TOP FLIGHT economies?

Those arguing for a smaller state within the EU invariably face the charge that the Scandinavian economies demonstrate that big government is not an impediment to success.

This is a charge many find difficult to refute. The Nordic Model has become a key intellectual battleground over which the "big versus small state" war will be played out in the 21st century.

In his continuing series on Europe, GRAEME LEACH poses the question: HOW ATTRACTIVE IS THE NORDIC MODEL?

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

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

ONE OF THE PRIMARY REASONS FOR THE RECENT STRONG PERFORMANCE OF THE SCANDINAVIAN ECONOMIES HAS BEEN A RETREAT OF GOVERNMENT

This article 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. In other words, Nordic economic performance conforms with economic theory and makes the case for a smaller state.

Recent economic history in Scandinavia

Over the 15 years prior to the Great Recession government spending fell by more than 20 percentage points of GDP in Sweden. The smallest fall in the share of government spending in GDP was in Denmark where it still fell by 10 percentage points. These are stunning figures, although it also has to be acknowledged that the state remains very large, accounting for at least 50 per cent of GDP in the Nordic economies.

The reduction in government spending suggests that the private sector was being crowded-in, raising productivity and output growth. 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.

If we apply recent econometric estimates (*Government Size and Implications for Economic Growth*, A. Bergh & M. Henrekson: AEI, 2010) relating to the impact of the size of the state on GDP growth, they suggest that a fall in the size of the state in Sweden may have added 1 to 2 percentage points to the long-term potential growth rate. The comparable figures for the other Scandinavian economies are 0.9 to 1.8 percentage points in Finland, 0.7 to 1.4 percentage points in Norway and 0.5 to 0.9 percentage points in Denmark (see Table 1).

A different approach confirms the above analysis for most Scandinavian countries. If we examine the supply-side potential of the Scandinavian economies using OECD estimates of potential GDP growth, we find that only in Denmark has potential GDP growth declined in recent years. If we compare the decade before the Great Recession with the previous decade, according to the OECD, potential growth has increased from 2.0 to 2.8 per cent in Sweden, 2.5 to 3.2 per cent in Norway and 2.0 to 3.1 per cent in Finland. In contrast, potential GDP growth fell across the OECD and the euro area.

So has there been an acceleration in actual GDP growth over recent decades? All the economies (with the slight exception of Norway) display acceleration in GDP growth comparing 1997-2007 with the 1986-1996 period.

Finland and Sweden in particular show strong growth over the 1997-2007 period – well ahead of the Euro area and the OECD average. In the previous period, with the exception of Norway, the Scandinavian economies had lagged well behind the Euro area and OECD average growth rate. Norway's performance is often atypical because of large oil revenues.

Where are we now?

The Scandinavian economies still record the highest tax burdens in the OECD as a proportion of GDP. However, Scandinavian economies are no longer outliers when it comes to the extent of government spending: government spending in Sweden as a proportion of national income is roughly equal to UK levels.

Given that government borrowing is deferred taxation, we should probably look at government spending rather than average tax rates as the measure of the size of the government sector; here Sweden, at least, performs no worse than many of its EU counterparts. Furthermore, the introduction of lower marginal tax rates over recent decades has boosted the supply-side of the Nordic economies. OECD statistics on the marginal corporate income tax rate (CIT) suggest that the Scandinavian economies are relatively competitive on this measure.

Consequently the Nordic Model is not a simple story of big government. The reality is more complicated. In many areas, such as economic freedom and openness, the Scandinavian economies operate more like small state economies. In addition, it has to be acknowledged that the Nordic Model is not uniform. Denmark, for example, has a far more liberalised labour market than the other three economies.

THE LONG-TERM GROWTH DIVIDEND FROM THE SHRINKING STATE
(change to potential GDP growth rate % points)

	Cautious estimate	Optimistic estimate
Sweden	1.0	2.1
Norway	0.7	1.4
Finland	0.9	1.8
Denmark	0.5	0.9

Author's calculations, applying the relationship between the ratio of government spending to GDP and economic growth to the change in the share of government spending to GDP in Scandinavian countries.

Table 1

WHAT IS THE NORDIC MODEL?

THE TRADITIONAL VIEW – STATIST UTOPIA

The Nordic Model refers to certain structural characteristics shared by the four leading Nordic economies: Norway, Sweden, Finland and Denmark. The suggestion of a "Nordic model" does not mean that these economies are uniformly the same. One obvious difference is that they are not all in the euro or even in the EU. Finland is in the EU and the euro. Sweden is in the EU but not in the euro and has a freely floating currency. Denmark is in the EU but not in the euro but has a pegged currency. Norway is in neither the EU nor the euro.

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.

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 adhesion 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: so-called 'flexicurity'. However, in other Nordic economies, such as Sweden, whilst overall employment protection for permanent workers is high, 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: this high level of trust predated the welfare state. Three other points are worth noting: Scandinavian economies have much more private involvement in the provision of health and education than the UK; the relatively flat income redistribution actually predated the welfare state; and the extent of redistribution in the Swedish welfare state is no greater than that in the British welfare state.

See also FJORD FOCUS:
Is the British Left falling out of love with Sweden?
***Idealog*, page 40.**

FINLAND AND SWEDEN IN PARTICULAR SHOW STRONG GROWTH OVER THE 1997-2007 PERIOD – WELL AHEAD OF THE EURO AREA AND THE OECD AVERAGE

But, even when it comes to government spending, the Nordic economies are no longer significantly different from other EU countries. Historically, the Nordic economies have flourished when they are more liberal and go off the rails when higher taxes and more regulation have been imposed for any length of time.

However, despite the fact that we can build a strong case for recent economic success having being built on a movement away from the big-government model, aspects of the Nordic Model remain elusive and difficult to categorise.

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"*.

Graeme Leach
Chief Economist and
Director of Policy
Institute of Directors
graeme.leach@iod.com