The Nordic Welfare State in the 1990s: Consequences of Disinflation and Fiscal Consolidation in the Three Nordic EU Countries

Jaakko Kiander

Ezoneplus Working Paper No. 13D
Regional Input on Social Dimension
Supplement to Working Paper 13

February 2003

FIFTH FRAMEWORK PROGRAMME

Ezoneplus

The Eastward Enlargement of the Eurozone
Research Project HPSE-CT-2001-00084
Fifth Framework Programme 2001-2004
European Commission
www.ezoneplus.org

Jean Monnet Centre of Excellence

Freie Universität Berlin
Ihnestr. 22, 14195 Berlin, Germany
Phone: +49 (30) 838 – 54966
Fax: +49 (30) 838 – 52357
Email: info@ezoneplus.org

The Eastward Enlargement of the Eurozone

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Ezoneplus Working Paper No. 13D
February 2003

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Abstract

This paper reviews the current state of the so called Nordic welfare state, and the experiences of Denmark, Finland and Sweden in the 1990s in adjusting their public sectors to fiscal consolidation. The economic crises and structural changes of the1990s are viewed as a part of adjustment to integration and globalisation, especially to financial deregulation. Even after these hardships the Nordic model remains clearly distinctive and in many respects successful. Although the Nordic welfare model has survived many difficulties, there lie further challenges in the future. The most important of them are possible tax competition which may threaten the financial basis of current welfare systems, especially in Denmark and Sweden, and expected demographic change, which will add excess burden to the public finances within the next 20 years. However, the all Nordic countries have currently healthy fiscal surpluses, which gives them a better position than for most other Western European countries.

Keywords: welfare state, integration, Nordic countries

Corresponding author:

Jaakko Kiander
Government Institute for
Economic Research (VATT)
Hämeentie 3
P.O Box 269
FIN - 00531 Helsinki
risto.vaittinen@vatt.fi jaakko.kiander@vatt.fi

This paper has been prepared as a part of a broader Ezoneplus project that evaluates European Monetary Union (EMU) and its enlargement to prospective members in central and eastern Europe. The project is financially supported by European Commission (HPSE-CT-2001-00084).

1.Introduction

The Nordic countries include Denmark, Finland, Iceland, Norway and Sweden. All of them are usually thought to be so called welfare states – i.e., egalitarian societies with extensive public sectors and income redistribution. The best-known and the largest of the Nordic countries is Sweden and it is not uncommon that discussions on welfare state simply refer to so called "Swedish model". Although the Nordic countries and their welfare models are not identical there are so many similarities between them and so many differences between them and the other European countries that it is legitimate to speak about 'Nordic model'.

This paper reviews the current state of the so called Nordic welfare state, and the experiences of Denmark, Finland and Sweden in the 1990s in adjusting their public sectors to fiscal consolidation.

The economic crises and structural changes of the1990s are viewed as a part of adjustment to integration and globalisation, especially to financial deregulation. These changes were an essential part of the process of adapting to European common market and common monetary policy. Even after these hardships the Nordic model remains clearly distinctive and in many respects successful. The Nordic societies are highly egalitarian, and they have achieved high income and employment levels – in spite of high taxes and large public sectors.

Although the Nordic welfare model has survived many difficulties, there lie further challenges in the future. The most important of them are possible tax competition which may threaten the financial basis of current welfare systems, especially in Denmark and Sweden, and expected demographic change, which will add excess burden to the public finances within the next 20 years. However, the all Nordic countries have currently healthy fiscal surpluses, which gives them a better position than for most other Western European countries.

2. The Nordic welfare state

The Nordic countries are often seen as representatives of a special societal model which is usually called welfare state. Although such a generalisation is naturally a simplification it is not unjustified. There are lots of common features in the welfare models of the Nordic countries and in their historical backgrounds.

