system of registered transactions.

Other forms of anti-social behavior can also be more readily suppressed by the transaction register system. Criminals who have committed thefts may be more easily detected by irregularities in their patterns of consumption. It is also likely that it would become easier to trace drug addicts. Hence additional research efforts might well be able to identify the income and expenditure profiles that are strongly correlated with various types of criminal behavior. The systematic scanning of individual income and expenditure profiles would also be able to make a marked contribution to the rationalization of police work.

Goodbye to illicit distilling!

The heated debate on keeping a register of the purchase of alcohol would be automatically resolved. At the same time, there would be a certain check on illicit distilling and wine production. A household that purchases bread, sugar and yeast would immediately raise strong suspicions.

The issues of tax exhaustion and tax evasion need no longer act as a brake on the continued growth of the welfare society. What the Khmer Rouge was unable to achieve because of their technological backwardness will be fulfilled by the technical ingenuity and cultural prowess of the Swedish people over the

coming five year period.⁹ We have already taken the decisive step by adopting modern computer techniques and personal identification numbers.

As is evident the transaction register system will provide us with a wide range of substantial advantages. It should thus be introduced without further delay. Already 1984 seems too late.

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Editors' note: The introduction to the original article by Ståhl in *Svenska Dagbladet* stated that "We must create confidential relationships between the public and the tax inspectors! By 1984 every economic transaction should be registered and the tax authorities would then finally be able to have complete surveillance of everybody."

Two photos illustrated the article. The first photo displays a hand holding a citizen debit card in front of a supermarket cashier with the text: "With a few administrative changes we can get rid of the obvious anomaly that people can consume whatever they want. A citizen debit card should be introduced at the latest in 1984 in order that the State may finally obtain control over the individual..., as Ingemar Ståhl writes in a New Year satire."

The second photo shows a pen for scanning price tags with the text "The system of automatic scanning of price-tags which is already in use can easily become the basis of the transactions registration system. The point of the cashier's pen will be the eye of the State on your consumption."

The original article was also illustrated by six pictures of the citizen debit card issued by the Consumption Control Agency for "Ståhl, Ingemar 38 06 02 – 0859, Consumption area: Lund" with a photo of Ingemar Ståhl.

⁹ Editors' note: Ståhl is referring here to the policy of Pol Pot, leader of the Khmer Rouge, of abolishing money after taking power in Cambodia in 1975.

INGEMAR STÅHL

Chapter 6. What is Wrong with the Welfare State?

Ingemar Ståhl was fascinated by the rapid growth of the public sector in Sweden in the 1970s and 1980s and the subsequent rise in average and marginal tax rates. In numerous articles, he sought to uncover the causes of the swift expansion of government expenditure and to find a solution to limit the growth of the public sector.

In this lecture from 1987, he analyzes five different functions of government in modern society: the night-watchman state that produces pure public goods, the infrastructure state, the social state, the interest group state and the tax state. The social state, which corresponds to the welfare state, absorbs most of the government budget.

The size of the public sector in Sweden cannot be explained by the existence of the welfare state alone, he says. Special interests are also at work, able to successfully lobby a political system based on majority voting to further their claims. These interest groups form a major driving force behind government expenditures and higher taxes.

Ståhl argues that the Swedish welfare state has reached its limits in the sense that the burden of taxation has become too high. It would be difficult to reduce its size, but it could be done. A constitutional reform inspired by the work of Knut Wicksell, requiring supermajorities for some decisions, might be a way of arresting the growth of the public sector.

This lecture was prepared for the seminar "Limitations of the Welfare State: Experiences of Developed Countries," National Taiwan University, November, 1987. This is an edited reprint of the manuscript by Ingemar Ståhl.

During most of the postwar period, Sweden has been regarded as an interesting and intellectually challenging case with respect to

its ability to combine a relatively high rate of economic growth and a number of highly successful multinational companies on the one hand with possibly the most wholly encompassing social welfare state on the other. Conventional wisdom has told us that there ought to be a basic conflict between growth and extended social welfare. There should also be a conflict between economic growth and the building of a society that requires ample scope for party politics, bureaucracies and different kinds of interest organizations. This argument has recently been presented in a highly convincing way by Mancur Olson in his book *The Rise and Decline of Nations*.¹

This paper will analyze this paradox in the Swedish economy and offer some tentative conclusions. The explanation used by Mancur Olson in the introduction to the Swedish edition of his book, namely the role of encompassing organizations with some kind of social objectives covering the entire economy will be refuted. Instead, the main argument of this paper is that Swedish policy has concentrated mainly on ensuring conditions of free trade for the industrial sector. The Swedish economy can be said to have been characterized by free enterprise and social control in contrast to certain other social democratic or socialist societies where business enterprises have been taken into public ownership.

Where we have a combination of socialist enterprise and government interference in everyday life as is evident in most communist countries, we find many obvious cases of low standards of living, low growth rates and the suppression of civil, political and economic rights.

The first section presents some of the main features of the changes that have taken place in the structure of Swedish industry. The emphasis is on the importance of free trade for the emergence of a strong export oriented manufacturing sector. The growth of a number of large, multinational firms has been of major importance in this development. The second section deals with the growth of

¹ Editors' note: Mancur Olson's book *The Rise and Decline of Nations*, Yale University Press, was published in 1982, and shortly afterwards translated into Swedish.

the welfare state and the emergence of strong special interests.

The third section, the main part of the discussion, considers a number of major issues regarding what the state should do and what it is actually doing. It also deals with some of the basic problems of incentives in a state that has a large public sector. A major question discussed here concerns the type of dynamic behavior that would emerge in a society characterized by a decision rule based on a simple majority in combination with strong bureaucracies and special interest groups forming what the Norwegian sociologist Gudmund Hernes has called “iron triangles”.² Together they represent a type of monopoly in setting the agenda. It is evident that in this case, there will be clear difficulties in creating countervailing powers to restore free markets.

1. The growth experience of Sweden

When industrialization started in Sweden in the 1870s, the country was an underdeveloped agricultural economy. Traditional export products from earlier periods such as tar, iron and copper no longer played any role after the technological changes that had taken place in the early stages of the industrial revolution. Swedish economic development was largely an almost classical example of export-led growth. It started in the 1850s with the export of oats to Britain during the Crimean War. Subsequently, the British construction boom created a demand for timber. During the last decades of the nineteenth century, Sweden was the largest timber exporter in the world market.

Industrialization continued with the growth of the pulp and steel industries using imported coal instead of domestic charcoal. The new Thomas-process for steel manufacture made the large iron ore deposits in northern Sweden an important economic asset. One

² Editors' note: Gudmund Hernes' book in Norwegian *Makt og avmakt*, Universitetsforlaget, Oslo, 1975, was a source of inspiration for Ingemar Ståhl in his work on the political influence of special interests in Swedish society.

striking feature of this industrialization process was the creation at an early stage of a number of engineering companies, still in existence, whose production was based on either Swedish innovations (like SKF and ball bearings) or on domestic adaptations of foreign technology.

The role of government in this process was very limited. With the exception of the establishment of the rail network and the exploitation of domestic hydroelectric power, this expansion took place as a textbook example of export-led growth under capitalist market conditions. Until the 1970s, government played an insignificant role in the industrial sector. Sweden never had a period of nationalization similar to that in the United Kingdom, immediately after the Second World War.

Free trade was also an important part of the rules of the game for the interaction between industry and the labor movement (consisting of both the Social Democratic Party and the trade unions and their central organization, LO). Although nationalization of certain industries was a point of principle in the program of the Social Democratic Party, the question was never an immediate political priority. The large-scale nationalizations of steelworks and shipyards that took place between 1976 and 1980, occurred during a non-socialist government. They were partly attributable to the oil price shocks.

