PRE-RELEASE

INTRODUCTION
& CHAPTER I

THE FREE ENTERPRISE WELFARE STATE

A History of Denmark's Unique Economic Model

Edited by Lars Christensen, Matthew D. Mitchell, and Steven Globerman

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INTRODUCTION

Denmark is a highly regarded country for good reasons. Danes are healthy, wealthy, and happy. And they've been so for quite a long time. Foreign admirers—both left and right—often point to Denmark as a policy model, but few seem to appreciate the country's unusual combination of free enterprise and welfare state. In this short book, we examine the Danish economic model, including its origins, and draw some important lessons from the experience.

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. They can accumulate savings knowing that the government will not inflate away their nest eggs. They can acquire and use property, confident that the state will protect their property rights. And they can contract with others, knowing that the state will enforce these contracts. So, the first lesson we can draw from the Danish experience is that the economic freedom Danes historically have enjoyed underlies Denmark's high standard of living.

The second lesson, and 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.

Although this model works reasonably well for Denmark, it does have its economic limits. And that brings us to the third lesson: when Denmark experimented with an unsustainably large government, it did not go well. For most of its history, Denmark had a relatively small government. Even as late as 1970, the Danish government accounted for a smaller share of the economy than did the governments of the United States, the United Kingdom, Canada, and Australia. But from 1970 through the early 1990s, the Danish government grew dramatically, accounting for nearly 60 percent of gross domestic product by 1995. Government revenue did not keep pace with spending, so the government ran huge deficits. Debt piled up and inflation spiralled out of control. But something that can't go on forever, won't. And by the 1990s, nearly all Danish policy makers understood that they had to make a change. They began reducing spending, bringing it in line with government revenue. They also committed to sustainable budgeting practices, limiting both deficits and the growth of debt. As the government moved toward a more balanced budget, both inflation and interest rates declined. Danes found out the hard way that there are limits to big government.

In this pre-release, we focus on Denmark's historical roots as an economically free society with limited government. The rest of the book will discuss what happened when Denmark began to experiment with larger government and then found a more sustainable model.

CHAPTER 1

DENMARK: GETTING RICH BEFORE BECOMING A WELFARE STATE

Lars Christensen, Matthew Mitchell, and Steven Globerman

This chapter examines the growth of the Danish economy during the last 150 years, with a particular emphasis on the period following WWII. During this period, the Danish economy transitioned from an agrarian economy in which government played a very limited role to industrialization and the gradual expansion of the government's role, particularly in the provision of social services including health care and education, as well as in income redistribution.

Since the adoption of Denmark's first democratic constitution in 1849, the country's political and judicial institutions have remained largely unchanged, though there have been a few exceptions such as the growth in the number of political parties. However, the role of government in the economy has changed significantly over that time, although some features of government economic policy have remained largely unchanged, most notably broad-based public and political support for free trade, a rule-based monetary policy, and strong protection of private property rights. For the most part, various Danish governments have been committed to relatively sound public finances, though here again there have been exceptions, particularly the period from the mid-1960s to the mid-1980s when an explosive growth of government spending contributed to rapidly growing government fiscal deficits accompanied by high interest rates and inflation.

Denmark's preceding 150 years of economic expansion have taken place in one of the world's most stable democracies, with strong institutions in place to defend the rule of law and private property rights. The only significant exception was during World War II when Nazi Germany occupied the country from 1940 to 1945.

It is important to remember that as a small country that has been historically very open to international trade and mostly operating on a pegged exchange rate system, Denmark's economic growth has followed global business cycle trends to a large extent. Denmark has particularly followed the cycles of business development in Western Europe, where first Great Britain and then West Germany have been Denmark's prominent trading partners. As a result, all of Denmark's big recessions have coincided with global shocks—the Great Depression, both World Wars, the oil price shocks of the 1970s, the Great Recession of 2008-09, and, more recently, the great COVID lockdown crisis of 2020-21.

Furthermore, as an exporting country, shocks to import and export prices (i.e., terms of trade) frequently have had a significant impact on Danish economic growth. Given these considerations, it is difficult to precisely distinguish between the effects of global shocks to growth on the one hand, from the impacts on the economy of specific Danish policies and institutions on the other. Nonetheless, we will attempt to do so in this chapter.

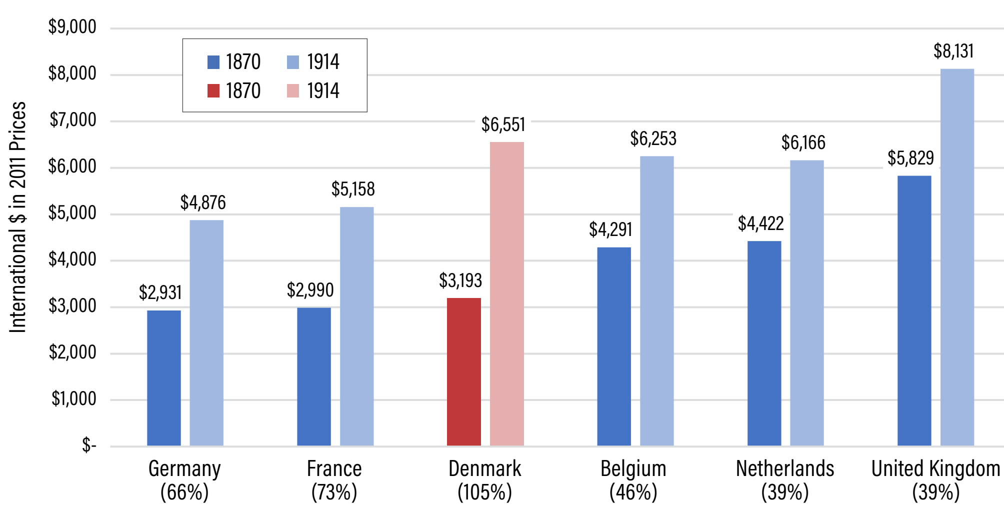
From stagnation to free markets and growth

Compared to many other European countries, Denmark's economy expanded greatly between 1870 and 1914. Figure 1.1 shows inflation-adjusted GDP per capita in 1870 and in 1914 in six Western European nations. In 1870 Denmark's per capita GDP was among the lowest in the group; by 1914 it was the second highest. The inflation-adjusted growth rates are shown in parentheses below each country name. Denmark's real GDP per capita more than doubled over this period, increasing 105 percent.[1]

During this period, and indeed up until WWII, the Danish economy was based mainly on agricultural production. In this regard, Olgaard (1980) notes that as recently as just before 1930, agricultural exports accounted for 75 percent of total Danish exports and well over 20 percent of the country's gross domestic product. As late as 1950, agricultural products still accounted for around 63 percent of Danish exports. The agricultural labour force accounted for fully 51 percent of the total labour force in 1875 and was still a relatively substantial 34 percent of the total labour force in 1929 (Olgaard, 1980: 46).

Significant advances in agriculture and manufacturing efficiency enabled Denmark to grow its exports and enjoy a relatively high standard of living. Beyond improved efficiency, the Danish dedication to free trade and to trade agreements that encouraged free trade were critical to the country's strong economic progress throughout this period. Openness

Figure 1.1: Per Capita GDP in Several European Countries in 1870 and 1914



Note: Inflation-adjusted growth rates are shown in parentheses beside each country name.
Source: Maddison Project Database 2020 (Bolt and van Zanden, 2020).

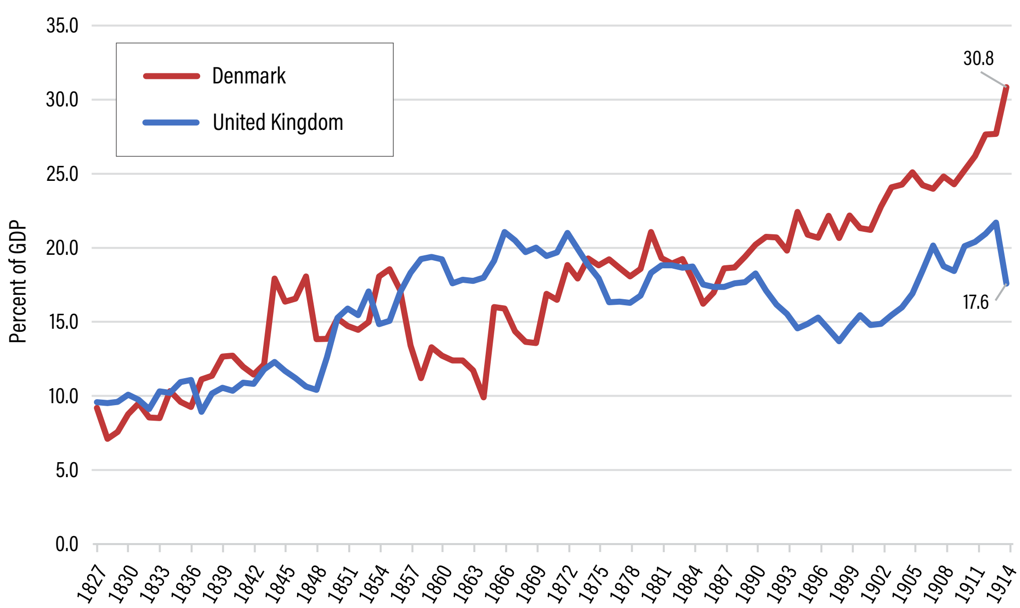
to international trade also enabled Danish agriculture and manufacturing businesses to expand their geographical markets and establish trade relations with countries worldwide, but particularly in Western Europe. Figure 1.2 shows the value of exported goods as a share of GDP for Denmark and the UK from 1827 through 1914. From the late 1880s onward, Denmark's exports soared, far exceeding those of the famously free trade-oriented United Kingdom.

