

Economic Freedom Underpins Nordic Prosperity

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KEY TAKEAWAYS

The overarching objective of economic policies must be to create an environment that provides the greatest opportunities for citizens to achieve prosperity.

The Nordic countries remain prosperous because of their durable commitment to allowing their citizens a large measure of economic freedom.

The Nordic experience demonstrates that free-market capitalism, not big-government socialism, is the best path to enduring prosperity and resilience.

The Nordic countries—Denmark, Finland, Iceland, Norway, and Sweden—offer valuable insights into the relative merits of various approaches to economic governance, both in short-term responses to the coronavirus epidemic and in the context of longer-term debates about the relative merits of socialist and capitalist ways of organizing economic activity. With a total population of 27 million, these countries as a whole have compiled a notable record of economic and social achievement. While the countries are sometimes identified as paragons of socialist success, the actual record tells a different story. For most of the past century, the region has been a bedrock of democracy, political stability, and free-market-based economic prosperity.

In a number of important respects, the economic policies chosen by the Nordic countries have produced outstanding results. The average per capita

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income in the region (on a population-weighted purchasing power parity basis) is over \$52,000. Economic growth has averaged 2.5 percent over the past five years, and inflation is averaging less than 2 percent. Unemployment has been moderate, averaging about 5 percent prior to the current health crisis. Public debt is below 40 percent of gross domestic product (GDP) except in Finland (60.5 percent).¹

While the governments in the region apparently deserve a lot of credit overall for getting the governance framework right, the countries also share a number of general societal characteristics—including honesty, fairness, efficiency, industriousness, and trust—that appear to play a vital role in underpinning economic policy and enhancing the effectiveness of free markets. A key question for policymakers then becomes: What specific policy choices have enabled the Nordic economies to be competitive and resilient, and to what degree does the success of these policies depend on other fundamental characteristics within Nordic societies?

The Characteristics of Economic Freedom

The Heritage Foundation's *Index of Economic Freedom*, an annual free-market policy guidebook, has shown empirically over the past 26 years that policies in four key areas—the rule of law, limited government, regulatory efficiency, and market openness—are hugely significant in determining a country's commitment to economic freedom and its overall success in increasing prosperity.²

The *Index* shows that what really matters for a country's lasting economic resilience and competitiveness is its policy direction, particularly its changes at the margins toward greater transparency, efficiency, and openness. Governments' policy choices in these key pillars of economic freedom shape private business sentiments and environments in both the short and long term. The *Index* is full of examples in various countries of sound—or unsound—policies in each of these key areas. Timely policy adjustments that enhance economic freedom are essential to preserve and advance economic vitality and resilience.

The Nordic Economic Policy Experiment

Today's successful economies are not necessarily geographically large or richly blessed with natural resources. Many economies have managed to expand opportunities for their citizens by enhancing their economic dynamism and integration into global markets. In general, the overarching

objective of economic policies must be to create an environment that provides the greatest opportunities for citizens to achieve prosperity.

From an empirical point of view, the *Index* data confirm that the economic dynamism and resilience of the Nordic countries stems from years of intelligent and decisive policy choices that have advanced economic freedom. By embracing timely reform measures that have kept the growth of government under control and enhanced the overall entrepreneurial environment, the Nordic economies have institutionalized greater degrees of economic freedom, which have in turn engendered enviable levels of economic vibrancy and resilience.

The Nordic model has been often widely regarded as an enviable benchmark. The Nordic countries have succeeded better than many other countries in combining economic efficiency and growth with a fair distribution of income and social cohesion. The five Nordic economies make up a small portion of the world, but they are all stable democracies with parliamentary systems of government and market-oriented economies that have long benefitted from high degrees of openness to the world. This unique economic model has been frequently pointed to as a source of inspiration for many policymakers and politicians on the left in their quest for a social and economic system that could be a viable alternative to free-market capitalism.

It would be a mistake, however, to hold up these countries, as many outside the region do, as examples of success in applying socialist principles in governance. The five Nordic countries as a whole are clearly not operating centrally planned economies. Although these countries have been known for high taxation and generous social programs in general, they remain prosperous because of their durable commitment to allowing their citizens a large measure of economic freedom. Indeed, it is more accurate, based on the evidence, to characterize them not as socialist but rather as among the finest examples of countries committed to the free-enterprise system. As Danish Prime Minister Lars Rasmussen famously said in a speech at Harvard University: “I would like to make one thing clear. Denmark is far from a socialist planned economy. Denmark is a market economy.”³

The State of Economic Freedom in the Nordic Countries

The five Nordic countries share similar institutions and policies, with high income equality, relatively high employment, and low public debt. They are bound by close economic linkages due to geographical proximity. At the same time, all of them are deeply integrated into the global trade

and financial networks. They also share some common challenges from an economic freedom point of view, such as high government spending and the extravagant scope of the public sector.

