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GROWTH AND EMPLOYMENT IN NORDIC WELFARE STATES IN THE 1990S: A TALE OF CRISIS AND REVIVAL

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Abstract: This paper reviews the macroeconomic performance of the so called Nordic welfare states, especially in terms of growth and employment. In the post-war years the Nordic economies enjoyed rapid growth and full employment. At the same time, under the rule of Social Democratic governments they also built their extensive welfare states. However, starting from the 1980s, the Nordics – together with other European countries – have suffered from various economic imbalances and crises, which have led many observers to doubt the economic viability and fiscal sustainability of the welfare states. In Sweden and Finland the economic problems and structural changes culminated in the beginning of the1990s in a severe macroeconomic and financial crisis, which can be viewed partly as an adjustment to integration and globalisation, especially to financial deregulation, and partly as a result of macroeconomic policy failures. In this paper we review the experiences of Denmark, Finland and Sweden in the 1990s in adjusting their public sectors and welfare states to the fiscal consolidation. It can be concluded that even after the hardships of the 1980s and 1990s the Nordic model of social policy remains clearly distinctive and in many respects successful. The Nordic countries have been able to maintain their position among the richest economies in the world and also to avoid the under-employment typical to larger European economies. However, there lie further challenges in the future. The most important of them are possible tax competition which may threaten the financial basis of the current welfare systems, especially in Denmark and Sweden, and expected demographic change, which will add excess burden to the public finances within the next 20–30 years.

Key words: Welfare state, integration, Nordic countries

Tiivistelmä: Tässä raportissa tarkastellaan pohjoismaisten hyvinvointivaltioiden taloudellista menestystä 1990-luvulla. 1990-luvun alun vakavat taloudelliset vaikeudet erityisesti Ruotsissa ja Suomessa herättivät kriittisen keskustelun pohjoismaisen hyvinvointivaltiomallin taloudellisesta toimintakyvystä. Suuret budjettialijäämät uhkasivat hyvinvointivaltion rahoituspohjaa ja korkeaksi kasvanut työttömyys romutti aiemman täystyöllisyysmallin. Pohjoismaiden talouksien nopea taloudellinen elpyminen 1990-luvun puolivälin jälkeen osoitti kuitenkin pahimmat pelot ylimitoitetuiksi. Pohjoismaat palasivat takaisin vahvaan budjettitasapainoon ja Suomea lukuunottamatta myös lähestulkoon täystyöllisyyteen. Edelleen suhteellisen korkeasta työttömyydestä huolimatta myös Suomen työllisyys koheni huomattavasti. Pohjoismaiden talouksien elpyminen osoitti, että niiden hyvinvointivaltiojärjestelmät eivät sittenkään muodostaneet estettä hyvälle työllisyydelle ja uusien työpaikkojen synnylle. Raportin loppuosassa pohditaan lyhyesti pohjoismaisen mallin tulevia haasteita, joista merkittävimmät ovat väestön ikääntyminen ja mahdollinen verokilpailu.

Asiasanat: Hyvinvointivaltio, integraatio, Pohjoismaat

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1. Introduction

The group of Nordic countries consists of five Northern European states: 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. They are also rich economies with high living standards and excellent quality of life. 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 macroeconomic performance and the current state of the Nordic welfare states, and focuses especially on the experiences of Denmark, Finland and Sweden in the 1990s in adjusting their public sectors to fiscal consolidation.[1]

In the post-war years – from the 1950 to 1970s – the Nordic economies enjoyed rapid growth and full employment. However, starting from the 1980s, they have together with other Western countries suffered from various economic imbalances – inflation, recession, unemployment, currency and banking crises and fiscal deficits – which have led many observers to doubt the economic viability and fiscal sustainability of the welfare states. It is nowadays easy to find expressions of an 'orthodox' view which emphasises the dismal economic consequences of redistributive welfare ('tax and spend') policies.[2] The analytical background to such a view is provided by mainstream economic theory on one hand and by the seemingly permanent economic problems of most EU countries since the 1970s on the other.

On average, the EU economies have suffered from slow growth, continuously high unemployment and low employment, and (as a result) public finance problems since the mid-70s. The logic of simple microeconomic models of economic behaviour helps to explain such phenomena by high marginal taxes and income subsidies to non-employed, which discourage labour supply. The explicit institutional reasons to that kind of economic malice (sometimes it is called Euro-sclerosis) are hence excessive taxes, regulation, trade unions, large public sectors, and too generous social insurance systems. Elements of such argumentation occur regularly in the reports of OECD, policy recommendations of ECB and the European Commission, and in the commentary of financial press.

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[1] The paper focuses mainly on Denmark, Sweden and Norway. Iceland is omitted because it does not have a large public sector, and Norway is omitted because of oil revenues, which help to finance generous public spending.

[2] It is easy to find examples of such opinions by reading e.g. The Economist, or the country reports of the IMF and the OECD.

Furthermore, usually the badly performing Western European economies are contrasted with the success of anglophone economies: not only the USA, but also the UK, Canada and Australia, and recently Ireland, too. New Zealand was also shortly used as an encouraging example, until it became evident that the market-friendly reforms of that country failed to deliver rapid growth. That kind of large-scale analysis does not, however, make justice to many smaller countries. The general picture of European economic gloom overstates the problems because of the problems of large countries. At the same time, many smaller European countries have done better, even the most advanced welfare states, the Nordics. This is of course against 'the OECD theory'. According to the 'orthodox' view, the Nordic economies look like fat birds with heavy burdens, and they should not be able to fly, but still they somehow manage to do that.

In this paper these macroeconomic crises and structural changes of the 1990s are viewed partly as an adjustment to rapidly advancing integration and globalisation processes – especially to financial deregulation – and partly as a result of macro-economic policy failures. These changes were an essential part of the process of adapting the Nordic economic policies to European common market and to the objectives of European monetary policy. Even after these hardships the Nordic model remains clearly distinctive and in many respects successful. The Nordics have been able to maintain their position among the richest economies in the world and also to avoid the under-employment typical to larger European economies, notwithstanding the alarming rise of unemployment in the beginning of the 1990s. The Nordic societies are still highly egalitarian, and they have maintained 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 the countries with highest tax rates (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 to adapt to these future challenges.

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 state models of the Nordic countries and in their historical backgrounds which make them different from the other European countries.

The Nordic welfare states and economies have also been successful in achieving good results in terms of general welfare and equity.

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.[3] 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.[4] 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 evolution of the increasingly complex systems of taxes and social programs which today form the essential part of the Nordic welfare model. The creation of welfare state has been a gradual long-term process. It began before the Second World War, and it was in its most intensive phase in the 1960s and 1970s. It started from universal provision of elementary education and basic health care, and proceeded then to national pensions and child benefits.

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

[3] 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).

[4] 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).

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 (or public sector) 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 decent homes to almost everybody. 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[5], 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 (or parental) 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.[6] The Nordic systems redistribute income within life-cycles, from middle-aged to young and old.

[5] Social services include mostly services to children, elderly and disabled persons.

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

Table 1. Decomposition of total public expenditure, as percent of GDP in 1999

	Gross expenditure	Primary expenditure	Welfare expenditure	Other expenditure
Denmark	52.5	50.3	34.8	15.5
Finland	47.1	45.5	31.2	14.3
Sweden	55.0	52.3	35.8	16.5
EU15	44.9	41.3	29.8	11.5
USA	29.9	27.1	18.5	8.6

Primary expenditure = gross expenditure minus net interest payments.
Welfare expenditure = total of merit goods and income transfers to households.
Source: OECD Social expenditure database and Education at a glance.