As already stated, the growth of internationally oriented corporations was an important feature of this process. Most of the ten largest corporations were started before the First World War or in the inter-war period. This applies to ASEA (heavy electrical engineering), SKF (ball bearings), Ericsson (telephones and electronics), Alfa Laval (food processing equipment), Atlas Copco (pneumatic equipment), Bofors (guns and heavy engineering) and AGA (automatic lighthouses and now gas production and distribution), which were all founded in an early phase of the industrialization era. They have subsequently grown into international corporations. Indeed in many cases, most of their production is located outside Sweden.

Three of Sweden's largest firms were started at a later date. The

inter-war period saw the establishment of Volvo (cars) and Electrolux (vacuum cleaners and kitchen equipment). The latecomer was SAAB from the Second World War (aircraft, cars and electronics). Other important corporations such as Swedish Match and Sandvik also belong to an early phase. The same is true for the raw material industries (metal ores, pulp and paper and steel), although there has been a large number of mergers during recent years.

The backbone of Swedish industry has thus been formed by private corporations operating in international markets governed by policies of free trade and international competition. Attempts to use active industrial policy measures such as nationalization of steelworks and shipyards during the 1970s turned out to be a failure. In more recent years, company closures and privatization have been adopted instead.

A dynamic export industry operating in a capitalist environment can accordingly be seen as the main factor underlying the growth process. However, this process has been susceptible to varying types of not entirely insignificant threats. A strong trade union movement has created a wage bargaining situation where inflation is higher than in other European countries. This has led to a number of devaluations. The attempts by the labor movement to introduce wage earner funds have posed a different type of threat. Here the intention has been to purchase stocks in the market using tax financed funds that are closely tied to the trade unions. It can, however, be argued that these funds may have had a larger symbolic value for the labor movement than actually presenting a real threat to a privately owned industrial sector.³

However, the growth process has slowed down during the 1970s and the 1980s compared with other OECD countries. The process of restructuring may not have been as active as before.

³ Editors' note: See chapter 3 for Ingemar Ståhl's analysis of the original proposal by Rudolf Meidner from 1975 for wage earner funds. The system of wage earner funds introduced in 1983 by the Social Democratic government was a watered down version of the Meidner plan. The center-right government that took power after the election of 1991 abolished these wage earner funds. Since then, the idea of such funds has disappeared from Swedish political debate.

To a large extent, the growth of car production has compensated for the decline in steel and ship-building. It is striking that no new companies of the same size as the aforementioned ten major corporations have emerged. All of them were started before 1945, most of them long before that date.

It is obvious that it takes time to build up a competitive industrial structure. It may also be possible to live a comfortable life on old investments or old firms for a considerable time. It is also equally obvious that many of these firms live an international life, partly separated from political conditions in Sweden. A recent example is the merger between ASEA and the Swiss corporation, Brown-Boveri. The new firm will have Switzerland as its base. There are certain limits for political action in a competitive world where corporations may vote with their feet.

It is also possible to look at the Swedish political situation as the result of three tacit agreements. The first was between the labor movement and the agricultural sector at the beginning of the 1930s when the Farmers' Party gave its support for a social welfare policy led by the Social Democratic Party and the trade unions. The price that the labor movement had to pay for their position of power was the protection of the domestic agricultural sector and domestic prices that far exceeded world market prices.

A second agreement was between industry and trade unions in the late 1930s which established the rules of the game for the labor market. Mobility of labor and restructuring of industry were accepted. Industry would work in a competitive international environment while social welfare policies became a matter for the political sector.

A third type of agreement can be said to have been reached between blue collar workers and white collar workers in the early 1960s when it was decided that the pension system would be a government affair based on a pay-as-you-go system rather than on a private funded system. Together these agreements built up a political structure that turned Sweden not only into a social welfare state but also a social-democratic state.

2. The development of the welfare state

Sweden was rather late in its development of the modern democratic and parliamentary institutions that were typical of Western European and North American societies. When industrialization got underway in the 1870s, the country had just changed from a parliament of no less than four estates stretching from nobility to free farmers to a two-chamber parliament that still had a rather limited electorate. Votes were allocated according to income and wealth. In the first elections to the new parliament, less than 20 percent of the male population was eligible to vote. In 1911, universal suffrage for men was introduced followed in 1921 by an extension of the suffrage to include women.

But this was also an era of limited government that dealt mainly with the tasks of the night-watchman state: protection against internal and external threats. Defense and justice were the main items of central government budgets while basic education was a task for the local authorities. The counties were created in the 1860s as elected political bodies to take charge of an emerging but rather primitive public hospital system. In 1900, the total government budget comprised about 10 percent of GDP. However, at the beginning of the 20th century, income tax was introduced. Up until then, tax revenues were principally raised from real estate and from customs and excise. The slow growth of the public sector was partly financed by the incomes from the new tax base which also necessitated fiscal reforms.

As usual, one should not underestimate the effects of new tax bases and new tax administrations for the continued growth of the public sector. By the beginning of the 1930s, the government's share of GDP had reached almost 20 percent. The first social welfare reforms were obviously inspired by the development of different types of social security systems in Germany. In 1913, the first bill introducing a general old age pension was passed. A limited basic pension was made available to all citizens above 67 years of age. These pensions were financed by a special tax on income. A few years later, tax financed unemployment benefits,

work accident insurance and private health and sickness payment insurances were introduced.

Hardly any reforms took place during the 1920s. In the 1930s, there was considerable growth of different welfare programs although the financial effects were rather limited. The introduction of more general programs tended to replace means-tested benefits. Two parallel trends may be observed. On the one hand, the gradual introduction of a comprehensive social security system that covered the life cycle from the cradle to the grave as well as different forms of risk protection in relation to unemployment and illness. On the other, there has been a growth in the public provision of social services. The extent of the services that should be provided by government and thus be highly subsidized and tax financed was increased during this period. It now includes schools, healthcare, day care for young children, homes for the old as well as to a certain extent housing. (About 20 percent of all apartments are owned by local government authorities.)

By around 1950, total public expenditure had reached a level equivalent to 25 percent of GDP. A level of 30 percent was reached ten years later in 1960. However, this level was similar to the level that prevailed in most other OECD countries at that time. In 1962 Japan and Switzerland had reached a 20 percent level while almost all other countries were clustered around the 30 percent figure with France, Britain, the Netherlands and West Germany slightly above the Swedish level.

A basis for further expansion of the public sector was adopted at the beginning of the 1960s when two new tax bases and taxes were introduced. One was the value added tax which started at a modest rate of 3 percent. The other was a payroll tax to finance the new pension system. This tax also started at a rate of 3 percent. At present (in 1986), the rate is 36 percent.

A marked acceleration in the rate of expansion occurred between 1965 and 1982 with something of a quantum leap occurring between 1976 and 1982. Since 1932, Sweden had been governed by the Social Democratic Party either with an outright majority or in a coalition with the Farmers' Party. After 44 years of Social-Democratic

dominance, a non-socialist coalition came into power in 1976. The new government comprised the Farmers' Party (now transformed into the Center Party with environmental questions added to the agenda in addition to the protection of the agricultural sector), the Liberal Party and the Conservative Party. Ironically, this coalition on the right of the political spectrum increased the government sector from about 50 percent of GDP to a world record of 67 percent in 1982 while tax incomes remained constant at a 50-52 percent level.

The new labor government took over in 1982 confronting large budget deficits. Public expenditure could have been reduced by dismantling the subsidy programs to ailing industries (shipyards, steel, iron ore mining, and textiles) after a combined devaluation in 1981 and 1982 of no less than 26 percent.

Very little has happened to the expenditure side since 1982. There has been an absence of structural reforms. It seems as if the Social Democratic Party from once having been an industrial workers' party is now turning into a party that relies mainly on the electorate employed in the public sector. The deficits have been drastically decreased mainly by increases in taxes and the introduction of new tax bases such as turnover taxes on the stock exchange, taxes on accumulated wealth in private pension funds, capital taxes on fixed property and on power production plants.

