Economic Lessons from SCANDINAVIA

Graeme Leach

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ABOUT THE AUTHOR

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Economic Lessons from

SCANDINAVIA

Graeme Leach
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The Scandinavian economies have performed strongly over the past 15 years, leading many to believe that the Nordic Model defies economic theory – which suggests that bigger government means lower growth and/or a lower level of income.

This report shows that one of the primary reasons for the recent strong performance of the Scandinavian economies has been a retreat of government – in terms of public spending, taxation and product market regulation.

Over the 15 years prior to the 2008 Great Recession public spending fell by more than 20 percentage points of GDP in Sweden. The smallest fall in the share of public spending in GDP was in Denmark, where it still managed to fall by 10 percentage points. These are stunning figures.

The reductions in public spending suggest the private sector was being crowded-in, thereby raising productivity and output growth. The reduction in the size of the state in Sweden may have added one to two percentage points to the long-term potential growth rate. The comparable figures for the other Scandinavian economies are 0.9 to 1.8 in Finland, 0.7 to 1.4 in Norway and 0.5 to 0.9 percentage points in Denmark.

The fiscal performance of the four leading Scandinavian economies, both prior to and during the Great Recession, has been outstanding. The headline budget deficits for all four economies peaked below three percent of GDP – compared with 11 percent of GDP in the US and the UK. The underlying budget balance – adjusting for the economic cycle – remained in surplus in three of the Scandinavian economies and was only slightly negative in Norway. The comparable US and UK deficits were nearly nine percent of GDP. Much of this success can be attributed to pro-market reforms, such as the introduction of fiscal rules, following the early 1990s Scandinavian economic crisis.
The Scandinavian economies still record the highest tax burdens in the OECD, as a proportion of GDP. However, the introduction of lower actual tax rates – the marginal rate – over recent decades has surely boosted the supply-side of these economies.

Despite the strong case for recent economic success having been built on pro-market foundations, aspects of the Nordic Model remain elusive and difficult to categorise as one model or another – Anglo-Saxon or EU.

In many areas, such as economic freedom and openness, the Scandinavian economies operate more like small state economies.

The Nordic Model is not uniform. Denmark, for example, has a far more liberalised labour market than in the other three economies.
SECTION 1

INTRODUCTION
INTRODUCTION

Those arguing for a smaller state in the Anglo-Saxon and continental EU economies, in order to achieve faster growth, invariably face the charge that the Scandinavian economies show big government is not an impediment to success. This is a charge many find difficult to refute. The Nordic Model has become the intellectual battleground over which the big versus small state war might be played out in the 21st century.

The Nordic Model has seemingly perplexed free market economists with its ability to achieve world-class competitiveness rankings and high per capita incomes, while at the same time operating very high tax and public spending levels as a proportion of GDP.

The four leading Nordic Model economies, Norway, Sweden, Finland and Denmark, consistently perform strongly in global competitiveness rankings. Table 1.1 shows the latest rankings on the 2010-11 World Economic Forum (WEF) – Global Competitiveness Index, where three of the Scandinavian economies appear in the top 10.

In the 2010 Legatum Prosperity Index, Norway, Denmark and Finland ranked first, second and third, with Sweden close behind in sixth place. The Scandinavian economies are clearly ‘doing something right’ by consistently earning front of the grid position.

A consistent picture emerges from the competitiveness analysis in Table 1.1. Key strength areas across the Scandinavian economies are institutions (property rights, trust, efficiency, ethical standards, transparency), innovation (capacity for innovation, quality of research, corporate R&D spending, university-industry collaboration, availability of scientists and engineers), technological readiness (availability of the latest technologies, firm-level technology absorption, breadth and depth of Internet use), financial market development (ease of access to funding, venture capital, competitive regulation) and business sophistication (nature of competitive advantage, state of cluster development, value chain breadth, production process sophistication, extent of marketing).

According to the WEF index on goods market efficiency, the only Nordic economy with a top 10 ranking in this area is Sweden. However, this headline result hides a deeper truth, which is examined in Section 3, namely the sub-indices components related to economic freedom – across all the Scandinavian economies.

1 Norway’s per capita income level is boosted by the impact of large oil production in a small economy.
There are common Nordic Model problem areas as well, shown in Table 1.1, with tax rates and tax regulation the most cited factors. Restrictive labour market regulation was also cited for all but the Danish economy.

Standard economic theory predicts that a high tax burden will retard economic growth and hinder the development of a dynamic economy, by undermining the incentive to work, save and invest.

Another element of the negative effect of government size on the economy could occur if public sector employees have lower productivity than private sector employees, and public sector employment comprises a significant share of the workforce in Scandinavia. General government employment, as a percentage of the labour force, is double the OECD average (15 percent) in the Scandinavian economies (around 30 percent).

Does the Nordic Model disprove economic theory and evidence from elsewhere around the globe? Or is there a much simpler explanation that these economies could have performed even better with a smaller state?

Chart 1.1 – GDP per capita, US$, current prices, current PPP
This paper attempts to answer the question as to whether or not the Scandinavian economies make the case for big or small government.

Over the past decade and in the wake of the Great Recession, the Nordic Model has come under increasing focus as a result of its favourable growth performance. At the 2011 World Economic Forum (WEF) in Davos, Scandinavian business and political leaders came together to promote a new report, *The Nordic Way – Shared Norms for the New Reality* that claimed to explain their competitive edge (WEF 2011).

According to *The Nordic Way*, the Scandinavian economies have been able to combine a successful formula of radical individualism, social trust and a tightly knit welfare safety net, without undermining competitiveness. Reports such as this have added to the Nordic lustre that the Scandinavian economies are somehow unique and are not replicated anywhere else.

