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## INTRODUCTION AND SUMMARY

The Nordic model:  
a benchmark and a  
bumble bee

The Nordic model is widely regarded as a benchmark. A number of comparative studies of economic and social performance have ranked the Nordics high. A common finding of cross-country comparisons is that the Nordics succeed better than other countries in combining economic efficiency and growth with a peaceful labour market, a fair distribution of income and social cohesion. The model is pointed to as a source of inspiration for other people in their search for a better social and economic system.

On the other hand, many observers around the world are amazed that “the bumble-bee can fly” – that the Nordic economies can prosper and grow in spite of the presumably weak economic incentives associated with high tax wedges, a generous social security system and an egalitarian distribution of income. Critics have been looking for inner contradictions in the model and they have questioned its sustainability. Some argue that the economic performance of the Nordic countries is simply a result of exceptional and temporary advantages, bound to disappear over time.

The model faces big  
challenges – bold  
reform is required

This report deals with the Nordic model, the reasons why it has worked in the past, and the challenges it is being subjected to in the future. Present economic and social trends, including globalization and demographic change, pose significant challenges to the model as we know it. The model will remain viable and successful only if the challenges and the need for reform are understood – and if action is taken.

Globalization is primarily an opportunity and not a threat. It has been the very basis of the growth in productivity and living standards that the Nordics have achieved. However, the continued trend of globalization will put the model under pressure. The emerging economic giants in Asia and Latin America will force us to restructure our economies at a rapid pace; relocation of production and job losses need to be compensated for through innovations and growth in new activities. Simultaneously, globalization may undermine the financial viability of the welfare state by increasing international factor mobility and tax competition between nations as well as by opening up the possibility of “social tourism” for eligible groups.

Globalization is beneficial, but it may undermine the financing of the welfare state

Demographic change – in the form of an ageing population – increases the size of the passive population (retirees), while tending to decrease the size of the active population (workers). The result is a dramatic rise in the dependency ratio and a strong pressure towards increased social spending and higher tax rates. The combination of ageing populations and high ambitions for welfare services will strain public finances, even more so if globalization increases the mobility of jobs and labour. The sustainability of present tax-transfer systems and public systems of care for the elderly are being seriously put into question.

Ageing populations put heavy pressure on welfare spending and the sustainability of public finances

In responding to these challenges we regard a number of proposed “solutions” as basically non-workable. For instance, the financial dilemma of the welfare state cannot be resolved through more rapid economic growth, higher taxes, increased fertility or more immigration.

On the other hand, we believe it is essential to preserve one central feature of the Nordic Model. The Nordics have been embracing both globalization and the welfare state, and we argue that the security offered by collective mechanisms for sharing risks has been instrumental in enhancing a favourable attitude to globalization and competition. This key characteristic of the model must be preserved – in order to maintain an economic and social climate which is conducive to future welfare and growth. Collective risk sharing should continue to offer a safety net which helps workers and their families to cope with risks and to adapt to new requirements in times of change.

The strength of the Nordic model should be maintained: risk sharing and a safety net to help workers and their families cope with risks and change

The incentives and the balance between entitlements and obligations must support a high rate of labour force participation

In addition, we emphasize that a high rate of labour force participation is an indispensable ingredient of the model. There must be sufficient incentives – in the form of financial rewards and/or workfare elements – to participate in the labour force and to work. Lengthening working careers must go hand in hand with increasing longevity. The “social contract”, including the public pension system, should not be based on the assumption that the tax burden can be passed on to future generations in the form of rising tax rates.

There is also a need to define the core tasks of the welfare state and to clarify the scope of the services that citizens are entitled to and should be able to expect. Higher productivity in the provision of welfare services is imperative and can be enhanced by, inter alia, privatization and outsourcing of public services, though only in cases where difficult and important issues of governance can be dealt with satisfactorily.

Finally, investment in human capital should not be the victim of increasingly tight budget constraints; what is good for the young is good for the future of society.

Our findings and conclusions are summarized in the sections that follow. The reasoning behind them is then developed in the ensuing chapters.

