

Policy Analysis

No. 603

November 5, 2007

<i>Routing</i>

What Can the United States Learn from the Nordic Model?

by Daniel J. Mitchell

Executive Summary

Some policymakers in the United States and Europe argue that it is possible to enjoy economic growth and also have a large welfare state. These advocates for bigger government claim that the so-called Nordic Model offers the best of both worlds.

This claim does not withstand scrutiny. Economic performance in Nordic nations is lagging, and excessive government is the most likely explanation. The public sector in Sweden, Denmark, Norway, Finland, and Iceland consumes, on average, more than 48 percent of economic output. Total government outlays in the United States, by contrast, are less than 37 percent of gross domestic product. Revenue comparisons are even more striking. Tax receipts average more than 45 percent of GDP in Nordic nations, a full 20 percentage points higher than the aggregate tax burden in the United States.

This bigger burden of government hurts Nordic competitiveness, both because government spending consumes resources that could be more efficiently allocated by market forces and because the accompanying high tax rates discourage productive behavior. A smaller state sector is one reason why the United States is more prosperous. Per capita GDP in the United States is more than 15 percent higher than it is in the Nordic nations. The gap is even larger when com-

paring disposable income, private consumption, and other measures that reflect living standards.

Notwithstanding problems associated with a large welfare state, there is much to applaud in Nordic nations. They have open markets, low levels of regulation, strong property rights, stable currencies, and many other policies associated with growth and prosperity. Indeed, Nordic nations generally rank among the world's most market-oriented nations.

Nordic nations also have implemented some pro-market reforms. Every Nordic nation has a lower corporate tax rate than the United States, for example, and most of them have low-rate flat tax systems for capital income. Iceland even has a flat tax for labor income. And both Iceland and Sweden have partially privatized their social security retirement systems.

The Nordic nations offer valuable lessons for policymakers, but they do not fit the traditional stereotype. Conservative critics correctly condemn the large welfare states, but often overlook the positive results generated by laissez-faire policies in other areas. Liberals, meanwhile, exaggerate the economic performance of Nordic nations in an effort to justify welfare-state policies, while failing to acknowledge the role of free-market policies in other areas.

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Introduction

Economic policy debates frequently revolve around the experiences of other nations. Conservatives often cite Hong Kong when they advocate the flat tax, Ireland as evidence for lower corporate tax rates, and Australia and Chile to show the benefits of personal retirement accounts. Liberals often invoke the Nordic nations as evidence that it is possible to have a large welfare state without sacrificing too much growth.

Proponents of this view argue that the United States should emulate Sweden, Denmark, Norway, Finland, and Iceland. The so-called Nordic Model (alternatively known as the Swedish Model or Scandinavian Model) is often cited by those who want an alternative to the supposedly Darwinistic free-market system of the Anglo-Saxon world. For instance:

- A study published by a government-subsidized think tank in Brussels asserts, “The ‘Nordic’ and the ‘Anglo-Saxon’ models are both efficient, but only the former manages to combine both equity and efficiency.”¹
- Foreign-aid advocate Jeffrey Sachs claims, “The Nordic countries outperform the Anglo-Saxon ones on most measures of economic performance.”²
- An article in the *International Herald Tribune* states, “European leaders want to know how Sweden and its Nordic neighbors, so heavily laden with cradle-to-grave welfare systems, float high.”³
- The head of the Tax Policy Centre for the Organization for Economic Cooperation and Development recently bragged that taxes are twice as high in Sweden as they are in the United States, but that economic growth is twice as fast.⁴

Some praise for the Nordic Model is understandable. Compared to most other European nations, Nordic nations are doing well. Average annual growth rates over the past 10 years range from 2.1 percent in Denmark to

4.3 percent in Iceland.⁵ Unemployment rates are all below 9 percent, with Iceland enjoying a jobless rate of just 2.6 percent.⁶ Per capita GDP also is reasonably impressive, especially compared to most parts of the world, ranging from nearly \$43,600 in oil-rich Norway to slightly more than \$34,400 in Sweden.⁷

Before drawing conclusions about the desirability of the Nordic model, however, it is important to answer three relevant questions:

1. Why are Nordic nations relatively rich?
2. Has the welfare state helped or hindered these countries’ economic performance?
3. Does the Nordic Model create more prosperity than the (relatively speaking) limited-government model in the United States?

The answer to all of those questions is that Nordic nations are reasonably successful in spite of the welfare state. Nordic countries benefit from institutions—such as property rights, stable currencies, and the rule of law—that facilitate economic growth. And although they have large welfare states and concomitantly high levels of taxation, their economic systems in other respects are very market-oriented. Combined with the fact that before the mid-1960s the burden of government in Nordic nations was modest, these factors help explain why those countries today are relatively prosperous.

But relative prosperity does not imply that the welfare state is good for growth, and it certainly does not suggest that the Nordic Model should be adopted by nations with smaller governments. The United States can learn something from the Nordic Model, but the main lesson is that a large welfare state reduces economic performance.

The main difference between the American system and the Nordic Model is that America has a medium-size welfare state and the Nordic nations have large welfare states. That explains, at least in part, why the U.S. economy generally outperforms the Nordic Model. Income is

higher in America, unemployment is lower, and long-term growth is more impressive. High levels of government spending in Nordic nations have hindered economic performance. Excessive spending invariably creates a culture of dependency and misallocates a nation's economic resources. A heavy burden of government also requires an onerous tax burden, even if a government seeks to raise revenue in a relatively nondestructive manner.

Comparing the United States and the Nordic Nations

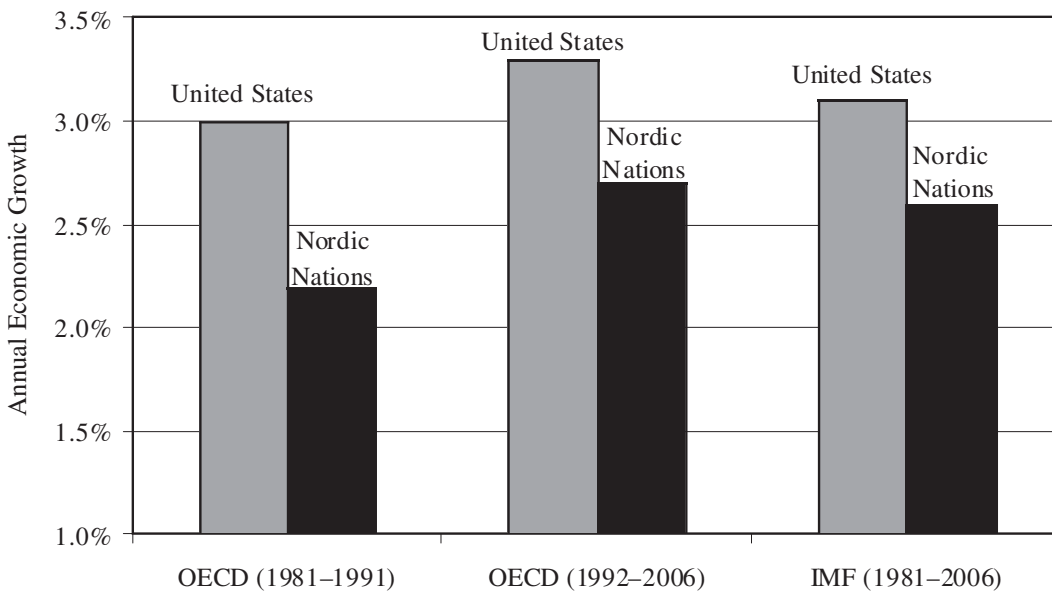
The two main ways of comparing economic performance are rate of growth and level of output. One measures how fast gross domestic product (or some similar measure of economic output) is expanding. The other compares the absolute level of economic output (or some similar measure of prosperity). By both measures, the Nordic nations generally do not fare well when compared to the United States.