3. The five faces of the state

In the traditional textbooks of public finance, the main arguments for government intervention in the market economy can be summarized under the headings of public goods, public utilities (mostly covering the case with decreasing average costs) and possibly merit goods. In this type of theory, the taxes necessary to cover public expenditures are determined on the basis of some kind of social welfare criterion as in the theory of optimal taxation that seems to predominate in modern textbooks.

It is obvious that this is not an adequate description of a modern

welfare state of the Swedish type where the government sector covers more than 60 percent of GDP and the tax share has reached a world record of about 55 percent. (Denmark is a good second in the race with a tax share of 52 percent.) The traditional theoretical discussion does not cover the enormous expenditures for a range of social security and social insurance programs. There is also a tendency to rationalize public policy by formulating the role of the state in terms of welfare economic theory where the state is regarded as providing (optimal) solutions to possible problems of market failures.

Using a public choice perspective, the role of government will be described in the following categories:

1. The night-watchman state (collective goods)
2. The infrastructure state
3. The social state
4. The interest group state
5. The tax state

These distinctions are not mutually exclusive and the interest group state will certainly overlap with the other aspects of government.

3.1. The night-watchman state

The night-watchman state is surprisingly small expressed as a share of GDP. If we add defense, justice and some of the basic functions of the public administration (such as the foreign service but excluding the administration of schools or social welfare systems), we will in the Swedish case reach a figure of somewhere between 8 and 10 percent in relation to GDP. This is a figure that has a striking similarity to the share of the public sector around 1900.

Some of the basic functions of government might not have grown much faster than GDP during this century. It can also be reasonably argued that the present “big government” has difficulties in providing sufficient quantities and quality of the public services

that come closest to the economist's concept of a public or collective good, i.e. a service where individual exclusion of consumption is technically impossible or excessively resource demanding. Competition between collective goods and other services or redistributions offered by the state in the political process and in the struggle between different interest groups seems to leave the collective goods or the basic functions of the state as a constant loser.

3.2. The infrastructure state

It can be argued that our standard textbooks in public finance devote too much space to the public goods case and neglect recent more costly developments of government budgets. This is perhaps still truer when we come to the case of public utilities and infrastructure. Optimal pricing and investment calculations based on benefit-cost analysis take up much of the time in public finance courses. As a share of government budgets, public utilities in a true sense are fairly insignificant. Only a very few cases, provide a strong argument for marginal cost pricing that produces losses that have to be covered by tax financing. Different combinations of two part tariffs, i.e. a fixed part plus a price for each produced unit, price differentiation (price discrimination) and peak load pricing will generally result in total costs being covered in the market without subsidies from the taxpayers.

In the Swedish case, the surplus from the taxes on cars and trucks (including petrol tax, which is close to a road user charge) is probably sufficient to cover losses on other infrastructure parts of government budgets. Although a gross calculation suggests that about 5 percent of GDP is spent on infrastructure through government budgets and taxes or quasi-tax pricing arrangements, there does not seem to be a real need for government financing through taxes. The road system could be financed as a public or private corporation with more sophisticated road user charges. The same will be true for many other activities such as harbors.

If the market could work with more sophisticated pricing methods, it would also be possible to challenge the conventional wisdom

that certain activities should be run by the government. There are no longer any strong technical arguments for a monopoly for postal services or telecommunications. The main current reason for state monopolies would seem to be that a monopoly can exercise what is called cross subsidization which is actually a type of income transfer from mainly rich areas to poorer areas. A common price for a whole country for postal services etc. is more the result of a political process in which the net winners of the cross subsidization can form a winning majority coalition. It is also self-evident that for example subsidies to ailing railways may also be a part of a political decision process in which local interest groups are able to form coalitions with trade unions keen to protect unprofitable jobs.

Economists have a tendency to rationalize decisions regarding the public sector in terms of social welfare maximization when a simple study of interest group behavior might produce much better explanations. In order to solve certain urgent problems of external and internal security, societies created a monopoly on the use of violence for the government. This monopoly also included the power to raise and collect taxes.

Much of the expansion of the public sector may be regarded as a result of a process in which different interest groups have used the political system to favor their own interests by getting tax financed subsidies. But it also belongs to the rules of the game of the political debate that interest groups will seldom argue in terms of their self-interest but will rather argue in what could be perceived as in terms of the general interest. It is important to have this in mind when analyzing the problems of tax financing of public utilities (as in many other parts of the expanding public sector).

3.3. *The social state*

The largest part of the government budget can be classified as belonging to the social state. To understand this part, we will use a further division into three different categories of problems that can be solved in either a political process or in the market or by voluntary action. The first part may be regarded as a life cycle problem.

The second may be viewed as a risk and insurance problem while the third category deals with redistributions to the genuinely poor or disabled.

The modern welfare state takes care of the individual from the cradle to the grave. Maternity leave paid by social security, a free natal service, highly subsidized day care centers plus children's allowances mark the start of human life in the welfare state. Then comes "free", i. e. tax financed, education from compulsory school to the university. From a life cycle perspective, an interlude follows when the individual has to work and pay taxes. Life ends with a period of state pensions and possibly a period of tax-financed long-term geriatric care. On average, these payments over the life cycle will even out and the role of the state can be regarded as providing a loan and savings account determined within a political and bureaucratic process.

This general pattern of the life cycle has always been a fact of human life. The transfers from one period in the life cycle to another have usually taken place within the family – or perhaps inside an extended family. Parents have taken care of their children when they are young and subsequently when the children have grown up, they have taken care of their old parents. The norms of the family system can be regarded as an implicit intergenerational contract. What the welfare state does is just to extend this intergenerational contract to a chain letter between all persons belonging to one generation to all persons in the next generation and so on forever. Is it certain that these chain letter systems will survive? No country has any experience for a period of more than 50-60 years – in many cases a much shorter time.

The alternative market solution is obviously that of a pension savings-system based on what is technically called a funded system in contrast with the pay-as-you-go systems that dominate social security systems. For some parts of the earlier phases of the life cycle, loan systems are the market alternatives, e.g. a student loan system to cover university fees as well as students' consumption expenditures.

The main differences between a social security pension system

and a market pension system are that the incentives for savings and capital formation may be drastically decreased in a pay-as-you-go-system in comparison with a funded system. This will have effects on the long-term growth rate. Another aspect is that social security charges have a tendency to closely resemble taxes which may have consequences for work incentives. A possibly more important long run consequence is, however, that social security systems would decrease the scope for individual freedom as the individual becomes increasingly dependent on political decisions and public administrations.

To monopolize the pension system for the public sector means an important shift of power from the market sector to the political sector. In this sense, Sweden is to a high degree, a political economy. A very large part of the individual transfers over the life cycle will pass through the political sector. Moreover, it is not only a matter of cash transfers. To a considerable degree, the transfers take the form of transfers in kind with government production and provision of different services. Local government will not only subsidize expensive day care centers. They will also manage and produce the services within the local administration. Universities are operated directly as a part of public administration etc.

Tax-financed public production and supply of services, which frequently have some degree of legal monopoly, will create a strong position for interest groups among public service employees, creating the aforementioned iron-triangles consisting of politicians with special interests, well-organized interest groups and bureaucracies. A university professor who wants to advocate a system with university fees and student loans will not be very popular among either his students or his colleagues. Why would an individual take on all the costs of arguing against a policy of tax-financed universities when all the direct benefits available to the individual correspond to a small fraction of a potential tax cut?

An estimate – or rather a guesstimate – of the scale of life cycle programs as a share of GDP would be somewhere between 20 and 25 percent. There are of course many difficulties involved in this estimate. How should public provision and production of day care

centers be treated when it is obvious that part of this expensive program is a subsidy to special groups including those employed in the program? The borderline between the social state and the interest group state is far from clear.