## 1.1 A NORDIC MODEL EXISTS

Shared attributes of the Nordics include a large welfare state, a particular set of labour market institutions and a high rate of investment in human capital

There is indeed a social and economic system that can usefully be referred to as the Nordic model. Obviously, there are important differences between the economies and policies of the Nordic countries. (The Nordic group is in our case limited to Finland, Denmark and Sweden, as Norway and Iceland would deserve special treatment due to their non-membership of the EU and their high reliance on oil and fishing respectively.) Yet, it is the similarities that are more striking, some of the principal features being the following:

- a comprehensive welfare state with an emphasis on transfers to households and publicly provided social serv-

ices financed by taxes, which are high notably for wage income and consumption;

- a lot of public and/or private spending on investment in human capital, including child care and education as well as research and development (R&D); and
- a set of labour market institutions that include strong labour unions and employer associations, significant elements of wage coordination, relatively generous unemployment benefits and a prominent role for active labour market policies.

To the extent that these features can be measured, the similarities of the Nordics are supported by statistical data. The Nordic countries tend to create a cluster of their own along many dimensions. Other European countries (notably the Netherlands and Austria) are often similar in certain respects, but in no important respect do we see an outlier among the Nordics.

While the similarities are important, they are not in themselves the essence of the Nordic model; its crucial characteristics are more difficult to capture, they relate to intangible and systemic features. We believe that the basis of the model is a combination of collective risk sharing and openness to globalization. There is a mutually supportive interaction between these two elements: collective risk sharing helps make globalization acceptable to citizens, by facilitating adjustments that allow the economy to benefit from changing markets and to raise productivity and incomes. While having large public sectors, the Nordics are also embracing the market economy and actions to foster competition. Underpinning this virtuous interaction of security and flexibility is the widespread feeling of trust – among citizens and in public institutions – and a sense of fairness related to the egalitarian ambitions of the welfare state (education, social policy).

The key feature of the model is the mutually supportive interaction of risk sharing and globalization

## 1.2 THE NORDIC MODEL HAS PERFORMED WELL IN THE PAST

The Nordics have achieved a satisfactory economic performance and high social ambitions

Growth has been associated with rapid technical progress and structural change

The Nordic model offers a good business climate

The Nordic countries have, according to many indicators, succeeded relatively well in fulfilling their social ambitions. Recently, this has been combined with a satisfactory economic performance in terms of employment and productivity levels as well as growth of GDP per capita. Also, the macroeconomic balance is good and public finances are strong. There is indeed a Nordic success story in the sense of a favourable combination of economic efficiency and social equality.

True, the Nordics went through a period of low productivity growth in the 1970s (like most other OECD countries) as well as a major financial and macroeconomic crisis with very high unemployment rates and large fiscal imbalances in the early 1990s (somewhat earlier and less dramatically in the case of Denmark). But even so, the Nordics have more or less managed to keep up with the US in terms of PPP-adjusted GDP over the last 25–30 years, which is more than can be said of most other EU15 countries. The long-term performance is mainly recorded as a high rate of total factor productivity growth. This indicates that technical progress, notably in the area of information and communication technology (IT), has played an important role in growth. More importantly, it also shows that the Nordics – contrary to popular belief – demonstrate a high degree of economic flexibility and capacity of structural change. The macroeconomic crises have helped the process by inducing growth-enhancing changes in structural policies (and, for a while, through the improvements of competitiveness caused by large depreciations in the early 1990s).

The Nordic countries are now at the forefront with respect to technological development and IT growth. Their financial markets are open to the world, the Nordics have developed a reasonably well-functioning system of corporate governance, and in the corporate sphere they have produced a disproportionate number of world leaders. The Danish economy is ranked by the World Bank as number 5 in the world with respect to the ease of doing business, with Finland and Sweden coming in at number 13 and

14, respectively, out of a total of 173 countries. In terms of ease of “Trading across borders”, the three Nordics are among the six top nations in the world (with Singapore, Hong Kong and Norway also in this group). The Nordics are well ahead of the average for the EU15 with respect to macroeconomic stability, in particular fiscal consolidation and the net foreign asset position, but also in combining price stability with a relatively low unemployment rate. In the “World Competitiveness” rankings done by the World Economic Forum the three Nordics are among the top six nations out of 131 for 2007–2008. In a recent ranking of “innovation ability” (“Innovationsfähigkeit”) of leading industrial nations in 2007 by the German Institute for Economic Research, Sweden, Finland and Denmark come among the top five out of 17 nations. One should be careful in interpreting such rankings, but based on the abundance of similar evidence it is hard to argue that the Nordic model is not consistent with a good business climate.