The OECD and the International Monetary Fund publish comprehensive economic data that can be used to compare growth rates in America and the five Nordic countries.⁸ As seen in Figure 1, this data shows that the United States has enjoyed a faster rate of growth. According to the OECD, the U.S. grew by an average of 3 percent between 1981 and 1991 and 3.3 percent between 1992 and 2006 (meaning average growth of 3.2 percent for 1981 to 2006). The Nordic nations, by contrast, grew by an average of 2.2 percent between 1981 and 1991 and 2.7 percent from 1992 to 2006 (meaning average growth of 2.5 percent over the entire period). The IMF, meanwhile, reports that U.S. growth averaged 3.1 percent from 1981–2006 compared to an average of 2.6 percent for Nordic nations in the same period.⁹

Some might argue that the faster rate of economic growth in the United States is the result of more rapid population growth. But that explains only a fraction of the difference. Moreover, differences in population growth are irrelevant when examining per capita economic output, and America clearly enjoys a

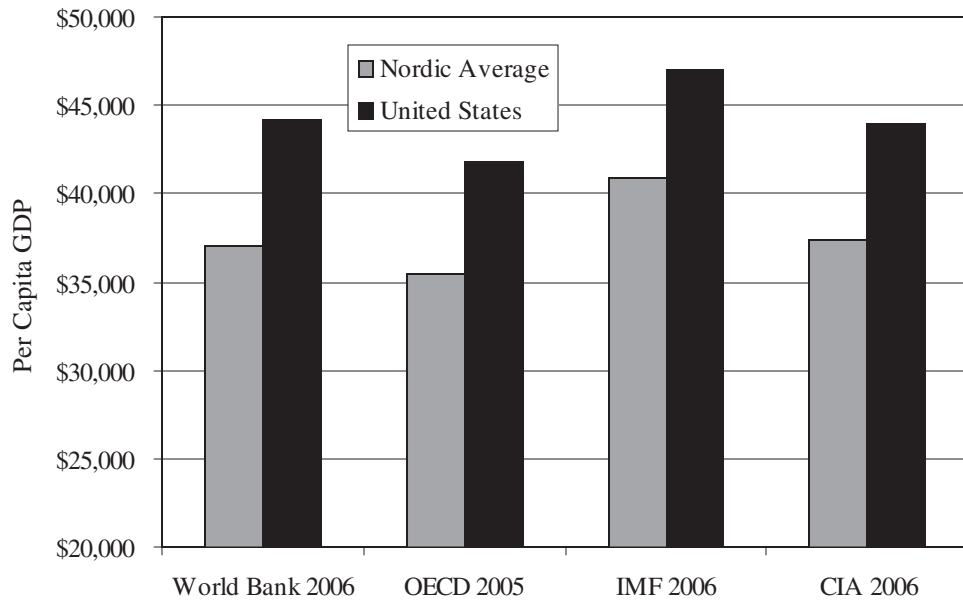
Measures of per capita GDP from the World Bank, the OECD, the IMF, and the CIA all show that Americans have about \$6,000 of additional economic output per person.

Figure 1
Faster Growth in the United States



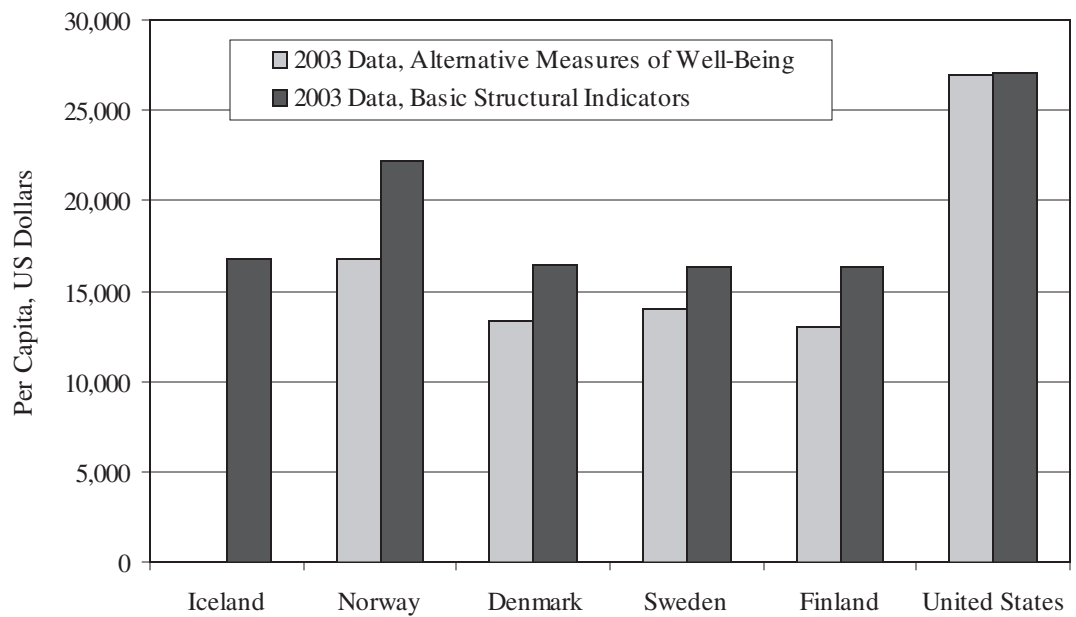
Sources: Organization for Economic Cooperation and Development, International Monetary Fund.

Figure 2
Americans Enjoy More Output



Source: World Bank, Organization for Economic Cooperation and Development, International Monetary Fund, Central Intelligence Agency.

Figure 3
Higher Levels of Disposable Income in the United States



Source: Organization for Economic Cooperation and Development.

large advantage using this comparison. As seen in Figure 2, measures of per capita GDP from the World Bank, the OECD, the IMF, and the CIA all show that Americans have about \$6,000 of additional economic output per person, significantly more than \$20,000 for each family of four.

Although per capita GDP is an excellent measure of overall economic output relative to population, it does not necessarily measure living standards. Comparing U.S. and Nordic living standards requires numbers for disposable income or personal consumption. Fortunately, both types of numbers are available. In both cases, the figures demonstrate that GDP statistics actually understate the degree to which people in Nordic nations have lower living standards compared to their American counterparts.

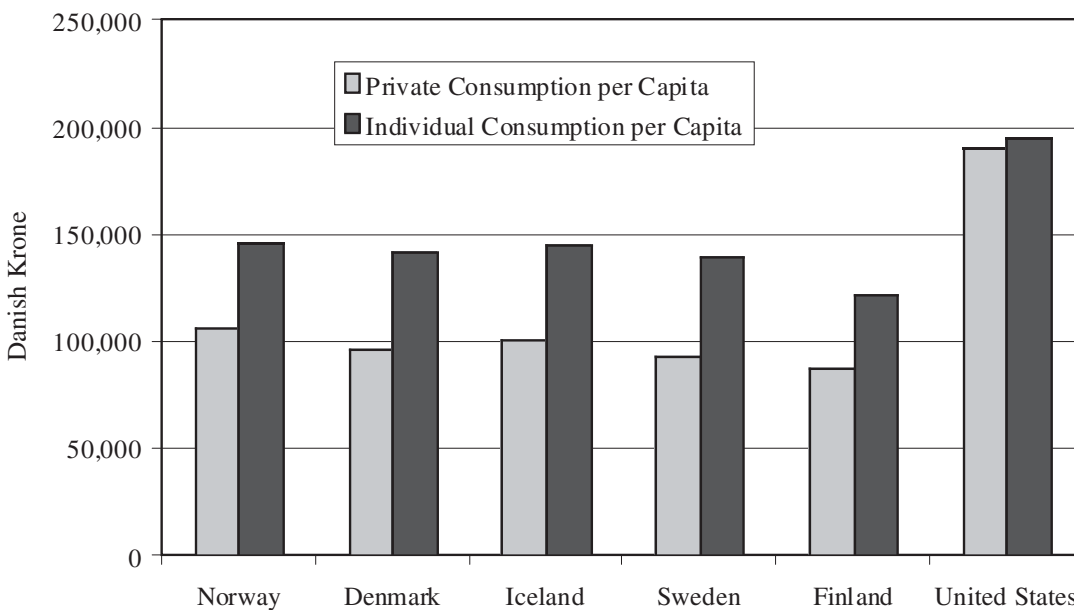
The OECD, for instance, has two data series for disposable income, both included in Figure 3. According to a study using 2003 data, the average person in the United States had more than \$27,000 of disposable income,

while the average person in Nordic nations (no data available for Iceland) had disposable income of barely \$14,300, less than 53 percent of the U.S. level.¹⁰ Even Norwegians, bolstered by oil wealth, had per capita disposable income of less than \$16,800, barely 62 percent of the American level. Danes and Finns are at the bottom, with less than 50 percent of the disposable income of the average American. A separate data series, which includes numbers for Iceland, is more flattering to Nordic nations. Per capita disposable income in America barely changes, but the average disposable income for Nordic nations climbs by more than \$3,000.¹¹ But even if this data series is more accurate, the average resident of a Nordic nation has only 65 percent of the disposable income of the average American.