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>2010-11</th>
<th>2009-10</th>
<th>2008-09</th>
<th>KEY STRENGTHS</th>
<th>PROBLEM AREAS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finland</td>
<td>7</td>
<td>6</td>
<td>6</td>
<td>Institutions, Higher education &amp; training (rank 1), Financial market development, Innovation, Business sophistication.</td>
<td>Tax rates, Restrictive labour regulation, Tax regulation.</td>
</tr>
<tr>
<td></td>
<td>Overall ranking out of 139 countries</td>
<td>Overall ranking out of 133 countries</td>
<td>Overall ranking out of 134 countries</td>
<td>Top 10 ranking in this area.</td>
<td>15 percent plus of respondents cited this factor as a problem.</td>
</tr>
</tbody>
</table>

THERE ARE SEVERAL QUESTIONS TO BE DISCUSSED:

- Just how successful is the Nordic Model? What have the Scandinavians got right?

- Is the Nordic Model an idiosyncratic case? Is it merely the result of special circumstances in small countries, related to social trust, which are not transmutable to larger economies?

- Is the secret of the Nordic Model an ability to combine high tax and public spending with high levels of economic freedom and openness?

- Do the Scandinavian economies manage to combine productive versus unproductive public spending and distortionary versus non-distortionary tax burden in a particularly efficient manner?

- Do we know the relevant counterfactual to the Nordic Model? The Nordic economies are clearly successful, but would they have been even more successful with a smaller state?

- Can the recent success of the Nordic Model – since the mid 1990s – be attributed to pro-market reforms? Has economic performance accelerated over recent decades because of a shift towards the Anglo-Saxon model?

Section 2 examines the issue of how successful the Scandinavian economies are. Section 3 discusses the scale and nature of government intervention. Section 4 analyses the scale and impact of market-oriented reforms over the past 20 years. The appendix sets out the theoretical and empirical evidence – from around the world – as to whether or not big government is good or bad for growth.

Note: Macroeconomic data relating to GDP growth and public finances are generally shown for the period up to 2007, i.e. before the onset of the Great Recession.
BOX 1.1 WHAT IS THE NORDIC MODEL?

THE TRADITIONAL VIEW – STATIST UTOPIA

The Nordic Model refers to certain structural characteristics shared by the Norwegian, Swedish, Finnish and Danish economies. It does not mean these economies are uniformly the same. One obvious factor is that not all of the economies are in the EU and/or the euro area. Finland is in the EU and the euro area. Sweden is in the EU but not the euro area – with a freely floating currency. Denmark is in the EU but not the euro area – but with a pegged currency. Norway is in neither.

The traditional perception of the Nordic Model has been its association with very high levels of spending and taxation, a large welfare state and an egalitarian approach towards the distribution of income. In many ways the Nordic Model was seen as the original Third Way between capitalism and socialism.

THE NEW VIEW – STATIST INDIVIDUALISM

The traditional view was always somewhat crude and became even less applicable in the 1990s. The weak performance of the Scandinavian economies in the 1980s, and subsequent economic crises in the 1990s, led to significant economic reforms. The new view is that the Nordic Model is characterised by a large state, but relatively little product market regulation and strong adherence to open markets and free trade. In the Danish version of the model, moderate employment protection legislation – making it relatively easy to hire and fire – is combined with a generous welfare safety net, often referred to as ‘flexicurity.’ However, in other Nordic economies such as Sweden, overall employment protection for permanent workers is high, but the labour market is more flexible for temporary workers. It is also suggested that the particularly high levels of social trust, displayed in the Nordic economies, helps economic growth by reducing transaction costs.
SECTION 2

NORDIC MACROECONOMIC PERFORMANCE
NORDIC MACROECONOMIC PERFORMANCE

Chart 2.1 shows the GDP growth performance of the Scandinavian economies from 1986-96 versus the 1997-2007 period – prior to the Great Recession. It shows there is no uniform Nordic Model pattern to GDP growth. GDP growth performance has differed significantly across Denmark, Norway, Sweden and Finland. Over the past decade Finnish growth was almost twice that of Denmark. Icelandic growth – not shown here – was even stronger.

ACCELERATING GROWTH – THE DEMAND-SIDE

However, all the economies (with the slight exception of Norway) display acceleration in GDP growth comparing 1997-2007 with the 1986-1996 period. Iceland, Finland and Sweden in particular show strong growth over 1997-2007, placing them ahead of the euro area and OECD average. In the earlier period, the Scandinavian economies, with the exception of Norway, had lagged well behind the euro area and OECD average growth rate.

2 The period immediately before the financial crisis is chosen because of the different speeds with which the OECD, euro area and Scandinavian economies slipped into recession and subsequently recovered. The period ending 2007 therefore provides a more reliable time frame over which to assess long-term trends.
The ultimate aim of all economic activity is consumption. Economic wellbeing is a function of the highest sustainable rate of private consumption growth. Chart 2.2 shows a very strong improvement in private consumption growth over 1997-2007 compared with the 1986-1996 period. Comparing the two periods, the rate of private consumption growth tripled in Sweden, more than doubled in Finland and Norway, and doubled in Denmark.

Chart 2.2 – Consumption growth performance

Over the most recent period Sweden, Norway and Finland considerably outperformed the euro area and matched or exceeded the OECD average. Over the previous period all the Scandinavian economies had lagged well behind both the euro area and the OECD.

The absolute and relative performance, of the Scandinavian economies, has improved significantly over the past two decades.
ACCELERATING GROWTH – THE SUPPLY-SIDE

In terms of gauging economic success it is the long-term economic potential which matters – the supply-side. This is because GDP and consumption growth in the short-term could theoretically be driven by unsustainable – demand-side – influences such as a rising debt burden.

If we examine the supply-side potential – using OECD estimates of potential GDP growth – of the Scandinavian economies we find that only in Denmark has potential GDP growth declined in the latest period. Chart 2.3 shows that potential growth increased from two to 2.8 percent in Sweden, 2.5 to 3.2 percent in Norway and two to 3.1 percent in Finland. In contrast, potential GDP growth fell across the OECD and the euro area.