### 1.3 THE NORDIC MODEL HAS BEEN CONDUCTIVE TO GOOD ECONOMIC PERFORMANCE

Professional economists have often been puzzled by the relatively good economic performance of the Nordic model, given its high taxes and its generous social protection systems as well as the role of strong labour unions and wage coordination. Obviously, there must be losses of economic efficiency caused by some of the characteristics of the Nordic model, and many studies have been devoted to the analysis of the economic costs of a large welfare state. But, equally obviously, there are other factors which have made up for such disadvantages.

The “other factors” can for the purpose of exposition be divided into three categories. The first category includes factors that are entirely exogenous to the economic system, such as geographic location, climate, natural resources, or religion. The second category comprises institutional factors that are related to the economic system, such as political freedom and absence of corruption, well-defined property rights and a reliable judicial system,

Economic performance reflects many factors – economic and non-economic

The Nordics are open to globalization, and state intervention in the business sector is comparatively limited, as is regulation of markets

High taxes are economically harmful, but their negative effects can be mitigated if public spending supports employment and growth and if entitlements in transfer systems are linked to labour market attachment

or good health and educational standards. The third category, finally, are factors that are a direct result of economic policies, such as openness to trade and factor mobility, a tax system favourable to labour supply, accumulation and entrepreneurship, and a good infrastructure for transport and communication.

While the Nordic success story could be partly explained by factors belonging to the first and notably the second category, we would for the purpose of this report like to focus on the final category, i.e. growth-enhancing economic policies. For more than a century the Nordics have been free-trading nations with a low level of protection in commodity trade (excluding agricultural products), leading to continuous structural change and a high degree of specialization in areas of comparative advantage. The Nordics have even longer been relatively open to migration, not least immigration of specialists and entrepreneurs with specific technical or commercial skills. A more recent development is that free enterprise on the whole prevails and that state intervention in the business sector is limited. The labour unions are politically influential but have not gone against these policies, nor have they resisted the introduction of new techniques or off-shoring of activities which have led to productivity improvements and displacement of labour.

One way of looking at the “bumble bee” feature of the Nordic model is by pointing to some significant characteristics of public spending. Much of it is on items like child care and education, the infrastructure, research and active labour market policies. Such spending may offset part of the negative effects of high taxes. Also, there is often a link between entitlements and contributions in transfer systems (notably pensions), which supports participation in the labour force. Furthermore, the importance of a high level of trust and absence of corruption must not be underrated – these phenomena help maintain the public backing and therefore the viability of a large public sector.

As already noted above, we argue that some of the key elements of the Nordic model have been conducive to the implementation and political acceptance of growth-enhancing policies. The argument is this: Economic growth is only to a limited extent achieved via pure accumulation of factors of production. More important

are the effects of technical change and reallocation of factors in response to changes in the international pattern of specialization. International trade and technical progress can lead to increased welfare only by way of structural change, a process with winners and losers. New competition has the consequence that some work places are closed down, jobs are lost and labour is displaced. The economic argument in favour of free trade and open markets is not that there are no losers, only that the winners have so much to gain that they can – in principle – compensate the losers. Such compensation, however, is not always achieved in practice. Thus, potential losers in many countries have used political and union power to create barriers to new competition by way of tight labour market regulation with strict job protection, tariff and non-tariff protectionism, government subsidies or public monopolies.

The Nordic model can be regarded as a way of generating political support for growth-enhancing technical change, free trade and open markets by creating a number of systems through which the winners from structural transformation at least to some extent compensate the losers. Solidaristic wage setting, active labour market policies, redistribution of income via tax-transfer schemes, comprehensive and generous unemployment insurance schemes and other elements of social protection can all be regarded as ingredients in such compensation mechanisms. This is not to say that *all* parts of such policies can be motivated by compensation arguments, or that existing schemes are particularly efficient in compensating the losers at the expense of the winners. In particular, a lot of public transfers amounts to redistribution of resources over the lifetime of a given individual rather than redistribution between different individuals. Nevertheless, we believe that social and labour market policies have been important in mobilizing political support in the Nordic countries for openness to new technology in production, free international trade and competition in domestic markets.