Each of the Nordic countries ranks among the top performers in the *Index of Economic Freedom*, ranging from Denmark in eighth place (out of 180 countries) to Norway in 28th place. As “mostly free” economies, they excel at keeping their economies free, open, and competitive.⁴

Despite their similarities, however, the countries are far from monolithic in their approaches to economic governance. Denmark, Finland, and Sweden, for example, belong to the European Union, while Iceland and Norway do not. Finland has adopted a multilateral currency, the euro, while the others maintain their individual *krona(e)*. Denmark and Sweden have high personal income tax rates, but corporate taxes are moderate in all countries: Finland and Iceland have lower corporate tax rates than does the United States.

Economic freedom, of course, is not a single system, nor does it lead to identical policies or results in every country. In many respects, its most notable feature is the absence of a single dominating system or authority. As the *Index* documents, the Nordic countries’ various policy experiments underscore the critical interaction between individuals and the government, particularly in the context of the four pillars of economic freedom and the direction of policy choices the five Nordic countries have made.

1. Preserving Effective Rule of Law

Rule of law is a fundamental precondition for liberal democracy. Well-functioning legal frameworks protect the rights of all citizens against infringement of the law by others, including by governments and powerful parties. As an essential pillar of economic freedom, the rule of law requires efficient and transparent judicial systems.

Some of the societal characteristics typical of the Nordic countries—particularly honesty, fairness, and trust—play a key role in enhancing the rule of law, and the Nordic countries lead the world in this area. They pride themselves on the honesty and transparency of their governments, and they have long benefitted from firmly institutionalized independent judicial systems.

Indeed, if there is one thing at which Nordic countries excel over other nations, it is the rule of law, as evidenced by various internationally recognized cross-country indicators. The Nordic countries lead the world in the rule of law and anti-corruption, according to the World Justice Project and Transparency International.

Not surprisingly, protections for property rights are also effectively enforced by trustworthy and independent judicial systems institutionalized throughout the Nordic countries. Intellectual property rights are well respected, and enforcement is consistent with world standards. Nordic governments are willingly subject to rigorous scrutiny, too, by the press and the public. This combination of traits and policies reflects, and perhaps also contributes to, a very low tolerance for corruption and has produced a system of government administration notable for its efficiency.

2. Moving Toward Limited Government

The cost, size, and intrusiveness of government is a central economic freedom issue, and the principle of limited government is critical to economic dynamism. The Nordic economies are known for their broad social safety nets, and the governments operate extensive programs underpinning what are undoubtedly large welfare states. The size of government in these countries is considerable, and a large degree of redistribution of income takes place through taxes and transfers.

Beyond that, however, there is also a strong commitment in the Nordic countries to government spending that can properly be characterized as investment. This includes not just normal government spending on things such as infrastructure but also spending for things such as education and child care that make it easier for people to work and improve their productivity when they do. Trust is a key element here. Nordic people tend to trust more than many others that their government uses their money wisely and openly.

Still, the Nordic countries have experienced the costs of big government and taken a number of counterbalancing policy measures to contain the expansion of the welfare state while adopting key free-market reforms. In other words, the Nordic governments are still big, but they are not as big as they used to be. Moving in the right direction, the Nordic states have generally consolidated public finances and even notably reduced the overall size of government through restraining government spending. For example, over the past 25 years, Sweden's government spending has dramatically fallen from over 60 percent of the country's economic output to below 50 percent.⁵

The imposition of high taxes, while clearly an infringement on individual economic freedom, is not necessarily a characteristic of socialism. Control of ownership, investment, and prices would be more telling indicators of socialism, none of which are particularly prevalent in the Nordic countries.

The Nordic countries do heavily and broadly tax individuals. The Nordic economies tend to raise a high amount of tax revenue as a percent of GDP through personal income taxes and social security contributions. Unlike the U.S., they also impose an additional value-added tax—a consumption tax—at a rate of 24 percent to 25 percent in addition to income and payroll taxes. On the other hand, perhaps to the surprise of many, business taxation in the region is moderate, and there is clear acceptance of maintaining business tax regimes at levels that allow Nordic businesses to be highly competitive internationally. Corporate tax rates, for example, are generally at or lower than the U.S. tax rate—even after recent U.S. tax reform.