Chart 2.3 Potential GDP growth rate – the supply-side

It would seem that, whether on the demand or supply-side, the Scandinavian economies (with the exception of Denmark) performed strongly in the decade preceding the financial crisis.

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THE GREAT RECESSION – DEBT AND DEFICIT

The Nordic Model’s fiscal performance through the Great Recession and subsequent recovery has been astonishing – when compared to the OECD and euro area.

Table 2.1 shows OECD statistics for the general government financial balance over the 2008-2010 period. Across the OECD, budget deficits rose to an average 8.2 percent of GDP in 2009, with the USA and the UK recording peak budget deficits of 11.3 and 10.8 percent of GDP, respectively.

In stark contrast Sweden recorded a peak budget deficit of just 0.9 percent of GDP and Finland and Denmark both reached their highest deficits at around 2.9 percent of GDP.4

Analysis of the underlying budget balance, adjusting for the economic cycle and other one-offs, shows that across the Nordic economies fiscal policy was kept tight through the recession. While the underlying budget deficit rose to 6.4 percent of GDP across the OECD, the Nordic story was very different. In Sweden the underlying balance showed a surplus, which increased to 2.6 percent of GDP. In Finland and Denmark the underlying balances fell as a proportion of GDP, but remained in surplus (See: Table 2.2).

The fiscal conservatism of the Nordic Model is further illustrated by IMF projections for general government debt.5 In Sweden gross public debt is projected to decline from 37 percent of GDP in 2011 to just 22.8 percent of GDP in 2016. The comparable G7 figures are 114.9 percent and 122.5 percent respectively.

Table 2.1 Government Financial Balance – % of GDP

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Norway</td>
<td>19.1</td>
<td>10.5</td>
<td>10.5</td>
</tr>
<tr>
<td>Sweden</td>
<td>2.2</td>
<td>-0.9</td>
<td>-0.3</td>
</tr>
<tr>
<td>Denmark</td>
<td>3.3</td>
<td>-2.8</td>
<td>-2.9</td>
</tr>
<tr>
<td>Finland</td>
<td>4.2</td>
<td>-2.9</td>
<td>-2.8</td>
</tr>
<tr>
<td>UK</td>
<td>-4.8</td>
<td>-10.8</td>
<td>-10.3</td>
</tr>
<tr>
<td>USA</td>
<td>-6.3</td>
<td>-11.3</td>
<td>-10.6</td>
</tr>
<tr>
<td>Euro-area</td>
<td>-2.1</td>
<td>-6.3</td>
<td>-6.0</td>
</tr>
<tr>
<td>OECD</td>
<td>-3.3</td>
<td>-8.2</td>
<td>-7.7</td>
</tr>
</tbody>
</table>

Negative sign = deficit.
Source: Data from OECD, “Annex Table 27” in Economic Outlook (OECD, 2011).

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4 Norway continued to run an enormous oil related surplus, with the smallest surplus being 10.5 per cent of GDP.
### Table 2.2 Government Underlying Balance – % of GDP

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Norway</td>
<td>2.4</td>
<td>-0.4</td>
<td>-0.6</td>
</tr>
<tr>
<td>Sweden</td>
<td>1.9</td>
<td>2.6</td>
<td>1.9</td>
</tr>
<tr>
<td>Denmark</td>
<td>2.9</td>
<td>0.0</td>
<td>0.8</td>
</tr>
<tr>
<td>Finland</td>
<td>3.4</td>
<td>0.8</td>
<td>0.5</td>
</tr>
<tr>
<td>UK</td>
<td>-5.2</td>
<td>-8.4</td>
<td>-8.3</td>
</tr>
<tr>
<td>USA</td>
<td>-5.9</td>
<td>-8.7</td>
<td>-8.6</td>
</tr>
<tr>
<td>Euro-area</td>
<td>-2.2</td>
<td>-4.2</td>
<td>-3.5</td>
</tr>
<tr>
<td>OECD</td>
<td>-3.8</td>
<td>-6.4</td>
<td>-6.1</td>
</tr>
</tbody>
</table>

The underlying balance is adjusted for the economic cycle and the impact of recession/recovery on public finances. Negative sign = deficit.

Source: Data from OECD, “Annex Table 29” in Economic Outlook (OECD, 2011).

Following the early 1990s economic crisis in the Scandinavian economies there has been a clear shift in fiscal policy, with new fiscal rules and determined efforts to balance the budget. These market-oriented reforms have paid rich dividends during the Great Recession.
SECTION 3

HOW ‘BIG’ IS THE ROLE OF GOVERNMENT?
HOW ‘BIG’ IS THE ROLE OF GOVERNMENT?

TAX AND SPEND
Charts 3.1 and 3.2 show the size of the state in the Scandinavian economies. High levels of public spending have to be paid for, and in 2007 total tax (and non-tax) receipts reached 59 percent of GDP in Norway, 56 percent in Denmark, 55 percent in Sweden and 52 percent in Finland. These numbers compare with an OECD average of 38.5 percent and a euro area figure of 45.3 percent.

Prior to the financial crisis, public spending stood at 51 percent of GDP in Sweden and Denmark, 47 percent in Finland and a comparatively low 41 percent in Norway. These numbers compared with an OECD average of 40 percent and a euro area figure of 40 percent.

The scale of the tax burden in the Scandinavian economies does present a challenge to free market advocates. According to the OECD (2007) the only countries in the world with tax receipts (and non-tax receipts) exceeding 50 percent were the four leading Nordic economies. The situation remained the same in 2010.

6 Figure for Norway includes oil-related revenues.
Chart 3.2 shows very high average rates of taxation across the Scandinavian economies. Indeed these are the only economies in the OECD to record a tax share above 50 percent of GDP.