Agriculture, Denmark's most important economic sector at the time, grew tremendously during this period. The concurrent decline in the relative share of the labour force working in the agricultural sector reflects the sector's productivity growth. The emergence of so-called cooperative movements in Denmark also contributed greatly to the agriculture sector's prosperity (Henrik, Lampe, and Sharp, 2011). Farmers increased their production and profitability by joining cooperatives, which allowed them to pool their resources and deploy capital more efficiently. Larger farm sizes also enabled farmers to realize economies of scale.

During this time Britain became an important trading partner for Denmark, particularly for Denmark's agricultural export sector. Indeed, for the past 150 years, Denmark's relationship with the United Kingdom has been centrally important, and the UK remains a very important trading partner for Denmark, even though it is no longer the primary market for Danish exports.

Industrialization was another important driver of Denmark's economic growth. By the 1890s Denmark had begun to industrialize, with approximately 30 percent of the population employed in crafts and industry. During the twentieth century Denmark

Figure 1.2: Value of Exported Goods in Denmark and the UK as a Share of GDP (1827–1914)



Source: Fouquin and Hugot, 2016.

also saw technological development and significant growth in industrial productivity (Hansen, 1976).[2]

A strong commitment to classical liberal economic policies aimed at enhancing the rule of law and minimizing the role of government in the economy was at the heart of Denmark's economic development. The late 1800s and early 1900s marked a period of primarily laissez faire economic policies for the country.

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.

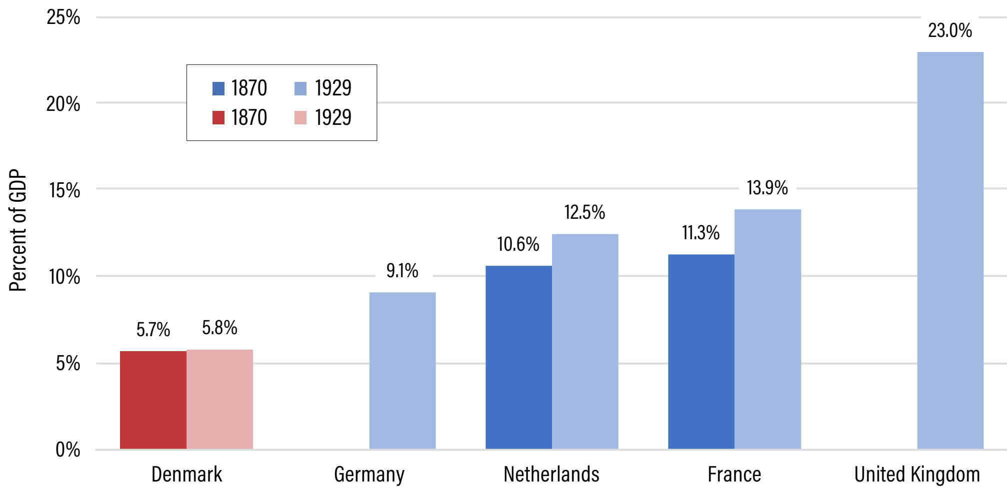
With the passage of the *Næringsfrihedslov*, these competition restrictions were lifted. As a result, the economy became guided by a philosophy of free and minimally controlled commercial activity. The era's classical liberal ideology was also critical to Denmark's economic prosperity. The Næringsloven Act of 1857 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 fuelled 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.

Details about government spending provide one indication of the government's limited role in the economy. Figure 1.3 shows central government spending as a share of GDP in the 1870s (when available) and in 1929 for five European nations. Not only did Denmark spend significantly less than others as a share of GDP, but its spending as a share of GDP changed very little over this 60-year period.[3]

With institutions conducive to growth in place, developments in trade, manufacturing, agriculture, and technology aided the expansion and innovation that marked Denmark's economic boom between 1870 and 1914.

Figure 1.3: Central Government Spending as a Percent of GDP (1870s and 1929)



Source: Flora et al. (1983).

Between the wars: From inflation to deflation

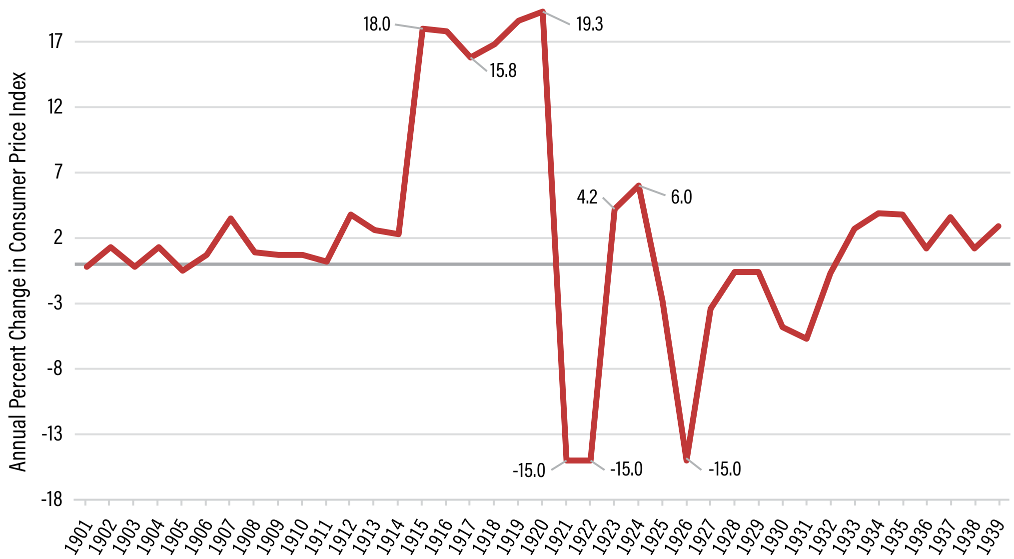
During World War I, Denmark remained neutral and did not take part in the fighting. However, the war had a significant economic impact on the country and with the de facto suspension of the gold standard inflation in Denmark skyrocketed, as it did in the rest of Europe. Danish exports, on the other hand, increased during the war, and Denmark exported to both sides of the conflict. However, despite rising exports, soaring inflation reduced real incomes during the conflict.

Following the war, Denmark endured a difficult economic situation as it was dealing with an impoverished Germany to the south and after 1920 also faced significant challenges reintegrating Southern Jutland.[4] After the war virtually every European country had currency problems and Denmark was not immune. Figure 1.4 shows Denmark's inflation and deflation rates, as measured by the annual percent change in the consumer price index from 1901 through 1939. From 1915 through 1920, inflation averaged nearly 18 percent. Then, starting in 1921, the nation experienced 15 percent deflation for two years in a row. The inflation rate stabilized again for two years before once again swinging to 15 percent deflation in 1926.

By 1919-20 the Danish krone's value had plummeted by around 50 percent as measured against the value of gold, and even though it regained a lot of ground in 1922, the krone's value remained unstable. The currency problem was a key political issue in Denmark in the early 1920s and the main political parties on both the left and the right generally concurred that a stable monetary order had to be re-established (Svendsen, Hansen, Olsen, and Hoffmeyer, 1968).

Politicians and policymakers shared a widespread concern that the ongoing German financial and economic crisis might extend to Denmark, so the government determined

Figure 1.4: Inflation and Deflation in Denmark (1901–1939)



Source: Statistics Denmark, (undated).

that the Danish krone would be returned to a value (against the gold price) closer to that seen prior to the war, a move that enjoyed broad political support. The government accomplished this by establishing the "ærlige krone" or "honest crown," which meant that the Danish krone could be redeemed for gold, as was the case before the war.