The level of total public expenditure is higher in the Nordic countries than in elsewhere, although some other European countries come close to the Nordic levels. The difference becomes clearer when the expenditures are adjusted for interest payments on public debt. It is noteworthy that not only welfare expenditures but also all other expenditures are higher in the Nordic countries than the European Union average, not to mention the USA (see table 1). The Nordics spend clearly more in publicly provided merit goods, i.e. to education, health and social services. This, of course, results from the principle of universal provision of public services. The level of income transfers to households (the largest item of which consists of pensions) is in the Nordic countries not different from other European countries.

Table 2. Total public welfare expenditure divided into services and transfers, as percent of GDP in 1999

	Merit goods	Income transfers
Denmark	18.8	16.0
Finland	13.9	17.3
Sweden	18.6	17.2
EU15	12.8	17.0
USA	10.9	7.6

Merit goods = education, health and social services.
Income transfers = pensions and social insurance benefits.
Source: OECD Social expenditure database and Education at a glance.

The level of public expenditure and social protection is very high in Denmark and Sweden. Finland is closer to EU average (see tables 1 and 2). 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 3). The Nordic countries spend much more to unemployment benefits and active labour markets policies than other EU countries.

Table 3. Distribution of the social protection expenditure; percent of GDP in 1999

	Education	Health	Social services	Pensions	Disability and family benefits	Unemployment benefits and ALP
Denmark	6.8	6.8	5.2	6.8	4.2	5.0
Finland	5.7	5.3	2.9	8.0	5.4	3.9
Sweden	6.6	6.6	5.4	8.2	5.1	3.9
EU15	4.9	6.4	1.5	11.2	3.5	2.3
USA	4.8	5.8	0.3	6.0	1.1	0.5

ALP = Active labour market policy programs.
Source: OECD Social expenditure database and Education at a glance.

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. As a result, the child poverty is very low in the Nordic countries.

It is noteworthy that public pension and health expenditures are lower in Denmark and Finland than in the other EU countries, and not much higher than in the USA. The low costs of health care can be explained 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.

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 (ALP). In Denmark the pensions are provided by state and financed by income taxes, in Sweden and Finland there are occupational pension insurance schemes[7] funded by compulsory payroll taxes.

[7] 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.

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 percent in Denmark, 13 percent in Finland and 18 percent in Sweden. The average after-tax compensation level of public pension systems for an average industrial worker with full qualifying period was about 70 percent 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.

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.

Earnings-related unemployment insurance is 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 – about 70–90 percent of workers are union members in Nordic countries – 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), she is entitled to 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 those who fail to find work in the open labour market. That explains why the spending on active labour market policies is so high in the Nordic countries in spite of their relatively low unemployment rates – except in Finland, where unemployment exceeded the EU average in 1992–2003.

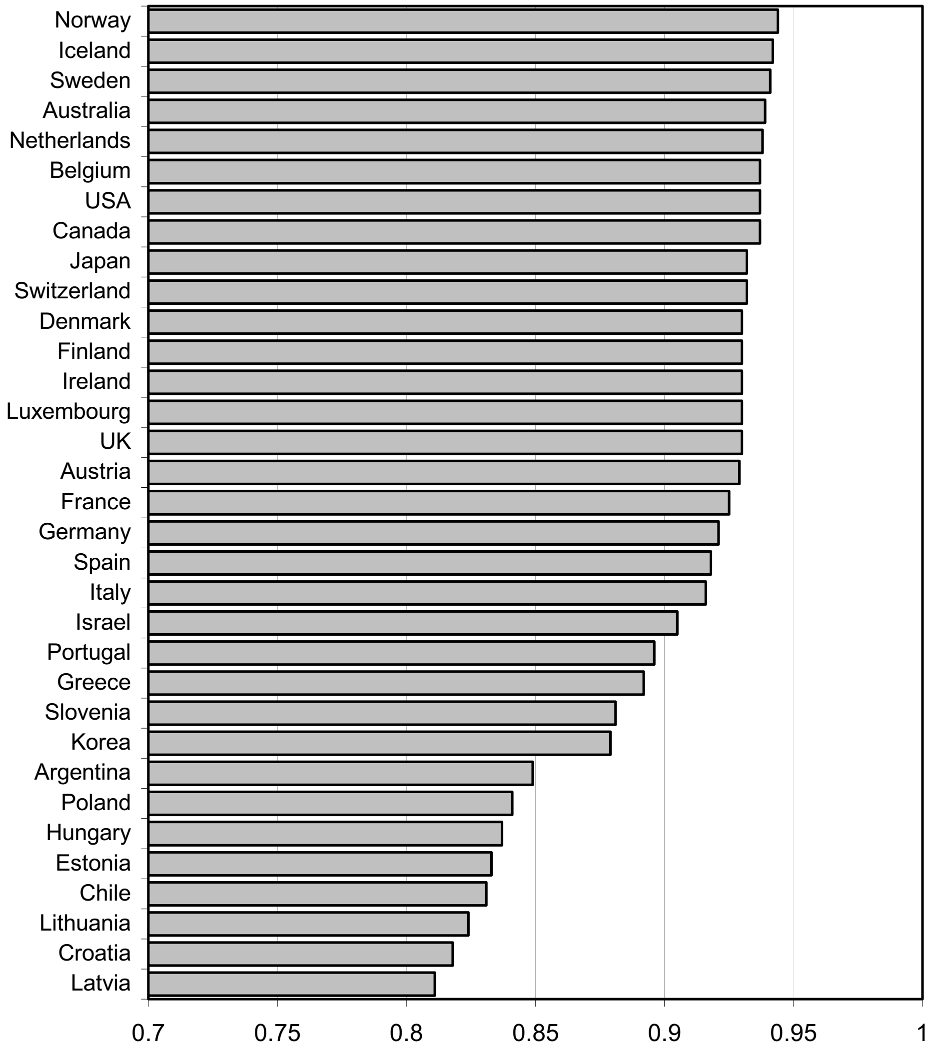
2.4 Wellbeing and equality

The Nordic welfare states have traditionally been good in improving the wellbeing of their citizens and equality between them. Especially the populations of Iceland, Norway and Sweden are healthy and enjoy very high life-expectancy. The Nordic social policies are by their nature egalitarian and universal in order to create inclusive systems. They aim to promote equality not only in regard of income distribution but also between genders.[8] Some of the benefits are universal

[8] 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

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.

Figure 1. Human Development Index 2001



Source: UNDP.