### Table 3.1 Global Effective Corporate Tax Rates (2006-09)

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>EFFECTIVE TAX RATE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>27.9</td>
</tr>
<tr>
<td>USA</td>
<td>27.7</td>
</tr>
<tr>
<td>Denmark</td>
<td>24.9</td>
</tr>
<tr>
<td>Finland</td>
<td>24.2</td>
</tr>
<tr>
<td>UK</td>
<td>23.6</td>
</tr>
<tr>
<td>Sweden</td>
<td>22.0</td>
</tr>
<tr>
<td>Norway</td>
<td>19.1</td>
</tr>
</tbody>
</table>

Effective rate is defined as total income taxes divided by pre-tax income.
Source: Data from PricewaterhouseCoopers, Global Effective Tax Rates (PwC, 2011).
However, high average rates of taxation do not tell the full story, the nature of the tax system is also important. OECD statistics of the marginal corporate income tax rate (CIT) suggest the Scandinavian economies are relatively competitive on this measure. The CIT in Norway was 28 percent, in Sweden 26.3 percent, in Denmark 25 percent and in Finland 26 percent. The comparable UK figure was 26 percent also. PricewaterhouseCoopers (PwC) estimates of the effective corporate income tax rate (allowing for deductions and allowances) over the 2006-09 period also show that Nordic competitiveness in business tax (See: Table 3.1) may be greater than suggested by the WEF’s Global Competitiveness Report. Part of the reconciliation between the OECD/PwC series and the WEF identification of tax as a problem area, is employer social security contributions.

A 2007 PwC-World Bank report, Paying Taxes 2011 – The Global Picture, attempted to estimate the total tax rate on companies across the world, based on corporate income tax, labour and other taxes. The results are shown in Table 3.2. Denmark stands out because of its very low employer taxes on labour.

<table>
<thead>
<tr>
<th>Country</th>
<th>Total tax rate %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Italy</td>
<td>76</td>
</tr>
<tr>
<td>France</td>
<td>68.2</td>
</tr>
<tr>
<td>Germany</td>
<td>57.1</td>
</tr>
<tr>
<td>Sweden</td>
<td>57.0</td>
</tr>
<tr>
<td>Finland</td>
<td>47.9</td>
</tr>
<tr>
<td>Norway</td>
<td>46.1</td>
</tr>
<tr>
<td>USA</td>
<td>46.0</td>
</tr>
<tr>
<td>UK</td>
<td>35.4</td>
</tr>
<tr>
<td>Denmark</td>
<td>31.5</td>
</tr>
</tbody>
</table>

Total = corporate income tax rate + labour tax + other taxes.

TOTAL INTERVENTION

Taxation is not the only burden placed on the economy by the state. The total cost of state intervention also includes the cost of regulation on households and companies.

For example, if one economy redistributes income through transfer payments and another mandates a legal minimum wage (which is effectively a tax on employers), a simple comparison of tax and spend shares will be misleading as to the extent of state activity. Onerous regulation imposes significant financial costs, which need to be added to taxation when assessing the total cost of state intervention – what might be termed a total intervention index.

Unfortunately estimating a total intervention index is easier said than done. No comprehensive national – let alone international – measures of the comparative cost of regulation, as a proportion of GDP, exist.

However, the lack of data does not prevent inference being made as to what a Nordic total intervention index might look like. Various ‘synthetic’ cross-country measures of regulation, competition and protection exist.

These suggest that there are three areas where the overall size and impact of the state may be less damaging (See: Section 4 for the theory and empirical evidence on the impact of the state on GDP growth) to long-term growth potential, than suggested by the headline tax and spend numbers:

- Economic freedom – openness, competition and markets
- Employment protection legislation
- Public sector competition

The various synthetic measures suggest that the relative competitive disadvantage of the Nordic Model – shown by the tax shares in Chart 3.2 – might be less if a total intervention index was estimated.

When these influences are factored in, the simple story of the big government Nordic Model evolves into something more sophisticated. Government is still big, but there are significant competitive forces as well, offsetting – or at least not exacerbating – the dead hand of the state.
COMPENSATING FOR HIGH TAXES – ECONOMIC FREEDOM

There are various measures of overall economic freedom such as those from the Heritage Foundation in the US and the Fraser Institute in Canada. As a result of low fiscal freedom (high shares of taxation and public spending in GDP) the Scandinavian economies do not rank as high on freedom indices as they do on competitiveness indices – such as in the WEF’s Global Competitiveness Report. However, in the 2011 Heritage Index of Economic Freedom, Denmark, Finland and Sweden still ranked in the world top 20. Similarly, in the 2010 Economic Freedom of the World Report from the Fraser Institute, Denmark and Finland ranked in the world top 20.

In the 2011 Heritage Index of Economic Freedom, all the Scandinavian economies scored higher than the United States, Australia, New Zealand, Japan and South Korea for trade freedom. The level of trade freedom was estimated to be of the same level as in the UK.

Detailed examination of the 2010-11 WEF Global Competitiveness Report is also revealing as to the degree of economic freedom in the Scandinavian economies. As stated above, of the four economies, only Sweden had a top 10 ranking for Goods Market Efficiency (GME). However, one of the key reasons for this was the poor performance across all the Scandinavian economies for the total tax rate and the extent and effect of taxation.

