SWP Comments

Stiftung
Wissenschaft und
Politik
German Institute
for International and
Security Affairs

The Economic and Social Model of the Nordic EU Members

Growth, Innovation and Budgetary Discipline despite High Government Spending Rates

Ognian N. Hishow

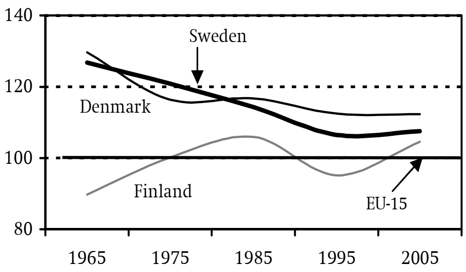
At the EU summit in Hampton Court on 27 and 28 October in discussions of a suitable European economic and social model that could assure sustainable prosperity and help master the challenges of the future, repeated reference was made to the performance of the Nordic member states. Despite—or because of—the high public sector share of GDP, all three countries have achieved budget surpluses and have low levels of income inequality. Yet there is no uniform Nordic model of employment and taxation. Striking differences exist between the individual countries. Finland suffers from persistent unemployment; Denmark has the most business-friendly tax policies in the EU; and Sweden has drastically cut back its welfare state. In the meantime the reduction of the government share of GDP has become a common feature of all three countries. Although a transfer of the Nordic system to the large EU economies is not possible for structural and historical reasons, individual economy-policy elements can indeed be adopted.

The small Nordic nations—Denmark, Finland and Sweden—have always been regarded as prosperous, peaceful and socially oriented. The high standard of living in Sweden and Denmark was no secret in Europe, especially after World War II. Per-capita incomes in both countries were still the highest among the EU-15 countries in the mid-1960s; government social services were regard as unique worldwide both in terms of quality and quantity. The key factor of the Scandinavian economic and social model is the broad social consensus as to the necessity and the maintenance of a comprehensive welfare state.

Relatively slow economic growth was another characteristic of these countries. Whereas post-war growth in Continental Europe (without the East Bloc) was comparably dynamic into the 1970s, Sweden and Denmark recorded smaller annual growth rates. In view of the high per-capita incomes, this caused no problems. Finland, in 1960 approximately 40% poorer than the other two Nordic countries, achieved continuously higher growth rates and caught up with the other two countries in 1975.

The slower long-term economic growth in Sweden and Denmark and the growth slow-down in Finland after the collapse of the former Soviet Union resulted in the Nordic EU members losing their leading positions in EU and OECD per-capita incomes (Figure 1).

Figure 1
Per-capita income at purchasing power parities relative to the EU-15, in % (EU-15=100%)



Source: *EU Commission*.

In the post-war period, per-capita incomes grew closer to the EU-15 average, and their relative loss in position would have been even more evident had not Germany, the EU's strongest economy, also experienced a perceptible relative worsening.

What distinguishes the Scandinavian societies from the rest of the Union, however, is the high degree of social cohesion, as expressed in the lowest income differentials after taxes in the OECD. In addition, they have coped better than most other partners in the European Union with the challenges of EU eastern enlargement and globalization. Since the mid-1990s Sweden and Denmark have achieved a higher, and Finland a much higher, economic growth than the rest of the EU-15. The process of relative loss in position has thus come to a standstill (Figure 1). In all three countries, unemployment rates have been reduced. Except for Finland, where at least the rate has been halved in the last ten years, unemployment is currently under the EU average.

In the debate on reforms in the EU, reference is often made to the economic-policy achievements of the Nordic EU members, which have come about despite—or because of—the high social standards. However, common employment and tax-policy principles that could define the "Nordic model" are not always evident. Indeed, the countries often go their own ways.

Employment and labor costs

One of the major differences among the EU Scandinavians is the employment situation. In the 1990s the Finnish economy was forced to make an integration-policy turnaround—away from its ties with the collapsing economies of Russia and the Community of Independent States (CIS) and towards the EU. Because of the higher demands that Western markets place on standards for goods and technology, a change in product structure also occurred that lowered the share of medium technology in Finland's exports and increased the share of high technology. This technological turnaround automatically led to a process of productivity increases, accompanied by restructuring and dismissals that shot up the unemployment rate. At the peak of the employment crisis in 1994, the jobless rate reached 16.6%, several percentage points above the German, French or Italian unemployment rates of the time.