Personal consumption numbers tell a similar story. In 2005, the Danish Finance Ministry produced numbers comparing per capita private consumption in OECD nations.¹² As seen in Figure 4, the average person in Nordic nations has barely 51 percent as much private

The average person in Nordic nations has barely 51 percent as much private consumption as an average American.

**Figure 4
Higher Living Standards in America**



Source: Danish Finance Ministry.

According to a KPMG study, Scandinavians are the poorest people in Western Europe once income is adjusted for taxes and the cost of living.

consumption as an average American. The Norwegians are the most prosperous, but even their private consumption is just 56 percent of U.S. levels. Both the Swedes and the Finns have less than 50 percent of the private consumption of average Americans.

Defenders of the welfare state could respond by arguing that people in Nordic nations do not need to worry about financing their own consumption because the government takes care of so many expenses. The Danish Finance Ministry study includes figures on individual consumption per capita, which includes items “paid for by the public sector.” This shrinks the gap, but Figure 4 shows that the U.S. retains a large advantage. Norwegians are the best regional performers and Finns are the worst, but gaps between individual Nordic nations are trivial compared to the gap between all the Nordic nations and the United States.

Even those numbers may overstate the prosperity of Nordic nations. According to a KPMG study, which attracted some attention in the Norwegian press, Scandinavians are the poorest people in Western Europe once income is adjusted for taxes and the cost of living. Danes had the lowest adjusted income, followed by the Norwegians and the Swedes. Finland managed to edge out Belgium, so the four Nordic countries in the survey occupied four of the bottom five slots.¹³

Where’s the Convergence?

Whether measured by annual growth rates or levels of output, income, or consumption, Nordic nations have inferior economic performance when compared to the United States. This does not mean Nordic nations are economically unsuccessful. Nor does it mean that the United States economy is without flaws. But it does mean that it is rather absurd to claim that, as Jeffrey Sachs does, that “the Nordic countries outperform the Anglo-Saxon ones on most measures of economic performance.”

The performance gap between America and the Nordic nations is particularly note-

worthy since economic theory generally assumes that a nation with less income should grow faster than a nation with more income. This phenomenon, known as convergence, is based in part on the relatively non-controversial proposition that more investment will flow to a poorer nation to take advantage of lower production costs and more profit-making opportunities.

There was substantial convergence for several decades after World War II, largely because European nations suffered so much damage during the conflict and started with low levels of income. But after several decades of strong growth, economic performance in European nations—including Nordic countries began to wane. And beginning in the 1980s, following Reagan-era reforms to reduce the burden of government, the United States has widened its lead. As Figure 5 illustrates, the United States has maintained a steady advantage over Nordic nations in comparisons of per capita GDP.¹⁴

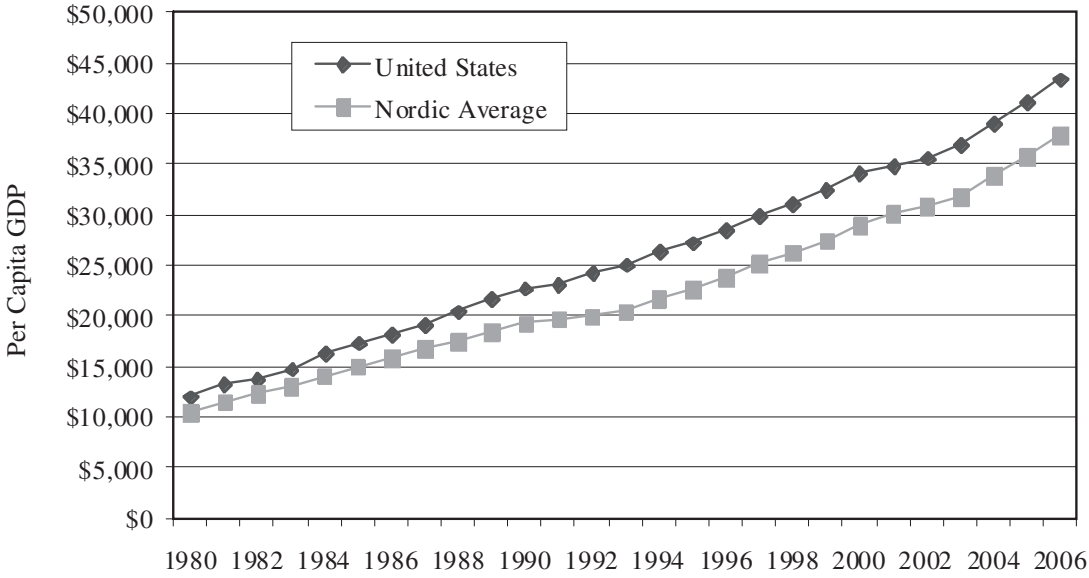
Not all Nordic nations are the same, of course, so “average” calculations often disguise important differences. Figure 6, for instance, shows per capita GDP figures for the individual Nordic nations measured as a share of U.S. output based on OECD and IMF data. Oil-rich Norway stands out as the strongest economy of the Nordic nations, surpassing even the United States according to IMF figures. Sweden and Finland, by contrast, are the least impressive nations in the region.

Other Measures of Prosperity

Unemployment is often one of the main indicators of economic vitality. Nordic nations generally have low levels of unemployment. Indeed, the average unemployment rate is not significantly higher than the American level. Iceland, Denmark, and Norway have especially strong job markets, while Finland and Sweden lag.

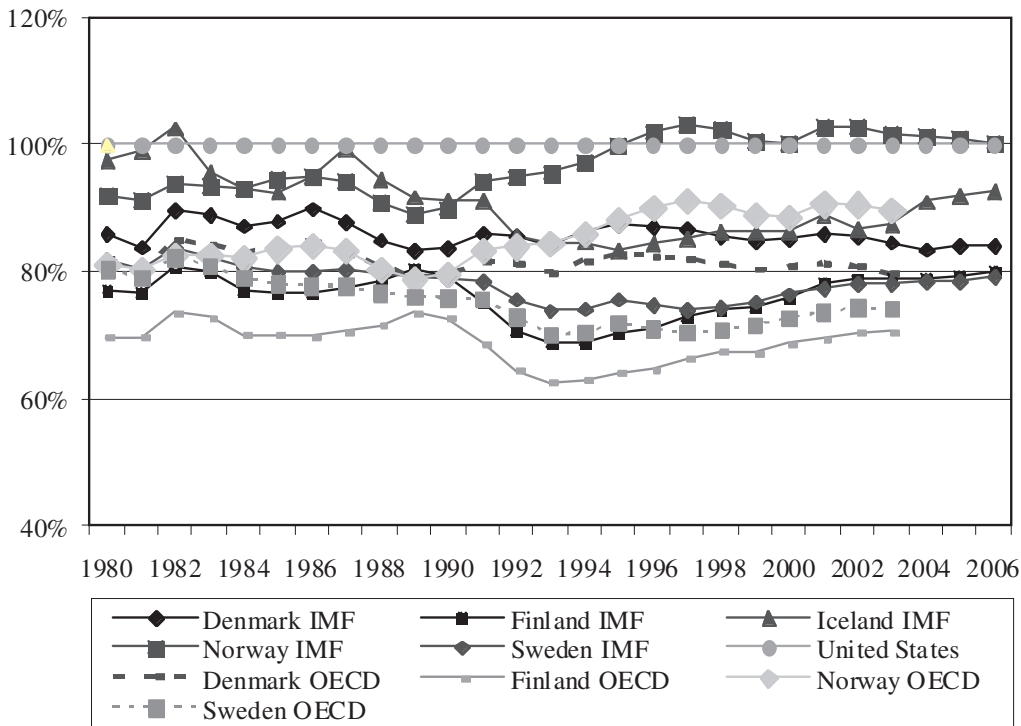
Youth unemployment figures show a similar pattern. The United States has a slightly

Figure 5
Nordic Nations Consistently Lag U.S. Economic Output



Source: International Monetary Fund World Economic Database.