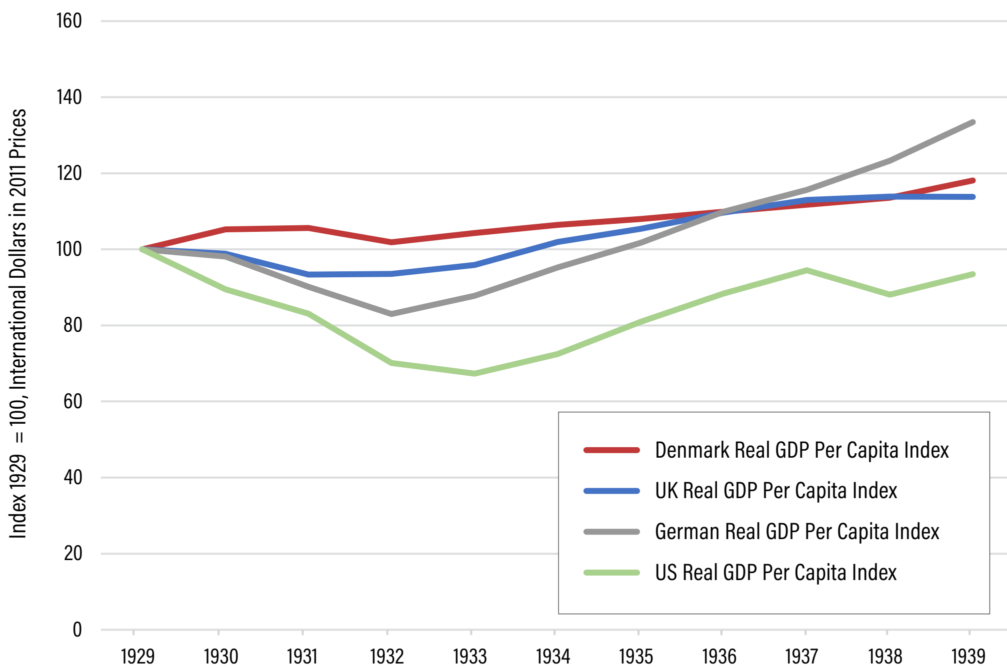
The Social Democrats were the ruling party at the time, and the party was eager to demonstrate that it could be trusted on economic issues and that it was serious about ensuring price and financial stability. As a result, when Denmark's largest trading partner, the United Kingdom, restored gold redeemability in 1924, Denmark decided to follow suit.

In fact, the decision to establish the honest crown proved to be a huge policy error; the Danish krone rose sharply when it was instituted and the economy was hit by its second major deflationary shock in six years, as shown in figure 1.4, causing unemployment to skyrocket to nearly 22 percent. The deflationary shock triggered turbulence in the Danish labour market, and the mid-1920s saw significant labour unrest in Denmark with militancy increasing among both unions and employers.

The deflationary shock along with labour market discontent slowed Danish economic growth in the mid-1920s and in many ways Denmark appeared to have entered the Great Depression before the shock affected the rest of the world economy in 1929. That did not mean that Denmark avoided the Great Depression, but it did fare relatively well in the late 1920s and early 1930s when compared to, say, the United States or Germany.

Indeed, in the first half of the 1930s, the Danish economy outperformed that of the United States, the United Kingdom, and Germany, as shown in figure 1.5, which reports index values (relative to 1929 as a base year) for the four countries from 1929 to 1939.[5]

Figure 1.5: Inflation-Adjusted GDP Per Capita as a Percent of 1929 Levels



Source: Bolt and van Zanden (2020).

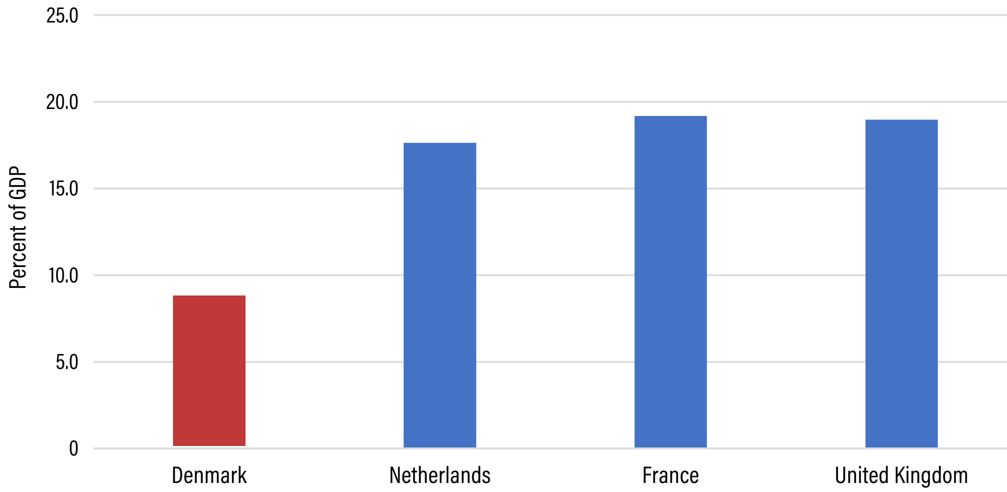
Denmark's relatively favourable economic growth rate was due in large part to the fact that while the US allowed the deflationary shock to worsen, Denmark did not. The UK and the Nordic countries, including Denmark, abandoned the gold standard in 1931, sharply devaluing their currencies and thereby ending the deflationary shock.

The Danish krone depreciated further in 1933 as part of the so-called *Kanslergade-forlig*[6] (Kanslergade Agreement) between the ruling Social Democratic government, the coalition partner Radicals (the social-liberal party), and the opposition party Liberals (Krake, 2023). The agreement, which is sometimes referred to as the establishment of the Danish welfare state (and which is clearly an exaggeration), increased government welfare spending, initiated public works programs, and, most importantly, devalued the Danish krone, which was a key demand of the opposition Liberal party that at the time had strong political ties to the export-oriented agricultural sector.

Following the Kanslergade Agreement the Danish economy grew steadily and unemployment gradually decreased until the outbreak of World War II. The main point to emphasize here is that monetary and exchange policy strongly influenced Danish economic growth, both positively and negatively, during the interwar period.

Notwithstanding increased government spending on social and public works programs, the size of government in Denmark was still limited at the end of the 1930s (see figure 1.6) and there remained a broad political consensus that the Danish economy should be

Figure 1.6: Central Government Spending as a Percent of GDP, 1938



Source: Flora et al. (1983).

based on free market principles and free trade. Even though there had been a gradual shift towards more income redistribution, the role of government in the economy remained limited.

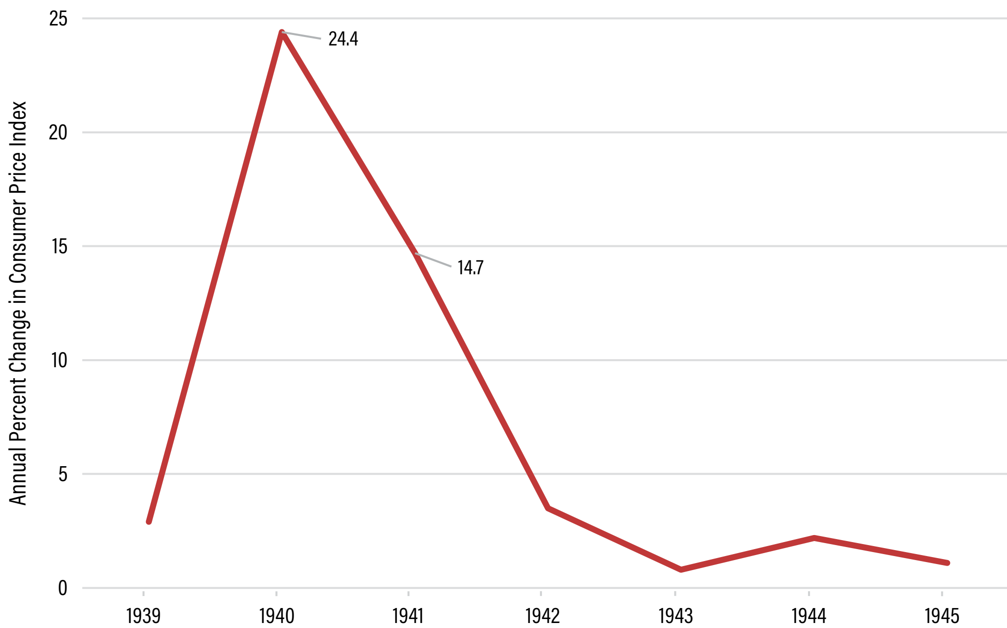
The Danish experience of the 1930s contrasts to that of the United States where the Roosevelt administration's policies significantly increased the role of government in the economy and where government policies encouraged the cartelization of industries. The structure of the Danish economy contrasted even more sharply to the economies of Nazi Germany and Fascist Italy, which both pursued corporatist economic policies. At that time Denmark maintained a mostly non-interventionist public policy regime when it came to economic activity, but World War II changed that.