Further exploration into the GME category reveals significant economic openness and competitive forces:

**Sweden**
- Ranks 1st in the world for the effectiveness of anti-monopoly policy
- Ranks 4th in the world for trade tariffs and 6th for the prevalence of trade barriers
- Ranks 4th in the world for the prevalence of foreign ownership

**Finland**
- Ranks 4th in the world for the effectiveness of anti-monopoly policy
- Ranks 4th in the world for trade tariffs and 8th for the prevalence of trade barriers

**Denmark**
- Ranks 6th in the world for the effectiveness of anti-monopoly policy
- Ranks 4th in the world for trade tariffs

**Norway**
- Ranks 11th in the world for the effectiveness of anti-monopoly policy

The influence of competitive forces can also be seen in the OECD Product Market Reform Indicator which shows that the Scandinavian economies appear to be less liberalised than the Anglo-Saxon economies, but more liberalised than much of Europe.
COMPENSATING FOR HIGH TAXES – EMPLOYMENT PROTECTION

The 2011 OECD Employment Protection Index – measuring labour market flexibility – shows that although Nordic labour markets are not as flexible as in the US or the UK, they are generally more flexible than in most European countries. The Danish labour market stands out as the most flexible of the Scandinavian group. Table 3.3 shows that all the Nordic economies, bar Norway, have less employment protection than in Germany, France, Italy and Spain. Furthermore, Denmark, Sweden and Norway have more flexible labour markets than 13 other European countries.

If we look back to the Labour Market Efficiency (LME) category within the WEF Global Competitiveness Report, while hiring and firing and other rigidities stood out as problems in Norway, Sweden and Finland, the opposite was the case in Denmark. That country ranked 1st in the world for redundancy costs, 3rd for hiring and firing practices, 8th for cooperation in labour-employer relations and 10th for the rigidity of employment.

Table 3.3 Strictness of Employment Protection

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>STRICTNESS OF EMPLOYMENT PROTECTION LEGISLATION 1990</th>
<th>STRICTNESS OF EMPLOYMENT PROTECTION LEGISLATION 2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>0.2</td>
<td>0.21</td>
</tr>
<tr>
<td>UK</td>
<td>0.6</td>
<td>0.75</td>
</tr>
<tr>
<td>Norway</td>
<td>2.9</td>
<td>2.69</td>
</tr>
<tr>
<td>Sweden</td>
<td>3.49</td>
<td>1.87</td>
</tr>
<tr>
<td>Finland</td>
<td>2.33</td>
<td>1.96</td>
</tr>
<tr>
<td>Denmark</td>
<td>2.4</td>
<td>1.5</td>
</tr>
<tr>
<td>Germany</td>
<td>3.17</td>
<td>2.12</td>
</tr>
<tr>
<td>France</td>
<td>2.98</td>
<td>3.05</td>
</tr>
<tr>
<td>Spain</td>
<td>3.82</td>
<td>2.98</td>
</tr>
<tr>
<td>Italy</td>
<td>3.57</td>
<td>1.89</td>
</tr>
</tbody>
</table>


For Norway, Sweden and Finland, the overall LME score hides competitive strengths. Exploring in greater detail the LME category reveals:

- **Sweden** – Ranks 1st in the world for reliance on professional management
- **Norway** – Ranks 2nd in the world for reliance on professional management
- **Finland** – Ranks 4th in the world for reliance on professional management

From a competitive standpoint, it would appear that the Nordic economies manage to offset labour market rigidity (outside of Denmark) with greater managerial efficiency.

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9 Norway is equal to Italy on the OECD measure.
COMPENSATING FOR HIGH TAXES – PUBLIC SECTOR COMPETITION

One particular aspect of the Nordic social welfare model is often overlooked, namely the degree of competition which is permitted in the provision of key public services such as education. The adoption of Swedish-style ‘free schools’ legislation in the UK has been made easier politically for the coalition government, because it is associated with the ‘progressive’ Nordic Model. Indeed, the implementation of the competitive schools reform in the UK is less consistent than in Sweden (following the 1992 reforms), where companies are able to earn a profit from providing education services funded by the state.

In Denmark, state-funded private schooling is also well-established and depends purely on parental choice, where funding follows the pupil regardless of the nature of the school.

There are two significant potential gains from state-funded private schools, one direct, and the other indirect, but both equally important:

- Direct – Wider school choice drives up educational standards as compared with state-funded monopoly provision (Sahlgren 2010).
- Indirect – School choice raises awareness of the benefits of competition and choice to both parents and children. This awareness has wider application across the whole of the economy and helps encourage contestable markets and competition.

THROWING COLD WATER ON TRUST? 10

Trust as an aspect of compensation is much more speculative and doubtful. The Scandinavian economies all show very high levels of social trust – they lead the world in this measure, according to international surveys such as the Gallup World Poll. It is theorised that this characteristic may offset some of the effects of big government (Bergh and Henrekson 2011).

One possibility is that trust makes universal welfare systems sustainable, because countries with higher trust levels will display fewer free-rider problems associated with extensive welfare systems. However, the ‘true’ unemployment rate, in countries such as Sweden, is much higher than realised, according to research by McKinsey (Economist 2006). This throws doubt on the argument that trust obviates free-rider issues and welfare dependence.

10 The competitiveness of the Scandinavian economies, in a related area, is strongly evidenced, as can be seen in the 2010 Economic Freedom of the World Report from the Fraser Institute where Denmark, Sweden, Norway and Finland were all in the global top five for legal and property rights.
An alternative mechanism might be that high levels of trust result in lower transaction costs, less corruption and also higher innovation rates (Bergh and Henrekson 2011, 18). In less trusting and/or more corrupt societies the economic cost of doing business, for a given level of government, might be much higher. This argument is credible but difficult to quantify.

We have already extended the definition of government size, by theorising as to the scale of total intervention measures. Trust moves beyond the total intervention measure to capture even more of the effect of government. In other words, even if countries had identical measures of tax and spend or total intervention, the impact of government could differ if the populations reacted in different ways to the actions of the state – for example if one country had a big shadow economy and the other did not.

As a result, high trust societies have the potential to reduce some of the negative consequences of a large state, and in doing so, make them more competitive in relative terms – when measured by a total intervention index plus shadow economy estimate. Of course, this is all speculative, because no accurate estimates can be made of the total intervention index plus the shadow economy.

