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Social Democracy is on the decline. According to its critics, social democracy introduces too much equality, too much security, and too much employment, thereby causing the economy to function poorly. Conversely, this paper argues that social democracy consisted of a set of institutions and policies that work efficiently to reduce insecurity and inequality of income without large sacrifices in economic growth and stability. By examining the experience of Norway and Sweden during the heyday of social democracy, this article shows how labor market institutions were crafted to merge equality and efficiency. This discussion can also be applied to the question of why social democracy has declined in recent years.

Corporatism and Competition

One of the most striking features of wage-setting in all four Nordic countries in the postwar period was the introduction of centralized bargaining. It is often mistakenly thought that corporatism is associated with restrictive trade policies. In fact, centralized bargaining was introduced to solve problems with trade openness. In Norway and Sweden, the drive to centralize bargaining began in the 1930s as a means of forcing all workers to share the burden of reducing the costs in order to maintain employment in the export sector. In the postwar period, centralized bargaining allowed workers whose wages were subject to international competition to set the pace of wage increases for the entire economy.

The Efficiency of Wage Equality

Because of the need to assure adequate profits to maintain employment and investment, unions can have a much greater influence on the distribution of wages among wage-earners than on the distribution of income between wages and profits. In the postwar period, the Scandinavian unions adopted a policy of promoting greater wage equality that was called “solidaristic bargaining.” These egalitarian wage policies were remarkably effective. Even today, Norway, Sweden and Denmark have the lowest wage differentials among OECD countries.

Many economists would assume that productivity would suffer from a wage system with a weak connection between productivity and wages. During the 1950s, however, Swedish trade union economists promoted solidaristic bargaining on the grounds that efficiency would be improved. This paper models the efficiency argument. It is assumed that productivity growth is embodied in plant and equipment such that newer plants are more efficient than older ones. Employment

per plant is assumed to be fixed. Thus firms have two decisions: when to build new plants and when to shut down existing plants. Total output and employment is determined by the number of new plants built each period and the age of the oldest plants in operation.

In this model, local bargaining produces a wage in each plant that is constant over time and dependent on the plant's age, with newer plants paying higher wages. With centralized bargaining, the wages is independent of the plant's age and rises over time at the same rate as productivity growth. Since local bargaining allows wages to vary in proportion to the productivity of the plant, older plants remain profitable so long as their productivity exceeds workers' reservation wage. With centralized bargaining, a common wage is set for all plants that is based on average productivity. If the uniform wage exceeds workers' reservation wage, centralized bargaining forces the oldest plants to close. At the same time, centralized bargaining increases the future discounted value of profits earned by new plants as long as the uniform wage is not too far above the market-clearing wage, as was generally the case in Norway and Sweden until the late 1980s, early 1990s. If centralized bargaining is accompanied by sufficient wage restraint, the number of new plants being built can be exceed the number of older plants that are forced to close, resulting in a net gain of employment and a more efficient industry.

This model can also be adapted do make a similar efficiency argument for the elimination of wage differences between industries. Centralized bargaining over a whole economy limits the ability of the most efficient industries to pay a wage premium and prevents the least efficient industries from staying in business by lowering wages. In effect, the elimination of industry wage-differentials can be seen as a subsidy for more efficient industries and a tax on less efficient ones. In contrast, strong unions with local bargaining slow the building of newer plants and the growth of new industries. Thus, in Sweden and Norway, the elimination of inter-firm and inter-industry wage differentials may have aided economic growth and increased aggregate profits.

The Maintenance of Full Employment

By today's standards, it seems miraculous that the Nordic social democracies were able to obtain wage equality and maintain full employment. Part of the explanation was the system of centralized bargaining. National-level union leaders are more sensitive to unemployment than local union leaders. Local union leaders represent workers with jobs, while national-level union leaders are more likely to consider the entire work force as their constituency. Another part of the explanation was the creation of labor-market policies that directly reduced unemployment by putting unemployed workers in labor-training programs. Yet another part of the explanation is that a full employment environment shapes employer's employment practices in a manner that increases the scarcity of labor.

This section presents a model in which employers, facing a fixed wage and stochastic demand for their output, choose between two employment strategies. One is a flexible employment strategy in which workers are hired when production is profitable and laid off when production is unprofitable. The second is a fixed employment strategy in which labor is hoarded when demand is low in order to have a full workforce ready when demand rises.

The choice of employment policy depends on the stochastic process that determines demand, the wage, and the ease of filling vacancies. The ease of filling vacancies, in turn, depends on the employment practices of other firms. If the other firms hoard labor, there are few workers looking for work and filling vacancies is difficult. In this case, a fixed employment strategy is likely to be optimal. If other firms layoff workers when demand for their output declines, there are more workers looking for work and filling vacancies is easier. In these circumstances, a flexible employment strategy is likely to yield higher profits. In sum, there can exist two equilibria, one where most firms follow flexible employment policies and only the most productive firms hoard labor and another where most firms hoard labor and only the least productive firms lay off workers when demand falls. The model implies that full employment is self-perpetuating, as long as demand shocks are not too severe. In Norway and Sweden, the full employment equilibrium lasted for four decades.

Social Democratic Decline

According to the arguments of this paper, social democratic labor-market institutions worked well for a long period of time. Social democratic institutions increased the equality and security of income without disrupting the capitalist economy. Core social democratic policies received support from both employers and organized workers. That time is over, however. The previous discussion of centralized bargaining and multiple equilibria in the labor market can also be applied to the question of why social democratic institutions have declined.

The recent rise in unemployment in the Nordic countries can be explained in macroeconomic terms. The governments of Norway and Sweden (and Finland) can be faulted for allowing unsustainable boom in the mid 1980s by failing to control the expansion of credit and, later, for pursuing a restrictive monetary policy in the midst of a severe contraction in 1989-90. As the model of multiple equilibria demonstrates, a severe macroeconomic shock can have long-lasting effects on unemployment.

At the same time, central control over wage formation was weakened, especially in Sweden. Centralized bargaining was supported by employers as long as the benefits of wage restraint exceeded the costs of wage compression. Over time, however, wage compression steadily increased while wage restraint grew increasingly difficult to achieve. Centralized bargaining initially reduced wage differences between firms and between industries, but not between occupations. As the wage policy changed from one of “equal pay for equal work” to one of “more equal pay for all work,” centralized bargaining created political and economic problems that split the union movement and induced some employers to push for the decentralization of wage-setting. By the 1970s, the dominance of the confederations of blue-collar unions declined as the membership of white-collar and professional union confederations grew. The professional unions, in particular, mobilized their members in defense of traditional wage differentials. In addition, the dominance of workers in the traded-goods within the blue-collar confederations declined as employment in the traded-goods sector declined as a share of total employment. The fastest growing affiliates of the blue-collar confederations in the 1970s and 1980s were the public sector unions representing relatively low wage employees, whose wage demands were not constrained by international competition. As centralized bargaining was increasingly torn by conflicts between low-wage and high-wage workers and between private-sector and public-

sector workers, wage restraint became increasingly difficult to achieve. Employers, particularly in Sweden, increasingly sought to decentralize wage-setting to the level of the industry or even, in the case of large employers, the firm.

There is no going back to the past. At the same time, the effects of social democratic labor market institutions may be long lasting. Union membership remains high, wages continue to be commonly set in centralized negotiations in all of the Nordic countries except Sweden, and the distribution of wages and salaries continues to be very egalitarian in comparison to other societies.