Figure 6
Where's the Convergence? Per Capita Output as Share of U.S. Level



Sources: Organization for Economic Cooperation and Development, International Monetary Fund.

A German think tank estimates that nearly one-third of Scandinavian workers are employed by the state. In the United States by contrast, government workers account for slightly more than 15 percent of the workforce.

lower rate of unemployment for ages 16-24, but the difference is not large and Denmark and Iceland actually have better numbers than America. Statistics for long-term unemployment, however, are not flattering for Nordic nations. More than 18 percent of the unemployed in Nordic nations have been out of work for more than 12 months. In the United States, by contrast, fewer than 12 percent of the unemployed have been jobless that long.¹⁵

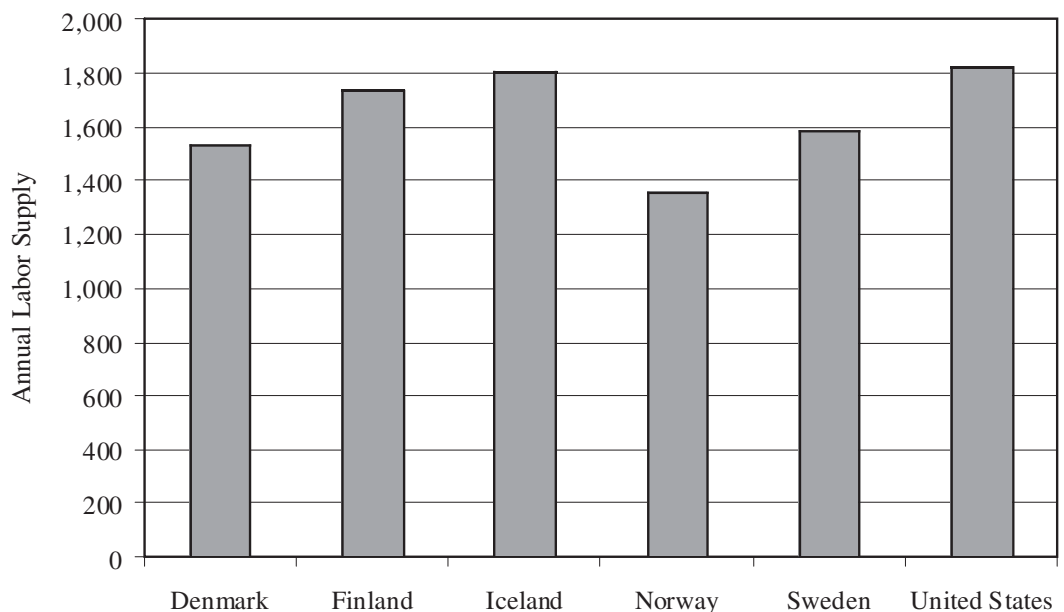
Another noteworthy feature of labor markets in Nordic nations is the role of government as a major employer. As noted by a German think tank, “On average, the share of state employment in total dependent employment across Scandinavia is 32.7%, compared to only 18.5% in the non-Scandinavian countries of the EU-15.”¹⁶ In the United States, government workers account for slightly more than 15 percent of the workforce.¹⁷ Moreover, the same researchers say that some Nordic nations are prone to re-characterize welfare beneficiaries as government employees, a practice that artificially overstates economic output (since government salaries are added to

GDP) and artificially understates unemployment.¹⁸

Proponents of the Nordic model argue that the United States does not have an advantage in every measure of prosperity and the quality of life, and they often cite leisure time as an important variable. It is certainly true that Americans spend more time on the job. As seen in Figure 7, Americans spend more time each year working than the residents of every Nordic nation. According to OECD data, only people in Finland and Iceland work similar hours to Americans, while Norwegians work 400 fewer hours each year.¹⁹ The Nordic Statistical Yearbook has weekly labor supply estimates that show a similar pattern, with Americans working 41 hours per week while residents of Nordic nations work between 35 and 38 hours each week.²⁰

It is unclear, though, whether working fewer hours than Americans translates into more leisure time for people in Nordic nations. The workweek is composed not only of hours in paid employment, but also of time spent in household production (cooking, cleaning,

Figure 7
Average Annual Hours Worked



Source: Organization for Economic Cooperation and Development Country Statistical Profiles.

household repairs and maintenance, etc). There are not many cross-country studies of household work, so comparing America and the Nordic nations is rather difficult. But a Swedish study found that 90 percent of the gap between the hours worked by Swedes and Americans disappeared once household production was added to the equation. Inferences can also be drawn by comparing the United States and Germany. A German study explains: “On average Americans and Germans spend roughly the same hours working, but Americans spend more time in market work while Germans spend more hours in household production. Americans do not work longer hours than Germans overall, but they allocate a larger share of working time to gainful employment and invest less in self-provision.”²¹ The study explains that tax policy is a key factor.

Moreover, even if people in Nordic nations truly have more leisure time, it is not necessarily what they prefer. As the president of the European Central Bank recently remarked:

Lower participation rates are not necessarily solely associated with personal preferences, but are also triggered by the legal and regulatory environment, tax systems and social institutions. Benefit systems that are too generous discourage job search, early retirement schemes encourage early withdrawal from the labour market—employment rates for older workers aged 55–64 stood at just 40.2% in the euro area in 2005 and, according to the OECD, at around 60% in the U.S.—and marginal tax rates that are too high discourage labour market entry and have a downward effect on average hours worked.²²

A study from the Bank confirms this analysis. It explains that “while the overall tax wedge in the euro area currently amounts to roughly 64 percent of the earnings of an average production worker, that of the United States is limited to about 37 percent.” It then reports: “Our analysis using the [New Area-Wide Model] confirms the widely-held view

that reductions in tax distortions have beneficial effects on labour-market outcomes and general economic performance. In fact, lowering euro area tax wedges to levels prevailing in the United States is found to result in a rise in hours worked and output by more than 10 percent in the long run.”²³