German occupation, regulation, and inflation

On April 9, 1940, Nazi Germany attacked Denmark (and Norway), and Denmark was quickly overrun. Unlike in Norway, the Danish government surrendered almost immediately. The German occupiers and the Danish government quickly 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, defence, and economic policy. The Danish military was disbanded and the country was occupied by the German army, the Wehrmacht. The Danish government also agreed to supply agricultural and industrial products to Germany almost exclusively. Exports to Germany increased from around 25 percent to roughly 80 percent of total exports, while trade with the United Kingdom (Denmark's largest trading partner until then) declined.

Figure 1.7: Inflation in Denmark (1939–1945)



Source: Statistics Denmark, (undated).

Furthermore, and 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, as shown in figure 1.7.

Because of the dramatic spike in inflation, the Danish government implemented tight price restrictions and rationing and also imposed rent control (Hansen, 2022). In many ways, these measures placed the Danish economy in a "deep freeze" and this, combined with the collapse of Danish agricultural exports to Britain, caused the economy to plummet and remain frozen until May 4, 1945, when the allied forces freed Denmark.

1945-65: Deregulation, re-globalisation, and catching up

At the end of World War II, per capita GDP in Denmark was nearly 50 percent lower than in the United States, and it was obvious that Denmark's economic development was falling behind.[7]

Even though Denmark was not one of the countries that participated in the conflict during the war, and despite the fact that there had been relatively limited harm in Denmark to productive assets such as factories as a result of the conflict, the Danish economy lagged behind the US economy in economic growth during the war.

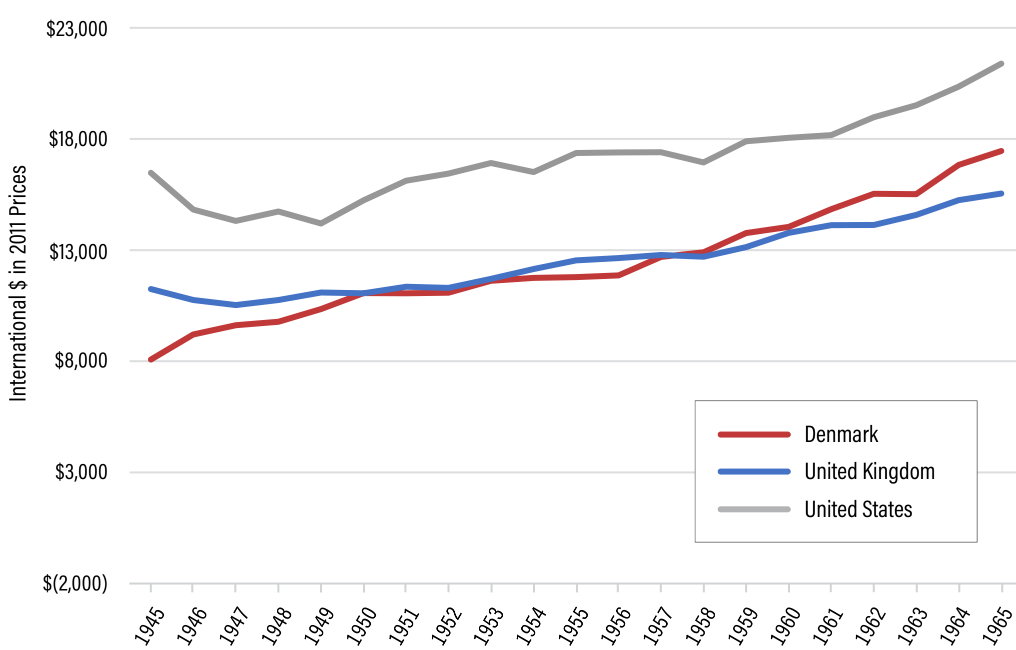
Given the significance of price controls and product rationing that occurred during and in the years immediately following the war, it is highly likely that economists underestimated Denmark's real economic growth, perhaps to a significant extent, due to statistical problems with the measurement of economic activity.

That said, there is no doubt that the Danish economy had suffered a major negative economic shock due to wartime protectionism and to the fact that the UK market had effectively evaporated during the war. The trade restrictions Nazi Germany imposed on Denmark had a particularly harsh effect because the country is tiny and has a fairly open economy that is highly dependent on trade for its prosperity (Hansen, 1983).

Immediately after the war there was significant public pressure to eliminate price controls and rationing, and a similar amount of pressure to do away with currency and capital controls. It was increasingly obvious that these rules and laws were the primary reason for the huge surge in black market crime that occurred in Denmark in the years immediately following the war. It was also increasingly clear that in those years the amount of corruption in the Danish police force had reached an all-time high. As a result, most of the regulations that had been imposed during the conflict were nullified in the years following. However, certain regulations proved politically more difficult to eliminate, and some of them are still in effect today. The most notable example is rent control, which is still in effect, albeit in a modified form, to this day.[8]

As figure 1.8 demonstrates, the removal of post-war economic regulations and the subsequent re-opening of the global economy and the restoration of trade with the British market

Figure 1.8: GDP Per Capita in Denmark, the UK, and the US (1945–65)



Source: Bolt and van Zanden (2020).

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.

It is also important to note that Denmark was not the only country that rapidly expanded during the early post-war period. Sweden also went through a period of rapid economic expansion and closed some of its pre-war, per capita GDP gap with the US. The dedication of both Nordic countries to free trade, as well as their access to global markets, was a significant factor in their ability to catch up economically.

Denmark, like other Western European countries, received financial aid from the US Marshall Plan. This initiative helped Western European countries rebuild their physical capital and import critical inputs from the United States. The aid was given on condition that the receiving countries liberalize their restrictions on imports of manufactured products. As a consequence, by the beginning of the 1950s, manufacturing industries in Western Europe, including Denmark, were able to significantly expand their exports of a wide range of products. By 1960, Denmark's exports of manufactured goods exceeded its exports of agricultural goods.[9]

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 and Sweden than it was in the United States and the United Kingdom throughout the 1950s, '60s, and '70s, as shown in figure 1.9. At that time, neither Denmark nor Sweden had the kind of universal welfare states that we are familiar with today. In fact, both countries stayed relatively faithful to the traditional liberal economic values that had fuelled their economic expansions nearly a century before.

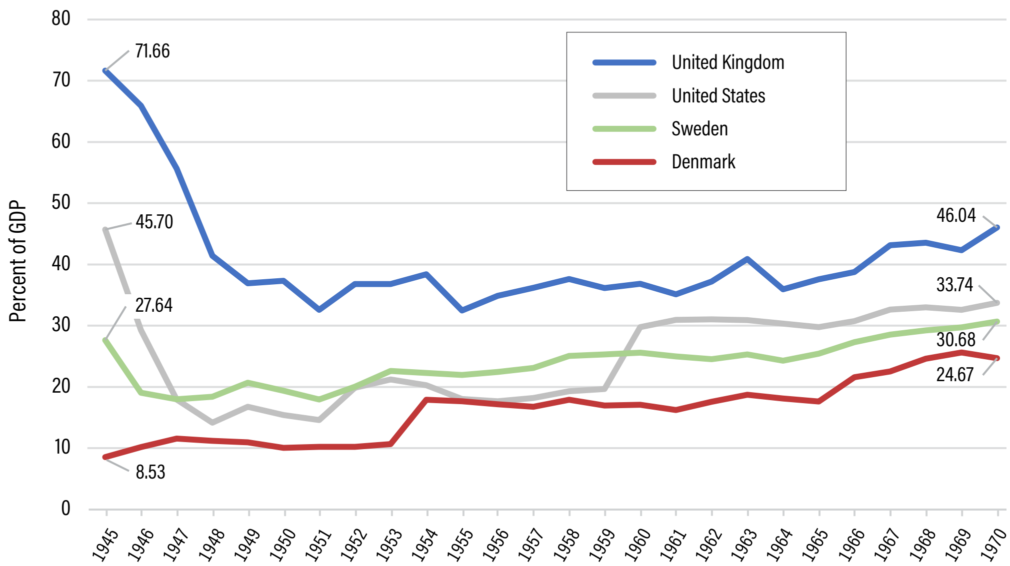
As a result, Denmark became wealthy before substantially increasing government spending and taxes to support the large welfare state we associate with the country today.

Figure 1.9 also shows that it was during the late 1960s that things began to change. Olgaard (1980) remarks that if the 1950s can be properly labelled as Denmark's second industrial revolution, the 1960s might be called the years of uncontrolled revolution in the size of government. To illustrate, from 1965 to 1980, total taxes as a share of Denmark's Gross Domestic Product increased from 29 percent to over 40 percent (see figure 1.10). The two most important categories of central government spending financed by the increased tax revenues were social services and education.

Nevertheless, it is important to keep in mind that the post-war growth boom in Denmark was driven to a considerable extent by the global wave of trade liberalization and re-opening of markets, as well as by domestic deregulation in Denmark.

