

## **NORDIC MODEL – A SUCCESS STORY?**

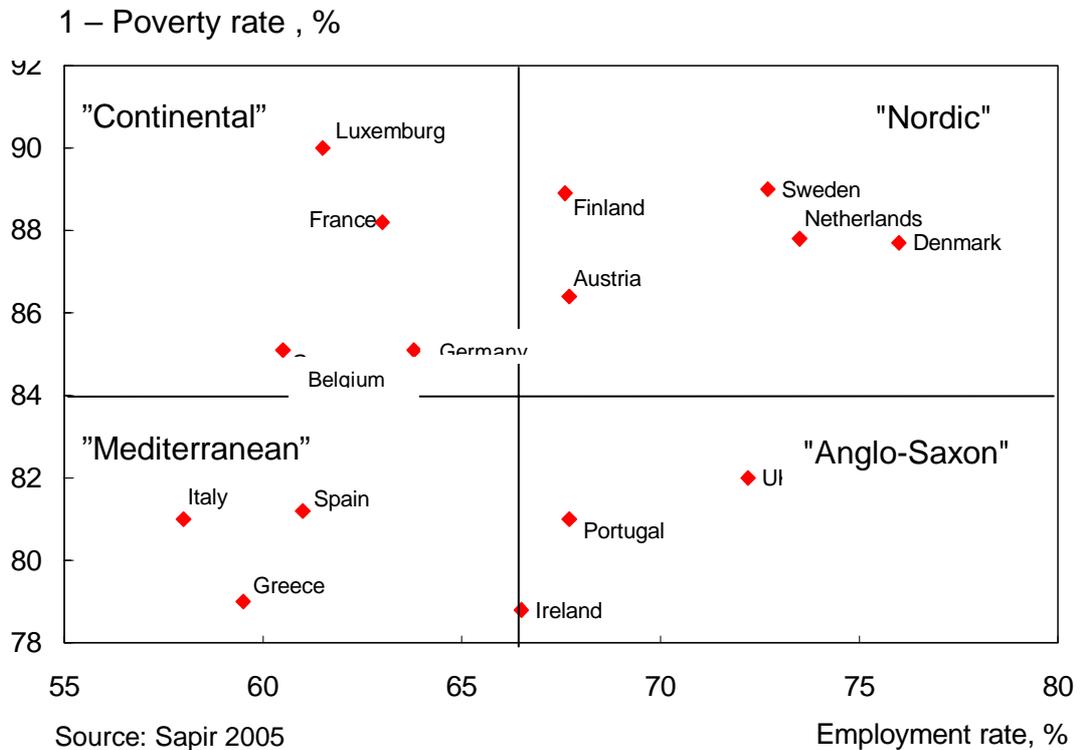
*Remarks by Ms. Sinikka Salo, Member of the Board,  
in the seminar at the Banco de España, 27 March 2006*

Key points of the presentation:

### **Introduction: equity and efficiency**

- There is a strong political will in Europe to provide protection for the vagaries of the labour market, as well as a more egalitarian income distribution. Social protection, in the form of pensions, health and long-term care, protection for the poor and disabled, and policies to support people in the event of unemployment, features in the Member States on average 27 % of GDP, in contrast to only 15 % in the United States and 17 % in Japan. Developments in demography – ageing population - technology and globalisation tend to increase the pressure to increase spending for social protection even further in most Member States.
- There are in fact a wide variety of social models in the Member States, even if we omit the new Member States. The comparison of different social models has stimulated interest in interdependencies between competitiveness, employment and social security and there has been increasing debate about the appropriate trade-offs between economic and social outcomes. One key challenge is to draw lessons from the examples of success within Europe in balancing the need for labour market flexibility and effective social safety nets.
- One participant in this discussion has been Professor André Sapir, who in his presentation for the informal Ecofin meeting in Manchester last year grouped social models in the EU-15 countries into four groups. In Sapir's analysis the "Continental" and "Mediterranean" models, which together account for 90 per cent of the GDP of the euro area, are inefficient and must be reformed, probably by adopting features of the two more efficient models. Of these, the "Nordic model"

combines high employment and low probability of poverty and is thus more attractive politically than the "Anglo-Saxon" model. (Chart 1)