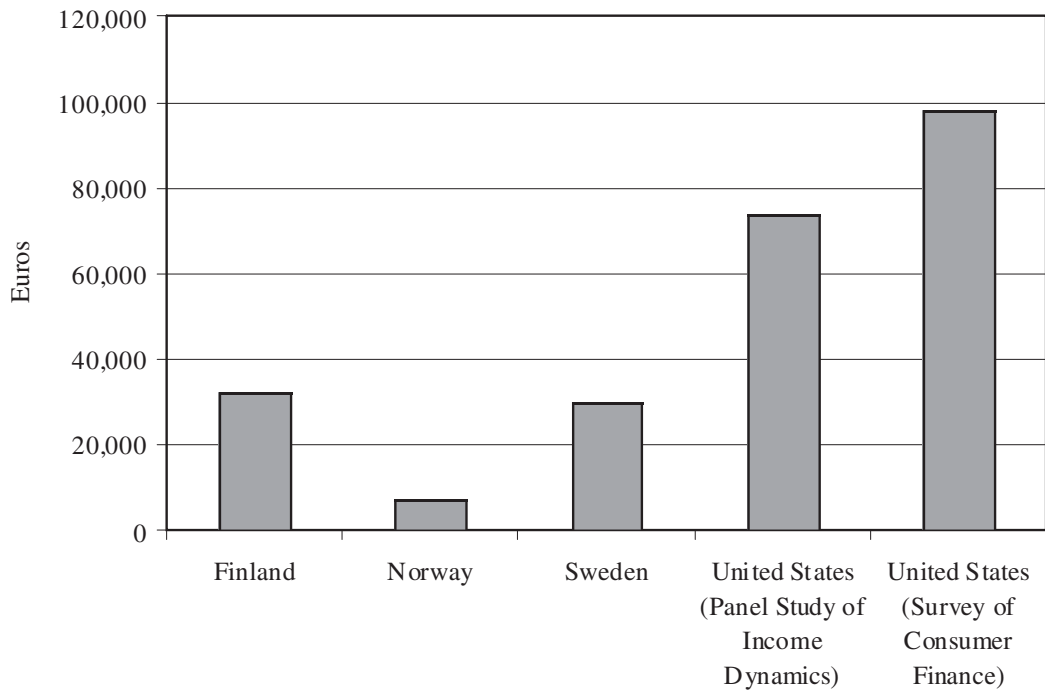
An OECD study also threw cold water on the assertion that Europeans have freely chosen to work less:

The leisure time enjoyed by individuals is obviously important for any evaluation of well-being, and workers’ choices on how to allocate their time have a direct bearing on cross-country comparisons of economic aggregates. . . . As European workers worked more than their US counterparts up to the late 1960s, it is difficult to invoke long-standing cultural differences to explain current labour-utilisation patterns. A different explanation focuses on the role of policies and institutions, which may both depress and boost working hours. . . . [R]elatively low hours worked per person in Europe can be fully explained by policy distortions arising from high marginal taxes on labour.²⁴

Shifting to another measure of prosperity, cross-country wealth data is relatively scarce and presumably less precise than income data, but the figures that are available show that the United States has a large advantage in per capita wealth.²⁵ Indeed, as shown in Figure 8, Americans have twice the household wealth of Swedes, Finns, and Norwegians (no data available for Iceland and Denmark). Americans also own more consumer products, particularly durable equipment such as automobiles and household appliances.²⁶ Americans also enjoy more housing. Indeed, poor people in the United States have as much housing space as the average European.²⁷ As stated above, none of these comparisons suggest that Nordic nations are economic failures. Indeed, they are among the world’s wealthiest economies, but high taxes and excessive government spending

Americans have twice the household wealth of Swedes, Finns, and Norwegians.

Figure 8
Per Capita Net Wealth



Source: Luxembourg Wealth Survey Project.

mean that they are not as wealthy as they could be. It also means they trail the United States in almost all measures of economic success.

Last but not least, defenders of the Nordic Model argue that the United States suffers from greater levels of income inequality. Various measures of inequality, such as Gini coefficients, confirm that “wealthy” Americans earn a bigger share of the pie than upper-income citizens in Nordic nations. But this data is incomplete without also looking at the size of the pie.

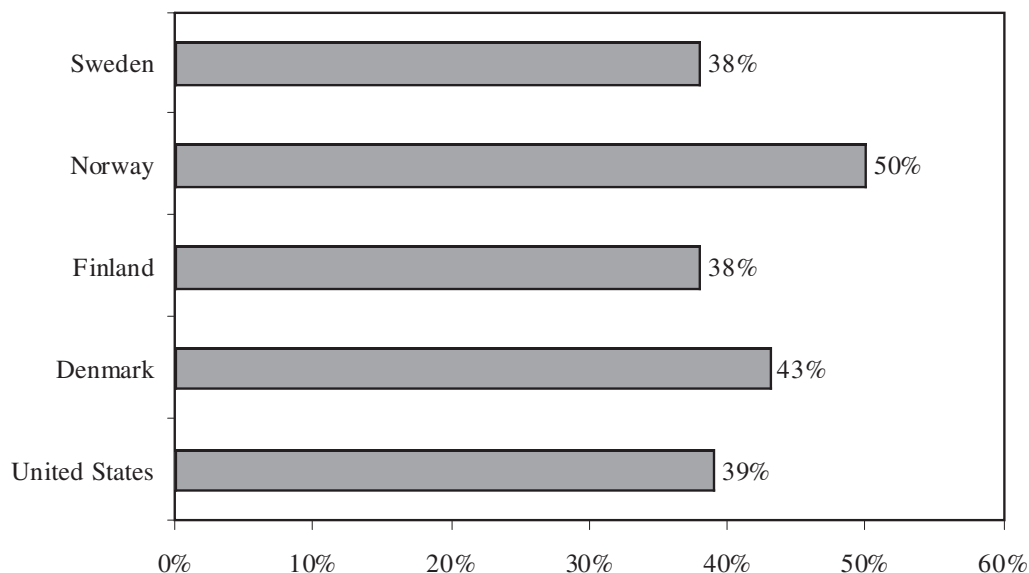
As illustrated in Figure 9, the poorest 10 percent of Americans have about the same level of income as the poorest 10 percent of Finns, Swedes, and Danes. Only in oil-rich Norway is there a noticeable gap (data for Iceland not available). What differentiates America from the Nordic nations is the income of everyone else. The rich, the middle class, and the working class in the United States enjoy higher levels of income than their Nordic counterparts.²⁸

If nations are being judged on the prosperity of their poorest citizens, then Nordic nations certainly are equal to the United States. Indeed, they even have a slight advantage (though even that advantage might disappear if Nordic nations had US levels of immigration). But if nations are being judged on factors beyond just the well-being on the poorest segment of the population, then the United States holds a clear edge.

There is also some evidence that Nordic nations are moving in the wrong direction, particularly when compared with other European nations with smaller burdens of government. As one researcher explained, “Over the last decade, the incomes of the poorest 10% of the population have grown eight times faster in Ireland than in Sweden, and six times faster in Britain. As a result, so-called Anglo-Saxon economies like Ireland and the UK now for the first time have a smaller proportion of their population below the poverty line than does Sweden.”²⁹ This

If nations are being judged on factors beyond just the well-being on the poorest segment of the population, then the United States holds a clear edge.

Figure 9
Share of U.S. Median Income Received by Low-Income OECD Households, 2000



Source: Economic Policy Institute.

may be more a reflection of positive reforms in nations such as Ireland rather than an indicator of problems in countries like Sweden, but it does suggest that strong economic growth is better than income redistribution if the goal is to help the least fortunate in society.

The United States has enjoyed faster economic growth than Nordic nations. Moreover, per capita GDP is higher in the United States, as are levels of disposable income and private consumption. Unemployment is modestly lower in America, and per capita wealth is significantly higher. The Nordic Model may be instructive, but not in the way advocates claim.

The Costly Nordic Welfare State

Why are people in the United States more prosperous than their Nordic counterparts? Is it by chance, the result of different endowments, or the consequence of policy choices? Regarding the latter possibility, policymakers in America and the Nordic nations have

made divergent choices about the burden of government.