2.1. Origins

In search for the origins of the modern Nordic welfare models one cannot neglect the decisive impact of long-time political dominance of social democratic parties and their political ideas as one of the most important factors explaining the birth of extended egalitarian welfare state model in the Nordic countries.[1] That influence began seriously in the 1920s and 1930s, when the social democratic parties first time formed governments in the Nordic countries. Since that the social democratic parties have been the major governing parties in all Nordic countries most of the time.[2] Together with strong trade union movement that has meant a significant position of power for many decades. This position of power or even political hegemony has enabled the gradual

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[1] For a survey on the history of Nordic welfare states, see for Sweden Lundberg & Åmark (2001), for Denmark Christiansen and Petersen (2001), and for Finland Kettunen (2001).

[2] In Sweden and Norway the social democratic parties have been strong enough to rule alone. In Finland, Denmark and Iceland they have had to rule in coalition governments with other parties. See e.g. Esping-Andersen (1985) and Hicks (1999).

evolution of the increasingly complex systems of taxes and social programs which today form the essential part of the Nordic welfare model.

2.2. Characteristics

Although the Nordic countries are far from identical, the Nordic welfare states have some important common features which characterise them. This is why the Nordic model is usually acknowledged in classifications as a separate social model. For instance, Esping-Andersen (1990) distinguishes between three different types of the welfare state. The liberal or marginal welfare state is based on the social protection provided by private market and family. In such a model social benefits are means-tested and low. In the second model social provisions are distributed on the basis of merit and work performance. According to Esping-Andersen, the Scandinavian model is the third one, based on universality principle. That model promotes redistribution and social equity.

There is a certain holistic or universalist thinking behind the welfare state system in the Nordic model; the society is supposed to take care of citizens from 'cradle to grave' and protect them from the economic and social risks. This is done by providing affordable care, education and housing to everybody – at least in principle. At the same time the welfare system redistributes income between households by using taxes and transfers, and thus decreases inequality. The universality of the welfare system is important in the Nordic countries. Everyone is entitled to the same services and to same benefit systems. The eligibility does not depend on income and wealth as much as on age or needs.

2.3. Public sector and social protection

A simple way to measure the size of the welfare state is to compare public expenditure, and especially social expenditure and public consumption, which broadly measure the production of public services. On average the share of public expenditure as percent of GDP is in the Nordic countries clearly higher than in other comparable countries. There is no question that the Nordic countries have large public sectors, by any measure.

The public expenditures of the Nordic countries are largely used to finance the production of public welfare services and large-scale income transfers. The social expenditure in the Nordic countries includes public provision of day-care and other social services, free education (from elementary school to university level), health care, and active labour market policy measures. Incomes are redistributed through taxes and transfers. In all Nordic countries there are transfers and subsidies to almost everybody: public old-age and disability pensions, child benefits, housing benefits, student benefits, unemployment benefits and maternity benefits. The idea of the system is to provide assistance when it is needed (as young and old, for instance), and thus minimise poverty risks.[3]

[3] Cf. Kangas and Palme (2000).

TABLE 1

Total public expenditure and social protection expenditure in the Nordic EU countries, as percent of GDP in 2000

	Public expenditure	Social protection expenditure
Denmark	51½	29
Finland	45	25
Sweden	54	32½
EU15	44½	27½

Source: OECD and Eurostat

The level of public expenditure and social protection is very high in Denmark and Sweden. Finland is close to EU average (see Table 1). There are a few other European countries which also have very high public expenditures, like France, Belgium and Austria. However, if the level of social expenditure and public consumption is taken into account, one can still argue that on average the group of Nordic countries is spending more than any other country on welfare state. Especially the number of public sector employees is high, more than 30 percent of total employment in Sweden and Denmark, and about 25 percent in Finland. These figures are clearly higher than in the other EU countries. The Nordic trio spends more money to families, disability and unemployment than the other EU countries, while the public pension and health care expenditures are lower in the Nordic countries (Table 2).