The second category within the social state is government provision of risk insurances. These mainly comprise health insurance in relation to the provision of health services produced by the public sector, sickness payment insurance, a disability insurance and finally a broadly defined unemployment insurance (covering not only traditional cash payments but also retraining programs, sheltered employment, relief work and mobility support). A good guesstimate would be that this risk insurance that constitutes part of the social state will amount to about 20 percent of GDP.

In principle, it is true that health insurance and unemployment insurance could be provided by the market. The traditional arguments for public provision, the problems of moral hazard and adverse selection, are not very strong. It is obvious that private insurance firms cope with such problems in other areas of insurance, for example in relation to car accidents. Another argument is the free rider problem or the problem of the Samaritan. An individual may hope to be saved by the others even if he lacks insurance coverage. If this is really a problem, it is an argument for compulsory (but perhaps private) insurance rather than for public insurance. Even with government insurance, there are few good economic arguments to combine this as is the case with Swedish healthcare that has almost 100 percent public production of health services.

But as has already been indicated, a political monopoly of the provision of health insurance and healthcare means that citizens are dependent for their almost physical survival on the political system and will feel grateful towards politicians who provide individuals with all the vital services. A typical feature of risk insurance systems that make them more political and public than in many other countries are that they are combined with the provision of services that are also produced in the public sector. In most cases a monopoly position applies. It will be difficult for a private hospital

or a private day care center to receive the same subsidies as the public provider.

A third category in the social state refers to transfers to persons or groups who are permanently disabled and where it would be impossible to have an insurance system. Examples in this category would be persons who have inborn defects. A rough calculation of the social transfer systems that are actually allocated to persons within this category, excluding the cases of inter-temporal transfers over the individual life cycle that could in principle be managed by a combined loans and savings system, ultimately arrives at an astonishingly low figure for the pure insurance cases. Less than 5 percent of GDP would be necessary to cover a decent standard of living for the chronically disabled.

We now wish to discuss transfers to the genuinely poor. The low figure that we reached is also an indication that many of these social problems could be solved by individual charity. It is important to stress the necessary distinction, not at least from an ethical point of view, between charity aimed at the poorest whose circumstances we do not envy and the large scale transfers through the government sector to insurance and pension cases. If we discuss support for truly poor people, we could perhaps also include aid to underdeveloped countries in this category. At present, Sweden provides about 1 percent of GDP as foreign aid. Nevertheless, the total budget for morally motivated transfers ends up with a figure at around only 5 percent of GDP.

It can also be questioned whether large parts of foreign aid should be treated within the interest group state. A large part of Swedish aid goes to socialist countries such as Angola, Mozambique, Vietnam and Nicaragua where governments deliberately suppress individual economic and political rights. It is difficult to explain this allocation as an expression of voluntary contributions from Swedish citizens. It is easier to explain it with reference to internal and external pressure groups including a left wing foreign aid administration.

3.4. *The interest group state*

In the previous discussion, we have tried to find arguments for government spending that rely on standard economic theory. However, it is evident that this does not really help us to understand why certain modern welfare states allocate far above half of their GDP to the public sector. In order to shed further light on this matter, we have to discuss the political processes that underlie the systems of expenditure and taxation. One possible decision method comprises the use of an (almost) unanimity principle. Public goods as defined here would probably be provided in sufficient amounts even with the use of a unanimity rule. The standard results in welfare theory going back to the analysis of Knut Wicksell are actually based on a concept of unanimity. If there is a genuine market failure when it comes to infrastructure or social insurances, a similar argument can be made. However, there are many doubts that market failures are that severe.⁴

Adopting a majority rule, where it is only necessary to have 51 percent of the electorate behind a decision, other allocations would be possible. This is not the place to provide an analysis of the results from modern public choice and social choice theory. It is just sufficient to base the argument on two fairly stable conclusions.

Firstly, there will be a strong tendency to favor the median voter. With a progressive tax system, the taxes paid by a person on average income would be higher than the tax paid by the median voter and income-earner. There will accordingly be a tendency to redistribute towards the median voter. Tax systems and social benefit systems typically illustrate this feature. There is really no guarantee that majority voting will favor those who are in the worst position.

A second conclusion is that strongly organized interest groups in the middle of a left-right spectrum can favor their own special interests by forming a winning coalition with either the left or with

⁴ Editors' note: Ingemar Ståhl was much inspired by the public finance theory of Knut Wicksell, professor at Lund University 1901-1916. Wicksell argued that decisions by public assemblies should be based on rules that prevented the majority to oppress the minority.

the right. Well-organized special interests seem to be winners and to have a potential for taxing the rest. Benefits are concentrated while taxes or costs are spread throughout the entire population. The staff of the day care centers has a strong interest in a monopoly position and tax financing of their activities. Similar arguments can be made for many interest groups. Farmers prefer a protected market that offers domestic prices far above world market prices. However, they will not present their argument as a case of special interests. Instead, the political discussion about protected agriculture will be formulated in terms of defense, environment or regional balance with a touch of more general interest.

A recent study of Swedish agricultural policy showed that the benefit of protection for farmers was worth roughly 4 billion SEK while the cost for consumers was 7 billion SEK. However, to deregulate agricultural prices would mean capital losses of perhaps 50 billion SEK for about 60 000 farmers while the annual gain for each consumer would be less than 1000 SEK. The problem that the value of some of the privileges created by government subsidies, protection or regulation has been capitalized makes it even more difficult to switch to a pure market regime. However, it would be obviously possible to compensate the losers in the case of a deregulation of agriculture.

3.5. *The tax state*

There are obvious difficulties in reversing a trend when government expenditure comprises 63 percent of GDP (1987) and more than half of the population are either on government pay rolls or on welfare payments. A tax system that can finance a public sector of this size must raise taxes equal to 55 percent of GDP. As capital income is taxed at a lower effective tax rate than labor income, the average tax rate on labor income and private consumption must necessarily be very high. The present tax rates provide a good indication of this problem. We have previously mentioned a value added tax of about 19 percent and a pay roll tax of 36 percent. In addition, the basic rate of income tax starts at 30 percent while the marginal tax rate for

full time blue-collar workers is at 60 per cent. The corresponding marginal rate of tax for professional staff is 75 percent.

However, a complete estimate would require that the combined effects of all three taxes should be taken into account. If the alternative is to produce certain services at home such as repairing or painting the house, the combined effect of the value added tax, the payroll tax and the income tax would determine the choice between work in the taxed sector or work at home or in the black economy, which is probably fairly limited considering the high tax rates due to efficient control and tax collection systems. This total tax wedge could easily be around 85 percent for full time workers.

The problem is of course that there is a negative impact on work incentives or rather that people prefer to work in the untaxed sector. Average working hours in Sweden are at present the lowest in the OECD area. This can only be explained by the combined effects of taxes and social welfare systems. The system may be characterized as an economy where there is a gulf between working efforts and actual living standards. The economy may also be described as a new type of dual economy that has on the one hand an efficient export oriented industrial sector and on the other, a highly sheltered and protected public sector.

It is not easy to change the present situation. Politicians are becoming aware of some of the substantial indirect costs through the disincentive effects of high marginal tax rates. The remedy seems to be a tax reform that would provide broader tax bases and lower marginal taxes while maintaining the same share of taxes in relation to GDP. It is obviously very difficult to get a majority for a roll back of the public sector in an economy where a majority of the population receives a basic part of their income from the public sector. There will always be well-organized interest groups that will feel threatened by the smallest attempt to reduce budget expenditure. Initiating a process of budgetary and tax decreases is very similar to a disarmament process involving many parties.