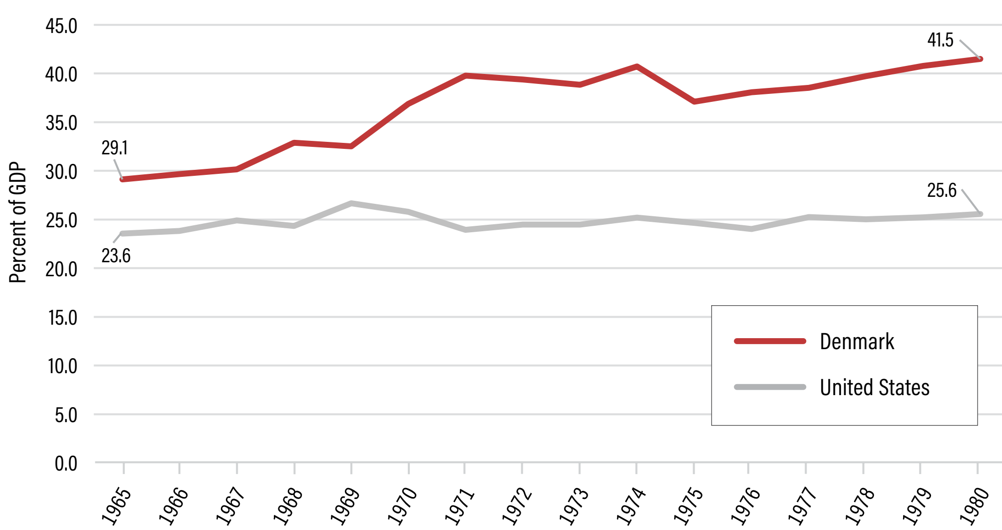
Clearly, there was a significant political shift in Denmark commencing in the early 1960s that coincided with the beginning of a movement toward allowing government to have a

Figure 1.9: Total Government Spending as a Share of GDP (1945–1970)



Source: Mauro, Romeu, Binder, and Zaman (2015).

Figure 1.10: Total Government Taxation as a Share of GDP (1965–1980)



Source: OECD Revenue Statistics, (undated).

larger role in the economy, including a larger role in the process of income redistribution. The following section takes a more in-depth look at these patterns.

Shifting political winds

In the years immediately following WWII political sentiment in Denmark clearly shifted to the left, and the Danish Communist party in particular enjoyed widespread public support. This was primarily due to the role that the Communists had played in the

Danish resistance movement against the German occupation during the war, as well as widespread public sympathy for the Soviet Union for the role that it had played in the liberation of Europe. This sentiment caused the ruling Social Democratic party to be forced to the left, and as a result, their rhetoric regarding economic policy became more socialist than ever.

However, as the end of the cold war drew closer, public support for the Communist Party in Denmark declined rapidly, which resulted in the Social Democrats once again shifting their position, this time to one that was more pragmatically aligned with the centre-left. In light of this, it is worth noting that the Danish Social Democratic Party has never, during its time in power, advocated in Parliamentary proceedings for socialism in the sense that the government should take over the means of production. To the contrary, the Danish Social Democratic Party has, historically speaking, favoured private ownership of the means of production and has supported private property rights and relatively free markets (Fonsmark, 1990).

Moreover, in contrast to the policies of the Labour Party in Britain, the Social Democrats in Denmark did not nationalize privately held businesses. Nor has there ever been any substantial backing for this idea among Denmark's general population. The philosophy of the Social Democrats, which is consistently aligned with a broad consensus of the Danish public, has been pragmatic support for a free market system, especially for regulatory and judicial institutions that protect private property rights, but a system in which the government plays a prominent role in the provision of social services and reducing income inequality. Because Denmark has a parliamentary system with many political parties and democratic competition for the support of the median voter, there has been a distinct tendency for economic and political decisions to be made pragmatically and by consensus. As a result, it has been very difficult to fundamentally differentiate between governments that are centrist or lean to the centre-left.

In addition, whenever the Social Democrats have drifted too far to the left, the public has shown its disapproval by punishing the party with lower support at the polls. It is also noteworthy that the most influential Social Democratic politicians of the 1950s and 1960s were almost all economists (with the majority of them having been educated at the University of Copenhagen). These politicians realized that economic growth was a prerequisite for being able to finance public services and income redistribution.

In a similar vein, the two main "old" parties on the centre-right of Danish politics, the Conservative Party and the Liberals, maintained their support for a free market system despite moving toward the centre or even the left on income redistribution and the provision of public services such as education and health care.

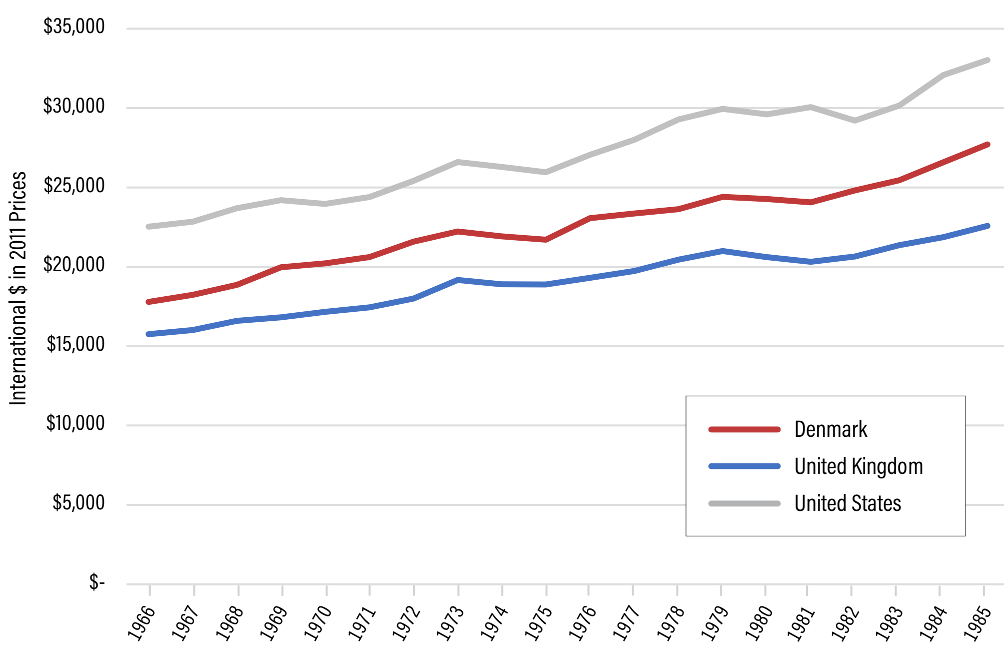
This meant that during the 1950s and 1960s Denmark gradually began to coalesce around a political consensus: that Denmark is fundamentally a democratic country with significant respect for the individual and the protection of private property, that it understands that the free market system is the foundation for economic growth, and that it sees government's role as reducing income inequality by providing social benefits and free access to education and health care, which are funded by a broad-based tax system.

Nevertheless, the sharp increase in public spending, particularly during the second half of the 1960s, suggests that during this period Danish politicians had largely forgotten the source of Danish growth, i.e., a relatively large and unregulated private sector. Still, it is useful to point out that government revenues were primarily raised through sales and personal income taxes. Indeed, the share of total taxes raised from the personal income tax increased from 30 percent in 1938/39 to 46 percent in 1973/74. Income taxes on companies accounted for a very small share of the total tax revenue government collected. The emphasis on taxing individuals relative to businesses is an enduring feature of the Danish tax system that will be discussed in more detail in a later chapter of this volume. Suffice to say here that relatively low corporate and property taxes do not fit the stereotype of the Socialist Democracy as propagated by US politicians such as Bernie Sanders and Elizabeth Warren.

From growth to stagflation

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. Figure 1.11 shows real GDP per capita in Denmark, the US, and the UK from 1965 through 1985. 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.

