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Hayekian Welfare States: Explaining the Co-Existence of Economic Freedom and Big Government

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Abstract

The idea that all types of economic freedom – including limited government – promote prosperity is challenged by the fact that some countries successfully combine a large public sector with high taxes and otherwise high levels of economic freedom. To explain the co-existence of economic freedom and big government, this paper distinguishes between big government in the fiscal sense of requiring high taxes, and in the Hayekian sense of requiring knowledge that is difficult to acquire by a central authority. The indicators of government size included in measures of economic freedom capture the fiscal size but ignore the Hayekian knowledge problem. Thinking about government size in both the fiscal and Hayekian dimensions suggests the possibility of Hayekian welfare states, where trust and state capacity facilitate experimentation and learning, resulting in a public sector that is big in a fiscal sense but not necessarily more vulnerable to the Hayekian knowledge problem. Pensions in Sweden are used as a case to illustrate the empirical relevance of the argument. The new pension system represents big government in a fiscal sense, but by relying on decentralized choice it requires relatively little central knowledge.

JEL-codes: H11, B25
Keywords: Welfare state, Hayek, Economic freedom, Economic reforms, State capacity

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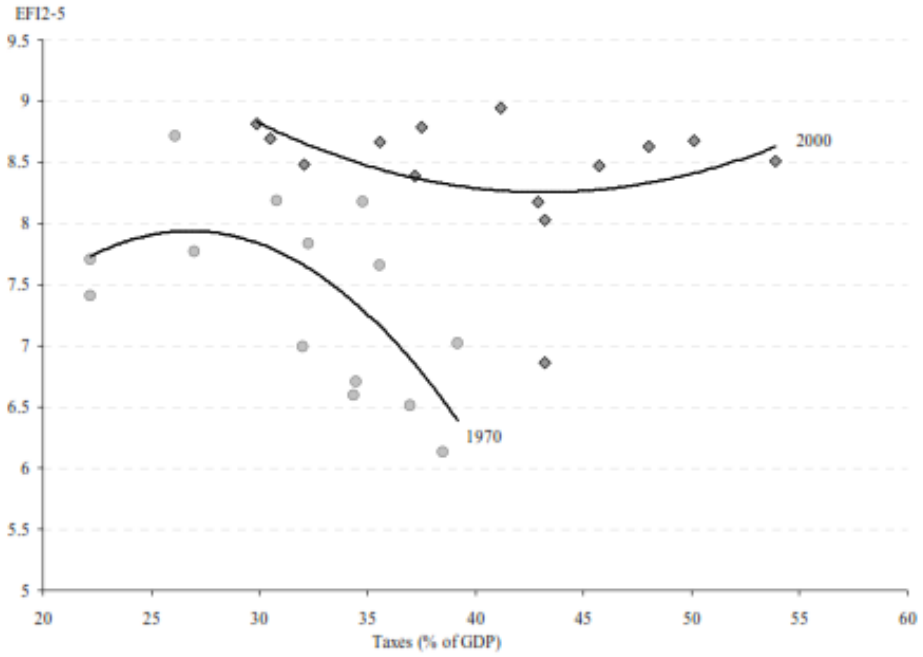
1 Introduction

The fact that some countries combine a large public sector and high taxes with high levels of economic freedom is increasingly being recognized and discussed (Bergh, 2006; Bergh & Erlingsson, 2009; Horpedahl, 2013; Huskinson & Lawson, 2014; Ott, 2018). In OECD countries, this pattern is the result of a process occurring in the 1980s and 1990s, when several countries with large public sectors implemented reforms that increased the level of economic freedom without substantially shrinking the size of the welfare state. This development is conveniently illustrated using the Economic Freedom Index (Gwartney, Lawson, & Hall, 2015), which quantifies economic freedom in five areas.[1] The first area of the index captures freedom from intrusive government, while the average of areas 2–5 can be interpreted as capturing the economic freedom of institutions (area 2) and policies (areas 3–5). Figure 1 illustrates how the economic freedom of institutions and policies was correlated with a standard measure of government size (i.e., total tax revenue as a percent of GDP) for OECD countries in 1970 and 2000. In 1970, countries with higher taxes also had lower degrees of economic freedom of institutions and policies, on average. In 2000, that negative correlation had ceased to exist and, if anything, the pattern had become U-shaped.

[1] The index is discussed in detail in section 2.