Estimates of the shadow economy, which are available, suggest that underground activity levels are extremely high in the Scandinavian economies (Schneider 2001, 19-32). In 1999-2000 the size of the shadow economy in Sweden was estimated to be 19.2 percent (up from 15.8 percent in 1989-90), in Finland 18.1 percent (up from 13.4 percent in 1989-90), in Norway 19.1 percent (up from 14.8 percent in 1989-90) and in Denmark 18 percent (up from 10.8 percent in 1989-90).

The Nordic economies might be closer to Greece (28.7 percent in 1999-2000) and Italy (27.1 percent in 1999-2000) than they are to the US (8.7 percent in 1999-2000) and the UK (12.7 percent in 1999-2000), in terms of the size of their shadow economies. This surely casts at least some doubt on the significance of trust as the dominant source of competitive advantage in the Scandinavian economies.
SECTION 4

SHRINKING THE STATE
SHRINKING THE STATE

Section 3 provided an essentially static analysis of the size of the state in the Nordic economies in the period immediately prior to the Great Recession. In this section we take a more dynamic view of the change in public spending and taxation – as a proportion of GDP – over time. The results are impressive as they show massive falls in public spending as a proportion of GDP over the past two decades.

PRIVATE SECTOR CROWDED-IN

Chart 4.1 shows the change in public spending as a proportion of GDP, over the 15 year period, 1993-2007. The smallest fall in the public spending share as a proportion of GDP was in Denmark, where it fell by nearly 10 percentage points of GDP. In Sweden the public spending share fell by more than 20 percentage points from 71.7 to 51 percent of GDP.

To put these figures in context, the fall in public spending across the whole of the OECD over this period was less than three percentage points. The reductions in the public spending share suggest the private sector was being crowded-in, raising productivity and potential output growth.

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Chart 4.1 Public spending change 1993 – 2007 as % of GDP

The fall in the tax burden as a proportion of GDP was far less than the spending share but nonetheless it suggests an improvement in competitiveness relative to the OECD average, for Sweden, Denmark and Finland. Firm GDP growth clearly boosted tax receipts.\(^{12}\)

Even if we employ a conservative estimate (0.5 percent extra growth for each 10 percentage point change in the size of the state) of the GDP growth to public spending elasticity cited in the Appendix, then the shrink in the state in Sweden will have added at least one percentage point to the potential annual GDP growth rate (See: Table 4.1).

**Table 4.1 The Growth Dividend from the Shrinking State**  
*(Change to the Potential GDP Growth Rate – % points, 1993-2007)*

<table>
<thead>
<tr>
<th></th>
<th>CAUTIOUS 0.5 PERCENT ELASTICITY</th>
<th>OPTIMISTIC 1.0 PERCENT ELASTICITY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sweden</td>
<td>1.0</td>
<td>2.1</td>
</tr>
<tr>
<td>Norway</td>
<td>0.7</td>
<td>1.4</td>
</tr>
<tr>
<td>Finland</td>
<td>0.9</td>
<td>1.8</td>
</tr>
<tr>
<td>Denmark</td>
<td>0.5</td>
<td>0.9</td>
</tr>
</tbody>
</table>

Table 5.1 applies the public spending to GDP growth elasticities shown to the change in the share of public spending to GDP shown in Chart 5.1.  
Source: Author’s calculations.

**THE EVOLUTION OF THE TAX BURDEN**

The relatively small falls in the tax to GDP share do not undermine the thesis that a smaller tax share is good for growth.\(^{13}\) Lower marginal tax rates could improve incentives, supply-side performance and GDP growth. Stronger GDP growth then improves tax receipts generally. In other words, lower marginal rates result in higher average tax rates.

OECD evidence on the evolution of the tax burden supports this argument.\(^{14}\) There are many permutations of household structure, earnings, income tax, employee and employer contributions available from the OECD database. However, implementing significant improvement in effective marginal rates is a consistent feature of many of the Nordic economies over the past decade:

- Across the OECD for single persons without children, at 100 percent of average earnings, the tax wedge (income tax plus employee and employer contributions, less cash benefits) as a proportion of labour costs fell only slightly, from 36.7 to 35 percent over the 2000-2010 period. In Denmark the fall was much greater, from 44 to 38 percent. In Sweden the fall was greater still, from 50 to 42.7 percent.

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\(^{13}\) OECD, “Annex Table 21” in *Economic Outlook No.89* (OECD Publishing, 2011)

For the same single person and income group, but for the narrower tax burden (income tax as a proportion of gross wage earnings) the contrast of the Nordic economies with the rest of the OECD is very apparent. In Sweden the income tax burden declined by nine percent of gross earnings, from 27 to 18 percent over the 2000-2010 period. In Finland the fall was 5.2 percent of gross wage earnings. In Denmark the fall was only four percent and in Norway two percent for this income group – the same as across the OECD.

Extending the comparison to the typical Nordic two earner married couple with two children, one at 100 percent of average earnings and the other at 33 percent, income tax as a proportion of gross wage earnings fell by 10 percentage points in Sweden, from 25 to 15 percent, while in Finland it fell by six percentage points to 18 percent.

If the above category is changed slightly, with the second income at 67 percent instead of 33 percent of average earnings, the income tax burden fell by four percentage points in Denmark and more than five percentage points in Finland. Sweden again led the way with a 10 percentage point fall.

WIDER MARKET REFORMS
Table 3.3 in Section 3 highlights the improved labour market flexibility of the Scandinavian economies over the past two decades. Flexibility notably improved in Sweden and Denmark, in terms of the declining burden of employment protection legislation. More competitive ‘hire and fire’ legislation helps raise underlying potential GDP growth.

OECD estimates of the burden of product market regulation have also improved over the past decade (See: Table 4.2). The Scandinavian economies again span the bridge between the Anglo-Saxon and Rhineland Models.

