Lesson 5: Denmark – The Free Enterprise Welfare State

Introduction

This lesson examines the Danish economic model, including its origins, and draws some important lessons from the experience, including how economic freedom underlies the high standards of living Danes enjoy, how its welfare state is financed with very high taxes on middle-income workers, and how Denmark's experiment with unsustainably large government did not go well and had to be (largely) undone.

Materials

Lesson 5 slide deck:
https://docs.google.com/presentation/d/1-nYvgrnEEqGdKl6y_pd-oi99-cKjxnrs/edit?usp=sharing&ouid=116660462288476410506&rtpof=true&sd=true

Optional: Lesson 5 **Background Information**. 1 copy per student (if assigned as student reading)

Key Terms

Entrepreneurship	A characteristic of people who assume the risk of organizing productive resources to produce goods and services
Economic Growth	An increase in real output as measured by real GDP or per capita real GDP.
Gross Domestic Product	The market value of all goods and services produced in a nation in a calendar year.
Inflation	A general increase in the price level.
Protectionism	The economic policy of restricting imports through methods such as tariffs or quotas.
Socialism	A society in which the state controls resources and makes decisions about production and equitable distribution.
Stagflation	A situation where high inflation and high unemployment occur at the same time.

Objectives

Students will be able to

- Identify examples of how Denmark's experiment with large government was unsustainable.
- Describe how Denmark's welfare state is different from socialism.
- Explain how Denmark's welfare state is funded by high taxes on middle-income workers.

Time Required

45 minutes

Voluntary National Content Standards in Economics

CONTENT STANDARD 11: Money and Inflation

Money makes it easier to trade, borrow, save, invest, and compare the value of goods and services. The amount of money in the economy affects the overall price level. Inflation is an increase in the overall price level that reduces the value of money.

- Benchmark 5: In the long run, inflation results from increases in a nation's money supply that exceed increases in its output of goods and services.

CONTENT STANDARD 16: Role of Government and Market Failure

There is an economic role for government in a market economy whenever the benefits of a government policy outweighs its costs. Governments often provide for national defense, address environmental concerns, define and protect property rights, and attempt to make markets more competitive. Most government policies also have direct or indirect effects on people's incomes.

- Benchmark 9: Governments often redistribute income directly when individuals or interest groups are not satisfied with the income distribution resulting from markets; governments also redistribute income indirectly as side-effects of other government actions that affect prices or output levels for various goods and services.

Procedures

- Prepare by reading the **Background Information** included at the end of this lesson.
- Use the **Lesson 4 slide deck** to teach the key ideas about the socialism experiment in Sweden.
- Alternate Activity: Assign the **Background Information** as a student reading.

Background Information

The following background information is quoted directly from the Fraser Institute publications of "The Free Enterprise Welfare State: A History of Denmark's Unique Economic Model" published as a part of the Realities of Socialism materials. For a complete copy of the readings please go to RealitiesofSocialism.org.

INTRODUCTION

For more than a century and a half, Danes have been among the most economically free people on earth, and they remain so to this day. They can start and run businesses with little government interference. They can exchange with whomever they want—domestically or internationally—on whatever terms they want, and again the state does not interfere.

The one exception to their economic freedom is that Danes pay for their welfare state with some of the highest taxes in the world. Denmark's two largest sources of state revenue are its value-added tax (VAT) and its personal income tax. Middle-class Danes largely bear the burden of these two taxes. All Danes pay the VAT when they buy goods and services. And at 25 percent, the VAT is one of the highest in the world. Denmark's top personal income tax rate is also among the highest in the world. But it's not just the wealthy who pay it—the top rate kicks in at a comparatively low level of income. So, while Danes have a large and expensive welfare state, they don't foist the bill onto corporations or the wealthy. Instead, they all pay for it.

HISTORICAL BACKGROUND

Since the adoption of Denmark's first democratic constitution in 1849, the country's political and judicial institutions have remained largely unchanged. However, the role of government in the economy has changed significantly over that time, although some features of government economic policy have remained largely the same, most notably broad-based public and political support for free trade.

