Chapter 1.

Introduction

The Nordic countries stand out in international comparisons for combining high living standards and low inequality. The system now widely known as the "Nordic welfare model" is quite comprehensive or "extended," including both the social safety net and the public provision of welfare services like care, education, and health services, all of which is financed by taxes, so the total tax revenue constitutes a high share of total income. All these aspects are hallmarks of the Nordic welfare model.

Frequent reference is made to the Nordic welfare model in international policy debates and election campaigns. In 2013 British magazine *The Economist* published an image of a Viking on its front cover to characterize this model as a "supermodel," while a publication from the US government in 2019 characterized it as a "socialist model." In an era with increasing inequality, the Nordic approach to welfare is seen by some as a solution that can accomplish inclusive growth, while for others it means the government playing too large a role. But what characterizes the model? And how is it that the Nordic countries – which are small and highly globalized – have managed to attain such economic success?

The Nordic experience is a puzzle that challenges the standard reasoning in economics textbooks on how the role of the public sector affects economic performance. Such reasoning has its outset in the disincentivizing effects of taxation: Taxes may help reduce inequality, but they distort economic incentives by reducing the after-tax return of various activities. As a consequence, income, employment, and so on are reduced. Lower inequality is achieved at the cost of a less well-performing economy, resulting in lower living standards. According to this standard reasoning, the Nordic countries, with their large public sectors, should not be performing economically on par with, or even better than, similar countries with smaller public sectors and lower taxes. But economic performance in the Nordics is among the best in the world, which is paradoxical in light of the standard reasoning. How can this situation be explained? The purpose of this book is to help answer this puzzling question, and to discuss some of the key challenges to the Nordic welfare model.

Understanding the Nordic experience means developing a more nuanced view of the role of the public sector than that captured by standard reasoning. Taxes may distort economic incentives, but the effect of taxes cannot be seen independently of what taxes are financing and how the economy is structured.

Two aspects are crucial for the economic performance of the Nordic countries. First, the welfare state is not passive. Rather, it is active in improving the opportunities for all to participate in the labor market, which includes searching for jobs and acquiring relevant qualifications to ensure high productivity. This, in turn, supports economic activity. Second, how the market mechanism operates cannot be assessed simply by looking at tax rates. Some public activities may make the market mechanism more efficient, and other types of regulations are also important. Adding to the list of paradoxes, the private sector is at least as liberal in the Nordic countries as it is in many countries with leaner public sectors. Combining a liberal private sector and a large public sector is sometimes called "the third way."

The Nordic paradox is compounded by the fact that these countries are small and open, which supposedly should make it more difficult to reconcile an "extended welfare state" with strong economic performance. However, Nordic policy-makers understand the importance of international competitiveness, and it has long framed policies.

The Nordic welfare model can also be characterized as an employment model. Achieving both high income levels and low income inequality relies on high employment rates – for men and women alike – and a low number of working poor. This is also critical for the financial viability of the model. If employment is low, tax revenues fall and social expenditures rise. Since the model has relatively high levels for both taxes and social benefits, this effect is strong. The financial sustainability of the model therefore depends on maintaining a high employment level in the private sector. It is misleading to characterize the model as a case of "politics against markets," or say that it relies on a decommodification of labor.

The aim of this book is to present some basic insights into the "economics of the Nordic welfare model," which are important in explaining how high income levels, low inequality, and an extended welfare state can coexist. The first part of this book lays out the structure of the Nordic model and provides some data showing how the Nordic countries stand out in a comparative perspective, and it also discusses the concept of welfare models. This is followed by a discussion of the standard view on the economic implications of government activities, and several economic arguments explaining the economic performance of the Nordic countries. The second part of the book looks into specific policy areas, and since this necessitates more detail, this part focuses on the experiences of Denmark: labor market policies (flexicurity), pension systems, and preparations to deal with an aging population. The challenges arising from new technologies and globalization are also discussed. The book concludes by considering what lessons may be learned from the Nordic experience.

The term “Nordic welfare model” is used in the generic sense to denote small, open economies with large public sectors, rather than in the narrow geographical sense. Among the Nordic countries there are significant differences, and historically, only Denmark, Norway, and Sweden were listed as “welfare states,” which initially gave rise to the notion of the “Scandinavian welfare model.” Later, Finland has been included, and there is an ongoing discussion as to whether Iceland fits this categorization. More recently, Norway can be considered a “special case” due to its large-scale extraction of oil and gas.

Throughout the book, the Nordic countries are compared to the OECD average in order to give a comparative perspective. Clearly, such averages can mask large variations, and in some cases reference is made to specific countries.

Chapter 2.

Economic performance in the Nordic countries

The economic performances of countries can be compared in numerous ways. Such comparisons usually have both a level dimension and a distributional dimension. What is the level of living standard in the country? And how equally are living standards distributed across the population?

