The Scandinavian Model and Economic Development

BY KARL OVE MOENE AND MICHAEL WALLERSTEIN

Praised but dismissed

TODAY THE EUROPEAN UNION looks to the Nordic countries in search of role models for how low inequality can be combined with good economic performance (Herald Tribune, 17.9.05). Yet, in spite of recent praise, the Scandinavian model is still dismissed as an infeasible model for developing countries. Based on generosity towards the poor and protection against market competition, the argument goes, the Scandinavian model is only possible in consensual, homogeneous and affluent societies with an extraordinary commitment to equality. In third world countries that are conflict-ridden, heterogeneous, and poor, the model has no relevance, it is claimed.

In Moene and Wallerstein (2005) we present a more agnostic view, which we summarize below. We argue that the Scandinavian model is not an end state, but a development strategy. Scandinavian consensus, homogeneity, and affluence are products of the model, not prerequisites. We claim that wage compression attained through highly coordinated wage-setting was the central policy. As we see it, the economic benefits of wage compression would be as significant in South Africa, Brazil, or India today as they were in Scandinavia between 1935 and 1970. The political feasibility of a policy of wage compression, however, is open to doubt. Hence our agnosticism regarding whether or not the Scandinavian road to affluence can be repeated.

Wage compression institutionalized

SOCIAL DEMOCRATIC GOVERNMENTS came to power in Sweden and Norway in the midst of the Great Depression committed to reducing unemployment and alleviating poverty. Both governments increased government spending on policies such as unemployment benefits, public housing, and agricultural price supports.

In retrospect, the key innovation was not the Keynesian policies that were adopted in the 1930s, but the institutional response to the problem that threatened the recovery program. To keep the increased government spending from raising the wages of insiders in the labor market, rather than increasing employment, wages were taken out of market competition and out of the hands of local unions.

The attempt to coordinate wages by centralized wage setting was the start of a gradual process of wage compression. Over time it generated the most egalitarian distribution of wages and salaries in the world. In the 1950s, wage compression was adopted as an explicit goal of the unions in both Norway and Sweden under the title of "solidaristic bargaining."

Equity as a byproduct of efficiency?

IN THE 1950S, two Swedish trade union economists, Gösta Rehn and Rudolf Meidner, argued that equalizing wages across Swedish firms and industries would promote economic development by forcing wages up in low-productivity firms (or industries) and keeping wages down in high-productivity firms. In a decentralized bargaining system, wages vary according to the productivity of the firm and the industry. In a centralized system, in contrast, wages are relatively insensitive to the profitability of the enterprise.

On the one hand, industries with low levels of productivity are prevented from staying in business by paying low wages with a centralized system of wage determination. On the other hand, workers in industries with high levels of productivity are prevented from capturing much of the productivity differential in the form of higher wages. By reducing profits in low-productivity firms and increasing profits in high-productivity firms, labor and capital would be induced (or coerced) to move from low productive to high productive activities, increasing aggregate efficiency as well as improving equality (Moene and Wallerstein 1997, Agell and Lommerud 1993).

A study of productivity growth in Sweden by Hibbs and Locking (2000) finds evidence that the gain in efficiency was substantial and the cumulative impact on the distribution of wages and salaries was large. Solidaristic bargaining extended the principle of "equal pay for equal work" from one industry to the entire economy, and then moved beyond the demand for "equal pay for equal work" toward the goal of "equal pay for all work."

Structural change and generous welfare spending

MANY OTHER FEATURES of the Scandinavian model follow from the policy of wage compression. Wage compression directly encouraged the movement of capital from less productive to more productive activities, but the effect on the incentives for workers to change occupations was mixed. While wage compression would increase job loss in industries with low productivity and job creation in industries with high productivity, employers in highly productive firms lost the ability to attract workers with the offer of higher pay. The government, unions and employers responded to the problem with an array of active labor market policies that subsidized the movement of workers from one industry to another with training programs and grants to cover moving expenses.

To keep highly productive employers from undermining

the policy of wage restraint by offering workers generous benefits (which were harder than wages to monitor at the central level), the Swedish employers' confederation lobbied the government to nationalize the provision of health care and pensions (Swenson 2002).

Moene and Wallerstein (2001, 2003a) show that expenditures on social insurance against the loss of income due to unemployment, disability, sickness and occupational injury rise as wage inequality declines. If insurance is a normal good, a policy that raises the income of the majority of workers with below average incomes increases the political demand for social insurance policies. The compression of wage differentials, in sum, had far-reaching economic and political consequences, one of which, we argue in the next section, was to increase the pace of economic development.