Prior to the passage of the so-called Næringsfrihedslov (the Freedom of Trade and Business Act) in 1856, the Danish economy was controlled by privileges held by market towns and monopolies held by the craft guilds (Sløk-Madsen, 2022). Ever since the Middle Ages, royal and state power had heavily interfered in the economy and controlled corporate life. This was accomplished by, among other things, granting the market towns the exclusive right to trade in commodities originating in the catchment area. According to the legislation, the farmers could sell their commodities in the town square only on market days. The trades were likewise controlled, granting local trade unions a monopoly on the practice of their craft.

With the passage of the Næringsfrihedslov, these competition restrictions were lifted. As a result, the economy became guided by a philosophy of free and minimally controlled commercial activity. The Næringsloven Act fostered free trade, prevented the creation of trade barriers, and made it straightforward for Danish firms to conduct business abroad. This classical liberalism encouraged **entrepreneurship**, competition, and innovation, which fueled the country's **economic growth**.

In September 1899 the main Danish labour union and the main employers' association agreed to recognize each other as equal partners in the Danish labour market. Since then, collective bargaining agreements have to a large extent governed Danish labour market conditions;

consequently the labour market partners rather than government determine labour market conditions such as work time and minimum wages.

Similarly, in 1933 the Social Democrats—the main centre-left party in Denmark—and the liberal party (Venstre) made a historical compromise (the "Kanslergade Compromise") that laid the foundation for the Danish welfare state model. This agreement was essentially the beginning of a long-standing compromise in Danish politics: the government would ensure certain welfare benefits for citizens as the Social Democrats wanted, and, in return, would stay out of business activities as Venstre wanted.

During the Great Depression, the Danish economy outperformed that of the United States, the United Kingdom, and Germany. Denmark's relatively favourable economic growth rate was due in large part to the fact that while the US allowed the deflationary shock of the period to worsen, Denmark did not. Instead, Denmark abandoned the gold standard in 1931, sharply devaluing their currencies and thereby ending the deflationary shock of the Great Depression.

On April 9, 1940, Nazi Germany attacked Denmark (and Norway), and Denmark was quickly overrun. The German occupiers and the Danish government established a so-called collaboration agreement, which marked the beginning of a fairly calm occupation of Denmark. Denmark was allowed to keep its own government and political institutions, but Germany had final say in matters of foreign policy, defense, and economic policy. The Danish government also agreed to supply agricultural and industrial products to Germany almost exclusively.

Perhaps most importantly from an economic standpoint, the cost of the German occupation was largely covered by having the Danish central bank print money for the occupiers. As a result, while Denmark was occupied from 1940 to 1945, the Danish central bank subsidized the German occupiers' use of services. This resulted in a dramatic increase in the Danish money supply, which, predictably, resulted in significant **inflation** throughout the occupation years. The Danish economy also suffered a major negative economic shock due to wartime **protectionism** and to the fact that the UK market evaporated during the war.

The removal of post-war economic regulations and the subsequent re-opening of the global economy and the restoration of trade all helped pave the way for a 15-year post-war economic growth boom in Denmark. As the Danish economy improved, the gap in inflation-adjusted per capita GDP between Denmark and the US narrowed. While Danish per capita GDP was just 49 percent of US per capita GDP in 1945, it was 82 percent by 1965. Over the same period, Danish per capita GDP surpassed that of the UK, going from 72 percent to 112 percent over this period.

The second half of the 1960s marked the start of what would become regarded as the "golden period" of economic growth following World War II. Total real GDP increased by almost 35 percent over the 7 years from 1966 to 1973. Over the same time, Denmark's unemployment rate averaged a very low 2.4 percent. While real GDP per capita increased by 54 percent in the US and by 45 percent in the UK, it grew by 59 percent in Denmark.