Many features of the Nordic model amount to mechanisms designed to give some compensation to those suffering from negative effects of structural change

## 1.4 MAJOR CHALLENGES TO THE NORDIC MODEL GIVE RISE TO AN URGENT NEED FOR REFORM

Functional as it may have been in the past, we believe that the Nordic model today is subject to a number of challenges that will put it under serious pressure and call for fundamental reform in order to make it sustainable.

The Nordic welfare state is vulnerable to changes in employment and the age structure of the population

The root of the challenges is inherent in the basic set-up of the Nordic welfare state, which is based on tax-financed public provision of a large number of social services: child care, basic and advanced education, hospital care and health services, and care for the elderly. This is an important aspect of the Nordic model, in that it makes the access to such basic welfare services independent of income and employment status. But it is also a problematic feature, which may in the long run lead to an impasse in public finances. This is so for two reasons.

First, demand for (some) welfare services tends to increase faster than income (a phenomenon known by economists as “Wagner’s law”). Second, by their very nature, productivity in the production of welfare services tends to increase at a lower rate, if at all, than in the production of goods (or other services). Assuming equal wage developments across sectors, unit costs must then increase faster in the production of welfare services than in the economy as a whole (a phenomenon known by economists as “Baumol’s law”).

The demand for welfare services tends to grow and the relative cost of producing them tends to increase, which is why spending on welfare services rises faster than GDP

The two phenomena taken together imply a tendency for total spending on welfare services to rise faster than GDP over time. As long as the production of these services remains in the public domain, or as long as they are tax-financed, the tax burden must also exhibit a tendency to rise continuously with GDP. This is a problem of the welfare state that we have been living with for decades now. However, starting from an already high tax burden, the efficiency cost of further increases in tax wedges will at some stage rise steeply, and high taxes will eventually cause serious harm to employment and growth. It seems to us that we may be close to a critical point where the deadweight losses due to high tax wedges

– and, particularly, their effect on labour force participation rates – start to bite seriously. This is particularly so in view of some of the consequences of globalization and demographic change.

Globalization is in general beneficial to economic growth as it provides an opportunity to increase the returns to factors of production via international exchange of goods and services and/or via international factor mobility. Nevertheless, increasing international mobility of labour also poses, if it continues unabated for long, a threat to the welfare state and the Nordic model. The entitlements to education and retirement as well as to care or benefits in the case of sickness, disability and unemployment belong to all citizens as individuals in this model, while the cost of these entitlements are born collectively and shared by all via the tax system.

With higher mobility of labour it becomes increasingly possible to benefit from the entitlements without sharing the cost (paying the taxes). There are many examples. Graduates from domestic tax-financed universities increasingly make their careers (and pay their taxes) abroad. Citizens who have spent most of their working lives (and paid their taxes) abroad, return to their home country after retirement to collect the benefits of free (or cheap) hospital care and care for the elderly. Unemployment rates and the frequency of disability pensions tend to be higher for certain immigrant groups than for domestic citizens. With increasing claims on entitlements due to “social tourism” and eroding tax bases due to factor mobility and tax competition between nations, the long-run sustainability of the Nordic model could be in serious jeopardy.

The most serious challenge to the Nordic model, however, is caused by the changing demographics, given the extensive role of the public sector in providing age-dependent social services and transfers. The age composition of the population will in most European countries change rather dramatically in coming decades. The shift is driven by two factors: a temporary “baby boom effect” as the large cohorts of the 1940s and 1950s reach retirement age, and a permanent effect caused by a continued increase in life expectancy. As a consequence, the working age population in Finland will decline from 66.5 per cent of the total today to 57.5 per cent by 2040. The share of those over 65 will increase from 16 to 26 per cent of the population, and the share of very old (above 85) will

Tax competition and social tourism may become an increasing source of concern for public finances

The dramatic shift in the demographics is the most important force undermining the financial sustainability of the welfare state

Public finances are presently recorded as having a large surplus – yet public finances are under present policies unsustainable in the long term

increase from just below 2 to over 6 per cent over the same time period. Figures are broadly similar (though somewhat less alarming) for Denmark and Sweden. Accordingly, dependency ratios will start increasing dramatically from around 2010.