1.11: GDP Per Capita in the US, the UK, and Denmark (1965–1985)



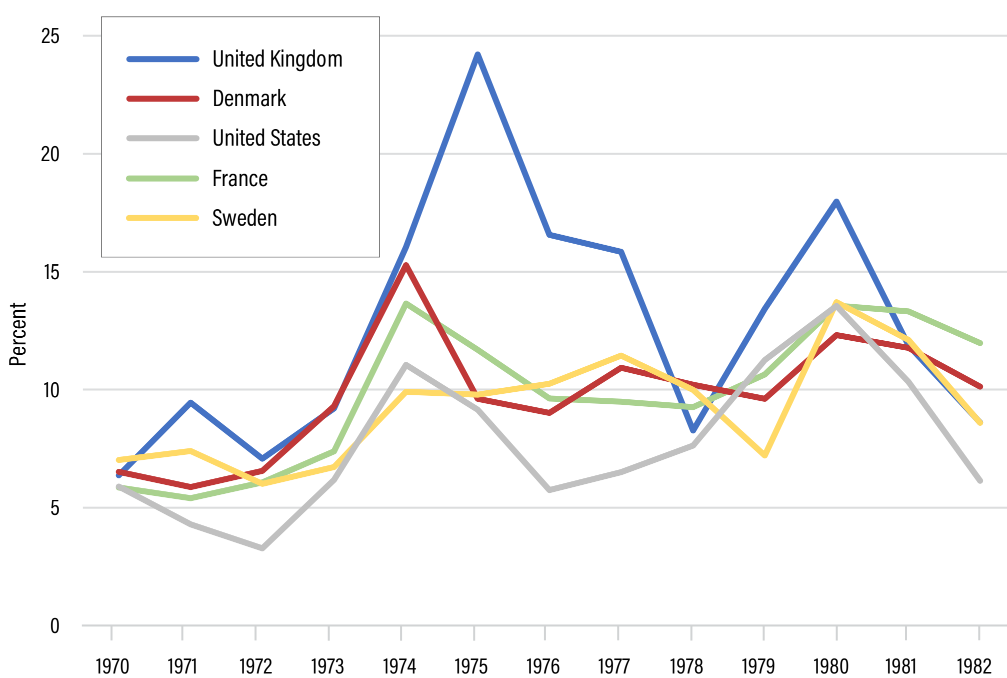
Source: Bolt and van Zanden (2020).

This strong economic performance occurred at the same time as there were growing concerns about the economic situation in Denmark's then primary trading partner, the United Kingdom, where growth had slowed significantly and the economy was suffering from a large current account deficit and growing public finance problems. These issues prompted the United Kingdom's government to announce a 14 percent devaluation of the British pound within the Bretton Woods framework of 1967, which allowed for countries to devalue their currencies against the US dollar if they were experiencing serious balance of payments problems.

As a result of the pound's devaluation, the Danish central bank was forced to allow the krone to be devalued as well; nevertheless, the central bank was concerned about the inflationary consequences of this decision and allowed the krone to be devalued by "only" 7 percent. The United Kingdom's devaluation of the pound sterling was effectively the beginning of the end of the Bretton Woods fixed exchange rate arrangement. The Bretton Woods system finally came to an end in 1971 when US President Richard Nixon declared that the US would no longer redeem dollars for gold (Garten, 2021). The "Nixon Shock" essentially removed Denmark's monetary policy anchor.

Despite efforts to establish a new anchor for European monetary and exchange rate policy, the 1970s were marked by considerable uncertainty about the monetary regime, and inflation in Denmark, as in most other European countries, rose significantly during that period.[10] Figure 1.12 shows the annual inflation rate for Denmark and four other nations

Figure 1.12: Annual Inflation Rate in Selected Countries (1970–1982)



Note: Data are for headline annual consumer price inflation.
Source: Ha, Kose, and Ohnsorge (2021).

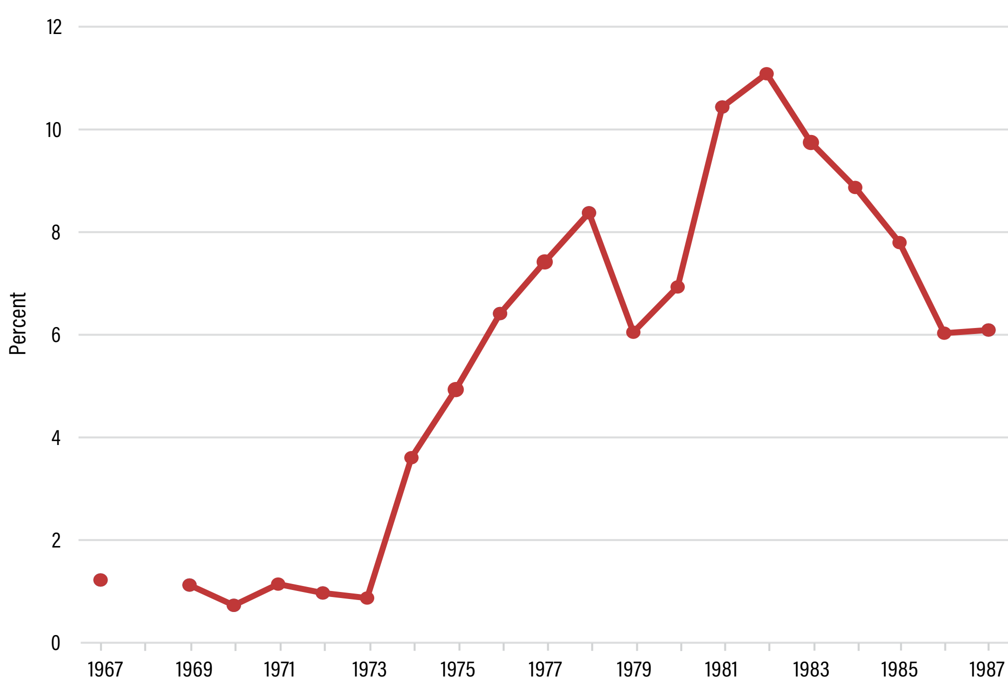
from 1970 through 1982. While Denmark's 15.28 percent inflation rate in 1974 is high by historical standards, the figure makes it clear that many western nations struggled with this problem in the 1970s.

The two major oil shocks that occurred in 1973 and 1979 worsened Denmark's inflation problem. By the mid-1970s, Denmark's economy was experiencing both inflation *and* rising unemployment (see figure 1.13)—what became known as *stagflation*.

These issues were exacerbated by the fact that Danish policymakers misdiagnosed the economic shocks and failed to recognize that the expansion of social welfare benefits during the late 1960s and 1970s had significantly contributed to increased inflation and structural unemployment during the 1970s. In particular, the extension of old age pension benefits to every Dane over the qualifying age starting in 1970 encouraged earlier retirements thereby exacerbating structural unemployment.

Furthermore, the stop-and-go macroeconomic policies implemented in Denmark during this period combined with the negative growth consequences of the two oil shocks resulted in a significant deterioration in Denmark's public finances throughout the 1970s and early 1980s. At the same time, export prices were declining relative to import prices, with the increase in import prices due mainly to increased energy prices. This deterioration in Denmark's terms of trade, along with a structural decline in Danish household savings and worsening state finances, resulted in a considerable increase in the country's current

Figure 1.13: Seasonally Adjusted Annual Unemployment Rate in Denmark, All Persons Aged 15–74 (1967–1987)



Source: OECD (2023).

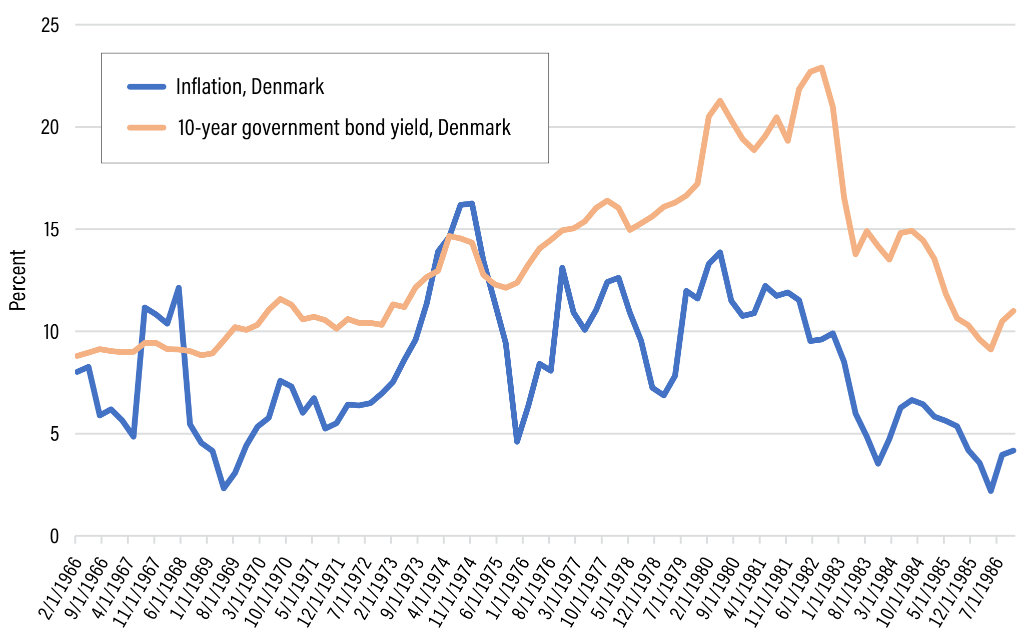
account deficit. As a result, the Danish government was forced to devalue the Danish krone several times during the late 1970s and early 1980s.