As a result of successful welfare policies the measures of wellbeing and equality usually give high ratings to the Nordics. The best-known measure is the Human Development Index (HDI) which measures a combination of real incomes, life

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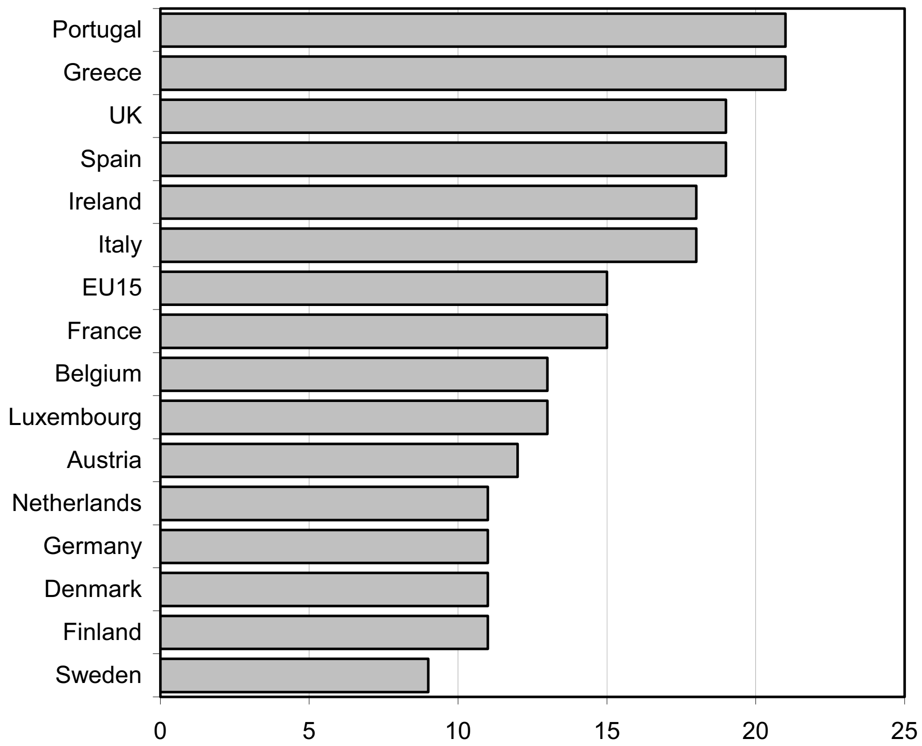
of which the Nordic countries offer ample evidence. It can also be said that there is no compelling empirical evidence that large public sectors as such would be harmful to growth.

expectancy and the average level of education. It gives highest rankings to Norway, Iceland and Sweden (see Figure 1). Denmark and Finland do not perform as well, because of lower life-expectancy.

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 resulting distribution of disposable family income is relatively evenly distributed.

In spite of the increased inequality in the 1990s, the Nordic countries do still have the lowest income inequality within OECD. The Nordic level of income equality is 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.[9] Even the rise of unemployment in the 1990s did not increase poverty rates.

Figure 2. Poverty rates in EU countries



Source: Eurostat.

[9] Jäntti and Danziger (1994 and 2001); see also Smeeding (2000).

A new study by Eurostat presents the share of population in EU countries, which is 'at risk of poverty'; poverty is here defined as an income level less than 60 percent of median income. It can be seen from Figure 2 that the Nordic EU countries (together with Germany) have the lowest poverty rates.

The low overall poverty rates and especially the very low child poverty rates of the Nordic countries are due to deliberate social policies which help to maintain the disposable incomes of families notwithstanding their labour market position. The egalitarian outcome is helped a lot by subsidised social services like day-care provided by the public sector. The effect of these policies is most visible when one compares the poverty rates of families with single mothers. In most countries the poverty risk of such families is very high, but not in the Nordic countries.[10]

2.5 Taxation

As a result of high expenditure level also the taxes need to be high. It is not surprising that the taxes in the Nordic countries are on average higher than elsewhere. The gross tax rates are in Sweden, Denmark and Finland higher than in any other industrial country. The high tax rates are basically 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, have since the mid-1990s been flat and low in Nordic countries. That can be seen as evidence of tax competition; in order to attract mobile capital and firms many small countries have been forced to cut taxes on profits and capital income. In the Nordic countries the introduction of low and flat rates of corporate and capital income taxes in the 1990s did not cause a fall in tax revenue.

Private consumption is taxed heavily in Denmark and Finland. Income taxes are exceptionally high in Denmark, but that is partly due to the very low level of social security contributions (in Denmark social security is financed by using general tax revenue). Employers' social security contribution rates are in Finland close to EU average, and higher in Sweden. Average income tax rates and marginal tax rates are highest in Denmark.

[10] Kangas and Palme (2000) show that differences in social policy explain the low family-related poverty rates in the Nordic countries. The same pattern is reflected by the results of Haataja (1999), according to which poverty in the Nordic countries is not connected with unemployment. Forssen (1998) has analysed the Nordic family policies and their distributional impacts.

Table 4. Indicators of tax burden in 1999, percent of GDP

	Total tax revenue	Taxes on income and profits	Taxes on goods and services	Social security contributions	Taxes on property
Denmark	50.4	29.6	16.3	2.1	1.8
Finland	46.2	19.0	14.3	11.8	1.1
Sweden	52.2	21.7	11.2	13.2	1.9
EU15	41.6	14.7	12.4	11.4	2.0
USA	28.9	14.2	4.7	6.9	3.1

Source: OECD Revenue Statistics.

The level and structure of taxation in the Nordic countries suggests that it is possible to maintain relatively high tax rates on labour incomes and private consumption without doing much harm to the economy. However, as small open economies the Nordic countries have been forced to respond to international tax competition in corporate and capital taxation, where the tax bases can move quickly over the borders. Lower corporate tax rates have not yet reduced much the tax revenues.

3. Growth and employment: crisis and revival

3.1 The Nordic recessions and their background

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.

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. 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.[11] 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).

[11] 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.

During a six-year period covering the end of the 1980s and the beginning of the 1990s all Nordic countries finally faced a severe economic crisis. In Finland and Sweden the recession was severe enough to be called a crisis or even a depression.[12] 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). While Norway, Denmark and Iceland managed avoided outright depression, they still suffered from low growth and rise in unemployment.

Table 5. The recession of the early 1990s in comparison

	Annual average rate of GDP growth in 1990-03	Cumulative change in unemployment rate 1990-03
Denmark	0.7	2.5
Finland	-2.7	13.3
Sweden	-0.9	6.5
EU15	1.4	2.8
USA	1.8	1.9

Source: OECD.

The Nordic crises were closely related to changing economic policy regimes in Western Europe (financial market deregulation and strong commitment to fixed exchange rate) and policy makers' determination to fight against inflation. It is difficult to explain even *ex post* how such deep recessions were possible and what was their ultimate cause. However, it is tempting to argue that the basic factor was a monetary shock: a sharp rise of interest rates in 1989-90 bankrupted many debt-ridden firms and forced households to cut their spending, which caused a deflationary spiral and a recession. Especially the recessions of Sweden and Finland were deep and dramatic. They were countries where the build-up of private sector debt was biggest after the financial market deregulation in the 1980s and where the rise of interest rates was sharpest in 1990. Denmark experienced a milder recession, more like the other EU countries and the US.[13]

An important explanation of the Nordic recessions were macroeconomic policy failures. The monetary and exchange rate policies were in that time not used to stabilise the economy (contrary to what had happened in earlier crises in the 1970s and 1980s). The things were made worse by stubborn (but in that time fashionable) policy of fixed exchange rates which prevented the needed currency depreciation and which forced the central banks to maintain high interest rates.[14]

[12] In the cases of Finland and Sweden the recession of the 1990s was deeper than the Great Depression of the 1930s if measured by output losses.

