

Equality and Creative Destruction under the Northern Lights

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May 26, 2014

Abstract

INCOMPLETE EXTENDED OUTLINE

1 Introduction

The Scandinavian achievements look impressive enough. Sweden and Norway have higher work participation, smaller wage differentials, and more generous welfare states than other countries. Yet from 1930 to 2010 Norway and Sweden have experienced higher economic growth than the US. They have also been more exposed to foreign competition than most other economies, and their economies are modern, outperforming the US in the share of occupations that intensively use information and communication technologies.

Does the experience of the small open economies in Scandinavia have any relevance for developing countries to day? To answer we have to explore how the economy in Sweden and Norway evolved as inequality dissolved. This paper discusses some of these experiences.

The essence of the Scandinavian development path is the real competition of continuous modernization where modern technologies displace the old ones, raising average productivity and incomes, enabling firms to make profits even with extraordinarily high minimum wages set by unions. In Scandinavia this process of creative destruction is not only reserved for private enterprises. It is also prominent in the relationship between markets and politics. The evolutionary perspective is 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

*This draft is part of the research at ESOP (the Center of Equality, Social Organization, and Performance) at the University Of Oslo

society and transformed Norway and Sweden to the most egalitarian countries in the world.

Evolution not intelligent design:

To understand the Scandinavian experience it should be noted at the outset that the social democratic road to affluence is not a story about a carefully planned development, or about any intelligent design more generally. The Scandinavian model is rather the result of evolution — a long string of trial and errors. The more workers were organized in unions, and mobilized as voters the less employers and governments were able to resist their demand. The more employers were organized in peak associations, the more of their collective interests prevailed. Each victory in parliament or at the bargaining table laid the foundation for new advances. Major actors, sometimes in opposition to each other some times in cooperation, implemented piece meal reforms and gradual adjustments based on local conditions. Social and political alliances have shifted. In the labor market the traditional conflict between capital and labor is not always salient. Other conflicts between sheltered and traded-goods sector can also be important.

Foreign competition crowd out domestic competition?

The most defining characteristics of the evolving system in these small open economies have been their exposure to foreign competition. Social experiments and reforms were contested by global forces in international markets — making the procedures of trial and errors more expedient and the selection of institutions and policies more efficient. To some extent external competitive forces may to some extent have crowded out internal competition. Strong unions and strong employers' associations, a high level of wage coordination with small wage differentials, a comprehensive welfare state with social protection, may all be viewed as free trade institutions under the northern light, making the competitiveness of the economy, all things considered, more solid by taking some aspects of wages and social insurance out of market competition.

I make a case for how external competition in international markets can induce more welfare spending, more internal cooperation on both sides of the labor capital split and collaboration between labor and capital; how cooperation and collaboration at home may generate outcomes more in line with optimistic text-book descriptions of perfect competition than of monopoly practices; and how wage compression and the protection and investments by the welfare state complement capitalist dynamics. In this respect I try to address the concerns of both the enthusiasts of the Scandinavian model, who wrongly may think that its social protection requires protectionism, and the skeptics of the Scandinavian model, who wrongly may think that social protection erodes market dynamics.

Below I discuss how market and politics work together. We are interested in how the process of creative destruction in private enterprises is affected by the process of taking wages out of market competition. and how the private developments affect policies and preferences — in short, how capitalist dynamics can coexist with socialist security offered by the welfare state.

So, can the Scandinavian path be repeated in other countries? Obviously, no country can, or would like to, follow the same pattern in any detail. Learning from the Scandinavian experience can nevertheless be useful.

2 The essence of the Scandinavian path

One reason why the Scandinavian model has worked so well is that there is a strong complementarity between non-market institutions and capitalist dynamics. This complementarity also help explain why the main institutions and policies have survived over 80 years. The following is based on mechanisms discussed in Barth, Moene and Willumsen (2014).

Capitalist dynamics: real competition vs ideal competition:

Many aspects of the Scandinavian experience become difficult to understand if one concentrate on static price competition only. Everywhere, but in particular in the small open economies of Scandinavia, market competition is much more than price competition. The real competition is dynamic, a race to create of new products, new technologies, new work organization where the winner obtains a temporary monopoly position. Or, as Schumpeter famously stated "in dealing with capitalism we are dealing with an evolutionary process ... long ago emphasized by Karl Marx" of how the dynamic competition "incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one. This process of Creative Destruction is the essential fact about capitalism. It is what capitalism consists in and what every capitalist concern has got to live in" (Schumpeter 1943: 82-83). Capitalist reality, he adds, is "distinguished from its textbook picture."

The real competition of continuous modernization means that modern technologies displace the old ones, raising average productivity and incomes, enabling firms to make profits even with extraordinarily high minimum wages set by unions. How is the process of creative destruction affected by wage compression?