3. Ensuring Regulatory Efficiency

An individual's ability to establish and run an enterprise without undue interference from the state is one of the most fundamental indicators of economic freedom. Burdensome and redundant regulations are the most common barriers to the free conduct of entrepreneurial activity. By increasing the costs of production, regulations can make it difficult for entrepreneurs to succeed in the marketplace.

The Nordic countries are continuing to upgrade and enhance their entrepreneurial environments by adopting regulatory reforms. Regulations in the Nordic countries effectively facilitate efficient business operation, with formation of a business requiring only five procedures or fewer.⁶ The result is that the Nordic countries consistently rank among the most business-friendly nations, where it is straightforward for entrepreneurs to start businesses and experiment with innovative processes and products.

Equally notable is that although the Nordic countries have long maintained a high degree of labor market rigidity often characterized by minimum wages, strong employment protection, and generous non-wage benefits, their labor markets are not overly rigid. Conditional unemployment insurance, for example, has injected a considerable degree of flexibility into labor markets and allowed for reallocation of labor resources while maintaining low unemployment. Danish labor laws, in particular, generally allow employers to adjust their workforces rapidly in response to changing market conditions.

4. Strengthening Market Openness

An open trade and investment environment provides maximum entrepreneurial opportunities and incentives for expanded economic activity,

greater productivity, and job creation. The benefits of such an environment flow not only to the individual companies that take an entrepreneurial risk in hopes of high returns, but also to society as a whole.

The five Nordic countries are generally open economies (with some sectoral exceptions) and have a long history of support for liberalizing international trade. The Nordic governments generally allow Nordic companies, like most other successful private enterprises around the world, to be fully exposed to hard competition in all its forms. That policy has forced Nordic companies and entrepreneurs to develop high standards of efficiency and productivity, and as a result, they compete successfully in global markets even as the countries remain welcoming, for the most part, to foreign imports. It has made the Nordic countries some of the most open and competitive economies in the world.

Not surprisingly, *The Economist* once described the Nordic countries as “stout free-traders who resist the temptation to intervene even to protect iconic companies.”⁷ Overall, trade-weighted tariff rates of all the Nordic countries are less than 2 percent.⁸ Exports and imports of goods are much more important than in the U.S., and a large portion of the public supports free trade in general.⁹

Over time, the need to capitalize on new financial opportunities and obtain access to international finance for domestic firms was also seen as a vital ingredient of growth and competitiveness. Reassessment of capital market controls and foreign exchange market regulations, reinforced by other modernization and reform measures in the banking and financial sector, led to the rapid development of financial markets that have made a broad variety of financing alternatives available to companies.

Critical lessons learned from past banking crises have also led to important reforms and sound financial-sector frameworks. The Nordic countries are no strangers to severe banking and financial crises. In 2008, governments were forced to intervene in the banking sector and financial markets through a massive bailout and deposit guarantees. However, the intervention was generally targeted and temporary and required banks to carry out painful yet necessary reforms that have increased the financial sector’s overall resilience through institutionalized prudence and transparency.

Advancing Economic Freedom: Key to Ensuring Future Nordic Prosperity

A never-ending key economic question facing any society is the degree to which economic activities should be organized or controlled by the state

or based instead on the voluntary actions of individuals and the private institutions of civil society. The Nordic experience and its ongoing policy experiments demonstrate that free-market capitalism, not big-government socialism, is the best path to enduring prosperity and resilience.

The multidimensional positive relationship between economic freedom and dynamic entrepreneurial growth has been comprehensively documented in empirical research such as that found in the *Index*. Not only does a high level of economic freedom clearly induce a greater level of prosperity, but it also facilitates progress in overall human development, including better health, longer lives, greater education, and cleaner environments. And freer countries have a much better record at reducing poverty.¹⁰

Free-market capitalism is not, of course, a one-size-fits-all dogmatic, rigid system. The very concept of economic freedom implies that individual actors will find their own unique paths to success. Governments can either create space for individual initiative, innovation, and investment, or stifle it through excessive regulation or state domination of resource allocation.

The Nordic countries provide informative and practical examples of societies struggling to balance the role of the government and that of individuals and private-sector firms. Their policies reflect a strong commitment to economic freedom based on an exceptionally high degree of mutual trust between individuals and government. Individuals trust government to handle a larger share of society's wealth effectively and honestly, and governments trust individuals to exercise their freedom in ways respectful of society's overall well-being. It is a balance that clearly works for these countries and may provide a useful template for others seeking to emulate their success.

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Endnotes

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