TABLE 2

Distribution of the social protection expenditure; percent of GDP in 2000

	Pensions	Health care	Families	Disability	Housing	Unemployment
Denmark	11.0	5.8	3.8	3.5	1.8	3.0
Finland	9.0	5.9	3.2	3.5	0.9	2.6
Sweden	12.6	8.8	3.5	3.9	1.5	2.1
EU15	12.7	7.5	2.2	2.2	1.0	1.7

Source: Eurostat

These differences reflect the strong emphasis which the Nordic model puts on universal social rights which arise from citizenship. High spending to disability and unemployment helps to prevent poverty and social exclusion within these groups. Similarly, generous support to families and housing subsidise child-bearing and helps to smooth the life-cycle income of families (Table 3). As a result, the child poverty is very low in the Nordic countries.

TABLE 3

Distribution of the social protection expenditure; percent of GDP in 2000

	Housing and families	Disability and unemployment
Denmark	5.6	6.5
Finland	4.1	6.1
Sweden	5.0	6.0
EU15	3.2	3.9

Source: Eurostat

It is noteworthy that pension and health expenditures are lower in Denmark and Finland than in the other EU countries. This is partly due to more favourable demographics. The low costs of health care are likely caused by the fact that public sector is the main provider and producer of health services in
the Nordic countries. It is typical that public health care systems tend to be less costly than those based on public insurance and private provision.

There is a strong egalitarian ethos in the ideology and practise of the Nordic welfare state. Equality is produced by extensive and universal public service provision and by high and progressive taxation. In addition to this, also the wage bargaining system dominated by large and mostly social democratic trade union confederations have aimed to wage compression. A central part of the model has for a long time been the regulation of labour markets through collective agreements between the organisations representing employees and employers.

Important parts of the inclusive nature of the Nordic systems are national pensions systems, family policy programs as well as unemployment benefits and active labour market policies. In Denmark the pensions are provided by state and financed by income taxes, in Sweden and Finland there are occupational pension insurance schemes[4] funded by compulsory payroll taxes. For those who have not managed to achieve sufficient occupational pension, there is a national minimum pension. In 1996, the share of pensioners receiving only the basic pension were 45 % in Denmark, 13 % in Finland and 18 % in Sweden. The average after-tax compensation level of public pension systems for an average industrial worker with full qualifying period was about 70 % in the all countries (NOSOSCO 1998).

Families with children are in the all three Nordic EU countries supported by child benefits, generous parental leaves and publicly provided and heavily subsidised day-care services.

Earnings-related unemployment insurance in organised in the Nordic countries in an exceptional way. Unemployment insurance is voluntary and it is provided by trade unions. Because of high unionisation rate, almost all workers are insured. If one is not insured or is not entitled to the unemployment insurance benefit (because of insufficient prior working period), it is possibly to receive a means-tested basic unemployment allowance. In practice the effective after-tax replacement ratios of the unemployment benefits are relatively high in the Nordic countries, especially in Denmark and Sweden, and especially for low-income families with children.

In addition to generous benefits, the Nordic countries support the unemployed also by providing extensive active labour market policy programmes, which offer training and subsidised work for

[4] In Sweden the pension system is run by public pension funds, in Finland by private but government-regulated pension insurance companies. In both countries the pension systems are partly funded.

those who fail to find work in the open labour market. That explains why the spending on labour market policies is so high in the Nordic countries in spite of their relatively low unemployment rates (except in Finland, where the unemployment has been high since 1992).

2.4 Taxation

As a result of high expenditure level also the taxes need to be high, and the Nordic taxes are on average higher than elsewhere, too. The gross tax rates are in Sweden, Denmark and Finland higher than in any other industrial country. The high tax rates are basicly due to relatively high and progressive labour income taxes and consumption taxes – and in Sweden also to property and wealth taxes. Corporate and capital income taxes, in turn, are flat and low in Nordic countries.