However, there is also a general feeling that the ceiling has been reached. Given the impossibility of increasing the share of GDP and a commitment to increase pensions for future generations that

will have to be honored, there is a constant squeeze on budgets for publically provided services. At the same time, the growth of productivity within the public sector has been very slow and perhaps even negative. This would indicate a lower quality of public services that would create a possibility for parallel private services that charge the customers full market prices.

It is obvious that the welfare state has come to the end of the road. Astonishment and bewilderment are more typical for the political bodies than determination to handle the situation. However, all the interest groups are there to defend their interests. It is possible that changes will only occur when the decision process has been changed. Rules based on a simple majority create an environment where interest groups can act too easily. It might even be rather unproductive for economists to point out all the misallocations that take place in the public sector and in the tax system. Perhaps we should go back to Knut Wicksell's analysis of 1896 that argues in favor of qualified majorities for tax and expenditure decisions and supports the case for constitutional reforms rather than marginal changes of the present programs.⁵

⁵ Editors' note: Ingemar Ståhl is referring to Knut Wicksell's study (in German) *Finanztheoretische Untersuchungen* (Studies in the Theory of Public Finance) published in 1896. Here Wicksell argued that taxation should be based on the benefit principle.

INGEMAR STÅHL

Chapter 7. A Coasean Journey through Estonia

– A Study in Property Rights and Transaction Costs

The work of Ronald Coase on property rights and contracts was a great source of inspiration for Ingemar Ståhl. He became a pioneer in Sweden introducing this approach in his policy analysis as well as in his teaching. To him, the contract was the essential concept in economic analysis. He titled one of his lectures “If private property rights did not exist, we would have to invent them”.¹ The market economy can only thrive successfully with well-defined property rights. Economics should preferably be the study of contracts – not the study of optimization.

In this chapter, Ståhl applies a contractual approach to Estonia immediately after the break-up of the Soviet Union in 1992. Estonia was just starting the transition from a Soviet-style command economy to a market economy. At this early stage, Ståhl stressed that Estonia lacked the institutions necessary for a market economy.

Ståhl conducts a journey to shops, firms, factories, houses and markets in Estonia with the work of Coase as his travel guide. His tour brings out in a most vivid manner the shortcomings of the command economy as well as the challenges facing Estonia as it turns the ownership of firms and housing to private hands. Along the way, he also identifies shortcomings in the standard textbooks in economics used in the West concerning the dynamics of a market economy.

This chapter is a reprint of chapter 17 in Laszlo Somogyi, ed., The Political Economy of the Transition Process in Eastern Europe, Aldershot, UK and Brookfield, Vermont: Edward Elgar, 1993.

¹ This talk is reprinted as chapter 24 in Jonung and Jonung, eds., *Ingemar Ståhl – en ekonom för blandekonomin*, Dialogos, 2018.

Introduction

The Estonian Republic together with the other Baltic republics (Latvia and Lithuania) were the first republics in the Soviet Union to start a movement for political independence during the years of glasnost and perestroika. Formal independence was secured in August 1991 after the failure of the coup in Moscow and the Baltic republics had been formally recognised not only by a significant number of Western states but also by Russia and other new states in the new federation. There is a proposal for a new constitution that will be approved in a referendum after which there will be the first free election, probably during 1992.

Tallinn – the capital of Estonia – is the closest foreign capital to Stockholm, scarcely 500 kilometres away. However, since the end of World War II, the iron curtain in this area was very difficult to penetrate. It had a top priority in the Soviet air defense and was (and perhaps still is) an important base and operations area for the *Baltiskij Flot*. The history of the country is mainly a story of occupations and suppression by foreigners. The local population speaking Estonian – a Finno-Ugric language – have been the underdogs for centuries. It is also a history of foreign domination with a base in the few cities and the manor houses of the feudal estates: a succession proceeding in historical order from the Hanseatic league, the German Order, Denmark, Sweden (1564–1710), Russia (1710–1918), and finally the Soviet Union 1940–91 interrupted by a German occupation during World War II. The history of national independence is limited to a short spell of twenty years in the inter-war period.

Because of its limited size – 1.7 million inhabitants of which 60 per cent are of Estonian nationality and 35 per cent of Russian nationality – and its closeness to Scandinavia and its relative openness, Estonia is a good subject for studies of the transition from a command economy of the Soviet type to a mixed economy more similar to the economies of Western and Central Europe.

Its political independence from the new federation centred around Russia might also give some hope for a quicker transition than for some other former Soviet republics.

In this paper, I will take a journey through the Estonian economic landscape. The Baedeker I will use is a book containing the most important articles of Ronald Coase (1988). My choice is in honour of the pioneer in modern analysis of property rights, transaction costs and economic institutions. I could have used any of the modern textbooks or monographs on neo-institutional economics (Eggertsen, 1990; North, 1990; Ricketts, 1987; Williamson, 1985). In a way my travel guide is also the reverse of a Baedeker when it is used for a trip to an economy still dominated by the old Soviet system: many of the most important institutions that we experience in the market economies have not yet developed and the black holes that we may see in the command economy are a sign of some types of politically enforced restrictions (i.e. a kind of property rights exerted by government and the *nomenklatura*) or high transaction costs in the system. However, the main idea of the paper is that modern transaction cost theory and property rights analysis are very powerful tools in explaining and analysing the command economies and the problems that they encounter in the transition phase.

Underdevelopment and the lack of market institutions

After getting used to the general impression of sovietification and russification, the economic traveller will see an enormous number of structures in the economy that can only be explained by government property rights (or just ill-defined property rights), by extremely high transaction costs and institutional black holes. Economic journeys of this type will teach us not only about the command economies but also about many features of the market economy of which we are often not fully conscious.

One conspicuous difference between Stockholm and Tallinn is of course the general standard of living. Estonia had a standard of living before World War II that was a little bit bigger than the standard of living in Finland. Nevertheless, the country had

a lower standard than Sweden at that time. Today Finland and Sweden are roughly on the same level while Estonia is at a level comparable to South-East Asian countries like Malaysia or the Philippines but with some important differences. Most important is probably the lack of all the market institution that even in an underdeveloped Asian or African economy creates some smoothness in the workings of the economy. The oriental bazaar is not only a charming market place but it will also do all the things that socialist planners, do-gooders or just corrupt bureaucrats can never manage.

It is generally difficult to judge the standard of living in a socialist economy for many reasons. The constant shortage of consumer goods and the queues both outside and inside the shops mean that the consumers spend a considerable part of their non-working time chasing even the simplest kind of goods. Although the formal prices – at least up to a year ago – were very low, the total price of roubles plus time is in a way in an equilibrium. The time constraint might even in many cases be more important than the monetary budget constraint. In addition to the budget constraint and the time constraint there is an extra constraint for some goods rationed through a coupon system. Measuring the queues outside the main supermarket in Tallinn in the autumn of 1991, it seemed to take an hour to perform simple everyday purchases – bread, some margarine, a piece of sub-standard beef or pork, a small sausage and a box of canned fish.

There is always some type of lottery involved with queues waiting for the next delivery to the department store without even knowing what the delivery to the shop may consist of. However it does not really matter if the delivery consists of products that the waiting consumers cannot use immediately for their own consumption. The products may still be valuable as a store of value – in an economy expecting hyperinflation – or as a part of a future barter trade with other consumers. Most families have also adapted themselves to queue behavior. It is usual for each family member to take his or her queuing week. Some families have rationalised further and use grandparents as queue specialists. Although shops are generally empty, it may pay off for the Estonian consumer to stroll through

the shopping area looking out for some random deliveries. In the streets, you will often see potential consumers with empty plastic bags searching through the empty shops hoping for some random delivery or discovery; perhaps the staff in the shop might decide to take out some parts of the stock for immediate selling.