While many North American politicians characterize Denmark as a "socialist democracy," it is relevant to note that the size of the government, measured as a percentage of GDP, was actually lower in Denmark than it was in the United States and the United Kingdom throughout the 1950s, '60s, and '70s. *Denmark became wealthy before substantially increasing* *government spending and taxes to support the large welfare state associated with the country today.*

It was during the late 1960s that things began to change. Danish economist Anders Olgaard (1980) remarked that if the 1950s can be properly labeled as Denmark's second industrial revolution, the 1960s might be called the years of uncontrolled revolution in the size of government. From 1965 to 1980, total taxes as a share of Denmark's **Gross Domestic Product** (GDP) increased from 29 percent to over 40 percent and by 1983 Danish government consumed more than 58% pf GDP. The two most important categories of central government spending financed by the increased tax revenues were social services and education.

This change was driven by a widespread shift in political sentiment in Denmark following WWII. During the post war years, the Danish Communist party in particular enjoyed widespread popular support, in part for their role in the Danish resistance movement against German occupation during the war. This sentiment caused the ruling Social Democratic party to adopt increasingly socialist rhetoric to stay in power, although the party never advocated for **socialism** in the sense that the government should take over the means of production.

Government spending on social welfare benefits and education accelerated after 1965. During the same period, external events negatively impacted the Danish economy. The UK, Denmark's main trading partner experienced a widespread economic slowdown. In addition, the two major oil shocks in 1973 and 1979 added to the economic woes. By the mid-1970s, Denmark's economy was experiencing both inflation and rising unemployment – what became known as **stagflation**.

These issues were exacerbated by Danish policy makers who misdiagnosed these economic shocks. They failed to recognize that the expansion of social welfare benefits during the 1960s and 1970s contributed to increased inflation and rising unemployment. The extension of the old age pension benefits to every Dane over the qualifying age, for example, encouraged early retirements, strained the public finances while incentivizing people to leave the labour market.

The combination of high inflation, negative terms-of-trade shocks, deteriorating public finances, and a lack of a clearly defined rules-based economic policy framework weakened the credibility of the government's economic policies. There was a general feeling among both the general population and those responsible for policymaking that Denmark had failed and that its economic policies had failed.

In 1982, the Social Democratic cabinet of Prime Minister Anker Jørgensen collapsed and a new centre-right coalition government was formed under Conservative Party leader Poul Schlüter. Unlike his Conservative counterparts in the US and UK, Ronald Reagan. and Margaret Thatcher, Schlüter did not have an ideological agenda and his government's approach to economic policy can be seen as highly pragmatic. It was a policy of necessity and can be seen as a return to "normal" Danish economic policies aimed at balancing public finances and ensuring price stability through stable monetary policy and exchange rate policy.

The new government's course amounted to a major break with the previous decade. Schlüter's macroeconomic approach rested on three pillars: 1. Significant fiscal consolidation through a combination of tax increases and public expenditure cuts. 2. A "hard" fixed exchange rate peg against the German mark. 3. De-indexation of public expenditures and wages

The post-1982 period has been marked by continuous and gradual economic reforms aimed at reining in public spending and curbing public debt. Beginning in 1993, working-age unemployment and social benefits were gradually reduced. This development, combined with the fact that Denmark's unionization rate had steadily declined since the 1980s as Denmark transitioned from a manufacturing to a service economy led to significant wage flexibility. The result has been a reduction in a structural unemployment rate above 10% to current structural unemployment of around 3% as of 2022.

These reforms have served Denmark relatively well in the aftermath of the Great Recession of 2008-09, the euro crisis of 2011-12, and the COVID pandemic of 2020-22, with unemployment remaining quite low—very low in international comparisons. Although the service sector is now the largest component of the Danish economy, the most important drivers of income growth in Denmark continue to be Denmark's internationally successful industrial firms such as Novo, A.P. Moller – Maersk, LEGO, and Carlsberg, and the country's major agricultural exports. Denmark's relatively low corporate tax rates can be plausibly highlighted as contributing to the development of its home-grown and successful multinational companies. Denmark's excellent governance institutions, particularly its independent judicial system and transparent and relatively corruption-free regulatory system, have also been central to the country's economic development over the long run.