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sweden</td>
<td>1.93</td>
<td>1.30</td>
</tr>
<tr>
<td>Norway</td>
<td>1.85</td>
<td>1.16</td>
</tr>
<tr>
<td>Finland</td>
<td>2.08</td>
<td>1.19</td>
</tr>
<tr>
<td>Denmark</td>
<td>1.59</td>
<td>1.06</td>
</tr>
<tr>
<td>Germany</td>
<td>2.06</td>
<td>1.33</td>
</tr>
<tr>
<td>UK</td>
<td>1.07</td>
<td>0.84</td>
</tr>
<tr>
<td>France</td>
<td>2.52</td>
<td>1.45</td>
</tr>
</tbody>
</table>

Lower number indicates less regulation.
Source: Data from OECD, “Product Market Regulation Indicator” in OECD StatExtracts Database (OECD, 2011).

The size of the state, both directly (public spending) and indirectly (labour and product market regulation) has fallen in the Scandinavian economies in recent decades. The downward shift in the public spending to GDP ratio is stunning and must have helped boost productivity and GDP growth by crowding-in the private sector.

Consequently there is a strong argument that much of the GDP improvement over the past two decades can be attributed to the withdrawal of the state. If the Scandinavian economies had maintained the size of the state at 1980s levels their growth performance over recent decades would surely have been far worse.
BACK TO THE FUTURE?

Between 1960 and 1980 public spending in Sweden doubled as a proportion of GDP. In a sense the Scandinavian economies appear to be going back to the future. Historic evidence on the size of the state in Sweden and Norway shows that their GDP growth was strongest when the state was smaller, and economic performance then faded as the state grew (Tanzi 2005). It is only with the latest shrinkage that it has been able to thrive again.

Recent reforms are even more significant when considered alongside the potential for the elasticity of GDP growth with respect to the tax share to be higher in the 21st century than in the 20th. This is obviously speculative but the tax burden of the state could become greater because of underlying changes in the structure of economic activity:

- Long-term increases in per capita income may result in more middle-income groups behaving like upper-income groups – reducing their labour supply. Labour supply elasticities are stronger for higher income groups.

- The new economy is associated with greater labour market flexibility. This provides more incentive and opportunity to adjust individual labour supply than was previously possible.

- High female labour force participation. Labour supply elasticities are stronger for female workers (Evers et al 2008).

- The need to increase labour utilisation and the number of hours worked – around half the per capita GDP gap between the US and Sweden is attributable to fewer hours worked.

- The need to boost entrepreneurship – Nordic economies such as Sweden have the lowest rates of self-employment in Europe.

- Any future shifts towards a more individualistic society may result in demands for higher post-tax disposable income in order to facilitate greater consumption. As a proportion of GDP, post-tax household consumption is much lower in the Scandinavian economies than in the rest of the OECD.\(^\text{15}\)

\(^{15}\) OECD. “Table 10.1” in National Accounts at a Glance 2010 (OECD Publishing, 2011). The divide when measured by actual individual consumption is less, but this does not remove the potential for consumption growth.
CONCLUDING REMARKS

The Nordic economies seem to flourish when they are more liberal, and go off the rails when higher taxes and more regulation are imposed. However, despite the strong case for recent economic success having being built on pro-market foundations, aspects of the Nordic Model remain elusive and difficult to categorise as one model or another.

The words of Milton Friedman seem appropriate:

“The Scandinavian countries have a very small, homogenous population. That enables them to get away with a good deal they couldn’t otherwise get away with. What works for Sweden won’t work for France or Germany or Italy. In a small state you can reach outside for many of your activities. In a homogenous culture, they are willing to pay higher taxes in order to achieve commonly held goals. But common goals are much harder to come by in larger, more heterogeneous populations. The great virtue of a free market is that it enables people who hate each other, or are from vastly different religious or ethnic backgrounds, to cooperate economically. Government intervention can’t do that. Politics exacerbates and magnifies differences.”

(Friedman 2006)
APPENDIX

GOVERNMENT SIZE & GROWTH
GOVERNMENT SIZE & GROWTH

The issue of government size and the implication for long-term growth (the supply-side or potential output of the economy) has long been a contentious area of economic research. In this Appendix we review the theory and empirical evidence on the relationship between public spending, taxation and economic growth.

THEORY

In traditional neo-classical economic exogenous growth models, taxation affects the level of long-term output but not the growth rate. However, more recent endogenous growth models show that taxation can affect not just the level of output but the long-term growth rate as well. A tax on income or investment will have a negative effect on the long run growth rate if it reduces incentives. In endogenous growth models, policies that affect the incentive to invest in either physical or human capital can have permanent and very substantial effects on the long-run rate of growth.

We can think of the impact of the size of the state on long-term economic growth as being determined by the effects of taxation and public spending on the capital stock and the supply of labour:

- The quantity of human capital – size of the labour force
- The quality of human capital – education and skills
- The quantity of physical capital – investment
- The quality of physical investment
- The efficiency with which human and physical capital are combined to produce output

The impact of the size of the state on long-term economic growth also depends on the nature of public spending and taxation, i.e. productive versus unproductive spending and distortionary versus non-distortionary taxation. Productive spending might include investment in infrastructure or education. Unproductive spending might include welfare payments. Distortionary taxes would include income taxes, whereas non-distortionary taxes would include lump sum charges.

BOX A.1 DEADWEIGHT LOSS – THE UNSEEN TAX

When examining the economic impact of taxation we do not look at the tax burden alone. We also need to examine the excess burden or deadweight cost of taxation. The deadweight cost of taxation is the loss of output, which would have occurred in the absence of the tax. It is a loss of economic welfare above and beyond the tax revenues collected. Because of deadweight costs, the taxpayer’s losses exceed the government’s gain. This means that an extra euro of public spending costs the economy more than a euro. In turn it also means that reducing taxes by a euro generates more than a euro of benefit to the economy.