With their closer traditional ties to the EU, Denmark's and Sweden's economies did not need to implement fundamental changes in their external economic policies, though they were forced to adapt to pressure from advancing globalization. Unemployment reached historic highs in Denmark in 1993 at 9.6% and in Sweden in 1997 at 9.9%; the unemployment rate at the time in reunited Germany was lower. Both Nordic countries basically followed the widely discussed course, also in Germany, of redistributing labor—they shortened somewhat the hours worked per employee and at the same time slightly raised the labor-force participation rate. As a result, more working hours per year and inhabitant are performed in Sweden and Denmark than in the slow-growing EU economies of France, Italy and Germany.

Finland also has much higher sums of annual hours worked per inhabitant than Germany, for example. But the hours worked per employee have remained at a higher level than in Sweden and Denmark. In combination with a participation rate that is smaller in comparison with the two other countries, this explains the higher unemployment rate in Finland.

To understand Sweden's better performance in GDP growth and employment, the productivity and income statistics are helpful. Sweden has only a slightly higher per-capita income than the EU-15 average, with a lower average hourly productivity. The latter, and thus a possible decline in the standard of living, is offset by more hours worked and by a higher participation rate than the EU-15 average.

Distributing work onto "more shoulders" presupposes a corresponding adaptation of labor costs in order to prevent less productive employees from being forced out of the labor market. In Sweden, unit labor costs –wages as a share of GDP—adapted to the business cycle both in the 1990s and also after 2000; in the phases of economic slowdown in 1991/92 and 2001/2002 they declined and thus had an anti-cyclical effect.

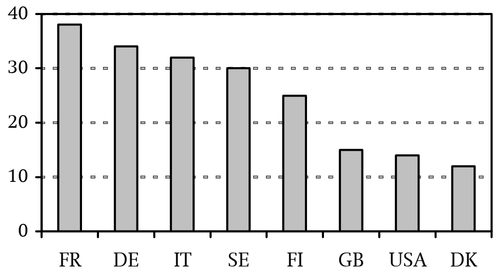
This should be kept in mind when the argument is expressed in economic-policy discussions that wage increases can stimulate demand from private households and with this demand the economy as a whole. It was precisely the Nordic countries that adjusted downwards and not upwards in economically difficult times. Falling labor costs had a positive effect on the supply of labor and in turn on economic growth and employment.

To be sure, other EU countries like Germany or France also reduced their unit labor costs, but in these countries either growth was slower (Germany) or unemployment greater (in both). Labor costs (hourly wages plus employers' contributions) are just as high in Sweden as in Germany, whereas French labor costs are lower.

One reason why Sweden has its unemployment under control is its economic structure: The share in GDP of high-tech industries and services is ca. 11% (in 2000), nearly twice as large as in Germany and a quarter larger than in France. The higher productivity in this sector permits higher incomes (wages) without endangering competitiveness. The statistical effect is that a larger share of employees has high earnings. Wage adaptations in the remaining sectors with lower incomes have less serious effects, and fewer jobs are eliminated at the lower end of the labor market. In this respect the more favorable sectoral structure of the Swedish economy leads to a greater employment potential.

To explain Denmark's lower unemployment rate in comparison with Germany and France a different argument is necessary. Here non-wage labor costs, which are minimal compared with the EU and OECD average, play the major role (Figure 2). In addition, employer contributions are practically non-existent. Gross wages in Denmark are also smaller than in Germany and Sweden, and similar to those in France. The combination of lower gross wages and perceptibly lower non-wage labor costs makes Denmark attractive for investors, although it has a traditional economic structure without a large high-tech sector. The reason is that after deducting the non-wage labor

Figure 2
Non-wage labor costs in the EU/OECD, as % of gross earnings



Source: *OECD*, Taxing Wages, <http://www.oecd.org/dataoecd/26/8/2495227.pdf>.

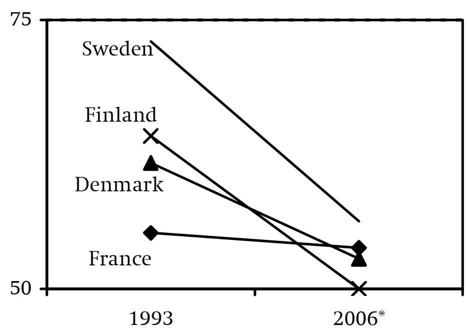
costs from the "gross," a sufficient "net" amount remains in comparison with other high-wage countries. This has a moderating effect on the development of wages and lessens the displacement effects in sectors with low productivity, which particularly suffer from the burden of non-wage labor costs, as seen in EU countries with high unemployment.