Obviously, the balance between those contributing to and those benefiting from the welfare state is shifting to such an extent that these demographic trends are putting the financial sustainability of the system in danger. In the absence of corrective measures Finland's general government budget surplus will – according to calculations made in the Ministry of Finance – turn into a growing deficit (and public debt could amount to 120 per cent of GDP by 2050). The projection (which is no forecast) brings home the message that public finances are unsustainable in the long run when assessed in the light of current spending programmes and tax rates. Somewhat paradoxically, the general government finances are presently recorded as being in a large surplus, yet are deemed to be unsustainable in the long run unless significant action (corresponding to at least 1–2 per cent of GDP) is undertaken to improve the budget on a permanent basis.

## 1.5 MANY PROPOSED “SOLUTIONS” ARE UNWORKABLE

In public discussion there have been a number of suggestions as to how these challenges can be handled. Unfortunately, many of those suggestions turn out to be non-workable on closer inspection. We will deal here with some of these not-so-helpful reform proposals and explain why they do not work.

More rapid growth will not solve the sustainability problem of public finances

*Economic growth.* One of the most common proposals for solving the fiscal sustainability problem of the Nordic model is to undertake measures to raise the overall rate of GDP growth. The suggestion appeals to common sense: by “baking a bigger pie” we could get enough tax revenues and other resources to handle the increasing demands on the welfare state. Yet a little reflection reveals that economic growth per se does not solve the problem, and might even aggravate it. It should be emphasized that we are

not contesting economic growth as the key to higher living standards in the future. But however desirable growth is, it is unlikely to resolve the financial dilemma of the welfare state that we see looming in coming decades.

Growth of GDP is mainly achieved via increased productivity in the production of goods, while productivity change in the provision of many services is lagging behind. Nevertheless, higher private sector productivity will raise real wages not only in the private sector but in the whole economy, including in the public sector (as a consequence of market forces and/or wage coordination by unions). Though growth increases tax revenues, it also raises the public sector wage bill. In addition, political pressure will normally prevent public pensions and other transfer payments from falling permanently behind general income developments. Finally, higher incomes are likely to increase the demand for publicly provided welfare services. The overall result may, therefore, be that more growth leads to a deterioration rather than an improvement in public finances. It can help public finances only under the dubious or unrealistic assumption that public sector wages and/or transfers are allowed to fall permanently behind general income developments.

*Higher taxes.* Technically, the fiscal sustainability problem can be solved by sufficient increases in tax rates, either now (for “tax smoothing” reasons) or later when deficits would otherwise start to materialize. However, tax increases can solve the fiscal problem only under the assumption that they do not negatively affect the size of tax bases – or at least that such effects are quite small. We do not believe that this assumption is realistic in economies which already have quite high tax rates and which operate in an increasingly globalized environment. Higher tax wedges would lead to further substitution away from taxed activities (like work in the regular sector) to untaxed activities (like leisure, household production and work in the “informal” sector). They can also have detrimental effects on entrepreneurship, saving and capital accumulation – and thereby on economic growth. In the longer run, internationally mobile tax bases, like highly skilled labour, will spend an increasing proportion of their activity in jurisdictions with a lower tax burden.

Growth increases the tax base and tax revenues – but also the public sector wage bill and transfers as well as the demand for welfare services

Higher overall tax rates are no longer a realistic option

More children may be desirable – but will not solve the problem of public finances

Therefore, we do not believe it is advisable in the present Nordic context to attempt to increase tax revenue by raising further the overall tax burden of the economy. This does not exclude, of course, efficiency-enhancing tax reforms where certain taxes may be raised – in particular, perhaps, “Pigouvian” taxes like emission or congestion charges, or taxes on relatively immobile tax bases.