**Chart 1: Employment rates and probability of escaping poverty**

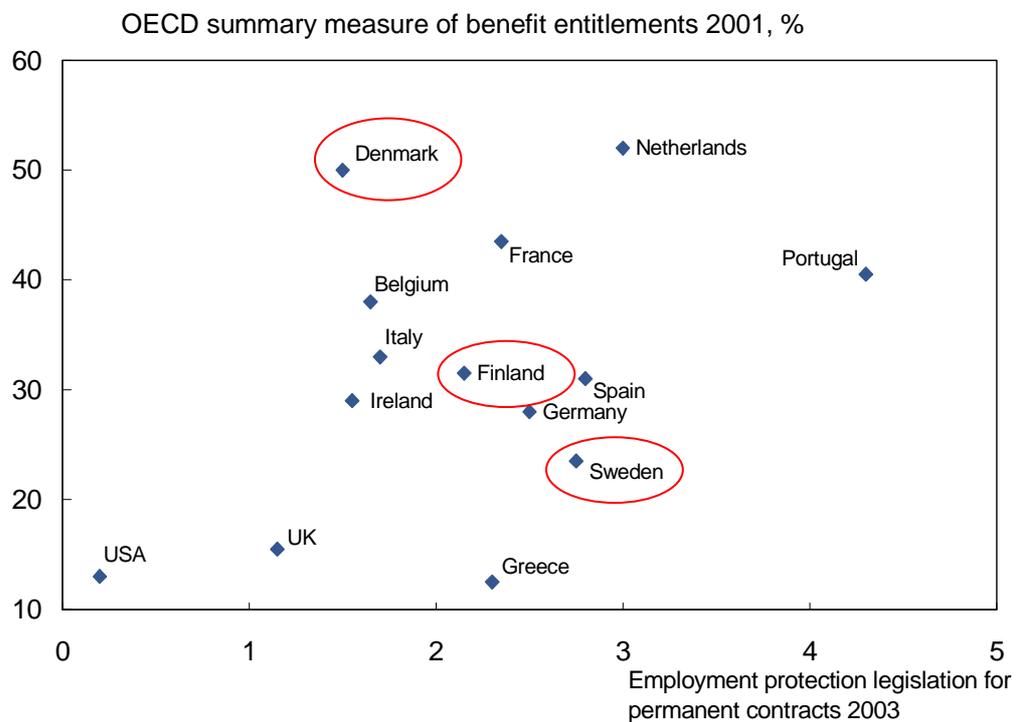
- Professor Sapir argues that strict employment protection has rendered the economies of Continental and Mediterranean inefficient whereas the generosity of unemployment and other social benefits in Nordic countries are less harmful and potentially even useful for employment. Perhaps in the same vein, the European Council recently invited Member States and social partners to pursue reforms in labour market and social policies under an approach which combines in an integrated manner flexibility and security, adequately adapted to specific institutional environments.
- This presentation discusses strengths and weaknesses of the Nordic model. In many cases, it takes Finland as an example, this being the country I know best. While the Nordic countries are similar in terms of income distribution and em-

ployment performances, their economic structures and social and labour market policies vary considerably, and each country appears to provide its own combination of employment protection, unemployment benefits, and active labour market policies. In many respects, Nordic countries - and Finland among them - have been a success story, but it is not entirely clear what kind of conclusions one can draw from them in the debate about reforming Europe's social systems.

### **Employment protection legislation and unemployment benefits**

- There are many reasons why strict employment protection legislation may be an unsatisfactory tool for employment protection. It protects only those who already have a job, while it may have serious adverse effects, especially on the weakest groups in the labour market, and the cost to firing workers entails disincentives to hiring in the first place. The job prospects for those with relatively weak attachment to the labour market, such as young workers, women and long-term unemployed have been found to be compromised by strict employment protection legislation. Moreover, if wages are not sufficiently flexible to allow high dismissal costs to be reflected in lower wages, the job prospects of low-wage workers will be adversely affected.
- On the other hand, there is also much evidence that the level and duration of unemployment benefits correlate positively with unemployment. High unemployment benefits may reduce the job-search intensity of the unemployed and their willingness to accept job offers, and by lowering the economic cost of unemployment, they may put upward pressure on workers' wage claim and thereby reduce labour demand.
- Different countries have adopted different combinations of employment protection legislation and unemployment benefits. Professor Sapir's characterization of Nordic countries as having a low level of employment protection legislation but generous and comprehensive unemployment benefits clearly applies to Denmark, but less so to Sweden and Finland, where employment protection legislation and