Tax and public-spending ratios

How have the Scandinavian countries achieved higher growth rates than Germany despite their higher public sector share in GDP? Why are the budgets of the Nordic countries in surplus and the national debts lower than in many other EU economies (e.g., France)?

Unnoticed by the general public, the Scandinavian EU members have partly revised their high-tax policy. Currently Denmark and Finland have a lower public-spending ratio than France, for example, and the Finnish tax-to-GDP ratio is below that of France (see Figure 3 and Table, 1st and 2nd line). The three Nordic countries reduced public spending in the past 15 years much more dramatically than the other high tax countries in the EU. All three countries are now characterized not by high shares of public spending but by their courageous reductions of these shares. In Sweden, Finland and Denmark, the public spending ratio was reduced from its heights in the 1990s to 23%, 22% and 14% respectively; in France the corresponding cuts were merely 3%, and in most other EU countries with high public spending ratios the cuts were even smaller. As a result the Scandinavians have moved close to the average public spending ratio in the EU-15.

Figure 3
Public spending ratio in the Nordic countries and France, as % of GDP



* Estimate.
Source: *EU Commission*.

The next interesting observation is that the Nordic EU members do not have uniform tax structures and policies, neither among themselves nor in comparison with other EU/OECD countries (Table). Denmark levies the highest taxes on earned incomes and keeps non-wage labor costs correspondingly low, which is an advantage in attracting investment. Finland has the lowest state tax and public-spending ratios among the Nordic countries; it places a larger corporate tax burden on its businesses, however, which is one explanation for its higher unemployment (see Table, second last line). Unlike the other two countries, corporations in Finland have fewer tax write-offs.

In the expanded international comparison, the tax ratios in Finland and France are similarly high but differently structured. Social insurance contributions and with them non-wage labor costs are higher in France and Germany than in Finland and much higher than in Denmark (see Table, last line). With a similarly high unemployment rate in France and Finland, the Finns have higher economic growth rates and relatively larger tax revenues. Denmark and Sweden also keep non-wage labor costs in check and thus promote growth in their economies. As a result all three Scandinavians achieve budget surpluses, while France and Germany have regularly violated the Stability and Growth Pact in recent years.

Consequently, the differences among the Scandinavian countries with regard to the public spending ratio, the tax structure and tax rates are larger than their common characteristics. In spite of this their budget policies are better aimed at not retarding growth and at achieving budget surpluses

Tabelle
Steuerindikatoren nach Ländern 2005, in % des BIP

	Denmark	*Finland*	*Sweden*	*Germany*	*France*	*USA**
Public spending ratio	53.7	50.6	56.6	46.6	53.9	33.8
Tax-to-GDP ratio	48.6	44.4	50.2	39.5	44.8	25.7
Share in total tax revenues (in %, for 2000, without "Others")						
Indirect taxes	30.8	28.5	20.0	27.2	25.2	20.0
Income tax	52.7	30.7	35.6	25.3	18.1	35.0
Corporate tax	4.9	11.7	7.6	4.7	7.1	10.0
Social insurance contributions	4.5	25.6	28.0	39.1	36.2	27.0

* Partly estimated.

Quelle: *EU Commission*; *OECD*; *UN ECE*, ESE1/04, Tab. 5.3.5.

than in other countries. In contrast to the slow-growing EU countries, the main source of revenue is the tax on personal income. Taxes on profits and burdening labor via social insurance contributions are of lesser importance. In this respect the Scandinavian tax structure resembles that of the United Kingdom or Ireland as well as that of the US, which serve as benchmarks for growth and innovation in the Lisbon process (see Table).

Lessons from Scandinavia: quality before quantity

Despite all national differences, the Nordic economic and social model is characterized by the active role played by the state and the high measure of social cohesion. The Gini coefficient—a measure of inequality—for the OECD is lowest in Scandinavia since income disparities are clearly reduced via taxation and transfers.

This raises the question of why other high tax countries in the EU must accept greater social inequality and/or unbalanced budgets. One explanation is that the tax elasticity of the labor supply is lower than in other EU societies. This means that in the Nordic countries the high marginal tax rates are much less a deterrent on the willingness to take on work. This explains why the labor force participation rate is above the EU average, including a higher female participation rate. In other EU countries, in contrast, companies (and employees) migrate more readily to other countries or drift into the shadow economy.