*Higher fertility – more children.* The demographic challenge arises from the trend towards an ageing population with more retirees and fewer workers. Encouraging larger families with more children may sound like a straightforward solution to the demographic challenge, but as a matter of fact it is not. Increasing fertility today would actually lead to an even sharper increase in the dependency ratio over the next two decades. There would be more children to support and educate at the same time that the baby-boomers go into retirement and will become increasingly dependent on care for the elderly. In the longer run, the extra new-borns will experience the same increase in life expectancy and they will therefore not be net contributors to the welfare systems in a lifetime perspective. So, while higher fertility may be desirable for other reasons, it cannot help resolve the fiscal sustainability problem of the welfare state, particularly not over the next couple of decades.

More immigration may be helpful – but cannot realistically solve the financing problem

*Immigration.* Migration is a natural part of globalization, and flows of labour can support economic growth by, e.g., alleviating specific skill shortages. Immigration could also bring a temporary relief to the demographic challenge – but only under conditions which we believe to be politically unacceptable or unrealistic for other reasons. First, we must reserve the right to admit only young immigrants who are ready to join the labour force quickly and to accept the jobs offered. That puts high demands on the selection of immigrants with respect to age, education, health and language skills. Second, we must not admit dependents (children, parents, relatives) to come with them unless they also fulfil these criteria. Third, we need to ensure that the immigrants do not rely more on the welfare systems than the resident population, i.e. they must not have higher frequency of, for instance, sick absence, unemployment or early retirement. Even if these politically unrealistic conditions could be met, the positive effects of immigration would peter out as immigrants reach retirement age.

## 1.6 AN EFFECTIVE WAGE BARGAINING PROCESS IS ESSENTIAL

The parties on the labour market can contribute towards the reforms needed to adapt the Nordic model to its challenges, particularly by introducing a more effective process of wage bargaining. Experiences from Denmark and Sweden demonstrate that a continued role for collective agreements can go hand in hand with quite individualized wage setting.

The role of collective agreements could be reduced to the following tasks, which are of great importance: First, they should continue to impose industrial peace, while leaving much of the negotiations over pay to the local level. Second, central organizations need to agree on certain general conditions, notably those concerning overall working times. Third, the organizations may define rules or boundary conditions for local wage setting.

We believe that there are strong reasons for individualized wage setting, which would deserve more attention also in the case of Finland: The organization of production has changed in ways which give a premium to incentives and flexibility, differently from the days of Taylorist organization. Economic shocks are increasingly firm-specific rather than general, and they therefore call for adjustment within firms. The need for flexible wage setting is also related to the large possibilities for outsourcing of particular functions and tasks. Experience in Sweden and Denmark suggests that decentralized wage formation increases wage dispersion somewhat, while reducing wage drift. On balance we think that macroeconomic stability and comprehensive social protection have changed the environment of the labour market in ways which both underline the importance of more decentralized wage setting and ensure that its consequences should be less of a concern from the point of view of workers.

Collective agreements will remain important, but labour market organizations should re-consider their role

The world has changed in ways which require and justify a more decentralized wage setting process – also in Finland

## 1.7 PRIVATIZATION AND/OR OUTSOURCING OF PUBLIC SERVICES CAN CONTRIBUTE TO EFFICIENT PROVISION

While it is important that the public sector retains its organizing and financing role for a number of core services, it is equally important to ensure that those tasks are performed in a cost-effective manner. Productivity in the production of such services could be enhanced by having them subjected to competition from other public or private providers. Raising productivity in the provision of public services is indeed essential for resolving the fiscal dilemma described in this report.

More privatization and/or outsourcing of public services may in some cases help raise efficiency, if difficult and important issues of governance can be successfully dealt with

But we need to caution against a too simplistic belief in this solution to the fiscal challenges. Many proposals for privatization and outsourcing are based on a false analogy between private and public sector activities. Therefore, claims can be overly optimistic or even entirely wrong-headed. Part of the output from the public sector concerns truly public goods that cannot be individually priced and subjected to market transactions. Obvious cases in point are defence, law enforcement and public administration. Attempts to increase productivity in such areas by way of market-like incentive systems carry with them risks of corruption and serious problems of quality, which may ultimately infringe upon the legal rights of individuals and the rule of law in general. What may look like excessive bureaucracy in these areas may be entirely rational and purposeful from this perspective.