unemployment benefits are at about the average levels of industrialized countries. Moreover, in Sweden and Finland comprehensive social contracts play a significant role in employment protection. While strict employment protection legislation may be one reason for the low level of employment in Mediterranean and Continental countries, its absence does not explain of the high level of employment in Nordic countries, at least not in Sweden and Finland. Nor do Sweden and Finland provide strong evidence for the claim that generous unemployment benefits are not harmful for employment, and even in the case of Denmark it should be noted that unemployment benefits has decreased considerably from their very high level in the early 1990s. (Chart 2; the data source is OECD) ("Assessing the OECD jobs strategy: past developments and reforms" by Brant, Nicola, Burniaux, Jean-Marc and Duval Romain, Economics department working papers no. 429, 2005).

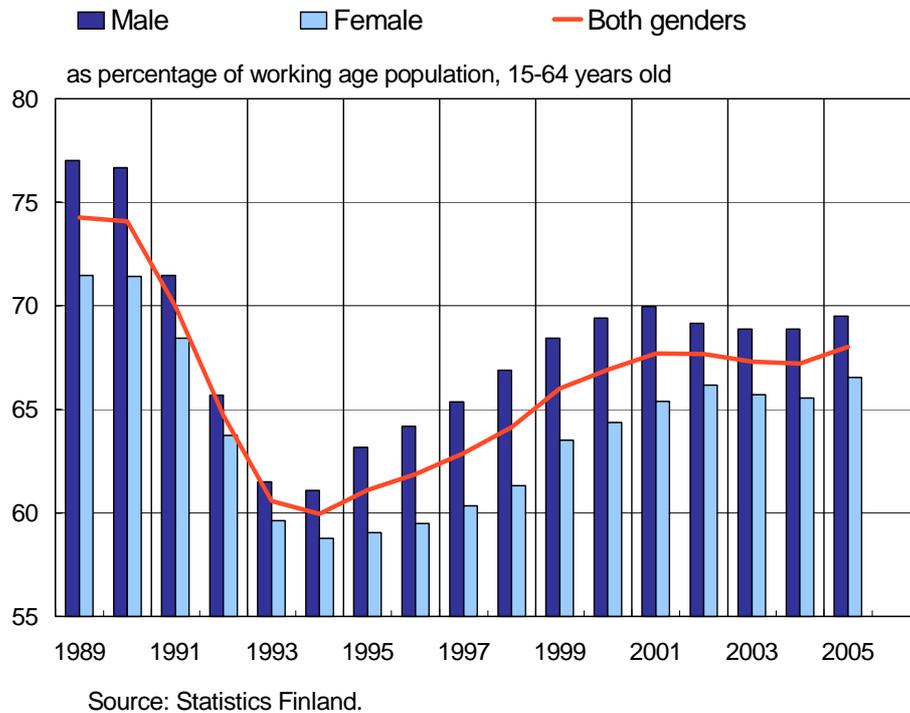


**Chart 2: Employment entitlements and employment protection legislation**

## Public employment

- Active labour market policies, for example in the form of public job creation and wage subsidy programmes, are used extensively in Denmark, Norway and Sweden, as well as in the Netherlands. Also Finland has experimented with them, but the outcomes have been not entirely encouraging, and the expenditure on active labour market policies is in Finland on average European level only. Nevertheless, there is a substantial reserve of hidden unemployment in all Nordic countries, including Finland.
- If "active labour market policies" is defined so as to include public sector employment, it amounts to a significant share of total employment in all Nordic countries. In Finland, almost one fourth of total employment is in the public sector. Welfare services such as health services, children's day-care, education and care of elderly are provided largely by the local government, which employs about three fourths of the public sector employees. After the decline in early 1990s in the aftermath of the recession and banking crisis, the employment in the local government has increased substantially, by about 10 per cent.
- A high level of participation ratios and employment in Nordic countries is related to a large extent to this type of "activism" by the public sector. By providing day-care and care for elderly people both parents are able to participate in work force. This is one corner-stone of the Nordic model – and the area where there may be lessons to learn for ageing Europe. I come back to this in my conclusions at the end of my presentation.
- High level of employment in the Nordic countries is a reflection of a high level of female participation and employment rates. In Finland female employment is higher than male employment and exceeds clearly the Lisbon goal of 60 per cent for female employment in 2010. (Chart 3). From the economic point of view this model has made possible to make efficient use of all resources (human capital of highly educated women, economies of scale for child care and taking care of elderly).