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

[14] Under fixed exchange rates high interest rates are needed to defend the exchange rate, if investors think it is overvalued, which was the case in most European countries in 1990-92.

The rules-based exchange rate policy doctrine was adopted widely by politicians and central bankers. The idea of the policy was to fight inflation by creating 'an anchor' for the value of domestic currency. However, the consequences of the deflationary policy were not properly understood at the time, and the resulting recessions were to large extent surprises to decision makers and economists.

It is likely that both the boom and bust phases could have been largely stabilised by floating exchange rate. However, all European countries (and the Nordics were no exception[15]) tried to maintain their exchange rates fixed (vis-a-vis the strongest currency, the German Mark), which made the European crises worse in 1991-92. In the boom phase the fixed exchange rate helped to increase currency inflow and supply of credit, whilst in the bust the speculation against the fixed parity caused currency outflow and extremely high rates of interest.[16] The period of high real interest rates caused in Norway, Sweden and Finland a collapse in asset prices and domestic demand, a wave of bankruptcies and banking crises. As a consequence, the real economy suffered and unemployment rose, too. This deflationary process ended only when the Nordic countries (together with many other European countries, most notably the UK) were in the autumn of 1992 forced to abandon the fixed exchange rate regime.[17] The resulting currency depreciation improved their competitiveness (which helped to increase exports) and enabled the central banks to cut interest rates quickly. The Nordic and other European economies started to recover in 1993.

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 failure but instead a deeper systemic malfunction 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.

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[15] They could have been an exception since at that time Denmark was the only Nordic country belonging to the ERM, the exchange rate mechanism of the European Monetary System.

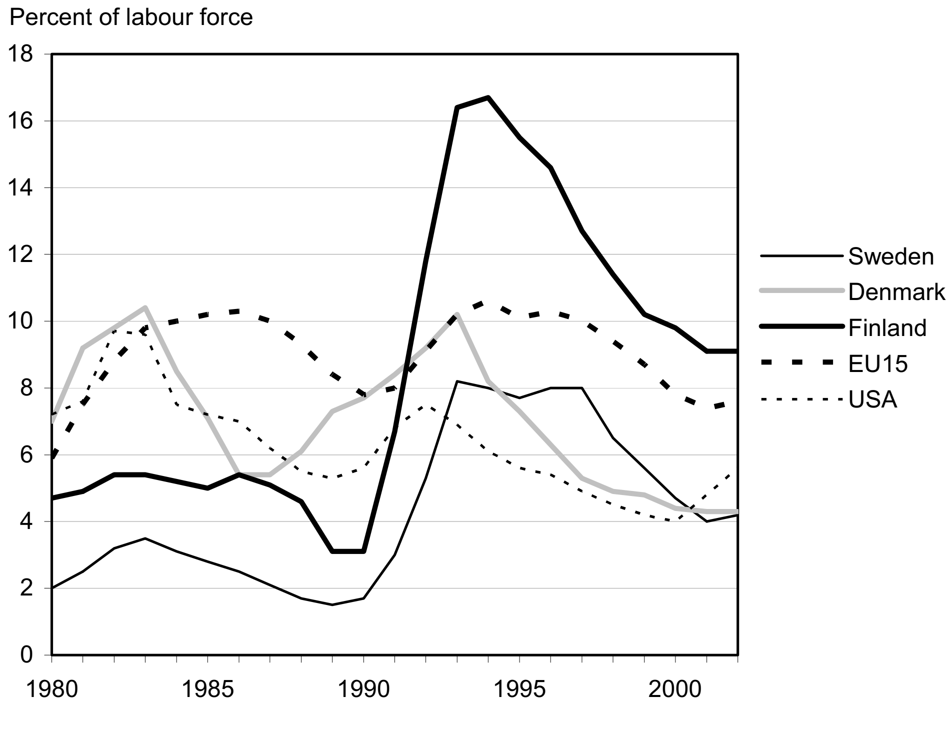
[16] See Svensson (1994).

[17] They were forced because the market pressure against the fixed parities grew too much. The abandonment of the restrictive monetary policy was not deliberate and it was opposed by the European governments and central banks.

3.2 Employment and unemployment

The Nordic welfare states are egalitarian societies with high taxes, organised labour and large public sectors. As such, they have been criticised for being sluggish and structurally weak. Redistributive tax and welfare systems are usually by economists seen as bad for work incentives, and hence also bad for job creation. Moreover, high unionisation rates and labour market regulation are also usually thought to be obstacles to employment because they tend to raise minimum wages and compress the wage structure, which should be bad for employment[18]. In all Nordic countries the employment rate is currently 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. But even the Nordics have not been able to avoid problems in past.

Figure 3. Unemployment rates



Source: OECD Economic Outlook.

The Nordic labour markets faced serious shocks in the 1980s and 1990s. These changes were reflected in unemployment rates (see figure 3). However, in spite

[18] 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. The Nordic countries and Austria are usually used as examples of countries with such systems.

of these negative shocks, the Nordic unemployment rates have generally been lower than the EU average. In the 1980s Finland and Sweden enjoyed very low unemployment (almost full employment) while Denmark suffered from high unemployment in the first half of the decade. In the 1990s it was the turn of Sweden and Finland to go through a severe macroeconomic crisis and an unemployment shock. In the case of Finland, the shock led to an exceptionally sharp rise in unemployment in 1991–94. The rise was not permanent. The period of economic recovery was accompanied by a relatively rapid fall in unemployment in 1995–2001.

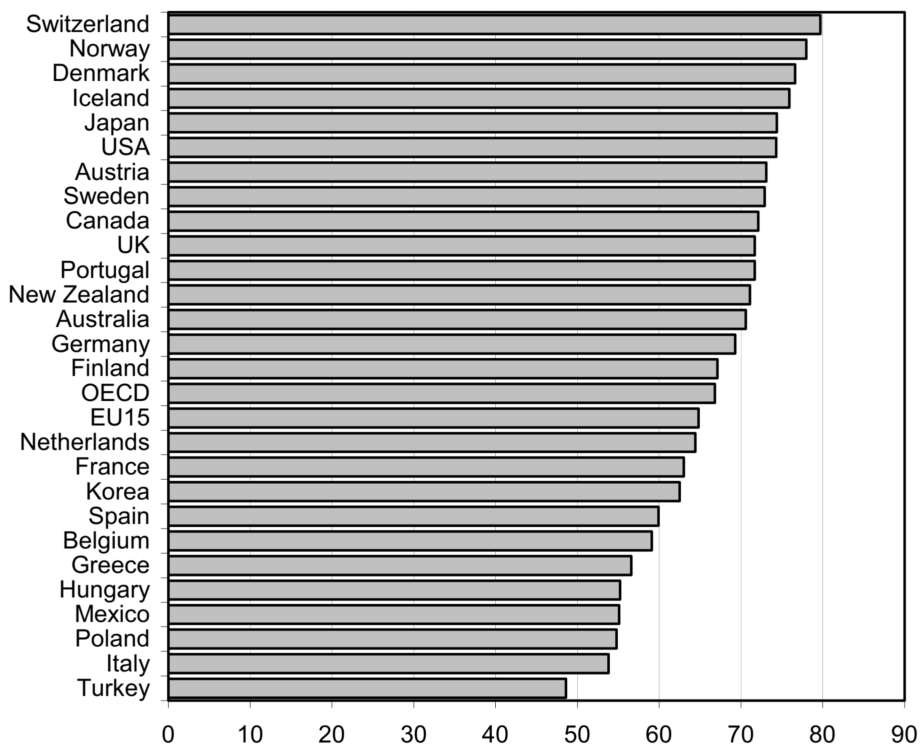
In the mid-1990s, many observers were ready to conclude that the rising unemployment in Sweden and Finland was evidence of the malfunction of the Nordic welfare state. However, the rise of unemployment turned out be only a temporary shock. The Nordic unemployment was much less persistent than that of the large EU countries. Figure 4 shows the devastating effect of the economic crisis of 1990–93 on the Finnish and Swedish employment rates. It also shows that the sudden rise of unemployment was not a result of a long term deterioration of employment but a consequence of a drastic destruction of jobs within a period of three years. After the crisis employment in each country recovered quickly, supporting the view that the Nordic labour markets were relatively flexible, after all.