The pace of economic development

IN MOENE AND WALLERSTEIN (2005) we explore the potential importance of wage compression for economic development within a dual model of industrialization. The central aspect of development that model incorporates is that the growth of a modern sector at the expense of traditional production depends on the size of the market for modern goods.

The model distinguishes between modern and traditional sectors depending on the technology they apply. While old technologies are assumed to have decreasing returns to scale, new technologies are assumed to have increasing returns. Increasing returns to scale imply that the profitability of modern plants depends on the size of the market. The dependence of the growth of the modern sector on the size of the modern sector creates a feedback loop. The result may be a poverty trap, in which growth fails to occur, or sustained development in which initial growth of the modern sector encourages further modern sector growth until the traditional sector disappears.

Whether the economy develops or not, depends on the profitability of modern production. Modern employers must receive a minimum share of the surplus to be willing to invest. This share would decline as modernization goes on as profitability increases with the size of the market.

One obstacle to modernization was therefore strong local unions whose wage premiums restricted the expansion of the most productive sectors. Large wage differences between the modern and traditional sectors could therefore block economic growth. Reducing the share of surplus received by relatively privileged workers, we suggest, was the essence of the social democratic development strategy.

Essentially, centralization took wage setting out of the hands of the unions representing relatively high-paid workers and put wage setting in the hands of leaders of the labor movement as a whole. Thus the social democratic approach was not to ban unions in order to raise profits. On the contrary the strategy was to strengthen unions as institutions and to structure collective bargaining in a highly centralized manner that reduced the influence of highly paid workers in the wage setting process and increased profits.

Ends against the middle

WHAT MAKES THE SCANDINAVIAN experience exceptional was that the policy of wage compression was voluntary, not coerced, and implemented by a union movement that included as members many of the high-wage workers whose wages would be restrained in the name of greater equality. Thus, the great challenge faced by those who would apply the Scandinavian lessons in the third world today is political. How can a democratic political movement with close ties to the unions implement a development strategy that centers on wage restraint?

One of the central groups who supported centralization in the 1930s and 1940s and solidaristic bargaining in the 1950s and 1960s were the employers (Swenson 1989, 1991). Employers much preferred to bargain with the "sensible" leadership of the union confederations, rather than with the militant leadership of the shop floor union bodies. Moene and Wallerstein (1997, 2003b) demonstrate that employers may be able to increase aggregate profits by reducing wage inequality relative to the wage schedule associated with decentralized bargaining and even relative to the wage schedule associated with a competitive labor market where employers set wages unilaterally.

The other important group that supported the policy of wage compression was the leadership of unions of low-wage workers. Since the union movement was encompassing, both low and high wage earners had influence in union policy. While the policy of wage compression was controversial in unions of high-wage workers, it was enthusiastically supported by unions of low-wage workers. Thus, the political coalition that prevailed in the 1950s and established the pattern of solidaristic bargaining that was to last until the 1980s was comprised of the low-wage unions and employers.

High paid unions were prevented from leaving the centralized negotiations by the threat of lockouts. It is unlikely that the low-wage unions and the leadership of the union confederation would have been able to force the high-wage unions to accept an egalitarian wage policy without the backing of employers and the threat of lockouts against recalcitrant unions.

Scandinavian exceptionalism?

WE DO NOT BELIEVE that Scandinavian workers are inherently more egalitarian than other workers. Rather, our belief is that a preference for greater equality is widespread. The preference for greater equality can only be acted upon to the extent that wages are set centrally. When wages are set at the plant level, for example, wage compression can only occur within the plant. When wages are set at the industry level, wage compression occurs within the industry. When wages are set at the

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national level, wage compression occurs at the national level.

Is the Scandinavian model politically feasible in the third world? This, it seems to us, is the critical question. The elements that appear to have been important in allowing wage differentials to be reduced through collective bargaining were (a) well organized employers, (b) encompassing trade unions that included the low-paid workers and (c) immediate benefits of wage compression in terms of the earnings of those at the bottom. These conditions are not notably present in Africa, Asia and Latin America today. But we still understand very little of the political dynamics that made wage compression possible in an environment with strong unions and a government that considered industrial workers to be its core constituents. Thus, we are reluctant to conclude that the social democratic experience cannot be repeated.

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