TABLE 4

Indicators of tax burden in 2000

	Tax rate	Income tax	Empl.tax	VAT	Corporate tax
Denmark	48.4	39.3	1.5	25	30
Finland	47.1	33.7	24.1	22	29
Sweden	53.3	34.3	32.8	25	28
EU15	43.5	31.3	26.3	18.3	32.5

Tax rate: Tax revenues as percent of GDP
Income tax: Average income tax rate of an average production worker
Empl.tax: Employers' average social insurance taxes
VAT: General VAT rate
Corporate tax: The corporate income tax rate

Source: OECD

2.5 Inequality and poverty

The Nordic social programs are egalitarian and universal in order to create an inclusive systems. They aim to promote equality not only in regard of income distribution but also between genders.[5] Some of the benefits are universal and independent of family income like basic pensions, child and student benefits, while some benefits decrease with income like housing benefits, and some are earnings-related like unemployment insurance and occupational pensions. Denmark and Sweden are most generous in the provision of public services and income transfers, while Finland is more modest and less ambitious.

The Nordic welfare states have produced egalitarian societies with relatively equal income distributions and low poverty rates. If measured by gini-coefficients, the inequality of factor incomes is in the Nordic countries almost as high as in other comparable countries. However, after including the income transfers received by the households and the taxes paid by them the

[5] Tanzi and Schuknecht (2000) argue that increasing the size of public expenditure above 30 percent does not yield any economic gains. Such a view seem to neglect the equity improving impact of welfare states of which the Nordic countries offer ample evidence. It can also be said that there is no compelling empirical evidence that large public sectors as such would be harmful to growth.

resulting distribution of disposable family income is relatively evenly distributed. Table 5 presents the decomposition of the Finnish income distribution in years 1990, 1995 and 2000. It can be seen that the inequality of factor incomes increased markedly during the 1990s while the inequality of disposable income increased less.

TABLE 5

Gini-coefficients by source in Finland in the 1990s

Year	1990	1995	2000
Factor income	39.4	46.4	47.6
Gross income (incl. transfers)	25.8	26.2	30.6
Disposable income	20.5	21.8	26.6

Source: Statistics Finland

In spite of the slightly increased inequality in the 1990s, the Nordic countries do still have the lowest income inequality within OECD. The Nordic gini-coefficients are in the range of 20-25 percent. Such figures are only matched by Belgium and the Netherlands. As a result of extensive income support systems and redistribution, income poverty is also rare. Especially child poverty in the Nordic countries is lower than elsewhere.[6] Even the rise of unemployment in the 1990s did not increase poverty rates.

2.6 Employment and inactivity

The Nordic welfare states are egalitarian societies with high taxes, organised labour and large public sectors. As such, they have been criticised and viewed sluggish and structurally weak. Redistributive systems have widely be seen as bad for work incentives, and hence also bad for job creation. However, the most extensive welfare states in the world – Denmark and Sweden – have achieved high living standards, high employment levels and low unemployment. Due to the severity of the economic crisis of the 1990s Finland has been less successful. The labour force participation rates of the Nordic populations are as high as in the U.S. and much higher than the EU average.

[6] Jäntti and Danziger (1994 and 2001).

TABLE 6

Labour market participation and inactivity indicators in 2000

	Participation	Employment	Inactivity	Unemployment
Denmark	80.6	76.4	19.4	5.2
Finland	74.7	67.9	25.3	9.1
Sweden	76.3	72.7	23.7	4.7
EU15	69.7	64.0	30.3	8.2

Participation: share of working-age population belonging to labour force
Employment: share of working-age population actually employed
Inactivity: share of working-age population not employed
Unemployment: commonly used unemployment rate

Source: OECD

The high Nordic employment rates are mostly due to high public sector employment.[7] The private sector employment is in Sweden and Finland even lower than in the other EU countries (Table 6).

TABLE 7

Public vs private sector employment as percent of working-age population in 2000

	Public sector	Business sector
Denmark	22.9	53.5
Finland	16.9	51.0
Sweden	22.9	49.8
EU15	10.7	53.3

Source: OECD

3. Welfare state and the fiscal consolidation in the 1990s

3.1 The background of economic hardships

In the golden years from the 1950s to 1980s the economic policy put much emphasis on full employment in all Nordic countries. Full employment was achieved by employing Keynesian ideas of economic policy: active demand management, continuous public sector growth and incomes policy through centralised wage bargaining. The Bretton Woods system enabled this policy model. Due to regulation of domestic credit markets and international capital movements the governments were able to control interest rates and investment activity.