Figure 4. Employment rates

Source: OECD Economic Outlook.

By the end of the 1990s it was clear that the most extensive welfare states in the world – Denmark and Sweden – were still able to maintain high living standards, high employment levels and low unemployment. The labour force participation rates of the Nordic populations were in the beginning of the 21st century as high as in the U.S. and much higher than the EU average; the same applies to employment rates, which in the Nordic countries tend to stay clearly above the OECD and EU averages. Due to the exceptional severity of the economic crisis of the 1990s and resulting high unemployment Finland was an exception to this rule in the 1990s. However, even the less successful Finland had an employment rate above the OECD and EU averages in year 2000 (see Figure 5).

Figure 5. Employment rates in OECD countries in 2000



Source: OECD Economic Outlook.

The employment and unemployment figures of Sweden and Denmark were in 2000 very close to the corresponding U.S. figures (see Table 6). Four of the five Nordic countries were in 2000 very close to full employment, situation which was in striking difference from the more gloomy European Union average with 8 percent unemployment rate and much lower employment rate.

The 'secret' of the high Nordic employment rates is most likely the Nordic welfare state itself. The high taxes of welfare states may be harmful to private sector employment but the high level of public sector employment more than compensates that.[19] The Nordic welfare state model is a system, which creates incentives and possibilities to increase labour supply, and particularly labour supply of women. Taxation based on individual incomes together with many incomes-related benefits (most importantly pensions, but also maternity and sickness benefits) favour a family model where both parents work. Publicly provided and heavily subsidised day-care for children makes that an easy option even for the mothers of small children and for those which low incomes. Furthermore, the large scale public provision of social services offers lots of employment opportunities, especially to women. As a result, the Nordic countries have labour markets where men typically work in business sector and women in public sector jobs.

Table 6. Labour market participation and inactivity indicators in 2000

	Participation	Employment	Inactivity	Unemployment
Denmark	80.1	76.6	23.4	4.4
Finland	74.5	67.1	33.1	9.8
Sweden	76.4	72.9	27.1	4.6
EU15	70.3	64.8	35.2	7.8
USA	77.4	74.3	25.7	4.0

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 Economic Outlook.

The public sector is a very important provider of job opportunities in the Nordic countries. Especially this is the case in Denmark and Sweden, where almost 23 percent of working-age population (or about 30 percent of labour force) is employed by public sector. In Finland the figure is lower, 17 percent, which still is much higher than the EU average of less than 11 percent. As a result of very large public sector, the private sector employment is in Sweden and Finland even lower than in the other EU countries (see Table 7). In Denmark the number of business sector jobs is almost the same as in other European Union member countries.

The figures in Table 7 suggest that – at least when compared to the other EU countries – the large public sectors of the Nordic countries do not crowd out much private sector employment. The number of business sector employees as share of population is roughly the same in both groups. The impact of the large public sector is that it has created new jobs in public services and shifted a part of unpaid household work (mostly done by women) to the market.

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

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.

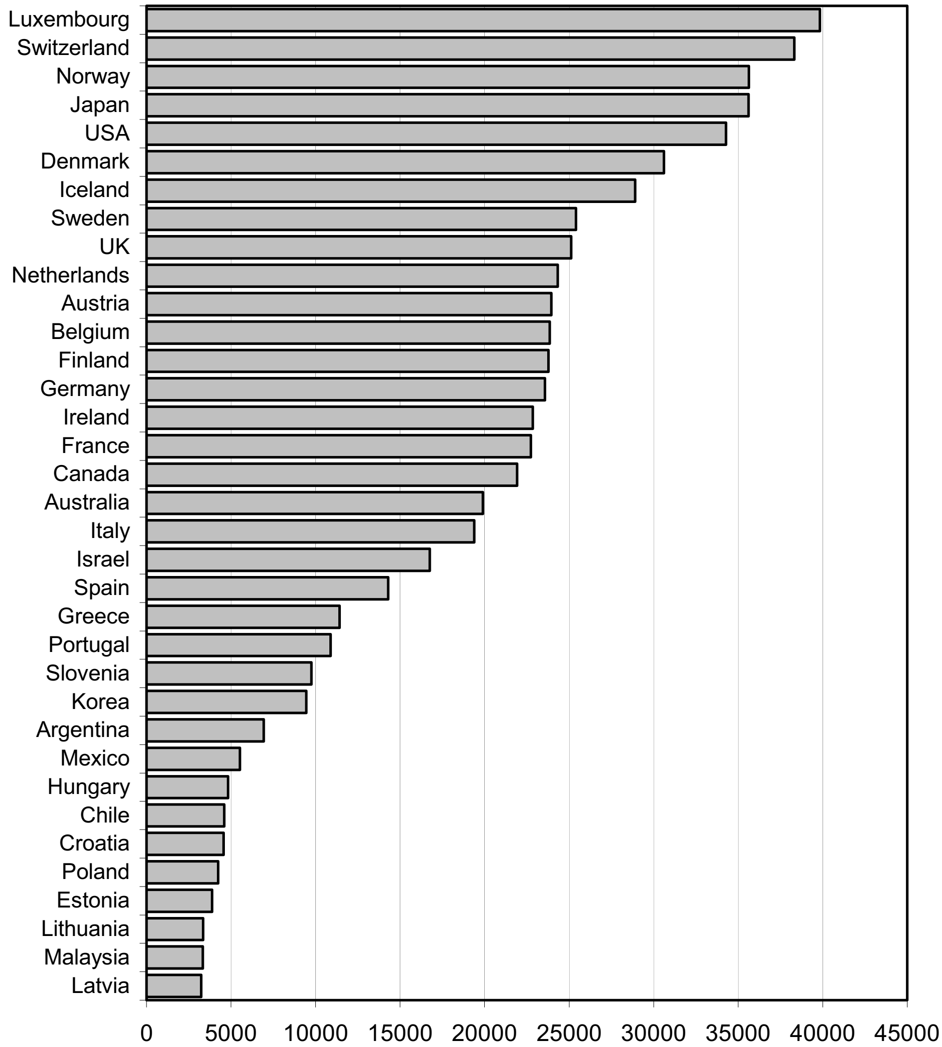
3.3 Economic growth

The good employment record of the Nordic countries would suggest that the real incomes per capita in these countries should also be relatively high. That indeed is the case. Especially the nominal (in dollar terms) incomes of the Nordics are very high. Figure 6 ranks countries by their income levels. Norway is 3rd, Denmark, Iceland and Sweden hold the ranks 6-8 and Finland is number 13. However, that ranking gives artificially good positions to the Nordics because of their high relative price levels. Figure 7 shows the real income levels per capita using purchasing power parities which take into account the differences in price levels between the countries. Such a correction causes Finland and Sweden to drop to ranks 18 and 19. Sweden even gets a lower ranking than Finland. Norway, Iceland and Denmark more or less maintain their original rankings.