This was an era in which Danish economic policy was in upheaval in many ways, particularly with regard to the country's monetary and exchange rate policies. Essentially since the establishment of the Scandinavian currency union in 1875 when the Scandinavian currencies were pegged to each other within the gold standard framework and until the breakdown of the Bretton Woods system in 1971, Denmark had pursued a pegged exchange policy in one form or another to ensure price stability. This system was only interrupted by the two World Wars.

Following World War I Denmark gradually established a peg to the British pound, which was largely maintained within the Bretton Woods framework after World War II as both Denmark and the United Kingdom maintained a peg to the US dollar during this period. In essence, going back to 1875 and until this day, Denmark has adhered to a policy of relative price stability by implementing a pegged exchange rate regime in one form or another.[11] However, this policy was challenged during the 1970s as there was basically no anchor to which to peg the krone as high inflation and monetary instability were the international norm at the time.

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, which in turn caused interest rates and bond yields—both in real and nominal terms—to increase dramatically though the 1970s and early 1980s in Denmark (see Figure 1.14).[12]

Figure 1.14: Inflation and Interest Rates (1966–1986)



Source: The Danish Central bank (Danmarks Nationalbank)

However, unlike the Great Depression and the economic situation during the two World Wars when the crises were perceived to have their origins abroad, the situation in Denmark during the late 1970s and early 1980s was markedly different. Specifically, 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.

The Social Democratic party, in particular, became associated with these failed economic policies, and the failures of economic policy during the 1970s had a considerable impact on the political and economic consensus in Denmark at the start of the 1980s (Olesen, 2019). The new economic consensus was largely a return to what had been essentially the economic consensus prior to the dominance of Keynesian thinking in the 1960s and 1970s. More on that below.

Even as Danish fiscal and monetary policies seemed lost in the wilderness in the 1970s, the political commitment to free trade remained constant despite enormous current account deficits. For example, Denmark joined the European Economic Community (EEC) (later the European Union) following a referendum in 1973. The "yes" vote in the referendum was likely influenced by the fact that the United Kingdom had entered the EEC in 1973, and it was thus critical for Denmark to join so it could maintain its exports to the UK.

In this regard, it is worth noting that after Denmark joined the EEC it held a number of referendums on establishing closer political and economic integration with other European countries, and that while Danes in general have become more sceptical about European political integration, they have remained very positive about free trade within the European Union (Sørensen et al., 2022).

1982: Starting to undo the mistakes of the 1970s

To understand economic policymaking in Denmark and how politicians, economists, and civil servants perceived it, it is hard to avoid mentioning 1982. That year marked a watershed in the country's economic policy. The disastrous economic developments of the 1970s and early 1980s undoubtedly caused Danish politicians, central bankers, economists, commentators, and the general public to question the Keynesian economic ideas that had begun to take shape in the 1960s and dominated economic policymaking in Denmark in the 1970s. By the early 1980s, inflation had risen above 10 percent a year, Danish government bonds were yielding more than 20 percent, and fiscal deficits were ballooning. This situation prompted Finance Minister Knud Heinesen, on handing in his resignation in 1979, to famously remark that Denmark's economy was on the "brink of the abyss" (Heinesen, 2008). The comment was seen as symbolic of the Danish economy's state in the late 1970s and early 1980s and of the failures of activist Keynesian macroeconomic policies.

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 in many ways it can be seen as a return to "normal" Danish economic policies aimed at balancing public finances and ensuring price stability through stable monetary and exchange rate anchors. Even so, the new government's course amounted to a major break with the previous decade. Schlüter's macroeconomic approach rested on three pillars (Arzrouni et al., 2007):

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 as opposed to the previous government's numerous devaluations.[13] The krone's peg to the mark was seen as appropriate considering Germany's role as Denmark's main trading partner at the time, as well as the Bundesbank's steadfast commitment to price stability.
3. De-indexation of public expenditures and wages, so they would no longer be automatically increased to keep up with inflation.

At the time, the government's austerity measures were strongly criticized, and mainstream economists were skeptical that they would prove successful. While the underlying reasons for the skepticism can certainly be debated, what is undisputed is that the Danish economy rebounded strongly, budget finances improved dramatically, inflation came down, and bond yields dropped. These developments were seen as vindicating the economic policies of the Schlüter government, while the success of fiscal consolidation—which ran counter to the Keynesian thinking prevalent at the time—caused a major shift in the economic and political discourse in Denmark. That shift has to a large extent lasted to this day, but it was particularly important in the 1990s when a centre-left coalition led by Social Democrat Poul Nyrup Rasmussen came to power.

The Nyrup Rasmussen government maintained its predecessor's commitment to fiscal consolidation and expanded supply-side reforms, further improving the condition of Danish public finances. Many of its structural reforms—notably a comprehensive overhaul of labour market and social welfare legislation introduced from 1993 to 2001—have continued to ease fiscal pressures to this day. Thus, the post-1982 period has been marked by continuous and gradual economic reforms aimed at reining in public spending and curbing public debt. At least until recently fiscal consolidation has enjoyed the broad support of both the left and right of Danish politics, instilling a fiscally conservative approach at the centre of economic policy making.

A key reason for this relatively strong political consensus is the Schlüter reforms' obvious success—particularly that the significant fiscal tightening did not, contrary to Keynesian thinking, produce an economic slump. In fact, quite the reverse was true: Denmark's economy boomed from 1982 to 1986. The unexpected success (at least unexpected by most Danish economists) of the Schlüter initiatives gave rise to what became known as "Schlüter optimism." In the economics literature, this boom came to be attributed to "non-Keynesian effects of fiscal contractions," of which Denmark's experience in the 1980s is often highlighted as a prime example (see, for example, Giavazzi and Pagano, 1990).

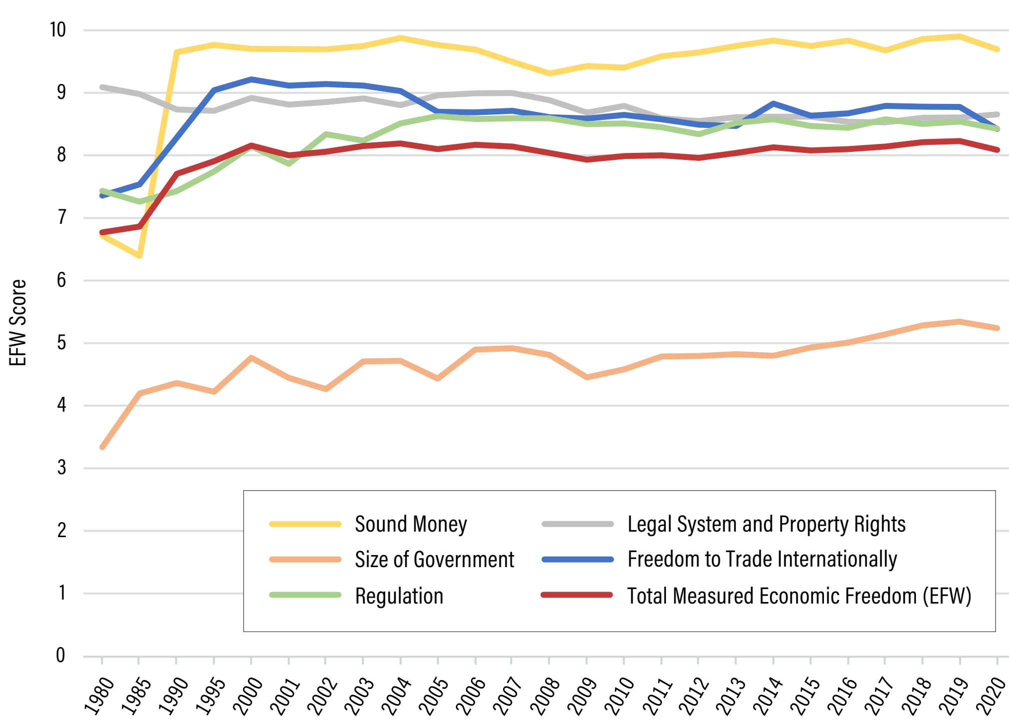
It became part of the accepted consensus among Danish politicians and the wider public that the failures of Anker Jørgensen's government in the early 1980s resulted from a combination of fiscal chaos and krone devaluations, and that the correct economic policy for Denmark was fiscal consolidation combined with structural reforms.

However, it should be noted that certain key issues in the Danish economy went unaddressed from 1982 to 1993 while Poul Schlüter was prime minister. In particular, the very high level of structural unemployment at the time remained mostly unaddressed. When Schlüter stepped down in 1993, the unemployment rate was 13 percent, and at the time it was the assessment of the government's own economists that structural unemployment likely was above 10 percent (Denmark, Ministry of Economics, 1993). That is, most unemployment was the result of structural features of the economy, including generous government social payments, rather than the result of business cycle conditions.

The reforms did, however, inoculate Danish policymakers and politicians from both the centre-left and centre-right against an over-reliance on expansionary fiscal policy as a short-term policy instrument.