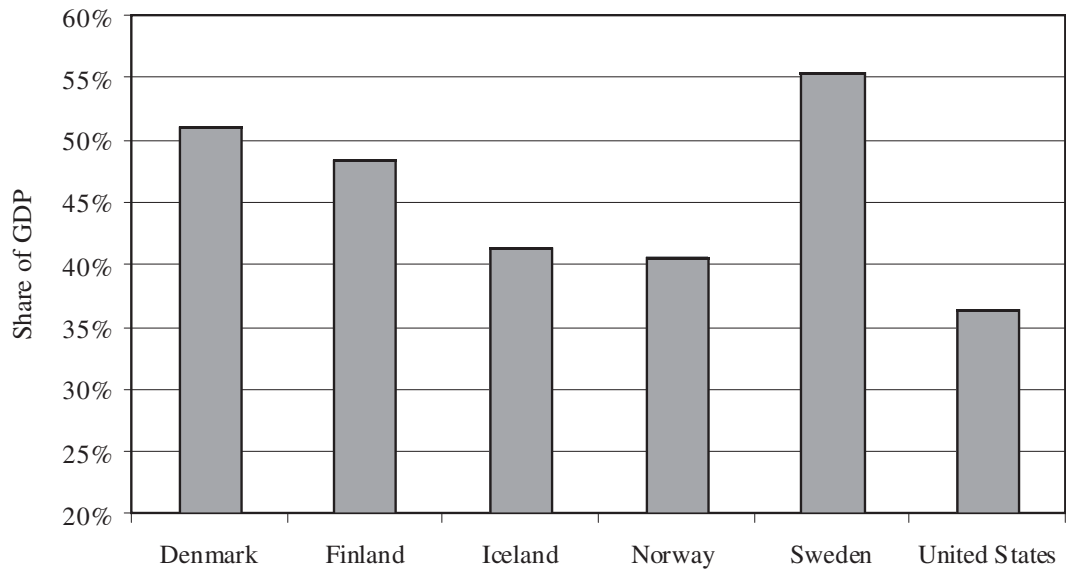
Government Spending

As seen in Figure 10, government spending consumes a larger share of GDP in all Nordic nations than it does in the United States. Sweden has the biggest burden of government, followed by Denmark and Finland, with Iceland and Norway closer to the American level. The larger burden of government presumably does not bode well for Nordic competitiveness since this means politicians and bureaucrats have more power over how resources are allocated. And since policymakers are more likely to be influenced by political considerations rather than economic factors, that undermines economic performance.³⁰

But not all government spending is created equal. Economists generally find that some forms of government spending cause less damage (or even generate some benefits), particularly outlays for physical infrastructure and education. That does not necessarily mean that spending in those areas leads to

In every Nordic nation, the top tax rate is imposed on taxpayers with middle-class incomes. Taxpayers in the United States do not get hit with the highest tax rate until income climbs to more than \$336,000.

Figure 10
Burden of Government Spending



Source: Organization for Economic Cooperation and Development Fiscal Indicators, 2006.

faster growth, but it does mean that there are some benefits to offset at least some of the costs associated with shifting resources from the productive sector of the economy to government.

Other types of spending, by contrast, are more likely to weaken economic performance, particularly consumption spending and transfer outlays.³¹ Figure 11 shows that governments in Nordic nations are much more likely to spend money in these areas.

Aggregate Tax Burden

High levels of government spending, not surprisingly, are associated with higher levels of taxation. Figure 12 shows total receipts (including non-tax revenues) and tax revenues for the United States and the Nordic nations. Total receipts is an important measure since it is a rough approximation of the amount of money being transferred from the productive sector to government, whereas tax revenue is an important measure since it is a rough approximation of the extent to which the fiscal system discourages work, saving, investment, and entrepreneurship.

Marginal Tax Rates

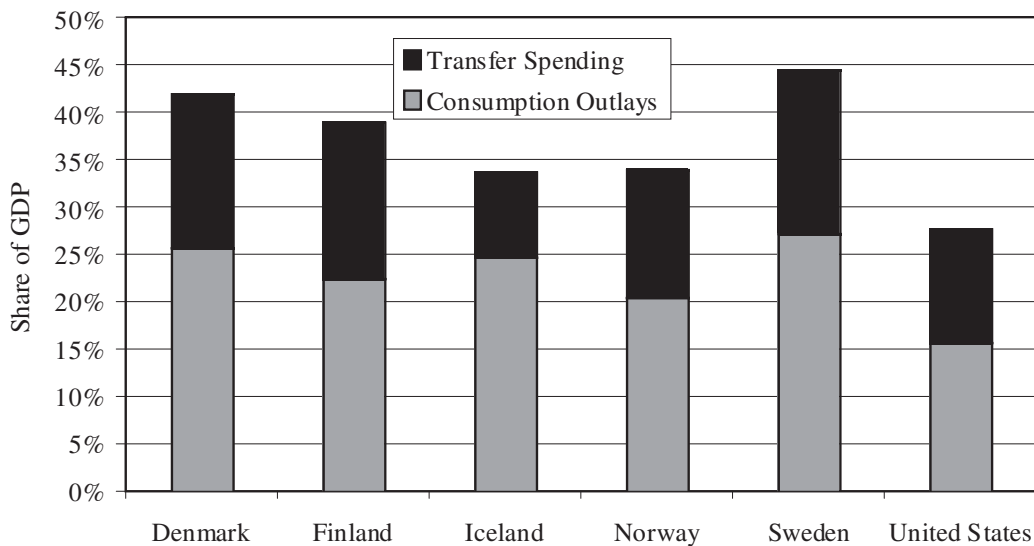
But just as all types of spending are not equal, neither are all forms of taxation. Revenues raised by a low-rate consumption tax impose only a modest burden on economic performance. Revenues collected as the result of high tax rates on productive behavior, by contrast, are likely to be associated with lower levels of work, saving, investment, and entrepreneurship.

Key factors to examine include the top tax rates on individual income and corporate income, but double taxation of dividends and capital gains is also an important gauge of the tax code's bias against saving and investment, as are direct taxes on capital, such as death taxes and wealth taxes. The existence of such taxes, particularly if tax rates are non-trivial, reduces incentives to engage in wealth-creating activities.

Looking at taxes on personal income, the United States has a significant advantage over most Nordic nations. As seen in Figure 13, Denmark, Sweden, and Finland all impose much higher tax rates on personal income. Norway's top tax rate is significantly higher if

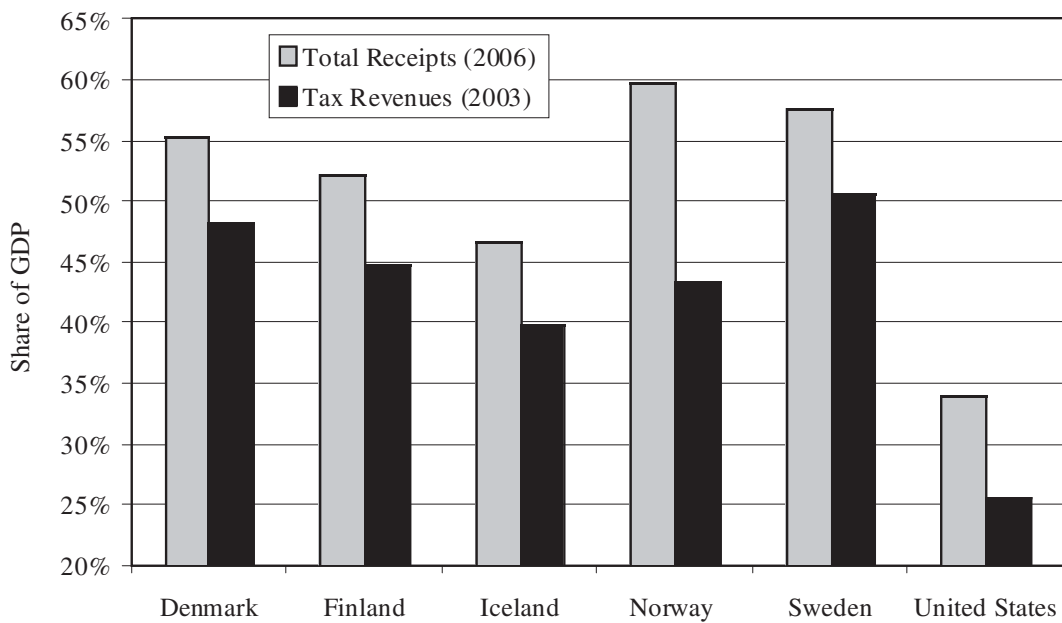
A Swedish study found that 90 percent of the gap between the hours worked by Swedes and Americans disappeared once household production was added to the equation.