erly). Family friendly policies have also resulted in birth rates which in Nordic countries are among the highest in the EU.



**Chart 3: Male and female employment in Finland**

- The provision of public welfare services has offered women an opportunity to participate in the labour force, and at the same time created job opportunities for them in the public sector. About 80 per cent of all employees in local government are women.

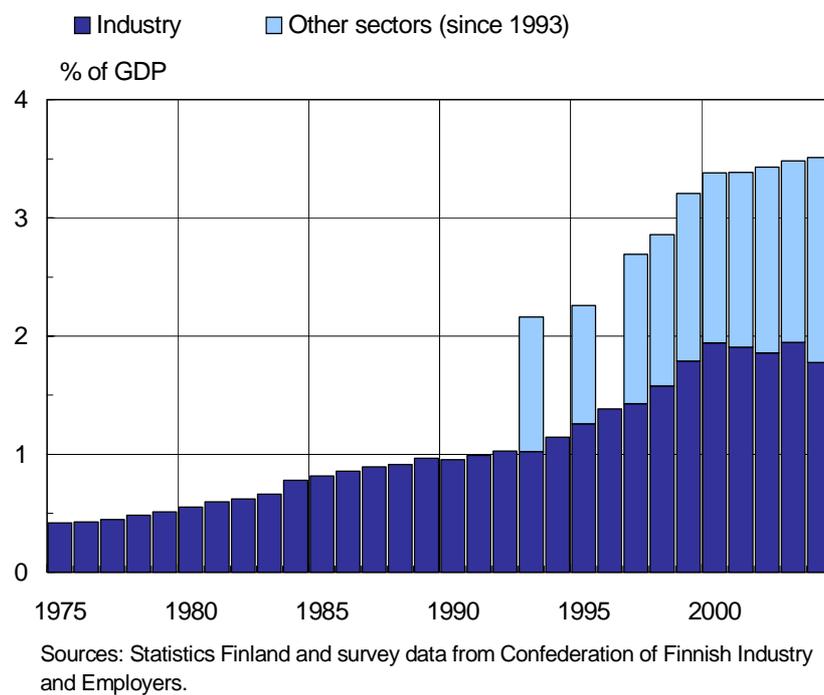
### Competitive open sector

- In spite of the large public sector, the open sector in Nordic countries is competitive. In many branches of manufacturing industries, productivity has reached or even exceeded the US level. In small and remote economies, exports have always been a prerequisite for firm growth, and irrespective of their political colour, the governments in Nordic countries have tried to keep business climate favourable.



- In the 1990s the economies of Sweden and Finland became technology-intensive. In the background was a long, self-strengthening and complex development process that began in institutions, organisations and throughout the society already in the early 1980s. Although measures by the public authorities created a solid foundation for developing competitiveness, the high-tech industry did not emerge as a product of old-fashioned industrial policies in the form of state subsidies or protected monopoly positions in the markets.
- On the contrary, as a result of the early liberalisation of telecommunication, heightened competition drove prices down and led to mass markets for wireless communication, providing a test laboratory for the equipment industry. The liberalisation of capital markets and the following rapid increase in risk financing gave a further stimulus to the growth, diversification and internationalisation of the technology sector.
- In telecommunication, standardization among the Nordic countries and in particular the NMT standard gave an early start for the internationalization of the mobile telecommunication industry. In the 1980s and early 1990s, the prospect of EU membership was instrumental for the adoption of the GSM standard, which opportunity the Swedish and Finnish mobile phone companies were able to exploit fully.
- In Finland, the cutting edge of the high-tech industry has been the mobile communications company Nokia. It is an illustration of the fact that it is feasible for a global enterprise to develop in a small country. Compared with the size of the Finnish economy, Nokia is very large in many respects. At the height of the IT boom in 2000, its market value was nearly double the value of the Finnish GDP, reflecting of course high – even if in retrospect misplaced – expectations of future growth of sales and profit opportunities.
- Research and development expenditure in Finland was in 2004 3.5 % of GDP, slightly less than in Sweden but well above the 3 % of GDP Lisbon goal for the EU in 2010. Research and development expenditure comes largely from the busi-