Figure 1. Economic freedom (average across dimensions 2–5) and tax revenue relative to GDP in OECD countries.



In many social and economic respects, the countries that combine large public sectors with otherwise high levels of economic freedom perform just as well as, or better than, countries with uniformly high levels of economic freedom. Table 1 compares the freest OECD countries (measured using aggregate economic freedom) with the OECD countries having the most intrusive government sectors (measured by the first dimension of the index). If big government is a major obstacle to prosperity, the latter group of countries should be doing much worse – but they are not.

Table 1. Economic freedom and social outcomes in selected OECD countries, 2015.

Most free (overall index)	A	B	C	D	E	F	G
New Zealand	8.2	5.6	8.9	36,200	0.91	4.52	31.4
Switzerland	8.2	7.7	8.3	58,600	0.93	3.67	29.8
Ireland	8.1	5.6	8.7	55,500	0.92	3.7	28.4
Canada	8.0	6.1	8.5	45,600	0.91	4.65	31.1
Australia	8.0	6.7	8.3	65,400	0.94	4.37	33.3
United Kingdom	8.0	6.1	8.5	41,200	0.91	4.38	35.5
Average	*8.1*	*6.3*	*8.5*	*50,417*	*0.92*	*4.22*	*31.6*
Least free (government size)							
Sweden	7.4	3.4	8.4	47,900	0.91	2.6	25.9
Netherlands	7.7	3.7	8.7	49,200	0.92	3.6	26.5
Denmark	7.6	3.8	8.6	45,700	0.92	4.05	26.1
Belgium	7.4	3.9	8.3	43,600	0.89	3.4	25.1
France	7.2	4.1	8.0	41,200	0.88	3.28	30.5
Finland	7.6	4.4	8.4	41,100	0.88	2.52	25.7
Average	*7.5*	*3.9*	*8.4*	*44,783*	*0.90*	*3.24*	*26.6*

A. Aggregate economic freedom, B. Freedom from big government (area 1), C. Economic freedom of policies and institutions (average for areas 2–5), D. GDP per capita (in PPP dollars), E. Human development index (HDI), F. Infant mortality, G. Gini (net income).[2]

The freest countries and the countries with the largest public sectors are strikingly similar when it comes to the economic freedom of institutions and policies (the average for areas 2–5 of the Economic Freedom Index is 8.5 for the former and 8.4 for the latter group). The countries with big government have slightly lower GDPs per capita, but they score almost as high on the Human Development Index and have lower infant mortality and income inequality.

The patterns just described suggest two questions: First, if big government is harmful for economic and social outcomes, why aren't the countries with the most intrusive governments doing worse than they are? Second, if some countries have found

[2] Sources: Gwartney et al. (2015) (A–C); CIA fact book (D and F), United Nations Development Programme (E), and Standardized World Income Inequality Database 4.1, Solt (2008) (G).

the key to combining prosperity and equality, why aren't more countries copying the strategy of Sweden et al.?

This paper introduces the concept of Hayekian welfare states and argues that it can help to answer both these questions. This concept can also in general help explain the successful co-existence of economic freedom and big government. The term "Hayekian" alludes both to the tendency to evolve through trial and error and to the tendency to have a public sector that is large in a fiscal sense without being highly vulnerable to the Hayekian knowledge problem, as described by Hayek (1945). In a nutshell, a Hayekian welfare state is an ideal type with three characteristics:

- a high state capacity that enables it to implement far-reaching policies,
- an ability to learn from experience and experimentation and alter policies accordingly, and
- a tendency to combine rule of law with a public sector that is large in a fiscal sense without being vulnerable to the Hayekian knowledge problem.

The term "state capacity" above is used as defined by Skocpol (1990) to denote the ability of states to achieve official goals, especially over the opposition of powerful social groups or in the face of difficult economic circumstances. Because the Hayekian welfare state is an ideal type, no single country conforms completely to these criteria. For example, when central decision making is present, the Hayekian knowledge problem cannot be completely avoided, but can be more or less severe.

The paper continues as follows. Section 2 discusses the dimensionality of economic freedom and its relationship to prosperity, concluding that rule of law is the component of economic freedom most strongly associated with prosperity, whereas the fiscal size of government is not. Section 3 describes the Hayekian knowledge problem and introduces a distinction between big government in a fiscal sense and in the sense of requiring considerable central knowledge. Section 4 presents the Hayekian welfare state in

theoretical terms and illustrates the empirical relevance of the concept using pensions in Sweden as an illustrative case. Section 5 concludes with a brief discussion of the potential for other countries to copy the example of the Scandinavian welfare states.