[7] See Rosen (1996) and Freeman (1995).

Eventually the policy of rapid growth and full employment caused inflationary pressures. This, of course, was not rare amongst the Western countries in the 1950s and 1960s. However, the Nordic countries (except Denmark) continued this policy longer than most other countries which allowed the unemployment to rise after 1973 and adopted anti-inflationary policies in the beginning of the 1980s.

Until the mid-1980's the Nordic countries were known as a group of small and rich countries with advanced welfare systems and corporatist labour markets. Four of them belonged to the EFTA, a free-trade association of mostly small non-EEC European countries, and they seemed to be immune to the rise of unemployment and related social problems experienced elsewhere in the Western Europe (or EEC countries) at the same time. In the 1970s and 1980s the unemployment rates rose almost continuously in the member countries of the EEC while unemployment in the Nordic EFTA countries fluctuated between 2 and 6 percent without any serious upward trend. The Nordic countries seemed to escape the perils of recession and mass unemployment plaguing most other European countries. The only exception in the Nordic group was Denmark, which – unlike the other Nordics – was a member of the EEC at that time and which in the 1980s started to suffer from low growth and a permanent high unemployment like other EEC countries. Finland and Sweden joined the in 1995 -- Norway's membership was once again rejected in a referendum.

3.2 The Nordic recessions

During the end of the 1980s and the beginning of the 1990s all Nordic countries finally faced an economic crisis. It is noteworthy that both in the 1980s and 1990s the Nordic countries were able to grow faster than the total European Union and to keep unemployment lower than in the EU. In the 1980s the Nordic unemployment rates were among the lowest in the OECD while the rate of inflation was slightly higher.[8] The Nordic crises were closely related to changing economic policy regimes and disinflation.

All Nordic countries suffered from severe recessions in the end of the 1980s and the beginning of the 1990s. In Finland and Sweden the recession was severe enough to be called a crisis or even a depression. If measured by relative output or job losses these recessions were worse than those experienced in other OECD countries at the same time (see Table 8). Especially the recessions of Sweden and Finland were deep and dramatic. Denmark experienced a milder recession, more like the other EU countries. [9]

TABLE 8

The recession of early 1990s

	Annual average GDP growth 1990-03	Cumulative change in unemployment rate 1990-93
Denmark	0.7	2.5
Finland	-2.7	13.3
Sweden	-0.9	6.5
EU15	1.4	2.8

Source: OECD

[8] It is most likely that the differences in unemployment developments between countries reflect corresponding differences in macroeconomic policies; cf. Blanchard and Summers (1986) and Ball (1999), who emphasize the role of macroeconomic shocks.

[9] For literature on the Nordic crises, see Jonung et al (1996), Kiander and Vartia (1996), Bordes et al (1993) and Honkapohja and Koskela (1999).

An important part of the Nordic recessions were policy failures. It is likely that both the boom and bust phases could have been stabilised by floating exchange rate. However, every country tried to maintain exchange rate fixed, which made the crises worse.

3.3 Fiscal squeeze

The Nordic recessions caused also a lot of strain to the public finances.[10] Initially the Nordic public sectors were in healthy surplus. The recessions, unemployment and high interest rates changed the situation quickly and fiscal balances deteriorated significantly; on average the change was more than 10 percent of GDP. Although the change was big and sudden, it was proportional to the employment losses. Hence there is no reason to argue that the large deficits would have been caused by expansionary fiscal policy.

The resulting large deficits caused much worrying about the sustainability of welfare state model. It was clear that the financing of the public expenditure could not rest for long time on large fiscal deficits. The Nordic governments reacted gradually by restricting the growth of public expenditure.