PUBLIC FINANCES

Broadly speaking, the role of the government sector in the "Danish economic model" can be described as "welfarist" rather than "socialist," in the sense that socialism traditionally has been defined as an economic system in which the state owns and controls the means of production. But in modern Denmark the state neither owns nor controls much of the means of production, placing the country closer to the capitalist model than to the traditional socialist model.

Government spending as a share of GDP rose precipitously in the early 1970s, more than doubling from under 25 percent in 1970 to more than 52 percent in 1980. By 1983, Danish governments were consuming more than 58 percent of GDP, significantly more than governments in the United States, the United Kingdom, and Sweden. The growth of government spending in Denmark during this period is closely linked to a drastic increase in the supply of social services provided by the government, most at no direct charge to citizens or at heavily discounted prices. Denmark's municipally operated kindergartens, for example, offer their services at well below cost, while most other education—even university studies—is "free." Health care is also mostly taxpayer funded.

Economic historian Sven Aage Hansen (1983) has argued that a key reason for the sharp surge in public expenditures during the 1960s and 1970s was very fast growth in tax revenue due to an unexpected acceleration in inflation. Known as fiscal drag, this occurs during inflationary periods if tax brackets are not indexed to inflation. Thus, when higher inflation and higher (nominal) wage growth push taxpayers into higher tax brackets, it produces a surge in government revenue. Although taxpayers' real (inflation-adjusted) earnings have not increased, they end up paying higher tax rates.

The current Danish approach to economic and fiscal policy is distinctive. On the one hand, limited regulatory intervention, openness to trade, a commitment to sound money, and strong protection of persons and their property make Denmark one of the most economically free nations on Earth. This helps explain why the country has thrived in recent decades. On the other hand, Denmark has a very large government sector with a rather robust social welfare state. The burden of paying for this large welfare state is shared broadly through Denmark's high VAT and its high personal income tax rates. Although the top marginal income tax rate is quite high, the threshold for paying this rate is comparatively low. Denmark also has a relatively low effective corporate income tax rate. For the past three decades, Denmark has maintained a strong commitment to fiscal sustainability. Deficits are rare and government debt has been declining—although at a slower rate in recent years. This political and cultural commitment to fiscal sustainability lately has been reinforced by institutional mechanisms.

DANISH HEALTH CARE SYSTEM

Denmark's approach to universal health care encompasses many of the attributes of a national (albeit decentralized) tax-funded system that, over time, has evolved to incorporate (to a modest extent) a blend of features found in health care systems with a permissive private market, such as those in Australia and Sweden.

Coverage for core medical services is universal, compulsory, and defined in broad terms. However, a distinctive feature of Denmark's health care system is the freedom of individuals to choose between two plans within the universal scheme. The 0.3 percent of the population voluntarily enrolled in a "Group 2" plan can access any general practitioner of their choice and, unlike individuals in Group 1, can access a specialist (in private practice) without prior referral. Further, while private insurance plays a secondary role in Denmark's health care system, it can offer coverage for core services that are also covered by the public system, examinations and medical treatments at private hospitals, increased choice of provider, and faster access to elective surgery in private hospitals. Between 30 and 42 percent of the population has secondary insurance coverage of this nature.

Regardless of which group they are enrolled in; patients can obtain treatment from private for-profit clinics and hospitals using their own funds or secondary private health insurance. Notably, if regions are unable to initiate treatment within a reasonable time (one month from referral), patients have the right to publicly funded treatment in a private hospital of their choice in their region. The one area in which Denmark departs significantly from the vast majority of universal health care systems around the world, is that, like Canada and the United Kingdom, it does not generally expect patients to share directly in the cost of core medical services. That being said, co-payments are generally required for pharmaceuticals purchased on an out-patient basis, as well as for physiotherapy, psychological treatment, home care, long-term care, and dental care (excluding children).

Denmark ensures universal coverage for its population regardless of ability to pay, primarily through a national tax-funded system. However, it permits the functioning of a robust private insurance market, does not force health care practitioners to choose between public and private service by restricting dual practice, and has moved increasingly toward funding services on the basis of activity. The associated performance of the system relative to 27 other members of the

Organisation for Economic Co-operation and Development (OECD) with universal health care is that of an average spender with mediocre or mixed results.