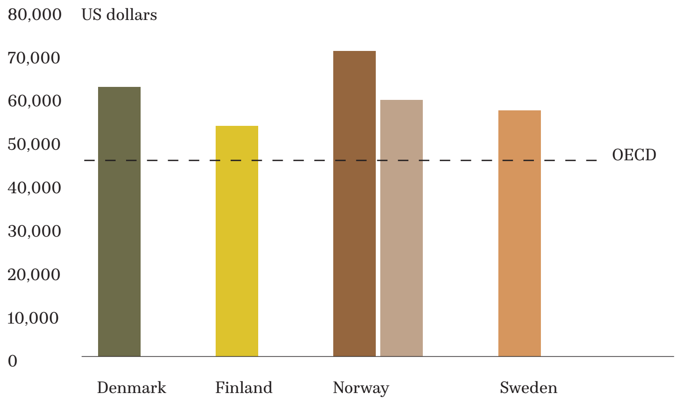
Living standards and their distribution profiles can be measured in many ways, but a key variable is income as a measure of material well-being – how much each person or family has at their disposal. Based on this, it is possible to consider both the average income (per capita income) and its distribution. Distributional issues are usually analyzed on the basis of disposable incomes, giving the resources the household has at their disposal; that is, all "market income" (income from labor and capital) less taxes and plus income transfers. In Figure 2.1 these two metrics are used to compare the Nordic countries with the OECD average.[1] This zooms in on the essence of economic performance in the Nordic countries in international com-

1. The Organisation for Economic Co-operation and Development (OECD) currently has 35 member countries; see www.oecd.org

parison: The income level is high, and incomes are relatively equally distributed.

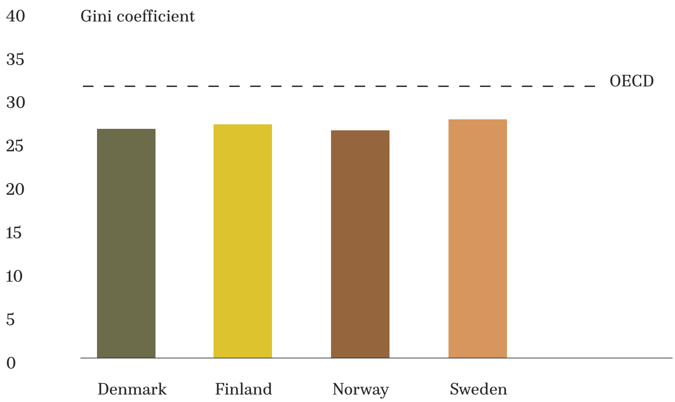
Figure 2.1 Per capita income and income distribution, Nordic countries and OECD average

a) Per capita income *



* Per capita income is given as Gross Domestic Product (GDP) per capita, in US dollars at current prices, with current purchasing power parities (PPP) for the year 2019. For Norway, the light brown bar refers to mainland Norway, i.e. excluding offshore activities

b) Income inequality **



** The Gini coefficient is calculated based on disposable income. The coefficient ranges between 0 and 100; the lower the coefficient, the more equal the income distribution. Data applies to 2018 or closest year for which data are available

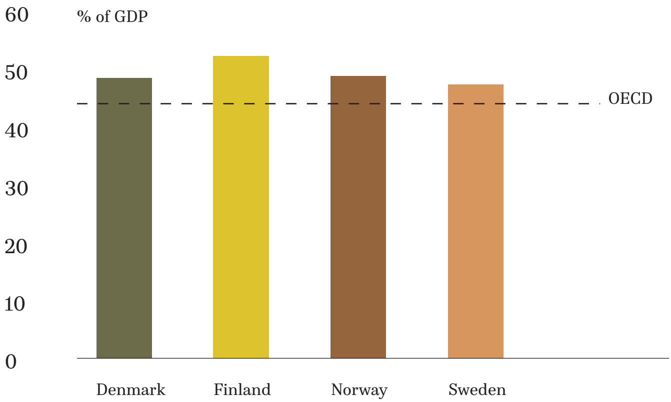
Source: www.oecd-ilibrary.org

Two remarks are in order. First, Figure 2.1 gives a snapshot of the situation in 2018, but the same pattern emerges in a longer-term perspective. The Nordic countries have persistently remained among the high-income countries in the OECD, and over time they have not lost ground to, for instance, low-tax countries. Second, in recent years, income inequality has also been increasing in the Nordic countries, as has generally been the case for OECD countries, but it remains low in international comparisons.

Factors other than income and material living conditions are clearly important too, and many comparisons include a broader set of metrics. As an example, the Human Development Index (HDI), compiled by the United Nations (UN), compares living standards based on three key components: per capita income, health measured as life expectancy at birth, and knowledge measured as a weighted average of literacy and school enrollment. The 2018 index ranks Norway as 1, Sweden 8, Denmark 11, and Finland 12, putting them among the best performing countries out of the 189 countries included in the data set.