TABLE 9

General government fiscal balance

	1990	1993	2000	change 1993-2000
Denmark	-1.0	-2.9	2.7	+5.6
Finland	5.3	-7.3	6.9	+14.2
Sweden	4.0	-11.9	3.4	+15.3
EU15	-4.0	-6.3	0.7	+7.0

Source: OECD

The growth of public demand was restrained in Finland and Sweden in the 1990s and the growth contribution of public demand was almost non-existent (see Table 10). This is a marked difference from the other recoveries of the 20th century. In here Sweden and Finland differed also from the other Nordic and EU countries in which the growth of public demand was allowed to continue also in the 1990s. It seems to be the case that especially in Finland and Sweden the welfare state went through a significant squeeze in the 1990s although there has not been any outright reductions in social expenditures. However, even after these adjustments, the Nordic welfare state model exists still as the most generous and extensive welfare model in most respects when compared to other European countries – especially in Denmark and Sweden (see Kautto et al, 2001).

[10] There have also been studies suggesting that the so called non-Keynesian effects of fiscal policy might have contributed to the recessions of Sweden and Finland, or that the crises would have partly been caused by excessive deficits (see Corsetti and Roubini [1996] and Giavazzi and Pagano [1995]). However, by looking to the timing of the output losses and rising deficits it is very hard to accept such a conclusion – unless one believes that consumers were able to predict the recession well in advance.

TABLE 10

	Public debt		Public expenditure		Annual growth of public consumption
	1993	2000	1993	2000	in 1992-99
Denmark	83.8	50.4	58.1	51.3	2.4
Finland	56.0	43.5	59.1	44.8	0.7
Sweden	73.7	56.2	67.5	53.9	0.3
EU15	70.0	70.3	50.6	44.3	1.3

Source: OECD

In the Nordic countries the labour markets seem to have functioned reasonably well, after all, even during and after the economic crises of the early 1990s, and in spite of collective bargaining and generous unemployment benefits. In fact, the Nordic countries can be used as counter-examples to the mainstream view professed by economic journalism and the OECD and IMF reports. In all Nordic countries the employment rate is higher than the EU average. The employment rate of Iceland, Denmark and Norway even exceeds that of the USA. The Nordic unemployment rates are lower than EU average (except in Finland), and long term unemployment rates are low.[11]

Especially the Swedish crisis intensified the critique against the Nordic welfare state model. The recession and the subsequent output and employment losses helped to make the case that the crisis and slow growth were not results of a mere macroeconomic co-ordination but instead a deeper systemic failure ultimately caused by the structures of welfare state. It was argued that the welfare state is generally bad for growth because it creates bad incentives. According to such view, overly generous benefits, labour market rigidities and high taxes will finally discourage investment, job creation and labour supply. By many critics the dismal growth record of the 1990s was used as evidence supporting this critical view both in Sweden and Finland. Since the all Nordic countries recovered from the crises, they cannot any more be used as an ultimate evidence of the failure of Nordic model. It is now more widely admitted that the recessions were related to financial factors and policy failures.[12]

4. The eastern enlargement of EU and the Nordic model

Welfare states have received lots of criticism during the last decades for many reasons. There is a wide literature which has concentrated on the lack of proper economic incentives in welfare states.[13] This criticism is closely related to the functioning of labour market, but also to savings and investment behaviour. It is feared that high taxes and high benefits gradually destroy people's motivation to work hard and take risks, and thus weaken the economic basis of welfare state.

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[11] Some researchers have presented evidence that taxes are not harmful in economies which are characterised by well-coordinated collective bargaining systems; see Summers, Gruber and Vergara (1993) and Kiander et al (2001) for more recent evidence.

[12] The experiences from the 1990s can be viewed as support for the Katsenstein's hypothesis of successful small countries; see Katzenstein (1985).

[13] See e.g. Lindbeck (1997). It is also commonplace that international organisations like OECD and IMF present repeatedly policy recommendations which demand further structural changes and reforms (lower benefits and taxes, privatisation and deregulation). Such claims are essentially criticism of the Nordic and other welfare states.