Figure 11
Spending on Transfers and Consumption



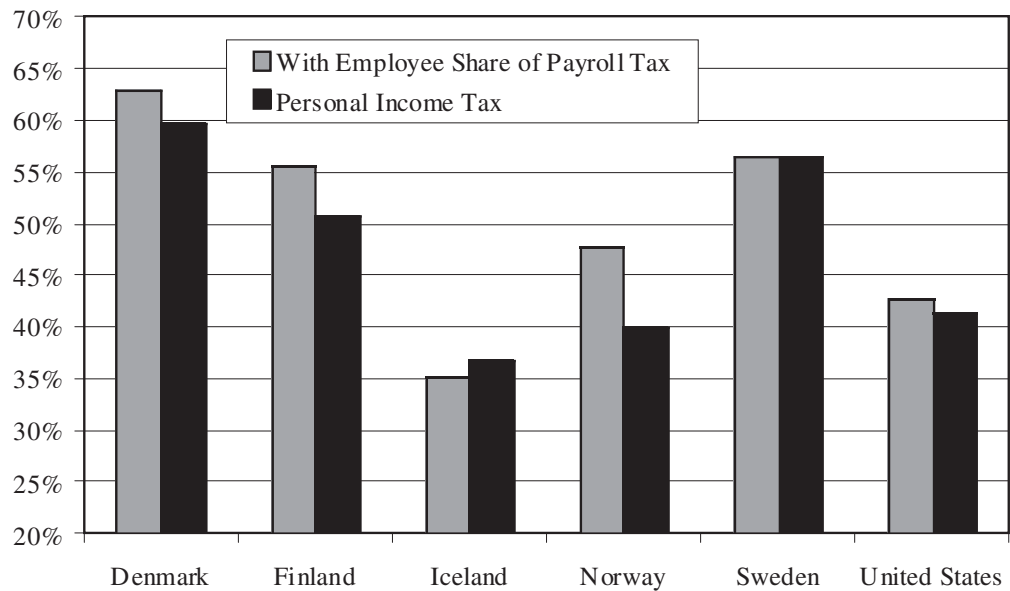
Source: Organization for Economic Cooperation and Development.

Figure 12
Government Revenue



Source: Organization for Economic Cooperation and Development.

Figure 13
Top Tax Rate on Personal Income, Including Sub-National Income Taxes



Source: Organization for Economic Cooperation and Development.

the payroll tax rate is included. Iceland, however, has a less punitive system for highly successful taxpayers, and Norway actually has a slight advantage over the United States if measuring only the personal income tax.

Another key difference between America and the Nordic nations is that top tax rates penalize a much larger share of the population in Nordic nations. In every Nordic nation, the top tax rate is imposed on taxpayers with middle-class incomes. Norway is the most lenient of the Nordic nations, allowing taxpayers to earn the equivalent of about \$75,000 before the top tax rate takes effect. Taxpayers in the United States, by contrast, do not get hit with the highest tax rate until income climbs to more than \$336,000.

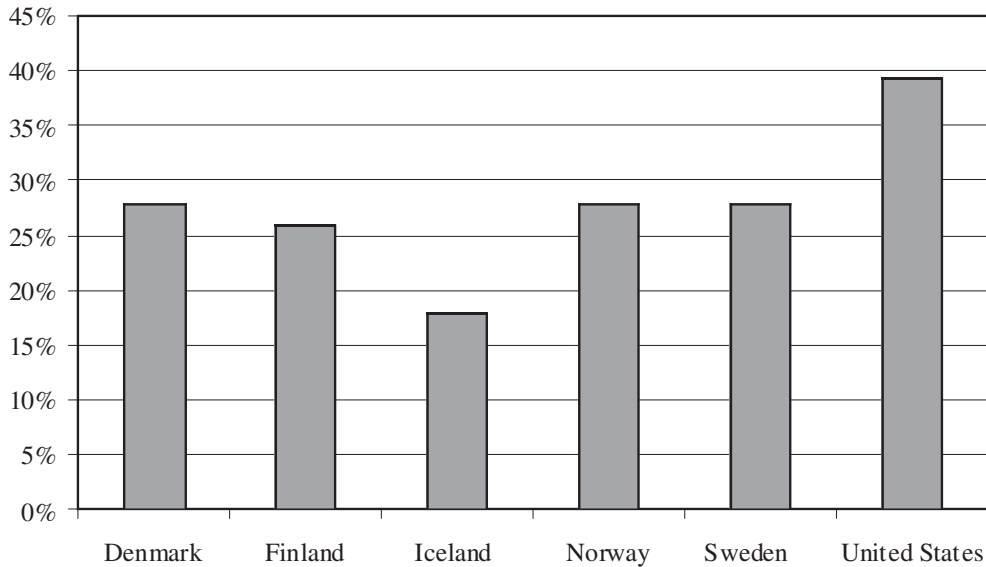
On the other hand, every Nordic nation enjoys a lower corporate tax rate than the United States. Corporate income in the United States is taxed at 39.3 percent, while the tax rate in Nordic nations is no higher than 28 percent.³² As seen in Figure 14, Americans firms face a competitive disadvantage in this key measure.

Many other tax measures also play a role. Payroll taxes reduce incentives to work, and these levies tend to be more onerous in Nordic nations. Taxes on saving and investment are especially important, with the United States also having a modest advantage in this area. America's biggest advantage, though, is the tax burden on consumption. Value-added taxes (VATs) tend to be less destructive than income taxes, but they still undermine growth by driving a wedge between earnings and consumption. Simply stated, people sacrifice leisure and earn income because of the things money can buy. But if taxes reduce the amount of possible consumption—either because the money is taxed when earned or spent, then there is less incentive to be productive. The United States does not have a VAT, but all Nordic nations have high-rate VATs, with Sweden and Denmark imposing the maximum rate of 25 percent.³³

The absence of a VAT does not mean there is no tax burden on consumption in the United States. Sales taxes are imposed by 45 states, and the federal government imposes

Every Nordic nation enjoys a lower corporate tax rate than the United States.

Figure 14
Nordic Nations Have Lower Corporate Tax Rates



Source: Organization for Economic Cooperation and Development.

numerous excise duties. Moreover, the tax burden on consumption in Nordic nations is not as onerous as the rates suggest since some goods and services benefit from preferential rates. Yet, as illustrated in Figure 15, even with these caveats, the tax burden on consumption is about three times higher in Nordic nations than it is in the United States.

formance, there is ample evidence that excessive government spending³⁴ and high tax rates³⁵ hinder economic growth. Moreover, there do not appear to be other factors that would be causing economic growth in America and the Nordic nations to follow divergent paths.

Does Big Government Explain the Gap between the United States and Nordic Nations?

Although rich by world standards, Nordic nations are not as prosperous as the United States. Nordic nations also have bigger governments than the United States. The obvious question to ask is whether these facts are related. Is excessive government the reason Nordic nations are not as wealthy as America?

While this paper does not seek to answer whether this correlation necessarily means that big government is causing the economy in Nordic nations to lag America’s economic per-