For Sweden such a low ranking has been viewed by some analysts as embarrassing given that in 1970 Sweden still belonged to the group of top 5 countries. The fact that Sweden has been surpassed by almost 15 countries in the time of 30 years has given rise to lots of criticism against the Swedish welfare state (‘the Swedish model’). However, at the same time three other countries with Nordic welfare state systems (i.e. Denmark, Norway and Finland) have been able to maintain or improve their relative positions in the ranking. It is not hence clear what to conclude. In Denmark and Sweden the size of the public sector and overall tax burden are almost the same. Still Denmark seems to have been more successful in economic terms. One explanation may be that the income and price level statistics are not very accurate. Another would be that the structure of taxation and the regulatory framework are better in Denmark.[20]

[20] It has been argued by Lundvall (2001) that one reason to the economic success of Denmark is the strong population of small and medium sized firms. They are more flexible than the Swedish corporate sector which is dominated by large multinational enterprises.

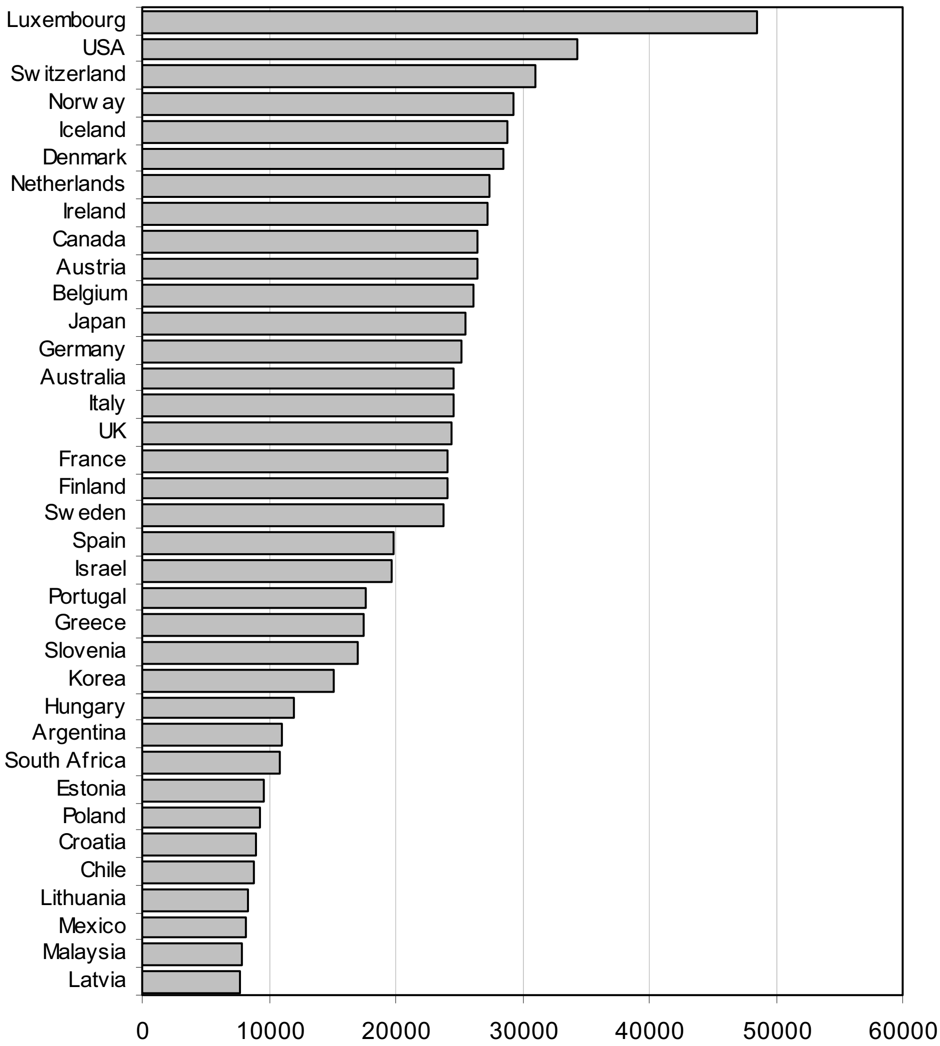
Figure 6. GNI per capita in 2001, USD



Source: World Bank.

The evolution of the level of GDP of three Nordics is in Figure 8 compared to the EU average and to the USA. In 1980 Denmark and Sweden were above and Finland slightly below the EU average GDP per capita. After that the most striking development has been the rapid growth of the American GDP.

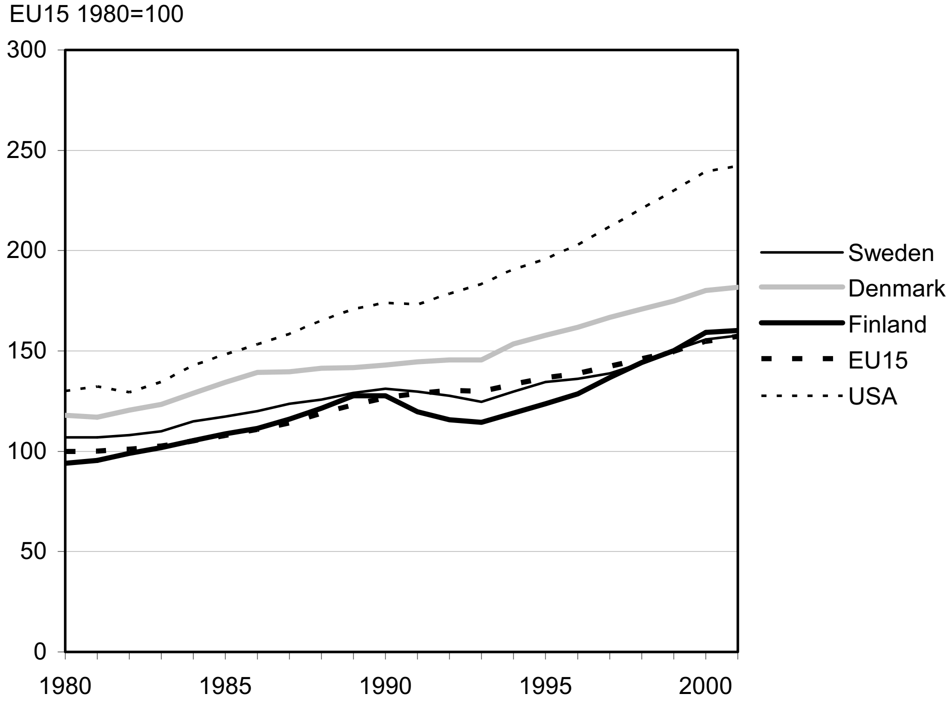
Figure 7. Real GNI per capita in 2001, USD in PPP



Source: World Bank.