Integration and globalisation can also be seen as threats to welfare state for the same reason. The current Western European and especially the Nordic models of welfare state are to large extent based on public expenditure finance by high tax rates. They may not be sustainable in long run if the mobility of capital, labour and services start to erode the tax bases. Another worry for the Nordic countries is that in long run the logic of economic integration may force them to cut taxes closer to the average levels of the rest of European Union. It is also feared that after the enlargement of the EU the good benefits of the welfare states may attract a wave of immigrants from poorer countries. These worries raise the question of what kind of long-term effects the deepening economic and also political integration will have on the Nordic welfare model.[14]

There are other potential threats to the Nordic welfare model, too. European integration diminishes the autonomy of national economic policies through monetary union and co-ordination of fiscal policy although it at the same time creates more stability. In longer run the expected demographic change will reduce labour supply and increase the burden of pension finance and rising health care costs. These changes affect all European countries but the Nordic countries may have less scope to adjust because they have already very high levels of public spending.

Although the Nordic labour markets are capable to deliver high employment and low unemployment rates, it is worth to ask what will happen to these regulated and unionised labour market institutions when integration proceeds. There are two reasons to argue that the present institutions can survive. First, most of the other EU countries have similar institutional labour market structures, too. That is why there won't be much pressure from the European Union to reform or liberalise the labour market. The second reason is that it is likely that the costs of employment protection and social benefits are in future born by labour, not by employers. If employees prefer to keep the current level of social protection in competitive environment with mobile capital, it is possible to do that, provided that the gross labour cost of the employer would stay on competitive level.

A potentially severe threat to the future of the Nordic welfare model is formed by international tax competition. As it was argued above, it is likely that the costs of social protection will be mainly born by labour in the form of high labour taxes. Until now this has been possible without risking the tax base since labour is rather immobile. However, it is not impossible that in the future increasing mobility induced by general economic liberalisation – call it globalisation – may have deeper impacts on the traditional welfare state systems by intensifying competition for skilled labour and factor mobility. There is already evidence that economic integration has forced most countries to cut their taxes on corporate profits and capital income. The Nordic countries are no exceptions to this rule; they have also reduced their corporate tax rates, but taxes on labour and private consumption have stayed on high level and even increased in the 1990s.

In the Nordic countries the tax burden lies mainly on the shoulders of employees and consumers. The overall tax rates, average income tax rates and effective consumption tax rates are much higher in the Nordic countries than in the other EU countries although the tax wedge is almost the same. Nordic income taxation is highly progressive and marginal tax rates are very high. Especially this holds for Sweden, Denmark and Finland.[15] At the moment the tax incidence is on relatively stable and non-elusive tax bases. As a result of high consumption and labour taxes

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[14] There is a wide literature which views the deregulated and globalised capitalism on one hand and the European integration on the other as major threats to traditional welfare models, and especially to the Nordic ones. See e.g. Leibfried & Pierson (2000) and Stephens et al (1999).

[15] It has been shown that in models where trade unions are engaged to wage setting progressive taxation may be good for employment; see Koskela and Vilmunen (1996) and Holmlund and Kolm (1995). There is also empirical evidence that even relatively high tax rates do not have significant effects on labour supply (for a survey, see Slemrod, 1998).

private consumption per capita is not so high in the Nordic countries as one might suggest on the basis of high GDP per capita figures.

As the European integration proceeds, it will become easier to purchase goods in other countries and to move to work to other countries with the single market. This will increase the pressure to harmonise the consumption taxes and also after-tax earnings. Although there is evidence e.g. from the USA, that some differentials may sustain between neighbouring jurisdictions[16], such Tiebout-type regional tax competition is likely to put pressure for the Nordic countries to reduce their currently high income tax and consumption tax rates. Especially this applies to Denmark and Sweden, but also to Finland. In Norway the pressure may be felt in the difficulty to maintain higher price level of private consumption than elsewhere (due to both agricultural protectionism and high consumption taxes). In Finland and Norway there is some room to compensate these changes by higher taxes on property. In Sweden and Denmark all taxes are already so high that tax competition will almost certainly reduce aggregate tax revenue – the only question is how much. That, of course, is likely to cause difficulties to the financing of the current welfare models which rely heavily on public expenditure.