PRIMARY AND LOWER SECONDARY EDUCTION

Denmark is known alongside the other Scandinavian nations for its high quality of life, well-educated population, and expansive welfare state funded by relatively high taxes. This might lead one to believe that Denmark's education system involves heavy central planning and control, but instead it is characterized by autonomy and diversity among schools. Although schools are heavily financed by the government, local communities and individuals maintain pedagogical and organizational control of much of the country's primary and local secondary schooling.

Denmark provides fully government-funded primary and lower secondary education and "free" (government-funded) post-secondary schooling. Primary and lower secondary independent schools, which account for about 45 percent of the schools in Denmark, according to the Danish Ministry of Education, are supported financially by the government via a school choice system, at about 75 percent of the rate of fully funded government schools. The Danish government acknowledges that government funding for independent schools receives broad support from all political parties because government public schools, too, benefit from the competition and experiences offered by independent schools. Government funding is sent directly to schools rather than to parents, on a per-student basis.

Danish parents can choose the school to which they send their child. Today, about 16 percent of students attend an independent school and that share is growing. Independent schools attract students from all socio-economic backgrounds and academic abilities. The school choice system, paired with independent schools' high level of autonomy, has resulted in more innovation in Danish classrooms than almost anywhere else, according to the OECD.

INCOME SUPPORT SYSTEM

The income support system in Denmark offers some of the most generous benefits among advanced countries around the world. Danish social security is based on a philosophy of strong support for families, protecting the most vulnerable in society, and encouraging a duty to participate in the workforce. Denmark has one of the most expensive governments to operate and one of the highest tax burdens in the OECD. Transfers to families with children, highly subsidized day care, maternity benefits, social assistance payments, and disability benefits are all important features of the Danish system.

Denmark's income support system emphasizes a large role for the government and an extensive host of generous benefits for individuals and families. The country is one of the highest spenders on public income support in the OECD and employs some of the highest tax rates as well. However, private occupational pensions are one of the most important features of its social security system and Denmark ranks in the top five among OECD countries for spending on private pensions. This allows Danes to have among the highest retirement incomes in the OECD and relatively few poor pensioners. Denmark also boasts a flexible and mobile labour market with comparably shorter durations of unemployment than most advanced economies. Generous benefits for families, maternity, social assistance, and disabled individuals appear not to have hindered the Danish labour market to a significant extent thanks to the country's high employment relative to its peers. A voluntary employment insurance system also differentiates the system from countries like Canada. Overall, Denmark has an expensive but well-managed income support system that features some unique components.

CONCLUSION

For the past 150 years Denmark has largely been an economic success. Starting the mid-1800s, Denmark liberalized their economy by adopting free trade, free markets, protection of private property and sound public finance. Historically, the Danes have had a relatively small government. This recipe served the Danes well, making them one the most economically free nations in the world and one of the wealthiest.

However, once the Danes created such abundance, they experimented with redistributing this wealth in the effort to create a more comprehensive welfare state. Starting in the late 1960s, the Danes expanded government spending to provide better pensions, healthcare coverage, and education for citizens. This well-meaning policy soon led to unsustainable public spending. That spending, along with labor reforms that pushed up structural unemployment, combined with the 1970s oil shocks, lead to substantial stagflation in Denmark. The Danes realize that if they wanted to maintain their generous welfare state, they needed to commitment to sound public finance and institute reforms to their welfare system.

The result of these reforms created an economic system that economist Jim Otteson characterizes as “welfarist” instead of “socialist”. The Danes pay high income and sales taxes to fund government spending on social benefits. However, the Danes also remain committed to free markets, protection of private property, free trade, and sound public finance. They have learned that there are limits to expanding the role of government and instead rely on free enterprise to provide the wealth that fund their welfare state. This commitment to economic freedom carries over to education, pensions, and medical care where the Danes have private and public entities competing with each other for consumers. It is a system that makes Danes healthy, wealthy, and happy.