2 The dimensionality of economic freedom and its relationship to prosperity

Does economic freedom necessarily imply limited government? The answer depends on how economic freedom is defined. Research on economic freedom often relies on the Economic Freedom of the World Index published yearly by the Fraser Institute.[3] Because the index has five areas, most scholars who use it implicitly assume that economic freedom is a combination of the following five dimensions:

1. The Size of Government (EFI1) area measures government size using indicators such as public consumption and transfers relative to GDP, top marginal tax rates, and state-owned enterprises.
2. The Legal Structure and Security of Property Rights (EFI2) area quantifies the quality and integrity of the legal system and the protection of property rights, and can be thought of as an attempt to quantify rule of law.
3. The Access to Sound Money (EFI3) area captures the effect of high and unpredictable changes in inflation and money supply.
4. The Freedom to Trade Internationally (EFI4) area combines measures of trade taxes, tariff rates, trade barriers, and capital market controls to create a composite measure of freedom to trade.
5. Finally, the Regulation of Credit, Labor, and Business (EFI5) area quantifies the regulation of credit markets, labor markets, and business in general.

[3] For overviews of the economic and social consequences of institutions and policies characterized by economic freedom, see Hall and Lawson (2014) and Berggren (2003).

The dimensionality of economic freedom is not settled simply because the Fraser Institute currently produces a five-dimensional index.[4] One salient possibility is that the five dimensions are proxies for the same latent variable, in which case the economic freedom concept is unidimensional. A simple correlation matrix (shown in Table 2 for the years 1980 and 2000) is sufficient to illustrate that there are indeed strong positive correlations between all dimensions of economic freedom – except for the first dimension, which captures freedom from large, intrusive government. In other words, countries with low levels of market regulation are also likely to be countries with high freedom to trade internationally, low and stable inflation, and a legal system with high integrity that protects private property rights. They are not, however, necessarily countries with limited government.

Table 2. Pairwise cross-country correlations in economic freedom.

a. 1980

	GovSize	Legal	Money	Trade	Regulation
GovSize	1				
Legal	–0.87	1			
Money	0.135	0.270	1		
Trade	0.055	0.711	0.316	1	
Regulation	0.345	0.500	0.230	0.539	1

b. 2000

	GovSize	Legal	Money	Trade	Regulation
GovSize	1				
Legal	–0.419	1			
Money	–0.051	0.550	1		
Trade	–0.182	0.607	0.662	1	
Regulation	0.044	0.574	0.532	0.603	1

[4] In fact, the first two reports (EFW 1975-95 and EFW 1997) had four dimensions, and the next three (EFW 1998/99, EFW 2000, and EFW 2001) had seven. The current five-dimensional structure was established with the 2002 edition (I thank Bob Lawson for this information)

The existence of successful countries with large public sectors and otherwise high levels of economic freedom challenges the view that all types of economic freedom foster prosperity. If proponents of that view maintain that limited government is an important part of economic freedom, the relative success of countries with big government weakens the empirical link between economic freedom and prosperity. An alternative view would be that economic freedom entails certain institutions and policies, but not necessarily a small public sector. In that case, the link between economic freedom and prosperity remains strong, but it would also imply that economic freedom does not necessarily entail limited government.

A small but important strand of the literature has examined the dimensionality of economic freedom and the link between economic freedom and prosperity in more detail using statistical techniques for data segmentation. Starting from the fundamental question "What is freedom?" Leschke (2000) uses factor analysis to conclude that there are two conceptually different types of economic freedom: one describing the appropriateness of the framework in which the market operates, and another describing the degree of political intervention in the market process.[5] Both measures are found to be strongly associated with various measures of prosperity (e.g., GDP per capita, growth, and the Human Development Index). Interestingly, the size of government dimension in the Fraser index is not singled out by the factor analysis and is thus not used in either of Leschke's dimensions.[6]

In a similar analysis, Rode and Coll (2012) used cluster analysis to rearrange the Economic Freedom Index into seven clusters to examine what policies matter the most for growth (measured as growth of GDP per capita over the 1992–2007 period). The

[5] While neither of these dimensions has a strikingly high correlation with aggregate economic freedom, a simple linear combination can explain 93 percent of aggregate economic freedom.