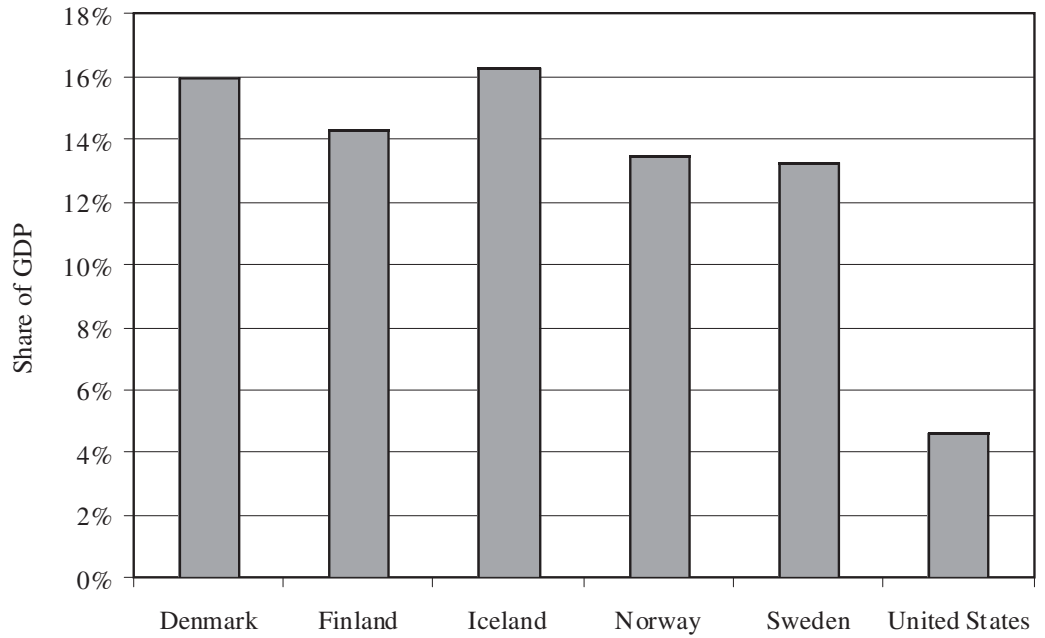
Nordic Nations: A Laissez-Faire Past and a Hopeful Future

As shown in Figure 16, the tax burden in Nordic nations and America was remarkably similar until 1960. Not coincidentally, it was during this pre-1960 era that Nordic nations grew rapidly and became rich.

Beginning in the mid-1960s, and accelerating through the 1970s and into the 1980s, however, the Nordic nations created large welfare states. Indeed, this is the key difference between America and the Nordic nations. The United States has a medium-sized welfare state and the Nordic nations have large welfare states. Otherwise, America and the Nordic nations have many features in common. Both

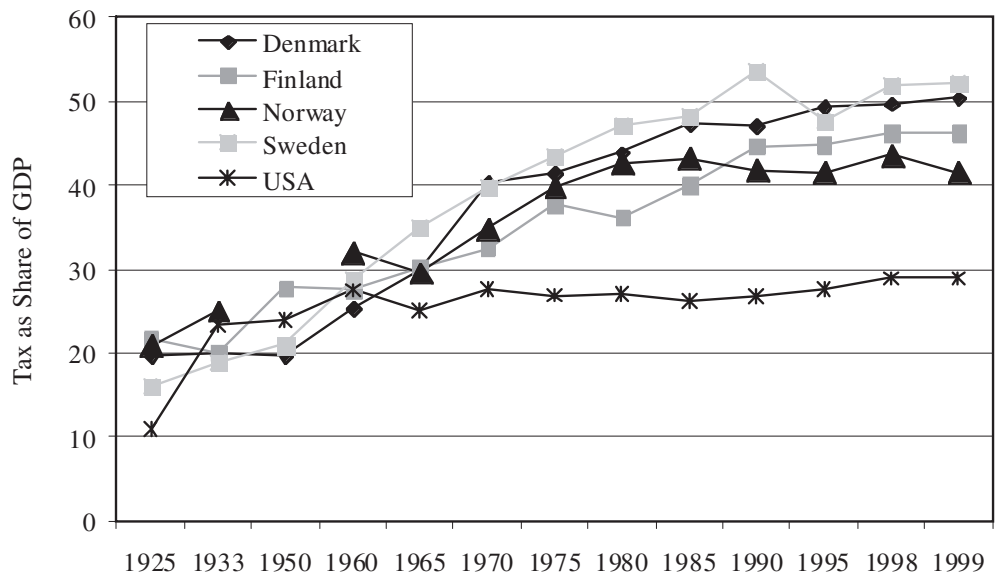
If the “size of government” factor is removed from the *Economic Freedom of the World* indicators, Nordic nations score an average of 8.35, ranking above the 8.25 score for the United States.

Figure 15
Higher Tax Burden on Goods and Services in Nordic Nations



Source: Organization of Economic Cooperation and Development.

Figure 16
Nordic Nations Used to Have Competitive Tax Systems



Source: Ratio Institute, Sweden.

the Nordic nations and America have sound institutions, including stable currencies, rule of law, and property rights. Both the Nordic nations and America have relatively open markets. Indeed, if the “size of government” factor is removed from the *Economic Freedom of the World* indicators, Nordic nations score an average of 8.35, ranking above the 8.25 score for the United States.³⁶

Other measures indicate the Nordic nations have sound institutions and pro-growth policies in areas other than fiscal policy. The World Bank publishes comprehensive rankings of national business environments. The United States is near the top of the list, ranked third, but all the Nordic nations rank among the world’s most open economies for business activity. Finland has the lowest ranking, but is still 14th out of 175 nations.³⁷

The World Bank rankings are not an outlier. Reviewing 11 different competitiveness scorecards, the United States has an average ranking of 6.6, compared to 10.6 for Nordic nations.³⁸ America scores slightly better, but the United States and the Nordic nations are all considered among the world’s most competitive nations. There are even some areas where Nordic nations score above the United States. In the first international ranking of property rights, for instance, the United States trails the four Nordic nations in the survey.³⁹ Norway is number one, Sweden and Denmark are tied for third, and Finland ranks number 11—all above the number 14 ranking for the United States.

The Nordic nations also have excellent reputations for honest government. According to Transparency International, the five Nordic nations rank among the eight least corrupt nations in the world, with Finland and Iceland tied for first place.⁴⁰ The United States also does well, with a ranking of 20 out of 163 nations, but the higher scores for the squeaky-clean Nordic nations presumably help offset the larger burden of government.

The Nordic nations also deserve attention for important reforms. Iceland, for instance, has a flat tax (albeit with a 36 percent rate), personal retirement accounts, and quasi-pri-

vatized fisheries. Sweden, meanwhile, has an extensive school choice system and personal retirement accounts.

Prosperity and the Welfare State: Understanding Causality

Many prosperous nations in Western Europe have large welfare states. This leads unsophisticated observers to sometimes assume that high tax rates and high levels of government spending do not hinder growth. Indeed, they sometimes even conclude that bigger government somehow facilitates growth. After all, government in Sweden is larger than it is in many nations that have lower living standards.

This analysis puts the cart before the horse. It is possible for a nation to become rich and then adopt a welfare state. There is even a relationship studied in academic literature, known as Wagner’s Law, which revolves around the tendency for policy makers to expand the size of government once nations obtain a certain degree of prosperity.⁴¹ A poor nation that adopts the welfare state, however, is unlikely to ever become rich.

Before the 1960s, Nordic nations had modest levels of taxation and spending. They also enjoyed—and still enjoy—laissez-faire policies and open markets in other areas. These are the policies that enabled Nordic nations to prosper for much of the 20th century. Once their countries became rich, politicians in Nordic nations focused on how to redistribute the wealth that was generated by private-sector activity. This sequence is important. Nordic nations became rich, and then government expanded. This expansion of government has slowed growth, but slow growth for a rich nation is much less of a burden than slow growth in a poor nation.

Conclusion

Residents of Nordic nations sometimes express public pride in their model, but their

Before the 1960s, Nordic nations had modest levels of taxation and spending. Once their countries became rich, politicians in Nordic nations focused on how to redistribute the wealth that was generated by private-sector activity.

private behavior presents a more complicated picture. Many productive people have departed for lower-tax jurisdictions. Others remain, but they move their assets so they are hidden from tax authorities.

Sometimes this hidden discontent becomes visible. Four of the five Nordic nations now have right-leaning governments. The Swedes elected a conservative coalition government late last year and the Finns made a similar choice earlier this year.⁴²

It is unclear whether electoral changes will lead to government reform. But if residents of Nordic nations want faster growth, more prosperity, and improved competitiveness, they need to reduce the size of the public sector. Excessive government diminishes growth. And although the Nordic countries' relatively free markets mitigate the damage caused by high taxes and high spending, the burden of government is hindering economic performance. The Nordic Model is preferable to the Continental or Corporatist Model of nations such as France and Germany, which combines welfare state policies and interventionism. But the Nordic Model does not look very impressive when compared to the United States.

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