ness sector, the R&D financed by the public sector being only about 1 % of GDP. The role of Nokia is significant also in here. It has been estimated that Nokia accounts almost 50 % of all R& D expenditure carried out by the business sector in Finland and its share in total R& D expenditure is more than 30 %. These values are only indicative, as Nokia does not publish R&D expenditures by country breakdown. (Chart 4)



**Chart 4: Research and development expenditure in Finland**

- It should be also mentioned that Nokia has benefited from Finland's educational system. The supply of high-skilled engineers has been abundant and consequently the wages of engineers have remained moderate in spite of strong demand in Nokia and the whole IT-cluster born out of Nokia's success. Free education may have contributed to wage moderation.

### **The Nordic model has performed well in many respects**

- Large public sector reflects choices by the politicians and ultimately by the electorate. Surveys of public opinion indicate that a large majority of citizens is satisfied with the welfare services and is willing to pay high taxes as the price of them. There are many explanations for the legitimacy of welfare state in Nordic countries:

(1) For geographic and historical reasons, populations in the Nordic countries are small and homogeneous. This entails that public services can be easily tailored for the "median voter". Perhaps the most homogenous of all Member States is Finland, where not only the income distribution is even but also the proportion of foreigners in total population is low, about 2 %, i.e. the lowest one among the EU 15 Member States.

(2) All Nordic countries have a tradition of strict budgetary discipline. This may reflect intergenerational solidarity, but may also be important on its own. In particular, budgetary discipline has helped to curtail expenditure on public debt interest, and thus providing room for socially more highly valued types of expenditure. Budgetary discipline may also have fostered good governance at all levels of government.

(3) The integrity of civil servants is not often questioned. According to the last Transparency International survey, Finland, Denmark, Sweden and Norway are all among the 10 least corrupt countries, whereas the world's least corrupt country being seen to be Iceland. The index defines corruption as the abuse of public office for private gain, and measures the degree to which corruption is perceived to exist among a country's public officials and politicians.

(4) Welfare services provided by the Nordic countries have performed well in international comparisons. A case in point is educational system in Finland. Finland has been among the top performers in OECD's Programme for International Student Assessment (PISA). This assesses how far students near the end of compulsory education have acquired some of the knowledge and skills that are essential

for full participation in society, covering the domains of reading, mathematical and scientific literacy. The survey was implemented in more than 40 countries in the first two assessments in 2000 and 2003. Finland has performed excellently in both surveys. In 2003, it kept its lead in reading but was now in the top also in sciences and second after Hong Kong in mathematics. PISA does not take into account resources devoted to education. However, there is no evidence to suggest that the Finnish educational system is more expensive than in other Member States the expenditure on education being at the average level of industrial countries.

(5) Public sector employees form a powerful interest group, and of course are interested in maintaining the welfare state.

- The educational level of public sector employees and the whole workforce is relatively high in all Nordic countries and has increased rapidly in recent years. To take again one example from Finland, the share of working age population who have completed higher education is higher than in other Member States, with the exception of Ireland, even though not as high as in the US. In 2000, 32 %, of total workforce in Finland had achieved tertiary education, while the EU-15 average was 24 % and the corresponding figure for the US 37 %.
- A certain degree of consensus in industrial relations has been a characteristic feature for labour markets in all Nordic countries. In Finland and Sweden the degree of unionization in labour markets is albeit declining still high for both employees and employers, and labour contracts have a relatively prominent role in shaping the relationship between employee and employer, instead of employment protection legislation. Comprehensive income agreements have suppressed wage differentials and contributed to relatively moderate wage increases and low inflation.