Outsourcing and market solutions are feasible for other services of a more private nature, like education, hospital care and care for the elderly. This may improve service quality by making providers more responsive to client needs and staff more task-oriented. But outsourcing is also associated with important problems of assignment. Handing over these activities to profit maximizing private companies can lead to bad outcomes, since costs are easy to measure but quality of output – in its many dimensions – is very hard to monitor. This is not to say that privatization and outsourcing in the production of welfare services can never be successfully implemented, only that this is a complicated procedure that had

better be tried in individual cases (with learning-by-doing) before being implemented on a large scale.

## 1.8 OUR GUIDELINES FOR REFORM

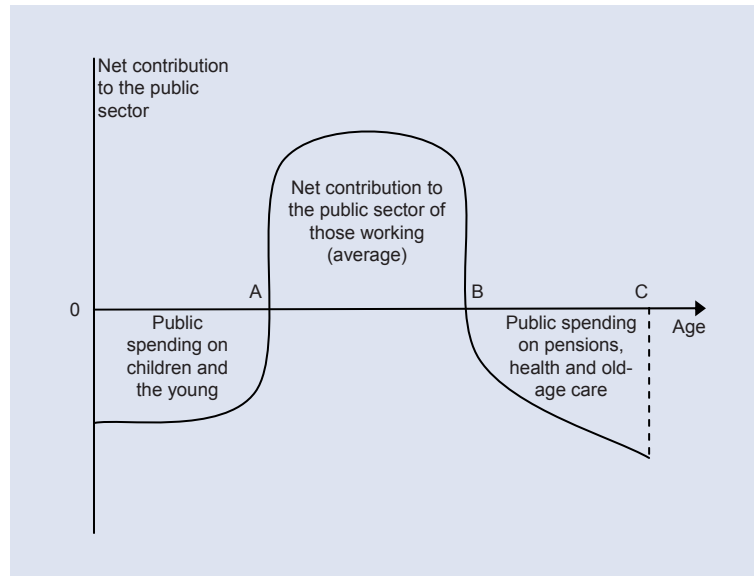
The Nordic model faces serious challenges and many proposed solutions do not stand up to scrutiny. Not surprisingly, there are no easy solutions for maintaining a large redistributive welfare state in an environment of ageing populations and intensified global competition. Yet, in order to secure continued political support for free trade and open markets we believe that the core of the Nordic model can and should be preserved. By the core we refer to the comprehensive and mostly mandatory systems for pooling and sharing labour market and other risks. We are in this sense not advocating radical change or an overhaul of the whole system. However, we do see a need for significant reform, including actions for which it may be difficult to get the required political backing. Above we already underlined the importance of an effective wage bargaining process and the potential for enhancing efficiency in the provision of public services. Here we refer briefly to a number of further elements where reconsideration and reform are called for; all these issues are dealt with in the subsequent chapters.

The issues at stake have a bearing on “the social contract”, and they can be illuminated by using the scheme set out in figure 1.1. This figure can be read in two ways. One way is to think of it as showing the net contribution to the public sector over the lifetime of a representative citizen. This citizen will benefit from public (or publicly subsidized) childcare and education when young, will pay net taxes during the active years, and will then again become a net recipient of public transfers and welfare services after retirement. Another way of reading the figure is to think of it as showing the aggregate or average relation between net contributions to the public sector and the age of various cohorts at a certain point of time.

The strains on public finances will depend importantly on both the age profile in net spending as set out in figure 1.1 and on the

The model should be reformed, building on its strengths

The financing problem arises from the combination of the social contract and the changing age composition of the population



**Figure 1.1**  
**The social contract**

Net contributions to the public sector over the life cycle or as a function of age.

People start to work later, they often want to retire earlier, and they live longer

distribution of the population as between the different age cohorts. Some of the challenges of the welfare state can now be rephrased as follows: The “baby boom” phenomenon means that a lot of people are presently or soon changing status from net contributors to net recipients, thereby reducing the positive contribution to public finances indicated by the area between A and B and increasing the negative contribution from the area between B and C. Also, working careers have tended to start later (point A shifting to the right) and end earlier (point B shifting to the left), at the same time that longevity has been increasing (point C shifting to the right). All these changes have the consequence of reducing the total amount of net contributions and increasing public spending on the elderly. A further factor increasing public spending on the elderly are the advances in medical science which continuously bring forward new and more expensive medicines and treatments of diseases (shifting the curve between B and C downwards).