[6] Leschke (2000) concludes that it does not suffice for governments to refrain from intervening in the market process, but that it is "even more important that governments design an adequate institutional framework for the market (regulation by general rules and principles)" (p. 277). Such a framework would include "a stable inflation rate, the rule of law, legal security of ownership rights, viability of contracts, and guarantee of political liberties" (p. 277).

authors found that a cluster including legal quality and limited business regulations is the only one significantly linked to growth in regressions using levels of economic freedom. In a first-difference analysis, increases in government size and labor market regulations (that end up in the same cluster) were, however, associated with lower growth. These findings fit well with the empirical literature on government size and growth, surveyed by Bergh and Henrekson (2011), in which the association between government size and growth is typically found to be negative when estimated for rich countries using variation in government size and growth within countries over time (i.e., using panel data with country fixed effects).[7]

The data-driven statistical approaches of Leschke (2000) and Rode and Coll (2012) differ regarding the appropriate dimensionality of economic freedom, but they both single out legal quality as the aspect of economic freedom that is the most important for prosperity. Similar results were presented by Berggren and Jordahl (2005), who studied the sub-dimensions of the Economic Freedom Index, and are found in the literature on institutions as fundamental causes of growth (Acemoglu, Johnson, & Robinson, 2005; Rodrik, Subramanian, & Trebbi, 2004).

Leschke (2000) and Rode and Coll (2012) also agreed that government size is not strongly related to prosperity. The role of government size in an index of economic freedom is also questioned by Ott (2018), who argued that the measurement of economic freedom is improved by excluding the size of government dimension and demonstrated that doing so results in stronger correlations between economic freedom and alternative types of freedom as well as between economic freedom and happiness.

In summary, the literature suggests that legal quality is the type of economic freedom that is the most robustly associated with growth. In contrast, the results regarding government size are mixed and more difficult to interpret: Increases in

[7] As discussed by Bergh and Henrekson (2011), the pattern in these studies also fits well with standard neo-classical growth models in which government size does not affect long-run growth rates, but changes in taxes and government spending do affect growth during the transition from one steady state to another.

government size seem to be detrimental to growth, but several countries combine large public sectors with high levels of prosperity. As noted by several authors, the content and structure of the public sector is at least as important as is its size in a fiscal sense. Along these lines, the next section introduces a distinction between two different types of big government.

3 Two types of big government

How surprising is the finding that having a large public sector is not necessarily a major obstacle to prosperity? The degree of surprise depends on one's priors. There are different reasons to expect a large public sector to be harmful for economic development. Reasons based on neo-classical economic theory typically start by noting that taxes and transfers cause distortions and weaken the incentives for work and innovation. In contrast, Hayekian reasons related to the knowledge problem described by Hayek (1945) are less frequently cited, but when they do apply they are persuasive.

In standard neo-classical economics, it is easy to show how a large public sector can harm the economy because of distortions and disincentive effects. The same theories and models, however, also provide several efficiency-based justifications for government interventions to correct market failure (e.g., Barr, 1992, 1998). As a result, neo-classical theory suggests that different types of public spending may have different effects on growth. Devarajan, Swaroop, and Zou (1993) distinguished between productive and unproductive public spending to separate spending that complements private sector productivity from spending that does not. If governments implement policy recommendations from neo-classical economics by adequately correcting market failure, emphasizing productive public spending, and refraining from highly distorting interventions and unproductive spending, a bigger public sector may well boost growth (cf. Lindert, 2004).

That last statement, however, rests on a crucial "if." From a public choice perspective, political failures imply that trying to correct market failures and aiming to implement optimal policies are risky endeavors and may do more harm than good. In public choice theory, countries with bigger public sectors are expected to suffer more from political corruption, rent seeking, and regulatory capture (Mueller, 2003; Myrdal, 1960; Stigler, 1971; Tullock, 1967). Even in cases of undeniable market failure, political failure might well worsen conditions.

While the concept of market failure and the distinction between productive and unproductive spending have become widely used, they both ignore the amount of knowledge needed for government intervention to succeed. By shifting attention to the knowledge requirement, it becomes clear that the Hayekian knowledge problem provides reasons to expect problems when policy makers intervene in the economy. These reasons differ fundamentally from those based on neo-classical economic theory.