A second problem is the poor quality of the goods. There is no difficulty in explaining why the products are of such low quality: it is a part of the system failure and I will return to that question later. However, the problem is how this quality counts in the standard of living. The actual number of television sets and refrigerators is a bad indicator of the standard of living if the machine breaks down often and there are no spare parts and very few repair shops – and of course no efficient factory warranty giving free repair during the first year.

A third aspect that has become more serious during recent years is the almost complete technical shortage of some commodities due to the breakdown of the planning system. Matches, for example, were almost impossible to acquire for months. Distribution of beer was almost completely stopped due to a shortage of bottles that might have been the result of some other technical shortage. If these commodities are complementary products, the value of other products that are possible to acquire might drop substantially.

A fourth aspect that will be treated at some length concerns the lack of variety and diversity in the supply of goods.

What we actually observe are high transaction costs. The smooth matching of consumers and producers that we are accustomed to in the market economies does not work. A market place like the shop is no longer a place where you can guarantee the supply. The producers are generally not interested in finding the customers and the consumers assume enormous pains in their search for commodities including all the primitive barter trade that takes place between consumers. Cheap and subsidised transport is part of this business and probably a large part of all private transport involves journeys to exploit barter opportunities and search for commodities that are more or less randomly distributed over the area.

The corruption, the nepotism and the bribes involved not only in this part of the system but which are characteristic for the whole

economy would be a possible theme for a separate paper. If you look in the ordinary shops that occasionally sell meat, you will never see the fillets or the *entrecôtes*. But Estonian or Russian animals are shaped like all other animals. The explanation is that the best parts disappear in complicated processes – special privileges for the *nomenklatura*, thefts and bribes – before they reach the ordinary consumer. The corruption of the system may also have detrimental long-term effects on the transition to a market economy. It is not only legislation regarding property, contract and tort that is lacking, but also all the norms of a market economy that are necessary to prevent or limit opportunistic behavior.

All the tacit institutions of the market economy like brand names, trade marks, repeated behavior to create trust and reliable seller-buyer relationships will take time to establish, especially in an environment in which opportunistic behavior and market behavior (market economy) for many persons are synonyms. This is a tragic legacy of the command economy in which market transactions by middlemen outside the command system were criminalised and severely punished. There is thus a mental association between the concept of a market economy on one side, and criminal behavior, black market operations, trading with foreign currency, prostitution and petty criminals ostentatiously drinking Russian champagne, wearing foreign clothes and driving German cars on the other side. Market-like operations have also been limited to the fringes of the economy often close to sectors where some part of the trade can be carried out in foreign currency (without reporting the proceeds to Gosbank). To re-establish the respectability and the moral norms of the market economy will probably take a very long time.

Did God create all the goods?

In the thirties we had the long debate between market socialists like Lange and Lerner, and liberal economists – liberal in the classic sense – like von Mises and von Hayek, about the possibility

(or rather the impossibility) of market socialism relying on government ownership and on equilibrium prices set by a benevolent and omniscient price control bureau. Most economists will now agree that the liberals won the battle. The arguments against market socialism were mainly based on the problems and the cost of processing information centrally and the advantages of decentralised information and knowledge connected with the proper decision rights. But what was perhaps very little discussed in that context was the poor quality of goods and the low diversity and variety especially of consumer goods in the socialist system. This might have been a minor problem in certain basic industries like the electricity generating industry (a kWh produced in a socialist economy is of course equal to a free market kWh regardless of possible interruptions in the supply) but it is a major problem in the consumer goods industries. The number of different commodities in a large department store or even in a supermarket in the Western economies is measured in tens or hundreds of thousands. A blue shirt of size 16 is a different commodity from a blue and white striped shirt of size 15 even if both are made of cotton and produced in the same factory.

In the command economies, as in any bureaucratic and administrative structure, there is a strong tendency to limit the number of versions and to standardise. It is then easier to achieve return to scale production and the administrative burden of sending out orders is diminished. The system is much easier to control and consumer complaints can easily be disregarded. There is also almost no threat of competition and the definition of a commodity is determined in an administrative process.

A good example may be the production and distribution of compact discs (CDs). Very few persons have CD-players and if they have acquired one it is probably from abroad. (The locally produced players are very few and probably of inferior quality.) Why should the prevailing LP-technology really have a competitor? In the two major record stores in Tallinn you can generally choose between four to six different discs of classical music: they are the production and the deliveries of the week. To build up a CD collection is not

only expensive in terms of direct expenditure – the price for a CD is about 3–5 per cent of a monthly salary – but still more in the time and search efforts that have to be spent. There is no competition in the production and no marketing efforts. One can only guess about the true incentives in the Soviet state company, *Melodija*, for selecting the music, the orchestra etc. Are there incentives outside the planning system of a highly personal type inviting nepotism and corruption? Who allocated the CDs to Tallinn instead of to St Petersburg or Moscow? A limited variety of recordings with each recording produced in large quantities will at least minimise efforts in the production unit and provide the appearance of high productivity and scale production.

In most formal models in economics, the number and the character of commodities are given exogenously. This is true for almost all the standard textbooks at undergraduate and graduate level. The only exception is the compulsory chapter on monopolistic and imperfect competition. Even in the West, there is a tradition in the teaching of Economics – but not in the real world firms – to take the commodities as given determined externally. Firms changing the character of the commodities are brought in under a headline containing the word *imperfect*. Except for attempts by Lancaster, Becker and Markowitz, there have been very few attempts to endogenise the commodities. Lancaster tried to define commodities as bundles of basic characteristics, while Becker regarded commodities as an input in the household production function. Markowitz showed that all financial instruments could be described by their expected return and variance of return and constructed a simple algebra for the formation of security portfolios. But outside these attempts economic theory has left the creation of different commodities as a phenomenon outside the market mechanisms.

It is a paradox that the possibilities and the potentials for a market economy to produce new commodities and varieties are treated very superficially in the textbooks. The difference between market economies and command economies when it comes to the supply of a rich variety of commodities is probably one of the most

impressive arguments in favor of the market system but is seldom exploited in modern theory.

The enterprise

A striking feature of the command economy is the limited number of firms and at the same time, the large size of each firm. Perhaps even the word firm is inappropriate because the main idea was to treat the whole country as one hierarchical production unit with production orders and deliveries administered by the central planning unit and the ministries. It is also obvious that the pioneers of the command economy had both the military organisation and the big firms in the USA – e.g. Ford or General Motors – as ideals.

In the modern economic theory of organisation inspired by Coase and followers like Oliver Williamson, the basic question is: markets or hierarchies? A small reformulation would be: should transactions take place between firms (based on voluntary agreements and contracts according to usual commercial law) or should they take place inside a vertical (or lateral) integrated firm? The solution of the problem emerges from traditional neoclassical marginal analysis but incorporates different types of transaction costs. If the sum of production costs and the costs of transacting through the market, i.e. making contracts with other firms, is larger than the corresponding costs inside an administrative hierarchy, there is an indication for integrating the operations inside the firm.

The limits of the firm and thus also the size of the firm will be determined by the transaction costs (and of course also by the production costs determined by the possibilities of returns to scale). Questions of this type are in a sense not relevant or important for the firm in the command economy as the typical voluntary transaction between firms is ruled out – disregarding black market operations or barter agreements in situations of critical shortages. All important deliveries of raw material are determined centrally and production is finally sent to other firms or distribution units according to centrally-determined 'plans'.

It is important to observe that these plans were never the results of some type of sophisticated mathematical planning performed by a super-brain. I think the best way to describe the planning procedure is to draw an analogy with the budget process in the public sector in the West: bargaining and negotiations – sometimes with exorbitant transaction costs, sometimes with large inefficiencies – are probably the most important ingredients in the allocation process.

