Scandinavian Equality Evolving

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The evolutionary perspective on the Scandinavian model is, of course, not new. It is well established that the model is not the result of intelligent design, but of evolution – a long string of trials and errors. The evolutionary perspective is also inherent in the political strategy followed by the social democrats, and by their political challengers, implementing what was politically feasible step-by-step. No reform was revolutionary in itself, but the cumulative effects of the gradual changes in policies and economic institutions have altered society and transformed Norway and Sweden to the most egalitarian countries in the world.

Both countries have experienced higher economic growth than the United States from 1930 to 2010. They have also outperformed the United States in the share of occupations that intensively use information and communication technologies. In addition, relative to the United States and most other countries, work participation in Norway and Sweden is higher, wage differentials are smaller, welfare states are bigger, and the exposition to foreign competition is stronger. To understand how and why, the interconnection between three sets of mechanisms should be emphasized (as more extensively summarized in Barth, Moene and Willumsen 2014, The Scandinavian Model - an Interpretation, forthcoming in the *Journal of Public Economics*):

1) The two-layer wage setting, combining central and local wage negotiations, compresses the wage distribution and induces efficiency at the workplace. It resolves, to some extent, the conflict between pay and performance. The work autonomy that Scandinavia is famous for means that workers can influence a broad set of issues in local bargaining, enabling union locals to enforce effort levels that maximize the value added, minus workers' costs of effort – irrespective of the wage distribution. Central wage compression is enforced by the restrictions on local industrial actions laid down in the main agreement between employers and workers. The restrictions make it impossible to completely overturn the small differences in the centrally negotiated wages. The entire wage structure is thus compressed: The wage of a particular job is made up of the centrally negotiated tariff wage plus a constrained wage drift linked to the productivity of the firm.

2) The link from wage compression to investments is best understood within a vintage approach to the process of creative destruction, where more modern technologies gradually replace the old and obsolete. The wage restraints in local bargaining imply a lower share of wage drift in each vintage of capital investments, ensuring higher expected profits and profit-induced investments. In turn, higher investments push up the demand for labor, and central wage negotiators can raise the lowest pay without causing unemployment.

As more jobs are created in each vintage, workers become more concentrated in high productivity vintages (enterprises, firms, industries). Surprisingly perhaps, the average wage goes up with more wage restraint at the same time as the expected wage costs for each investment project decline. The explanation is simple: More creative destruction, induced by lower expected wage costs, moves a larger share of the workforce to more productive enterprises, thereby raising average wages. In short, wage compression fuels capitalist investments in the process of creative destruction, increasing the average productivity and the average wage for a constant employment level.

3) The comprehensive cradle-to-grave welfare state in Scandinavia is based more on universalistic spending than on means testing. It obtains higher political support when the income differences in the workforce are small and when the productivity in the private sector is high. The key thing to note is that the welfare state is not a mechanism for pure redistribution from the rich to the poor, but rather it is a provider of goods and services such as social insurance, health care, and education. As these welfare provisions are normal goods and wage compression increases the labor income to the majority of workers, the political popularity of higher welfare spending becomes particularly high.

So why has the Scandinavian model worked so well? The answer summarized in Barth, Moene and Willumsen (2014) is that there is a strong complementarity between the Scandinavian non-market institutions and capitalist dynamics. This complementarity also helps explain why the main institutions and policies have survived for over 80 years. The gains are spread widely across groups. There are many winners and few losers. Both low-paid groups and employers are clear winners as wage compression and rising profits are two sides of the same coin. High-skilled workers are potential losers. But also high-skilled workers may gain from wage moderation as the average productivity goes up.

All in all, the stability of the Scandinavian model can in part be explained by good performance, and the good performance must have been helped by the stability of the model. The key is that both depend on the egalitarian aspects of the Scandinavian model that share the gains of good performance within almost all groups.