In Principles of Economic Growth, Thorvaldur Gylfason (1999) has stated that:

“Domestic tax distortions, for example, the tax wedges resulting from high marginal income tax rates, entail significant efficiency losses, and thus seem bound to impede growth … the welfare gain from removing a tax distortion is proportional to the square of the original distortion, a well-known result in welfare economics.”
Table A.1 The long term growth effects of fiscal policy

<table>
<thead>
<tr>
<th>FINANCED BY:</th>
<th>PRODUCTIVE EXPENDITURE</th>
<th>UNPRODUCTIVE EXPENDITURE</th>
</tr>
</thead>
<tbody>
<tr>
<td>DISTORTIONARY TAXES</td>
<td>Positive/negative depending on low/high government share</td>
<td>Negative</td>
</tr>
<tr>
<td>NON-DISTORTIONARY TAXES</td>
<td>Positive</td>
<td>Zero</td>
</tr>
</tbody>
</table>

Table A.1 highlights the potential growth effects of fiscal policy. Unproductive public spending financed by distortionary taxation is clearly negative for growth. In contrast, productive expenditure financed by non-distortionary taxes could be positive for growth. It all depends on the balance.

Figure A.1 is a stylised illustration, showing how the positive effects of government expenditure can dominate at small sizes of government but distortionary tax effects begin to dominate if government becomes too large – diminishing returns to greater government arise.
Commenting on the potential negative consequences from the growth of the state, Bassanini and Scarpetta (2001) have written:

“The main conclusion from the literature is that there may be … a size effect of government intervention … at a low level the productive effects of public spending are likely to exceed the social costs of raising funds. However, government expenditure and the required taxes may reach levels where the negative effects on efficiency and hence growth starts dominating. These negative effects may be more evident where the financing relies heavily on more distortionary taxes (e.g. direct taxes) and where public expenditure focuses on unproductive activities.”

**BOX A.2 ECONOMETRIC MODELLING – STILL FRAUGHT WITH DIFFICULTY?**

- The simultaneity of fiscal variables and growth.
- A negative correlation between government size and GDP growth does not necessarily imply causality – reverse causality might apply where social transfers act as automatic stabilisers.
- Economic impacts may be obscured if tax data is aggregated – e.g. distortionary versus non-distortionary, direct versus indirect and corporate versus personal taxation.
- Measurement of the tax burden – using marginal or average rates of taxation. High marginal rates may result in tax evasion and avoidance, thereby lowering recorded rates of average taxation.
- The burden of government needs to be assessed in a wider context e.g. a total intervention index incorporating regulatory effects – where low incomes are tackled by social benefits in one country and a mandatory minimum wage in another.
- Causality is difficult to establish because one or more of the explanatory variables in the regression are jointly determined.
- Statistical issues arise when using market prices versus factor cost measures of GDP as indirect taxation is a significant factor.
EMPIRICAL EVIDENCE

Myles (2009) states that, “empirical evidence for the hypothesis that the level of taxation affects economic growth is very weak.” This interpretation of the evidence can be partly explained by the potential offsetting effects of distortionary taxation and productive spending. Box A.2 also highlights the methodological difficulties in obtaining reliable estimates of the impact of public spending and taxation on long-term growth.

However, more recent econometric studies, which focus on the advanced economies and also attempt to adjust for the methodological difficulties outlined in Box A.2, do generate more robust results of the negative impact of taxation on growth.

Lilico and Sameen (2010) report that “the more recent literature has tended to find larger effects i.e. early studies suggested very limited effects, whilst more recent studies have tended to suggest that taxes do indeed affect economic growth and that their effects are larger than originally thought.”

In a similar vein, Bergh and Henrekson (2011) state that:

“For decades there has been an intense debate regarding the relationship between government size and economic growth. The state of research is seemingly contradictory, with some scholars asserting that big government decreases growth, and others denying this to be the case. A close look at the literature reveals these arguments are not as conflicting as they at first appear. Two important differences in existing research concern the measurement of government size and the type of countries studied (rich or poor). When we exclusively focus on studies that examine the correlation between growth of real GDP per capita and total government size over time in rich countries (OECD and equally rich), the research is rather close to a consensus: the correlation is negative … The most recent studies find a significant negative correlation: An increase in government size by 10 percentage points [of GDP] is associated with a 0.5 to 1.0 percent lower annual growth rate.”

Bergh and Henrekson (2010) point to a number of recent studies pointing to a clear negative trade-off between the size of the state and economic growth in the long term. These results suggest the possibility of an emerging consensus that 10 percentage points higher taxes (or public spending) has a substantial impact on growth, reducing annual GDP growth by 0.5 to 1.0 percentage points. This is not small change.

Table A.2 Long term GDP – Compound growth scenarios

<table>
<thead>
<tr>
<th>TREND GROWTH</th>
<th>CUMULATIVE GROWTH AFTER 10 YEARS</th>
<th>CUMULATIVE GROWTH AFTER 25 YEARS</th>
<th>CUMULATIVE GROWTH AFTER 40 YEARS</th>
</tr>
</thead>
<tbody>
<tr>
<td>2% per annum</td>
<td>22%</td>
<td>64%</td>
<td>121%</td>
</tr>
<tr>
<td>2.5% per annum</td>
<td>28%</td>
<td>85%</td>
<td>169%</td>
</tr>
<tr>
<td>3% per annum</td>
<td>34%</td>
<td>109%</td>
<td>226%</td>
</tr>
</tbody>
</table>

Source: Author’s calculations.

Table A.2 shows the enormous dividend from relatively small changes in GDP growth compounded over the long-term.
BIBLIOGRAPHY


OECD. “StatExtracts Database. OECD iLibrary, 2011.