In spite of the macroeconomic turbulence in the 1980s and 1990s, the long term growth record of the Nordic countries has not been bad. In spite of very slow growth in 1985–95, Denmark was able to maintain its advanced position vis-a-vis the European Union average. At least one has to conclude that the Danish welfare state has not been an obstacle to a good macroeconomic performance. Finland and Sweden suffered a serious shortfall of growth later, in 1990–93, but against the worst fears, that crisis turned out to be temporary, too. In spite of the crisis and large temporary output losses, in longer run Finland has even been able to catch up other countries and finally surpass the EU average and Sweden. In the light of such performance the Finnish economy can be viewed dynamic.

Figure 8. Evolution of relative GDP levels over time

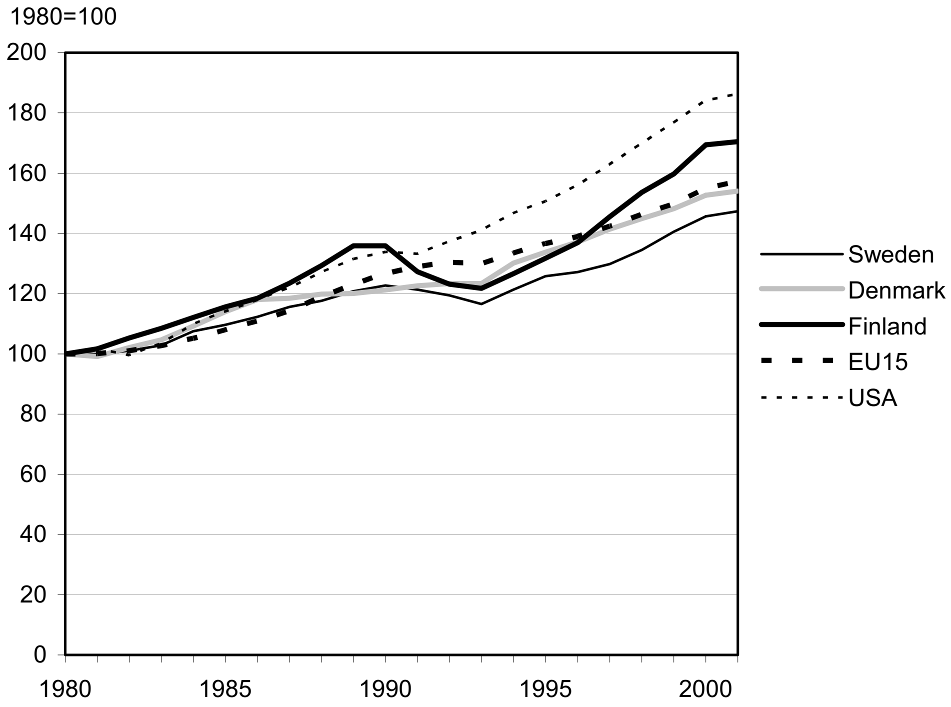


Source: OECD Economic Outlook.

The macroeconomic performance of Sweden was more mediocre in the 1990s. In the 1980s Swedish economy performed as well as the other industrial countries in terms of output; in terms of employment and unemployment the Swedish labour market performed clearly better than others. However, even after 10 years the Swedish economy has not been able to fully recover in terms of lost output from the crisis of the early 1990s. This gives rise to a question what's wrong in Sweden – or is there anything wrong in Sweden? It is safe to conclude that it is too early to make a final judgement on the Swedish economic performance. In absolute terms the GDP per capital in all Nordic countries is above the EU average. It follows that their advanced welfare states cannot be very bad for economic performance.

The relative growth records of three Nordic countries are depicted in figure 9. Once again, the USA economy delivers the most solid and stable growth path over the two decades. The European Union is clearly lagging behind, which means that the relative output difference between USA and EU has been widening.

Figure 9. Relative GDP growth in 1980-2000



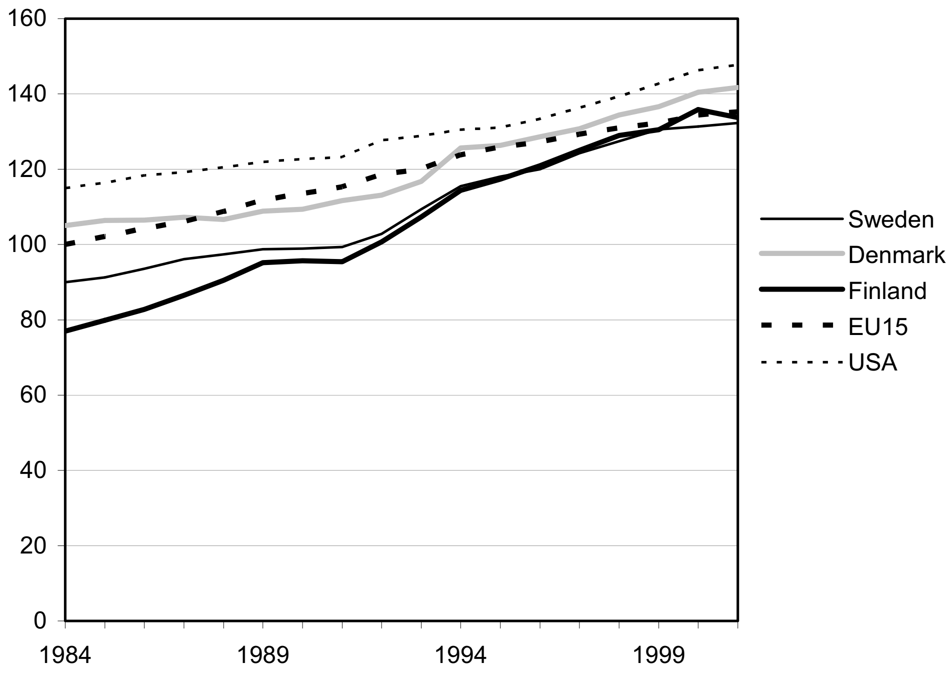
Source: OECD Economic Outlook.

It is interesting to note that Finland and Denmark have been able to grow faster than the other EU countries on average. It is only Sweden which has been lagging slightly behind the EU.

Comparisons based on GDP figures are misleading because they do not take into account differences in population growth and in annual working hours. The stronger US growth can be partly explained by faster growth of working-age population in America and by longer average working hours (because of shorter US vacations). Better measure of economic efficiency and economic potential is hence productivity. Figure 10 presents the time paths of labour productivity. Here one can observe clear convergence amongst the countries. All European countries have been able to catch up the US productivity level.

The productivity differences between the countries are small. In the case of Finland there has been a catch up process going on vis-a-vis all others. Sweden has been lagging behind others and losing relative position. That happened mainly in the 1980s, but not anymore in the 1990s. Danish productivity improved also in the 1990s.

Figure 10. Evolution of relative labour productivity levels over time



Source: OECD.

There was a clear productivity catch-up in Finland and Sweden in the 1990s. The economic crisis triggered a process of structural change and rationalization, which resulted in rapid growth of high tech industries and productivity. Especially the rise of wireless communication technology (the leading firms in that field were the Finnish Nokia and the Swedish Ericsson) manifested that change.[21] The rapid growth and especially the strong performance in new technologies have improved the image of the Nordic countries as dynamic, innovative and modern economies. It has even be argued that the Nordic welfare state may actually be good for such knowledge-intensive growth because it supports research and education and enables individual risk-taking.[22]

[21] For reviews of the growth of the Finnish wireless technology sector and Nokia corporation, see Rouvinen and Ylä-Anttila (2003) and Paija and Rouvinen (2003).