Hayek (1945) famously described the information necessary for governments to succeed in interventions and planning as existing "solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess" (p. 519). Even in the unlikely scenario that the government is fully informed at one point in time, that information will become dated when something relevant changes. When the government has only incomplete information about the preferences and circumstances of the actors in society, the probability that centrally planned interventions will do more harm than good must be acknowledged. In a complex world, actions often have unexpected consequences. As a worst-case scenario, Hayek (1944) depicted government planning as a "road to serfdom," making society less livable, more brutal, and more despotic.[8] Was he wrong?

An important difference between the neo-classical and the Hayekian warnings against big government is that the neo-classical theory offers detailed instructions on how to

[8] On the impact of Hayek's book (and for a critique), see Komlos (2017).

design policies, whereas the Hayekian argument suggests that centrally planned policies not informed by central knowledge are (more or less) doomed to fail. As was shown in section 1, it is undeniable that at least some countries have, for at least some time, avoided Hayek's "road to serfdom." To understand how that is possible, a distinction between the two types of government size is useful.

Government programs differ in the amount of knowledge needed and the amount of public funds needed. Programs that require a lot of knowledge are not necessarily programs that require a lot of public funds, and vice versa. Table 1 illustrates the typology.[9]

Table 1. A typology of government spending programs

	Knowledge needed		
Level of public funds needed		Relatively little	A lot
	Low	Type A. *Example: Income-tested welfare*	Type B. *Example: Seed capital and encouragement of entrepreneurs*
	High	Type C. *Example: Automatic stabilizers*	Type D. *Example: Discretionary Keynesian stabilization policies*

Program types A and B both require relatively limited public funds, but differ in how much knowledge the government needs for successful implementation; for example, an income-tested welfare program requires relatively little public funds and relatively little central knowledge. In contrast, programs of type B are relatively cheap in a fiscal sense, but the knowledge problem makes them difficult to implement successfully; examples of such programs include public seed capital, encouragement of entrepreneurs, and similar activities that require the government to pick winners.[10] Program types C

[9] The distinction was first introduced by Bergh (2016).

[10] See, for example, Gustafsson, Stephan, Hallman, and Karlsson (2016), who documented a lack of long-term positive performance effects of innovation subsidies.

and D both require a lot of public funds but differ in their knowledge requirements. Type-D programs require not only large amounts of public funds, but also knowledge that any central planner is precluded from ever possessing, because it is complex, dispersed, and rapidly changing; a discretionary Keynesian stabilization policy is a good example of such a program.

A central key to understanding why some countries have public sectors that do very little harm to (or even promote) their economic development is the existence of type-C programs. These require large amounts of public funds and, while the knowledge problem is challenging, it is not insurmountable for a country with enough state capacity. While discretionary Keynesian stabilization policies are difficult because they basically require decision makers to distinguish short-term GDP fluctuations from business cycles, social insurance schemes that react to fluctuations in a predictable and stabilizing manner function as automatic stabilizers (Darby & Melitz, 2008) and require much less knowledge to work as intended.

One implication of the above distinction is that a government with only limited public funds could still do a lot of harm to the economy by engaging in highly distortionary and unproductive activities and spending. Another implication is that big government (in a fiscal sense) is not doomed to fail. Simply put, the effect of government size on economic development depends not only on the amount of public funds needed, but also on the amount of knowledge needed.

The next section uses the case of Sweden and a special focus on pensions to illustrate certain Hayekian aspects of the Swedish welfare state: The recent reforms of the pension system exemplify the ability to learn from experimentation and devise a system that is big in a fiscal sense with relatively low central knowledge requirements.

4 The Hayekian welfare state: Examples from Sweden

As noted in section 3, the Hayekian welfare state is an ideal type that combines high state capacity, experimentation, rule of law, and a welfare state that is large in a fiscal sense without being vulnerable to the Hayekian knowledge problem. In practice, most countries possess these characteristics to varying degrees. In fact, Hayek (1976, pp. 124–125) noted that the process of learning by trial and error "must involve a constant disappointment of some expectations" (see further Lewis, 2016). Successful experimental learning entails making some mistakes, and no welfare state will ever be perfect by any criteria. Even if policies at one point in time are deemed adequate by some criteria, changing circumstances such as technological or demographic changes will create a need for welfare states to adapt. A common policy mistake in welfare states is to be unable to adapt to such changing circumstances.