The lack of a market environment is met by integration of different activities that are far away from the core production of the firm. Repair shops, construction units and transport units are usually integrated in the firm. The firm normally has its own catering facilities. It might also provide the employees with housing and different leisure activities. An important feature in many firms today is the food shop connected with the firm. In many cases this shop is supplied from nearby *kolchoses* which deliver food on a barter arrangement whereby some of the products of the firm go to the *kolchos*.

Barter arrangements of this type do of course involve enormous transaction costs but the value of having a food shop is obvious: the staff spend more time in the factory instead of cutting down working hours to get food after standing in the long queues outside the food shops. Time is more valuable than the roubles which are close to waste paper. A factory food shop will at least keep the workers in the vicinity of the factory.

The factory is in a way modelled on a military hierarchical blueprint. Even in the Western economies, military units and training establishments are run outside the market economy with production orders and physical deliveries of intermediate products and raw materials. In general the colonel of the regiment is not allowed to buy ammunition or rifles in the market but has to accept the commands and deliveries from superiors and the ordnance administration. I think if we want to understand the basis of the Soviet type of firm we have to look at similar organisations in our own neighbourhood.

I will take the large textile factory Krenholm in Narva on the

Estonian-Russian border as an example. The factory was founded in the late 19th century and was already in tsarist Russia an important producer of cotton cloth. What is striking to a Western visitor is the sheer size of the enterprise which has about 8,000 employees. This is partly due to a combination of low productivity and probably wide-ranging rent-seeking behavior. Wages for an unskilled female textile worker may be twice the salary of a female physician or fairly close to the basic salary for a university professor. But the integration into the firm of non-core activities is also important.

The low quality of the products is also striking. However, this may be quite deliberate and a part of the optimising behavior in full accordance with the incentives. As there are no external private owners and the management can regard the production orders and raw material deliveries mostly as exogenous restrictions, the easy way of describing the incentive structure is to rely on the economic theory of bureaucracy as it has been developed by Niskanen and other public choice economists. Combination of size maximisation (employment maximisation) or effort minimisation (with given production orders) are good candidates for the preference function of the enterprise.

The production target of the firm has been formulated in metres of cotton cloth. There are two main widths: 90 cm or 150 cm. The latter width now predominates in Western economies as it provides greater flexibility for the next step in the production: the manufacturing of clothes, curtains, bed sheets etc. In the Krenholm factory, the 90 cm machine predominates as it facilitates the fulfilment of the plan. The cloth is also stretched and thin but this is compensated for by the addition of starch, which at least gives it a more attractive appearance before the first wash.

The enterprise is also dominated by production engineers. The feed-back from consumers is very low as most of the production is just sent to final distribution according to centrally-determined 'plans' or orders. As the products are in short supply in the retail stage and the consumer prices are far below the equilibrium prices for the given supply, everything that is produced can also be sold. There is no need to use a trademark or market the Krenholm name.

Design and marketing departments inside the firm are almost nonexistent and there are a lot of internal complaints from more market-oriented engineers about the difficulties of introducing new designs and patterns.

The accounting system is from our point of view very primitive. It is at present impossible to construct a balance sheet and a profit and loss account for the Krenholm firm. But we must also ask the question why this is not possible – perhaps not even desirable. In a system based on quantitative production orders and physical deliveries, the firm needs other types of control instruments, mainly forms for checking all the quantities. The aggregation of the result in monetary terms is pointless when prices have very little meaning. It should be remembered that accounting in the Western economies is based on the equity capital of the firm, i.e. the aim of the accounting is to estimate the wealth of the firm to the shareholders. The principal-agency problem that modern accounting partly solves in the capitalist firms has to be solved by quantitative controls in the socialist firm.

The currency problem and the collapse of the rouble

At a seminar in September 1991 at Timbro – a market-oriented think-tank in Sweden – arranged with Gorbachev's two main economic advisors, academicians Shatalin and Petrakov, I asked them the following question: in the West, we have been very interested to know who has got the finger on the button to the nuclear missiles. But for economists a question of equal importance may be: whose finger is pressing the button on the printing process for bank notes at Gosbank, the Soviet national bank? Their reply was that they had some vague idea about the answer to the first question about the responsibility for the nuclear weapons, but they didn't really have an adequate answer to the second question about who is in charge of printing rouble bank notes.

However the answer may be that the rouble printing presses and

the nuclear missiles are run by the same power structure. During 1990 and 1991, the Soviet Union was in great difficulties in collecting the taxes from the republics and had to resort to the printing presses. The result was an ever increasing inflation rate – probably somewhere between 60–100 per cent during 1990. From May 1991 to May 1992 there are indications of a hyperinflation of more than 1,000 per cent price increases. The problems of measuring inflation rates become more complicated because at the same time there is an ongoing process of increasing administered prices or income cases liberating prices in order to decrease excess demand. After the coup, tax administration has been taken over by the republics. In the Estonian case, this means that all expenditures that were earlier financed from Moscow have now been taken over by the republic. The big exceptions are military expenditures, costs for still operating units of KGB and the pensions to former military and KGB staff.

As far as is known there is no agreement on how to finance the Soviet military forces through contributions from the republics and a good guess is that printing new roubles is a main source for financing the Red Army and its closest friends. The present budget deficit seems to be somewhere around 25 per cent of GDP in the former USSR. As the banking system is underdeveloped and there are virtually no financial markets and traditional financial instruments such as bonds, the deficit will mainly be financed by printing new rouble notes. The credibility of the monetary system received an extra blow in February 1991 when all higher denominations were declared non-valid and only a limited number of old banknotes could be exchanged for new ones.

Interest rates on savings accounts were around 3 per cent at the end of 1991 and it is difficult to explain why people still keep these accounts as they run a higher risk of direct confiscation of accounts than of banknotes.

Withdrawals from bank accounts were limited to around 1,000 roubles a month, i.e. slightly more than one month's salary for a well-qualified person. Three per cent seems to be a very low premium for the lack of liquidity and the political risks connected with the saving accounts.

The effects of the increasing inflation and the expected monetary collapse are dramatic. Everybody tries to get out of roubles and buy foreign currency, capital goods or consumer durables. This can be seen mainly through the price structure. Salaries at the end of 1991 were generally between 500 and 1,000 roubles a month. The price of an owner-occupied house in the suburbs of Tallinn was then about one million roubles, i.e. equal to the total of salaries for 100 years. Of course the only buyers are those who have made their incomes in the black market sector or have had incomes from abroad. Prices for secondhand cars were equally high – perhaps around 100,000 roubles. In most cases these transactions were conducted in foreign currency. In Estonia this often means Finnish marks, in the Soviet Union, US dollars or German marks.

The changes that have occurred in the exchange rates between the rouble and foreign currencies are also an indication of the problem of the monetary system. The official rate was for a long time 10 Swedish crowns to a rouble. (One US dollar is equal to six Swedish crowns.) This exchange rate has been used for recalculating Soviet GDP in official comparisons. A couple of years ago an official commercial rate was introduced with three Swedish crowns to the rouble. But this was above the black market rate that was one Swedish crown for a rouble. In 1990 this black rate was made official as a tourist rate. When currency auctions started in 1990 the exchange dropped further and in October 1991, the exchange rate was six roubles for a Swedish crown. Since then a further drop in the exchange rate has occurred and in December 1991 there have been auctions with exchange rates of more than 12 roubles for a Swedish crown.

This exchange rate, however, undervalues the rouble from a purchasing power parity (PPP) point of view. One should of course be careful when talking about purchasing power parity in relation to a system partly in chaos but we wish nevertheless to make some rough comparisons. My personal and partly intuitive feeling is that a purchasing power parity could be established around one Swedish crown equal to one Soviet rouble, or six roubles to the US dollar in 1991. This would have meant a monthly salary for a

university professor of about 150 US dollars a month and a wage rate in industry perhaps around 50 cents an hour but not a full dollar. Observations from Poland and Czechoslovakia with floating exchange rates and almost convertible currencies would give similar indications of PPP-wages in the former command economies.