In recent years, the role of local agreements has been on increase, and working time arrangements have been increasingly flexible at the local level, allowing firms to

adopt working hours to the cycle. Harmonious labour market relations are illustrated for example by the fact that recently a major pension reform was agreed and implemented in Finland without a single demonstration. I mention only three main elements of the reform. First, this reform abolished two early-retirement schemes. Second, there will be an automatic cut in pensions according to the increase in life expectancy. Third, benefits will be calculated on the basis of the whole lifetime income and not the last working years.

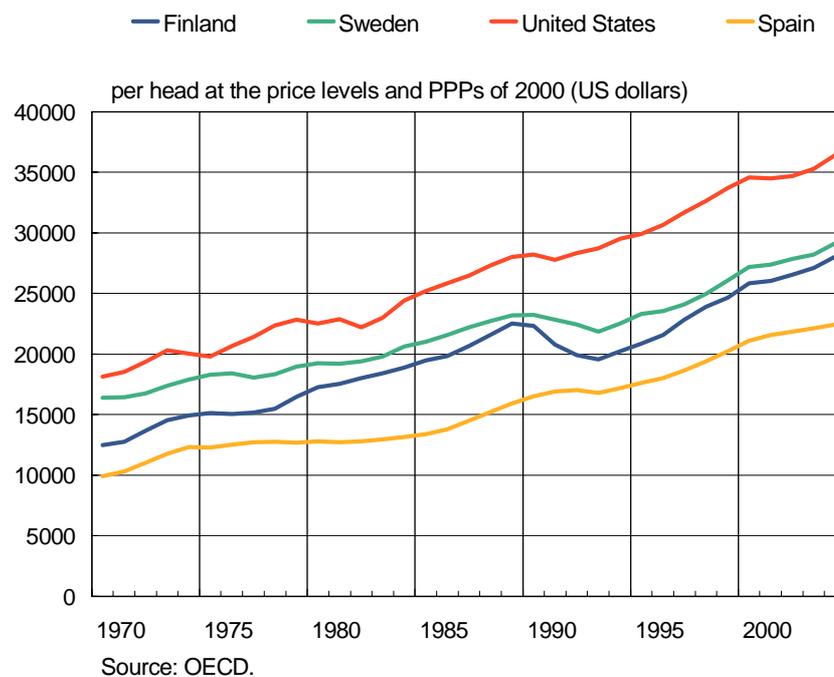
### **The challenges of the Nordic model are increasing**

- Generous provision of welfare services require high taxes, with the revenues of the public sector having been in recent years at the level of 58-59 % of GDP in Sweden, 55 % in Denmark and 53 % in Finland. Direct labour tax rate for average production worker income is around 40 % in Sweden and Finland and somewhat lower, around 30 % in Denmark. Although there has not been strong pressure from the electorate, policy makers have increasingly recognized heavy taxation to be a problem. In Denmark there has been a tax freeze in force since 2001, entailing a gradual but over time substantial decline in tax burden, and also Finland and to some extent even Sweden have eased especially wage taxation.
- A high level of wage taxation tends to suppress labour input, and similar considerations may apply to employees' and employers' social security contributions and value added taxes. Prescott (2004) and Ueberfeldt (2004) have argued that taxes play a determining role in shaping the dynamics of hours worked per capita. Hours worked per worker are below the OECD average in Sweden and Denmark, and clearly below in Norway, whereas in Finland average hours are at the average OECD level, comparably to the United States or the UK. The negative effect of taxation on employment may be weaker in the Nordic countries than in some other countries, because of the link between taxation and public employment. Moreover, compulsory pension contributions are more or less accurately actuari-

ally linked to pensions, mitigating the effect of social security contributions on labour supply.