Adapting the welfare state to new demographic or technological circumstances is no simple task. Countries differ in the extent to which they can learn from experience and adjust policies accordingly. Successful adaptation requires identifying changing circumstances, deciding what to do, and implementing those decisions. In this process, Hayekian welfare states will move towards policies that require less central knowledge. Such policies are less likely to fail and more likely to survive changing circumstances. In practice, such policies might entail avoiding detailed regulations in favor of setting up frameworks and deciding on benefit principles rather than specific nominal benefit levels.

The history of Sweden and the Swedish welfare state contains several examples that illustrate the idea of the Hayekian welfare state. A good starting point is to observe that for a period extending from roughly 1970 to 1995, economic policy and social policy in Sweden were often considered to have failed (see Bergh, 2014, for an attempt to summarize the consensus on what went wrong). However, making policy mistakes

can in many ways be an important learning experience, and the period has in fact been described by Lindbeck (1997) as "The Swedish Experiment." During this period, Sweden suffered from failed macroeconomic policies that included far-reaching attempts at Keynesian management of household demand in trying to smooth out economic fluctuations and at the subsidization of non-competitive industries. Policy in other areas was also very ambitious and demanding in its knowledge requirements. Through a combination of high marginal taxes and generous social transfers, the ambition was to reduce inequality in disposable income – already low by international standards – even further.[11] Towards the end of the problematic period, several gloomy predictions were made regarding the future of the Swedish model. In October 1993, *The Economist* published an article on Sweden headlined "Worse and worse," describing a country with increasing public debt, a budget deficit of 13 percent of GDP, and a currency falling rapidly after a grand failure to defend the fixed exchange rate. Free-market think tanks at this time used Sweden as a discouraging example (e.g., Stein, 1991). What followed was instead a remarkable revival of the Swedish welfare state that combined some degree of welfare state retrenchment with substantial increases in the economic freedom of institutions and policies, as documented by Bergh and Erlingsson (2009) and Bergh (2014).

One Hayekian aspect of the Swedish experience is that the problematic period was an important source of learning that paved the way for the reforms that helped Sweden get back on track. For stabilization policies, that learning process has been well documented by Jonung (1999). The case of pensions in Sweden is another interesting case from a Hayekian perspective.

[11] In addition to Lindbeck (1997), see also Henrekson (1996).

4.1 Pensions in Sweden

Often described as the first public pension system in the world, the Swedish pension system was introduced in 1913. The system was a funded one with benefits linked to contributions, complemented by a small means-tested benefit (see Lindbeck & Persson, 2003, on how pension systems can be classified into unfunded vs. fully funded, defined benefit vs. defined contribution, and actuarial vs. non-actuarial). With the introduction of the basic pension, decided on in 1946, the defined contribution feature was replaced by a defined benefit, non-funded so-called pay-as-you-go (PAYG) system. In such a system, future pensioners are promised certain benefit levels, and the primary policy instrument available to policy makers is the tax rate on current workers. Succeeding with such a system requires knowledge of the pension levels preferred by the population, changing circumstances, and feasible pension levels as determined by future demographics, productivity, and employment.

Even under the unlikely assumption that such knowledge is available to policy makers, there are no guarantees that preferred pension levels will remain feasible. In fact, a large theoretical political economy literature predicts that pensions will expand beyond optimal size in democracies (Browning, 1975; Casamatta, Cremer, & Pestieau, 2000; Sjoblom, 1985). In a nutshell, overexpansion occurs because policy makers who introduce PAYG pensions will benefit current voters by shifting costs to future generations that cannot vote when the decision is made. These models typically also assume that the resulting equilibrium is stable, and that contractionary reform will be politically difficult or even impossible.[12] For that reason, the decision of the Swedish Parliament in 1994 to introduce a new pension system that took Sweden back to a defined contribution system, and introduced a funded part to complement the PAYG part, was a remarkable one. After almost a century of expanding pensions in Sweden,

[12] The political economy perspective on pensions is also seen to be empirically valid; see Breyer and Craig (1997).

five political parties (at the time representing roughly 85 percent of the voters) agreed on a new system designed to halt and perhaps even reverse the increase in public pension expenditure.