The traditional willingness of the Scandinavians to accept a high public spending ratio is an expression of the positive historical experience with the state and its institutions. In contrast to other countries, the positive role of the state as welfare provider is regarded more highly, since with its extensive transfers the state is also seen as a source of prosperity and not merely as an unwelcome "taxman". This is a special feature of the Scandinavian consensus society that is not directly transferable to other nations.

The high level of skills and education in all three countries has led to high productivity and income levels and gives them sufficient scope for adapting to changing market demands. Because their economies are small and they have high export-to-GDP ratios, Finland and Denmark display flexibility in the international division of labor. They are able to compensate declining export demand from the slow-growing EU countries by a faster reorientation to other partners than larger countries. That the opposite result is possible was experienced by the Finns during their "Great Depression" of the early 1990s when Finnish output declined by ca. 15%. Larger economies are able to offset positive and negative external shocks because of their more broadly diversified sectoral and product structures. Small countries must react faster and more resolutely to master a crisis with a smaller cost for the economy. As the Finnish example shows, they must be willing to accept painful cuts, for example, in the form of jobs losses.

Sweden is in a more comfortable position, having retained its independent monetary and exchange-rate policies. These independent policies promote economic upturns. During the last two recessions, the krona was devalued in real terms against the euro and the British pound in order to stimulate Swedish export activity.

Denmark, which is also not a member of the euro zone, keeps its currency closely aligned to the euro and thus has little monetary policy leeway. When it encounters economically difficult times, Denmark will also need to make adjustments, especially of its labor costs (by decreasing them, as a rule), to achieve an economic upswing.

In addition to the special features already mentioned, the willingness to solve problems via consensus also plays a positive role in the Scandinavian countries. In all three countries this leads to moderate wage agreements that promote growth and employment.

Last but not least, the available natural resources in Sweden and Finland provide comparative advantages to particular branches of industry (wood, paper) over the international competition so that overall demand is supported even in phases of economic weakness.

The Nordic countries are by no means free of problems. Unemployment in Finland in particular has been persistently high, nearly four percentage points above that in the Anglo-Saxon economies. Finland, like Sweden, went through a recession in the beginning of the 1990s that was more severe than in other Western industrialized countries. In both economies economic output has declined three years in succession.

This macroeconomic shock had beneficial effects, however. Finland re-structured its economy at the cost of massive layoffs and returned to the growth path. Sweden radically cut government spending—from 73% of GDP in 1993 to a current 56.5%—thus converging with most of the other EU countries. Employment was reduced in the public sector, criteria for refusing job offers were made stricter. Simultaneously active employment policies were expanded: If the portion of unemployed persons in job creation schemes were included in the unemployment rate, it would be effectively two percentage points higher.

Denmark has always aimed at being an attractive business location—albeit not a highly developed high-tech locale in an international comparison—by business friendly tax policies and lower wage costs. The tax burden on businesses in Denmark is even smaller than in liberal market economies such as the US, the UK or Ireland.

Transferability of the Scandinavian model?

Directly transferring the Nordic experience to the large European economics suffering from faltering growth like Germany or Italy is neither possible nor wise. The high tax rate in the Scandinavian countries has caused private consumption to increase at a slower rate than the OECD average. For the small, extremely open national economies of Denmark, Finland and Sweden this effect is less problematic than for the large countries in which private consumption is the most important demand component. Here "bigger government" would hinder growth instead of promoting it. With this realization the Scandinavians have also cut their public spending ratios significantly.

What can be adopted from the Nordic economies is their joy of innovation, which gives them both competitive as well as growth and budgetary advantages. Worthy of imitation is also the determination both to assist the unemployed and also to insist that they take on jobs.

The success of the Nordic EU members is based on a combination of factors (small, open economies, traditional trust in the welfare-provider function of the state, and natural resources) and genuine achievements (high level of education and a resulting high productivity and incomes, adaptability in international competition, efficient public administration and control of government spending). It is not the size of the government in itself that has brought about the Scandinavians' success. Consequently any mechanical duplication of the Nordic economic and social model by nations with differing preconditions is ill-advised.

SWP
Stiftung Wissenschaft und Politik
German Institute for International and Security Affairs

Ludwigkirchplatz 3−4
10719 Berlin
Telephone +49 30 880 07-0
Fax +49 30 880 07-100
www.swp-berlin.org
swp@swp-berlin.org

ISSN 1861-1761