One way to assess the long-term change is to look at measured economic freedom. Figure 1.15 shows Danish economic freedom, as measured by the Fraser Institute's Economic

Figure 1.15: Denmark's Measured Economic Freedom (1980–2020)



Source: Gwartney, Lawson, Hall, and Murphy (2022).

Freedom of the World index, from 1980 through 2020. To assess economic freedom, the authors collect data on 42 variables to create economic freedom scores in five broad categories of government policy: sound money, legal systems and property rights, freedom to trade internationally, regulation, and size of government.[14] They also create a summary score of total measured economic freedom, where higher scores indicate that citizens enjoy greater freedom to engage in economic activity. Figure 1.15 shows Denmark's scores in each of the components as well as in total measured economic freedom. Denmark's scores improved in all categories but legal system and property rights, which fell only slightly. The biggest improvements were in size of government and monetary policy. Figure 1.15 also clearly shows that Denmark's size of government score is significantly lower than its scores in all the other components of economic freedom.

From collective bargaining to a mostly free labour market

The Danish labour market has a long history of collective bargaining dating back to the 1870s and the establishment in 1898 of the Danish Confederation of Trade Unions. The September Agreement of 1899, signed by the Danish Employers' Association and the Danish Trade Union Confederation, had as its goal to provide a framework for collective bargaining between companies and employees in Denmark. It recognized the right of workers to organize trade unions and engage in collective bargaining while simultaneously emphasizing the need for industrial peace and stability. Employers committed to recognize and negotiate with trade unions under the conditions of the agreement, while workers agreed to refrain from engaging in strikes and other types of industrial action. The agreement also established an arbitration system to handle complaints between companies and employees. If agreement could not be reached through arbitration, the Danish Parliament could mandate an agreement.

The September Agreement constituted a watershed moment in Danish labour relations and ushered in a new era of cooperation. Prior to the agreement, labour conflicts in Denmark frequently culminated in violent clashes between workers and police, with minimal cooperation between companies and employees.

The agreement helped create a more collaborative and peaceful approach to industrial relations in Denmark and helped establish a strong history of collective bargaining that continues to this day. This is referred to as the "Danish model." The Danish model also recognizes that labour concerns are best resolved through labour market discussions between labour unions and employers rather than through legal avenues. As a result, there is no national mandated minimum wage law in Denmark, for example. Rather, wages are negotiated between unions and employers.[15]

The collective bargaining arrangement has resulted in a particularly Danish model in which labour unions have always been very strong but actual labour regulation is rather light compared to, for instance, some continental European countries such as Germany or France. For example, Denmark has historically had and continues to have relatively liberal firing and hiring rules, and labour unions have historically accepted that the decision to fire or hire is the right and responsibility of employers. While there have been conflicts between unions and employers in the past, the labour market has generally been relatively free of major strikes and lockouts.

On the other hand, an opinion widely held among Danish politicians is that this essentially liberal system of labour market regulation must be accompanied by a relatively high level of social welfare payments. While this so-called "flexicurity model" is frequently highlighted as a success story, it is also important to note that it has not always been successful. For example, the "flexi" element of the concept was largely missing during the 1970s when trade unions became very militant and were typically unwilling to assume responsibility for securing a high level of employment. At the same time, most Danish economists feel that the "security" part had become overly generous in that period.

The combination of rigid and militant labour unions with unduly generous unemployment and social benefits was a major reason why structural unemployment surged significantly throughout the 1970s and stayed extremely high until the mid-1990s.

The Schlüter government of the 1980s mostly failed to address these issues though its commitment to price stability (the pegged exchange policy) and to fiscal consolidation likely forced labour unions to take on more responsibilities for maintaining the general level of employment and likely gradually reduced labour union bargaining power. Nevertheless, structural unemployment remained high during Poul Schlüter's tenure as prime minister.

In 1993 when Poul Nyrup Rasmussen became prime minister and formed a coalition government with three smaller centre-right parties tax and labour market reforms were conditioned by the coalition's minor parties. During the 1990s, several key reforms were passed that simplified the tax system, decreased marginal tax rates, and reduced some social benefits.

The Social Democrats have historically opposed reducing social benefits, but the Nyrup Rasmussen government made major reforms. In circumstances where it was politically difficult to reduce absolute benefit levels the government made other adjustments, such as making it mandatory for unemployed people to participate in education or workfare schemes if they wanted to receive unemployment or social benefits.

This meant that, beginning in 1993, working-age unemployment and social benefits were gradually reduced. This development, combined with the fact that Denmark's unionization rate has steadily declined since the 1980s as Denmark transitioned from a manufacturing to a service economy, has led to significantly increased wage flexibility; structural unemployment in Denmark today is likely around 3 percent of the labour force (Denmark, Ministry of Finance 2022).

Conclusion

Over the past 150 years, Denmark has largely been an economic success story.[16] A steadfast dedication to free markets, free trade, and private property rights that dates to the 1850s has been at the heart of the country's success.[17] Except for the period during the World Wars and the late 1960s and 1970s there has also been a solid political consensus about ensuring sound public finances and price stability within the framework of an exchange rate anchor.

However, the country has had some major policy setbacks, most notably the major macroeconomic policy mistakes of the 1970s when an explosion of government spending contributed to rapidly increasing wages, serious structural unemployment, relatively rapid price increases, and a balance of payments crisis. Even though major fiscal, tax, and labour market reforms have been implemented over the last four decades, the reform agenda, particularly regarding the large size of government, remains unfinished.

Since the early 1990s Denmark's economy has been remarkably stable, with low inflation (until recently). However, while economic growth in recent decades has been moderate and mostly stable, it is still far below that of the booming 1950s and 1960s, and the trend over the past two decades has been toward slower productivity growth.

Denmark has fared 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. This is arguably the effect of labour market reforms implemented in the early 1990s.

Denmark has evolved from an agrarian economy to an industrial economy and it is now predominantly a service-based economy. 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.

Notes

1 These are simple, not compound, growth rates.
2 Some companies formed around that time are still among Denmark's largest. They include the shipping and logistics company Maersk, Denmark's second largest company by capitalization, and the brewer Carlsberg, Denmark's sixth largest company.
3 Though the data are less complete, general government expenditures (which include local governments) show a similar pattern; Denmark spent about half of what the UK and the Netherlands were spending in 1929.
4 The Danes had lost this region to Germany in the nineteenth century. But following Germany's defeat in World War I, Germany ceded it back to Denmark.

5 An international dollar is a hypothetical unit of currency that has the same purchasing power parity as the U.S. dollar had in a given period.

6 The agreement was named after the name of the street where then Prime Minister Thorvald Stauning lived at the time.

7 This comparison is imprecise because in both countries during this period the government largely controlled prices. Hence, measures of economic activity relying on current prices in specific countries will be affected by differences in the nature and degree of government price controls.

8 In fact, Sløk-Madsen (2022) makes a compelling case that it was the fundamental failure of the Danish state to uphold legitimacy in the face of German aggression rather than an "ideological push" or a shift in voter preferences that was the catalyst for expanded government involvement in the economy and higher public spending in Denmark.

9 Danish agricultural exports as a share of total exports declined from 63 percent in 1950 to 50 percent in 1958 and continued to decline throughout the 1960s (See Olgaard, 1980). Olgaard refers to the 1950s as Denmark's second industrial revolution.

10 The rate of inflation in Denmark, as measured by the Gross Domestic Product price deflator, averaged 8.2 percent per year from 1971 to 1973, whereas it averaged 5.7 percent per year from 1967 to 1970. It increased further from 1974 to 1977, averaging 10.6 percent per year, although the rate did come down to 7.2 percent in 1977.

11 Denmark pegged its currency in the early 1980s to a basket of currencies in the European Monetary System and from 1999 to the euro. In 2000, the Danish electorate turned down the adoption of the euro.

12 By way of illustration, the yield on long-term Danish government bonds reached 16.6 percent in 1977.

13 Denmark maintained the krone peg to the European Monetary System's basket of currencies, which effectively meant a peg to the German mark until Germany joined the euro area in 1999. Since then, as noted earlier, the krone has been pegged to the euro, but Denmark has not joined the euro area.

14 In the 2023 report, the number of variables will be expanded to 45.

15 During the 1960s Denmark had an incomes policy, as did some other industrialized countries, which set out guidelines for permissible money wage increases. The guidelines were abolished in 1968 (Olgaard, 1980).

16 Denmark, like Sweden, has maintained a position among the top 15 countries measured by Purchasing Power Adjusted levels of per capita GDP over the past two centuries (see Abildgren, 2016).

17 While Denmark has a long tradition of supporting free trade, there was a departure from this policy during the 1930s, the WWII period, and during the 1950s, when Denmark imposed import restrictions as did most other countries (see Olgaard, 1980).

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