These figures seem at first glance to be very low but should then immediately be compared to the prevailing exchange rate as it is determined at currency auctions and in the black market. This exchange rate is of course highly influenced by the attempted flights out of roubles. At these exchange rates prevailing in 1991, the monthly salary of the professor would be around 30 US dollars and the hourly wage rate less than a dime. Of course, you could ask yourself the rethorical question how much you are willing to pay a professor who all his life has been lecturing economics students on Marxist-Leninism or how to fill in the forms from Gosplan and was not allowed to speak about supply and demand and market pricing until a few years ago and certainly knows very little about modern economic theory.

The constant shortage of goods is thus the result of an escape from the increasingly valueless rouble into durable commodities, the inadequate price structure and real shortages created by the break-down of the production system. A more anecdotal piece of evidence is to see what happened to the billions of cigarettes that Phillip Morris delivered almost as a gift in 1990 and 1991. Very few Soviet citizens would smoke these cigarettes as they have become a store of value that could even be smuggled to Finland and sold at a profit.

The failure of the monetary system increases the already exorbitant transaction costs in the Soviet economy. But it is also a basis for widespread corruption especially in the cases when people can make arbitrage between the regulated market and the free market.

Property rights

If an economist takes a walk through an old city and a brick falls down on the pavement in front of him, his immediate reaction might differ substantially from what we expect from a scientist or an engineer. They will probably talk about the strength of materials and try to explain the incident in statistical terms, perhaps even putting forward claims for increased government intervention with regard to safety regulations and control. The true economist would probably exclaim: I am obviously walking in an area under rent control. The economist will try to explain reality in terms of property rights, prices and regulations.

Except for consumer durables and a very limited number of owner occupied dwellings, there has been no private property. All enterprises – with the exception of recently formed cooperatives or joint ventures with foreign firms – are owned by the government. The lack of private property rights, including the transferability of rights, is of course one main explanation of the deterioration that is so characteristic of both urban and rural areas. The tenant has almost no incentive to repair and maintain his house or flat. But it is not only the low rent that does not even cover expenditure on heating and maintenance that is the main problem. A tenant could carry out some improvements at his own expense. But the problem is that he can never get back the value of the improvements. He has a protected right of tenure but he can never transfer this right in a legal way.

Ownership of the firms has until recently been divided between Moscow and Tallinn. Although Estonia has attained formal political independence, there are still disputes to settle. Some of the firms belonging to the union and not the local republic have been controlled by the Department of Defense and their position is thus still unclear. The present state seems to be that firms are still controlled politically in the same way as public service or public utilities are controlled in the West but that the control has been transferred from Moscow to Tallinn. As has already been discussed, these firms should theoretically be treated as government

bureaucracies that have a monopoly position and in which the employees and management have same property rights or privileges that cannot be transferred.

A special problem with property rights in Estonia concerns the major environment problems from e.g. the shale-fired electricity-generating stations. The question whether the polluter shall pay or the polluted shall bribe the polluter is in a sense meaningless in a situation where property rights in this context are undefined and where compensation or tort procedures are almost unknown. It is also of some interest to observe that internalisation with one owner has not solved the problem.

The transition problem

Can an economy like that in Estonia be transformed into a market economy? It is obviously not sufficient for the parliament to declare that the country should have private property rights and a market economy. In this final section, I will discuss some of the priorities.

The most important problem is to get out of the chaos created by the collapse of the rouble. An independent, national currency or a switch to a foreign currency, Finnish marks or US dollars are the main options which I had the opportunity to discuss at a recent seminar in Tallinn. The main proposal from the government and the Bank of Estonia is to create a national but not convertible currency (Estonian crown) by exchanging rouble assets for crowns up to a certain limit at a fixed exchange rate between roubles and the new crown. The authorities refer to the introduction of the D-Mark in the former DDR and will use that as a model.

However, the problem is of course much more complicated. The new crown lacks all the attractive features of the D-Mark. There is no Bundesbank. In addition – is it really possible to exchange only a small part of all the roubles floating around in what used to be the Soviet Union? Are there any guarantees that a new democratic government will not use the printing presses to finance popular expenditures and thus continue to create inflation. The most realistic

alternative seems to be to create a *currency board* with foreign aid providing a guarantee for the convertibility. The new currency would then have a fixed exchange rate in relation to some basket of European currencies. The rouble assets will not be involved and will not be exchanged officially but each individual is of course free to buy foreign currency in the black market or go to St Petersburg and try to buy consumer durables for his roubles. Here a small country has a possibility to get out of a declining currency that is not open to the currency area as a whole.

A *currency reform* and the introduction of a *convertible* currency can be regarded as a prerequisite for all other reforms. One important effect of a convertible currency is that large parts of corruption and rent-seeking connected with the rouble and the currency regulations will disappear immediately.

Personally I am very skeptical about the possibilities for large-scale *privatisation*. The large firms are at best organised as military units or public utilities. It is also typical for the economy that politicians have a very vague idea about what we see as natural borderlines between public activities and market activities. There is now a tendency that the management will buy out some of the firms. However, as the financial markets are rudimentary, it is not easy to finance MBOs and there is a major risk that the present management will buy out without competitors. Management looting the firms seems to be a possible course of events in many of the transition economies. It is also difficult to get foreign firms as buyers as long as the currency is not convertible.

A prediction would rather be that with freer markets – which require some important infrastructural legislation – the establishment of new domestic firms mainly in the service sectors will be the first step towards the market economy. In the command economy the service sectors were not only underdeveloped, there was also a prejudice against many of these activities as being unproductive. The break-down of the centralised command coordination leaves the economy in a sort of vacuum. In a market economy there are a lot of middlemen in the retail and in the wholesale sectors who perform some of the most important functions of the invisible hand.

Private lorry owners in the market combined with other middlemen will even out shortages – and hopefully make some money out of these arbitrage operations. The lack of middlemen and service industry has thus reinforced the shortages in the present situation. But free entry and establishment in these sectors could not only make the invisible hand visible and functioning but will also absorb a considerable part of the unemployment that will occur when the large production firms are rationalised.

Another step may be the establishment of foreign firms which will use the low wage level for subcontracting operations. In a final step we will see more privatisation of the existing and over-manned firms. Even here, however, it may be necessary as a first step to break up the firms and allow for limited MBOs of the non-core activities. Only subsequently will it be possible to privatize or sell the remaining big firms to foreign investors.

It is also obvious that the future of the companies depends on the switch from the relative price system of the Soviet Union to world market prices. Today it is virtually impossible to judge whether a firm is viable or not in a price system based on world market prices. However, the introduction of world market prices is closely connected with the implementation of a currency reform.

Post scriptum

This paper was written in early 1992. Many changes have occurred during the last year. Price reforms took place and some of the queues disappeared. The first democratic election has taken place and Estonia carried through a currency reform in June 1992 with an Estonian currency with a fixed exchange rate in relation to the German mark (8 Estonian crowns equal to 1 D-Mark). The currency is almost convertible for commercial purposes and inflation is down to perhaps 10 per cent a month. The exchange rate actually meant an undervalued Estonian currency but production is still decreasing and disorganisation is taking place in the industrial sector. However, Estonia and to some extent, Latvia have become

centres for trade – partly illegal or involving violations of customs rules etc. between Russia and the West. The present picture is one of some improvements in living standards for groups in the growing commercial sector and an access to most domestic and foreign consumer commodities in the shops but without most of the subsidies. The black market has ceased to exist for consumer goods. Ethnical problems between the Estonian and Russian sectors of the population are becoming increasingly more serious. I have preferred not to include these changes in my paper but will let it stand as an eyewitness report from an early phase of the transition.

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Data and observations from Estonia are based on personal communications and the above references.