The scheme of the social contract can also be used to explain the directions in which reforms must be sought and action undertaken:

First, *work careers could usefully start earlier*. There is clearly scope for better efficiency in education, notably in higher education. Also, we see no need for the state to subsidize the “consumption element” in education.

Second, the net taxes paid by those of working age would increase on average if *labour force participation were to be raised and unemployment reduced*. The Nordics will need to reconfirm the importance that they have traditionally attached to participation in working life and find means to reduce benefit dependency. This calls for lower taxes on work, further modifications of social protection so as to alleviate “unemployment traps”, including better use of workfare elements. Policymakers should abolish unnecessary disincentives to work, such as “sabbatical years” and other schemes that discourage active participation in the labour force.

High employment also calls for action to improve the *matching of demand and supply in the labour market* and well-functioning wage bargaining institutions. Here, the negotiating parties on the labour market rather than the state have important roles to play.

Economic research has demonstrated that active labour market policy measures have had a disappointingly weak effect on total employment. At best such measures can have positive effects on some subgroups, like e.g. youngsters who run the risk of otherwise becoming marginalized. On the other hand, a reduction of unemployment calls for reform of *unemployment insurance schemes*. There is a strong case for a decreasing time profile in benefit payments as well as an expiry date for their duration. More active monitoring of recipients’ search effort and conditionality of benefits on training or activation schemes can also speed up the transition from unemployment to work.

Third, *the effective retirement age should be increased further*, including measures weakening the incentives for early retirement, and pensioners should be encouraged to continue working. One way to enhance this would be to give working pensioners more generous tax allowances (referred to in Sweden and Finland as “jobbavdrag” or “ansiotulovähennys” respectively). It would also

be important for public authorities to facilitate the provision of work input by the elderly in the third sector.

Fourth, *pension costs must not be allowed to become an excessive burden* for young age cohorts, and pension rules (benefit levels and statutory retirement ages) should be adjusted in line with increasing longevity. The latter is already the case in the Nordic countries (though indexation of pension rules is done in different ways), but total expenditure on public pensions is still projected to increase significantly, notably in Finland. The outlook and risks attached to projected pension developments could usefully be reviewed with a view to capping the level of expenditure and the contribution or tax rate that rising pension expenditures are allowed to lead to (see Korkman et al. (2007)).

Fifth, *the core activities of the public sector in the provision of welfare services should be better defined* and the scope of the responsibility for health and old-age care clarified. Given the projected demographics, welfare services will not only absorb huge resources but will also cause serious pressure on tax rates. In the end this pressure can be alleviated only by capping the public provision and/or tax-financed provision of welfare services in one way or another. This is already what happens, as municipalities find themselves financially squeezed and react by lowering quality and/or rationing of, e.g., health and old-age care (thereby creating queues). More transparency with regard to the level and scope of services that citizens are entitled to and can expect would make it easier for citizens to plan (and save) over their lifetime and for complementary private services to develop.

Finally, *raising productivity in the provision of welfare services is crucial*. There are great difficulties in increasing productivity in the provision of face-to-face services. Nevertheless, such services are always associated with administrative and other tasks which can be rationalized significantly. As already noted above, there is scope in this area for improving incentives and organizations as well as for privatization and outsourcing. However, creating the right conditions for social goals to be enhanced through competitive provision of welfare services call for many hurdles to be overcome.

At best, the Nordic model combines strong government with effective markets. The aspiration to merge efficiency and solidarity

is worthy and realistic. But the demographic change will increasingly pose a dilemma for the welfare state. The ideal of universalism in the sense of high-quality welfare services available to everybody at no or low cost must be reassessed. Delineating and capping the scope of the public responsibility for our welfare should not be seen as an assault on the model but as a way to preserve its essentials and viability in a world characterized by changing demographics and increasing global competition. There is a need to re-emphasize the importance of work and employment as well as of a proper balance between entitlements and obligations of citizens for the Nordic model to be viable in the future.