As it turned out, Selen and Stahlberg (2007) demonstrated that the Swedish pension reform was compatible with the above-mentioned political economy results because of the 16-year phase-in period of the new system. By comparing the net effects of the new and old systems, they found that the contributions of the working generation (age <53) were reduced by more than their expected benefits, and as a result the median voter would favor the reform.

Identifying the need for pension reform and agreeing on a new system sufficiently early to allow for a 16-year phase-in period, however, was not a trivial task even in a well-functioning democracy. As demonstrated by Bergh and Erlingsson (2009), commissions were initiated in 1984 to propose adjustments of the existing system. In 1990 these commissions concluded that fundamental reform was needed. A new commission was initiated to propose a new system, which was presented in 1994.

In several respects, the new system is closer to the Hayekian welfare state ideal than was the old one. The new system does not have one fixed retirement age, but instead allows people to choose freely when to retire after the age of 61. The degree of retirement can be 25, 50, 75, or 100 percent, and pensions are adjusted in a budget-neutral manner based on remaining life expectancy. Compared with systems having a fixed retirement age, a system having a flexible retirement age and actuarial adjustment of pension level requires less central knowledge to work. In fact, as individuals made retirement decisions based on their own preferences and financial circumstances, the new system generated new knowledge. It turned out that some preferred to retire before the age of 65, and others preferred to retire later. Perhaps more surprisingly, a public commission (Ds 2011:42) concluded that people in general do not prefer to retire at one single time (the way the old system had assumed), but

instead prefer to combine work and retirement in varying proportions, which is allowed in the new system.

The new system results in pensions that are relatively low, with typical replacement rates of around 50 percent of the final working wage. As a result, most people top up their pension with private saving to reach their desired level of income smoothing over the lifecycle. The combination of a relatively low benefit in the mandatory system and optional topping up minimizes the risk of central decisions forcing people to over-save, thus making use of the decentralized knowledge that each person has regarding his or her preferences and economic circumstances.

5. Conclusion: How Sweden avoided the "road to serfdom"

The countries in the bottom half of Table 1, which successfully combine large public sectors with high levels of economic freedom and prosperity, suggest that Hayek's "road to serfdom" is not necessarily a consequence of big government as indicated by fiscal statistics regarding taxes and public spending. The success of the Nordic countries became particularly obvious after the financial turmoil in the wake of the 2008 global financial crisis, and since then the question has been asked several times: How does a country become more like Sweden, Denmark, or Finland?[13]

A first step towards answering that question is to remind oneself of the bumpy road these countries have taken to get to where they are today. There are many descriptions of, for example, Sweden's economic history, but few convey the unplanned, evolutionary nature of that path.

The present analysis suggests that even though there are some good explanations of how Sweden and the other Nordic countries became successful, it is nevertheless

[13] Norway is typically not mentioned, probably because its success is attributed to its oil reserves. Discovering highly valuable natural resources is, however, no certain path to prosperity. In fact, as noted by Mehlum et al. (2006), in the absence of high-quality institutions, natural resources may lead to corruption, conflicts, and even civil war.

difficult for other countries to copy them. These countries arrived at where they are through a process of trial and error, and the errors have sometimes been substantial. The ability to implement far-reaching policies, learn from experience, and adjust policies according to this experience requires very high levels of state capacity. Is it possible for all countries to achieve the state capacity needed to behave like a Hayekian welfare state? That remains an open question. It should be noted, however, that high levels of state capacity are probably difficult to achieve without high levels of social trust in the population. In the words of Newton, Stolle, and Zmerli (2017, p. 2), "social trust between citizens improves cooperative relations, reduces social conflict, and facilitates compromise," and a large literature (much of it summarized by Newton et al., 2017) links social trust to various desirable social and economic outcomes. For example, social trust has been linked to some types of reform capacity (Berggren, Daunfeldt, & Hellström, 2016) and also to welfare state size (Bergh & Bjørnskov, 2011). Sweden's particularly pragmatic and consensual approach to policymaking was documented early on by Anton (1969).

The lesson for other countries from the Nordics is thus not to copy the blueprint for the Swedish welfare state, for example, but rather to foster the state capacity needed for successful learning from experimentation. Trying to build a fiscally large welfare state without the fundamentals of state capacity and social trust may turn out to be a dangerous strategy. The fact that some countries succeed in combining a large public sector with high levels of economic freedom does not mean that all countries are able to do so.

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