[22] See Castells and Himanen (2002).

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

The Nordic recessions caused a lot of strain to the public finances.[23] Initially the Nordic public sectors were in healthy surplus; in 1990 Finland and Sweden had record-high fiscal surpluses and the Danish public sector was close to balance. However, 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 in Sweden and Finland. 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 deliberately caused by expansionary fiscal policy.

The resulting large deficits caused much worrying about the economic sustainability of the welfare state. 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 to the wide imbalances by restricting the growth of public expenditure and cutting the levels of some benefits.

Table 8. General government fiscal balance

	1990	1993	2000	Change 1990-93	Change 1993-2000
Denmark	-1.0	-2.9	2.7	-1.9	+5.6
Finland	5.3	-7.3	6.9	-12.6	+14.2
Sweden	4.0	-11.9	3.4	-15.9	+15.3
EU15	-4.0	-6.3	0.7	-2.3	+7.0
USA	-4.3	-5.0	2.2	-0.7	+7.2

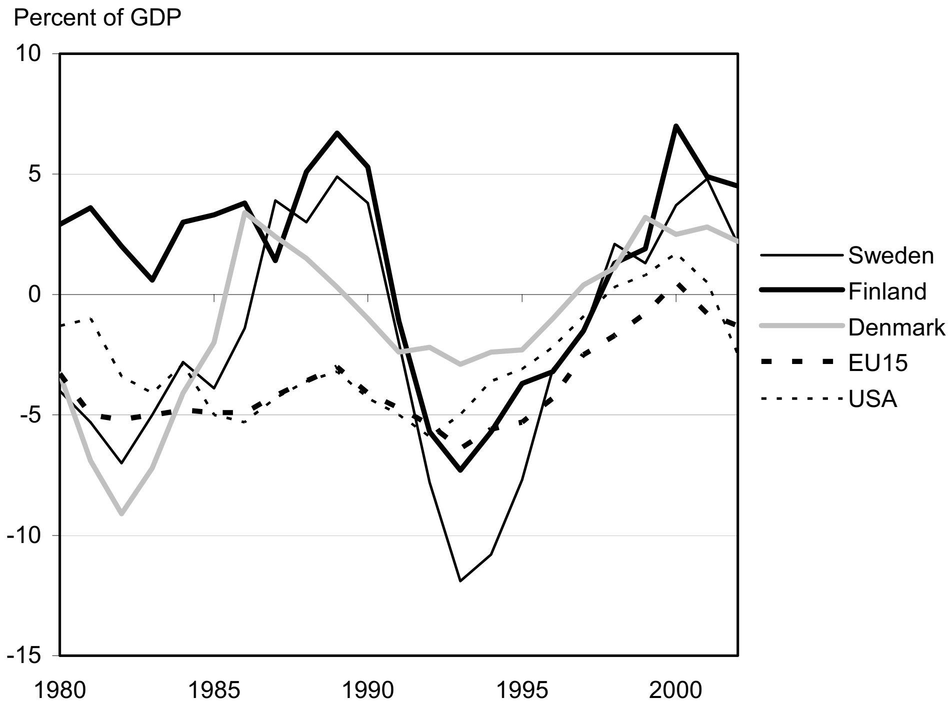
Source: OECD Economic Outlook.

As a response to fiscal deficits 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 in the sub-sequent recovery. This is a marked difference from the other recoveries of the 20th century when the rise of public spending has fastened economic growth. In here Sweden and Finland differed also from the other Nordic and EU countries where 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

[23] 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.

1990s although there were no outright reductions in social expenditures.[24] 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).

Figure 11. General government financial balances



Source: OECD Economic Outlook.

During the crisis it was widely thought that the large budget deficits would be incurable without abolishing the welfare state. The economic revival in 1995-2000 changed that picture faster than no one would have dared to expect. The public finances moved back to surplus. The public expenditures decreased as a share of GDP more than 10 percentage points, and the debt ratios even more (see table 9).

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[24] In fact, a lots of streamlining and organizational changes took place in the 1990s, and the number of public sector employees was reduced in both countries (see Palme et al., 2003). Towards to the end of the 1990s the welfare state seemed to recover from these measures.

Table 9. Public finance indicators, percent of GDP

	Public debt		Public expenditure		Annual growth of public consumption in 1992-99
	1993	2000	1993	2000	
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
USA	75.8	58.8	34.1	29.4	

Source: OECD Economic Outlook.

How was it possible to reduce the GDP share of public expenditures in Finland and Sweden within 7 years by 15 percentage points without destroying the welfare state? The primary answer is rapid economic recovery (which helped to increase tax bases) together with decreasing unemployment benefit expenditure and interest payments. In 1993, the non-cyclical public expenditures (i.e., primary expenditures without unemployment-related expenditures) were 45 percent of GDP in Finland and 52 percent in Sweden. In 2000 the corresponding figures were 38 and 47 percent. However, at the same time the Finnish GDP grew more than 30 percent and the Swedish more than 20 percent. As a result, the lower shares of larger output were used to finance non-cyclical public expenditure. In real terms these expenditures grew about 10 percent in 1993-2000 notwithstanding the austerity measures and fiscal consolidation. So the period of fiscal consolidation in the 1990s did not mean reduced public spending, it only meant that the growth of discretionary public spending was slower than before.

An important factor in the rapid recovery of the Nordic economies is that their 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. The good standing of the Nordic economies in the beginning of the 21st century enables one to use they as counter-examples to the mainstream view professed by economic journalism and the OECD and IMF reports.

5. Future challenges to 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.[25] 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.

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.[26]

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.[27] 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

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[25] 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.

[26] 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).

[27] The economic and fiscal impacts of the expected demographic change have recently be analysed by Kiander and Östring (2003), who compare all Nordic countries. More specific analyses on the Finnish and Swedish cases are provided, respectively, by Parjanne and Siren (2003) and Batljan (2003).

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.[28]

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.[29] At the moment the tax incidence is on relatively stable and non-elusive tax bases. As a result of high consumption and labour taxes 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[30], 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

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[28] A recent report on tax competition commissioned by the Nordic Council of Ministers takes a relatively relaxed view on the potential future threats; see Lassen and Sörensen (2003).

[29] 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).

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

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.

6. 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. 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. 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.

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 by many critics 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.

However, since the all Nordic countries recovered from their macroeconomic crises, their allegedly bad economic performance or public finance problems 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 more to financial factors and policy failures than to institutional weaknesses of welfare state.

One could even argue, that in the Nordic countries the labour markets have functioned well (and better than in larger EU countries) in the 1990s in spite of high unionisation, collective bargaining, and generous unemployment benefits. Furthermore, in spite of advanced social welfare systems and high taxes, the employment rate in the Nordic countries is higher than the EU average, and the employment rates of Iceland, Denmark and Norway even exceeds that of the USA. Moreover, the Nordic unemployment rates are lower than the EU average (except in the unfortunate case of Finland), and long term unemployment rates are low. In the light of these facts the performance of the Nordic countries could be used as counter-examples to the mainstream view which is eager to relate welfare states to economic stagnation.

In future the extensive Nordic welfare systems, although they seem to be functioning well at present, 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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