- In all Nordic countries, large public sector employment has certainly crowded out employment in the private sector, and may have distorted the allocation of labour input in the economy.
- A large public sector is a drag for productivity growth. In aggregate terms, the level of productivity in the public sector is lower than in the rest of the economy and in particular in the open sector, and productivity grows more slowly in the public sector than in the private sector. It is not surprising that in spite of the dynamism of the open sector, total factor productivity growth has been slower in the Nordic countries than in the Anglo-Saxon countries or in the US.
- In national accounts the public sector output is defined on the basis of inputs, and thus public sector's productivity and productivity growth are low almost by definition. There have been some attempts to measure public sector productivity by comparing different performance indices with physical inputs. These productivity indicators combine heterogeneous elements and give rise to difficult measurement problems even within a single function and they usually do not take into account changes in the quality of public services. Nevertheless, they may give some hint of true productivity trends in the public sector. Empirical estimates are rather gloomy. For example, in Finland the productivity of local government appears to have declined every year since 1998.
- Another indication of inefficiency are large and rather permanent differences in productivity between different production units. It has been estimated that for example in social and health services and in education, productivity could increase by 10-20 per cent, if all units would function as effectively as the most effective units. Even larger increases could be feasible by reforming structures and functioning of the system or by using modern information technology.
- Because of low productivity growth, the long-run performance of the mature welfare state Sweden was below the average of industrial countries for decenniums, and in Finland the catching-up process practically stalled after the gradual adop-

tion of the Nordic welfare state was more or less completed in mid-1980s. (Chart 5) Recently, the growth has picked up both in Sweden and in Finland, but this may reflect at least in part exceptional factors. First, after the banking crises of the early 1990s output has returned to normal level. Second, Sweden and Finland have been lucky to enjoy from the boost of the ICT-sector which has temporarily accelerated the growth of GDP. Nokia alone contributed 1.6 percentage points to Finland's overall GDP growth in 2000. The growth of the ICT sector has decelerated thereafter, but its contribution to the GDP growth has been substantial even in recent years.



**Chart 5: PPP output per capita**

- Even though public finances are in good shape in all Nordic countries, problems are already mounting on the horizon. The demand for welfare services increases as the population grows older, and at the same time, the room for financing extra expenditure by rising taxation is limited because of already high level of taxation and increasing tax competition. Expenditure savings in central government are

feasible, but they do not suffice to solve the problems at the local level. Indeed, it is in the municipalities who provide most services and where most rationalisation efforts are needed.

- A major challenge comes from globalization in the form of higher dispersion of income and increased immigration, and in future means are needed to maintain the solidarity and social cohesion needed to keep the Nordic model functional.

## Conclusions

- Each Nordic country has its own version of the "Nordic model", depending on geographical, historical and economical circumstances. This makes it difficult to draw universally applicable policy conclusions from the success of the model.
- Homogeneous societies tend to provide more public goods than heterogeneous societies, as public services can be more easily tailored for the needs of the "median voter". The Nordic countries are homogeneous, and it is thus be no surprise that the public sector is large in all of them.
- There is some evidence that the public sector services are provided in Nordic countries more effectively than in most countries - although there are room for improvement in this field as discussed before. This may also be related to the homogeneity of the society, but other factors such as the small size of the countries or a general tradition of the rule of law and lack of corruption may have contributed to the success of the public sector.
- Employment is high mainly because of the high level of female participation. The extensive provision of welfare services by the public sector has made it possible for the women to participate in work force and at the same time created job opportunities for them. As I hinted before this aspect of the Nordic model could perhaps be adopted also elsewhere in Europe. In a way this is implicitly included in the Lisbon strategy where more participation of women in work force is called for. This highlights, as a prerequisite, the importance of child care and care for elderly. These services can be provided either by the public sector or by the private sector. However, relying entirely on private sector may not produce these

services to the extent needed to raise participation rate of women to the targeted levels of Lisbon agenda. Therefore public money is needed. And there we come close to the service providing aspects of the “Nordic model”.

- High level of employment is instrumental for the prevention of poverty and marginalization. And perhaps one could draw from the Nordic model the lesson that universal and high-level education can reduce the risk of poverty by promoting the accumulation of human capital in the society. Finland and other Nordic countries have been successful in providing education not only at the elementary but also at the higher level.
- The importance of private sector competitiveness should be highlighted. In small and remote economies, exports have always been a prerequisite for firm growth, and irrespective of their political colour, the governments in Nordic countries have tried to keep business climate favourable.
- Finally, I would stress again that the Nordic model, like any of the European models, faces its challenges in an ageing society. The Nordic welfare state is based on economic growth and thus the most basic challenge is how to streamline the production of public services so that public finances can remain sustainable without distorting growth prospects with excessive taxation.