Some relief, however, can be found in the current fiscal surpluses of the Nordic governments which are higher than those of other European countries. Sweden and Denmark, for instance, would be able to cut taxes by two or three percent of GDP without a risk of fiscal deficit. Finland and Norway have even more leeway in that direction. Such changes may be sufficient to bring the Nordic tax rates close enough to the tax rates of other EU/EEA countries so that they would be sustainable.

5. Concluding remarks

After the deep recessions of the early 1990s, all Nordic countries have experienced a strong recovery. On average, the post-recession Nordic growth rates of output, employment and productivity are almost the same as in the USA in the same period, and much better than the EU average. Within the Nordic group, the output growth has been fastest in Finland and Iceland, and employment growth has been about two percent per annum in Finland, Iceland and Norway. Highest productivity growth has been achieved in Finland and Denmark.

The good economic record of the latter half of the 1990s may indicate, that the Nordic economies still are well-functioning, notwithstanding the earlier crises. What is the role of economic integration in explaining this? First it has to be remembered that there are lots of common in the Nordic economies. They are all subject to the single market regulations of the EU. Nordic countries have also been ahead of European deregulation by being first to liberalise telecoms and electricity markets.

A central part of the Nordic integration processes in the 1980s and 1990s have been changing monetary regimes. First in the 1980s all the Nordic countries had fixed exchange rate targets; they tried to imitate the exchange rate mechanism of the EMS although they were formally outside of it. After the currency crises of 1992 the paths of Nordic countries started to diverge. Finland's goal was to join the EMU. Denmark decided for political and clearly non-economical reasons to stay formally outside the monetary union but still have a fixed exchange rate vis-a-vis the euro. The rest of the Nordics – Sweden, Norway, Iceland – have remained in the regime of floating exchange rates with explicit inflation targets. In spite of different choices, all Nordic countries have adopted the policy of low inflation and central bank independency. The adjustment process

[16] See e.g. Krueger (2001).

to this new regime of stable prices was initially painful for all of them although the new regime has proven well-functioning afterwards.

The Nordic welfare model survived the test of the 1990s. The model faced a real crisis when the public deficits and unemployment rose to record levels (especially in Sweden and Finland, but in lesser extent also in Denmark, Norway and Iceland) in the mid-1990s due to recessions. However, instead of locking in unemployment trap the Nordic countries recovered quickly in the latter half of the 1990s. After the crises of the early 1990s, the Nordic countries have enjoyed similar growth rates of output, productivity and employment as the US economy. Within five years all Nordic countries were successful in reducing open unemployment significantly and in turning the public finances from deficit to surplus, and maintaining their welfare states. The adjustment was done by raising taxes and restricting the growth of public expenditures, but not by changing the basic structure of the national welfare models. Hence the Nordic countries can still be regarded as advanced welfare states with high public employment, universal benefit systems, extensive publicly provided welfare services, high taxes, low poverty, and corporatist labour market structures.

In future such extensive welfare systems, although they seem to be functioning well, are likely to face further challenges caused by integration, globalisation and demographic change. Further integration of European economies may increase pressure for tax competition, which can threaten the financial basis of the welfare state. The Nordic countries have already responded to tax competition by lowering the corporate tax rates and taxes on capital income. These changes have been compensated by raising other taxes, and as a result, labour incomes and private consumption are heavily taxed. It is not clear how sustainable such a regime of high taxes will be in the future if mobility of goods and employees increase. If further pressure to lower taxation will emerge in future, then the financing of the increasing public pension and health care expenditures of aging populations may be difficult – possible more difficult for the Nordic countries than to other European countries, because the initial level of taxation is so high and because there is not much scope to increase labour supply. Some leeway for the Nordic governments may be provided by their exceptionally good fiscal positions.

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