In international comparisons, the Nordic countries stand out due to their large public sectors, as shown in Figure 3.1. A substantial amount of resources is used or distributed via the public sector. Measured in terms of total public expenditures (or tax revenue), the public sector constitutes about 50 percent of total income (GDP). Put differently, roughly half of the income generated within the economy in a given year is allocated and distributed, one way or another, via the public sector. This is a defining characteristic of the Nordic welfare model. The public sector plays a large role in terms of providing a social safety net and a range of "welfare services," including daycare and care for the elderly, education, and health services, to the entire population. This is elaborated on further in Chapter 3.

Figure 2.2 Total public expenditure. % of GDP 2019 *



Source: www.oecd-ilibrary.org

* Unweighted OECD average. Notice that the lower tax burden in Norway is not corrected for the revenue from offshore activities

The Nordic countries are small, open economies, and their welfare model has not developed shielded from international competition or market pressure; on the contrary, openness has been a conditioning factor. Openness measured by the "trade share," which shows the importance of foreign trade (export and import) relative to GDP, is above the OECD average. In the past, trade was mainly *intra-industrial*; that is, based on differences in access to natural resources. Denmark was an exporter of agricultural products, while Norway, Sweden, and Finland had comparative advantages in wood and minerals. More recently, trade has become more *inter-industrial*; similar products are made in many countries, although oil and gas are particularly important for Norway. The Nordic countries have adapted to this by developing new comparative advantages in areas such as IT and pharmaceuticals.[2]

From the perspective of ongoing globalization, it is important to note that, historically, the Nordics have faced global competition. While globalization is presently taking on new forms and is perhaps more intense, due to both political decisions (further integration) and technological

2. Adding to the list of notable differences between the Nordics, Denmark has a large number of small and medium-sized firms, while Sweden has historically had many large firms. Norway and Finland are intermediary cases and have historically been closer to Denmark in this respect

changes (lower information and transport costs), the issue of how to balance social concerns with an internationally competitive economy has a long history, which has become deeply embedded in Nordic policies over the years. The concern with competitiveness has always been a framing factor, based on an understanding that productivity increases are the foundation for real wage growth and high employment. This is encapsulated in what is known as the "Scandinavian model of inflation," which states that wages should first be determined in ("tradeable") sectors facing international competition – like the industrial sector – which would then determine the potential room for wage increases in other ("non-tradeable") sectors – like services and the construction sector. The opposite sequence may jeopardize competitiveness and lead to more cyclical variations, according to this model. Even though reality has not always been in accordance with these principles, they have been anchor points for many years. Naturally, there have been conflicts between labor and capital, but these have been limited by the shared view that safeguarding competitiveness is in the best long-term interest of employers and employees alike.

A premise in many political discussions about the role of the state and markets is the assertion that a large public sector is tantamount to setting market forces aside. This is not a very accurate characterization of the Nordic countries. It is correct that the public sector is not guided by the market mechanism, but that does not imply that the welfare state is "politics against markets." First, many public sector activities such as education and active labor market policies can support work and productivity and thus improve market performance. Second, taxes are important, but it is often overlooked that many other factors influence how the private sector works (and are essential for competitiveness). Markets can be distorted not only by taxes, but also by a lack of competition, excessive bureaucracy, and so on. Therefore, a full and proper analysis of distortions should look beyond taxes and also account for these and other potential distortions. So while the public sectors are large in the Nordic countries, analyses often disregard that their private sectors are among the most liberal in the OECD area. As an example, the OECD product market regulation index, which measures barriers to entry and market competition, assesses countries in terms of "least regulation" and in 2018 ranked Denmark as number 3, Sweden as 6, Norway as 7, and Finland as 17.

To underscore the importance of globalization and competitiveness, Table 2.1 summarizes widely used indices on key aspects related to the private sector, where countries are ranked by performance, from best to worst. Across all three dimensions, the Nordic countries have relatively favorable scores. The Nordic economies are highly globalized, they are business-friendly, and they are competitive.

Table 2.1 Rankings of Nordic countries in Globalization, Ease of doing business, and Competitiveness *

	Globalization	Ease of doing business	Competitive business
Denmark	8	4	10
Finland	9	20	11
Norway	12	9	17
Sweden	4	10	8
Number of countries	203	190	141

* Globalization measured using the KOF index (2020); see http://globalization.kof.ethz.ch/. Ease of doing business index (2020) compiled by the World Bank; see http://www.doingbusiness.org. Competitiveness index (2019) published by the World Economic Forum; see http://www3.weforum.org/docs/WEF_TheGlobalCompetitivenessReport2019.pdf