To put it bluntly: the Scandinavian development strategy is to keep down the upper middle class in the name of solidarity, in order to raise profits, investments and the pace of creative destruction enabling an increase in the lowest wages. The wages of the upper middle class can be held back by subsidizing education or by wage restraints by the unions.

Scandinavia applies both.

When the majority get higher incomes, voters demand higher welfare spending, that feeds back to empower weak groups, raise education levels and the health of the population. 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.

A vintage approach to creative destruction

The link from wage compression to investments is best understood within a vintage approach to the process of creative destruction.

- More modern technologies gradually replaces the old and obsolete. The capital equipment belongs to vintages where newer vintages are more productive than older ones. Creating new jobs, or building new plants, is costly, so older designs are not immediately replaced. The key decisions are when to build new plants and when to scrap the old ones.
- 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).
- 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 work force 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.
- Free entry: new vintages are established as long as new investments yield positive profits.
- Free exit: old vintages that cannot cover variable costs are scraped.
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Huge wage inequality may result if wages in each vintage is tied to the local productivity. We can think of the wage as consisting of two parts the prevailing base wage that goes to everybody, and a local wage premium tied to the productivity of the local plant. Wage compression can thus be captured by reducing the local plant dependent component of the wage. To see the effect of compression let us compare two steady states, one with high local wage premium and the other with low one.

Comparing the two we find that wage restraints in local bargaining imply lower expected wage costs and thus higher expected profits over the lifetime of an investment. As a consequence investments go up, implying that the lowest wage is raised without creating unemployment. Since this wage rise goes to everybody in the form of a higher tariff wage, it benefits all workers.

- Wage compression that preserve the level of employment increases investments and income per capita. What we denote employment-preserving wage compression implies:
- higher investments,
- fatter vintages,
- shorter economic lifetime of each investment,
- a higher level of income per capita
- a higher average wage in the work force
- wage inequality is affected directly and indirectly via structural change that make the gap between most productive and least productive unit smaller
- compression is thus strengthened by an increase in the share of the work force in each vintage, and thus a higher concentration of workers in the most modern vintages, that further compresses the wage structure by rising the lowest wage

Wage restraint also implies that more jobs are created in each vintage. Workers are therefore more concentrated in high-productivity vintages (enterprises, firms, industries). It might be puzzling that the average wage in the work force goes up with wage restraint, at the same time as the expected wage cost of each vintage declines. The puzzle is resolved once we account for the fact that lowering the expected wage costs leads to more creative destruction that moves a larger share of the work force to more productive enterprises. So even though the local bargaining power of work groups decline, they are moved to more productive vintages where even a lower bargaining power yields a higher average wage.

The reallocation of workers contributes to wage compression. The highest paid workers receive a smaller rise as they work in the best enterprises, and cannot gain from the

reallocation of workers in other ways than through a higher tariff wage. Their total wage may thus decline as their local wage supplement might go down more than the tariff wage increases.

The clearest beneficiaries of wage restraint are low paid workers together with employers. The policy of wage restraint, or solidarity bargaining as the wage policy was called after 1958, was supported by an implicit coalition between employers and low-paid unions, a coalition of the ends against the middle.

A higher level of basic productivity leads to wage compression. A higher level of basic productivity in each enterprise, implies higher average incomes with lower economic lifetime and a higher concentration of workers in modern vintages. All this leads to more wage compression as common base wage goes up.

A higher level of basic productivity can be interpreted as a result of efficient work effort at the local level. It can also be caused by welfare spending connected to education and health. If the latter is the case, there is a positive link from welfare state provisions and the productivity of private enterprises. In addition, welfare spending that increases the level of basic productivity also compresses the wage structure, as investments and wages adjust to the new circumstances with better welfare state provision. If so, this is an example of the complementarity between worker security and capitalist dynamics.

A higher rate of technological change increases the share of workers in each vintage in operation. A higher rate of technological change lowers the economic lifetime of each investment and increases the share of workers in each remaining vintage. Speeding up the process of creative destruction implies that the distance in productivity between each vintage goes up, but that the distance in age between the least and the most efficient plant in use declines. As a result each vintage become fatter, and, as a consequence, the economy becomes more modernized with higher average productivity.

Specific Scandinavian institutions of wage compression:

- The two layer wage setting, combining central and local wage negotiations, compresses the wage distribution and induces efficiency at the work place.
- 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.

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

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 work force 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 machinery for pure redistribution from the rich to the poor, but rather 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.

3 Development first, then redistribution?

- In the following we make a case for the proposition that welfare spending is a normal good within each income class, but an inferior good across income classes.
- Many observers do not understand the political economy of the Scandinavian model. They think that it is important to become rich first, and next redistribute. The development show that this assertion is not true. Becoming rich with a certain income distribution, create economic and political interests that tend to sustain that distribution. Barth, Finseraas, and Moene (AJPS 2014) call it political reinforcement.
- A generous welfare state is not dependent on a Social Democratic party being in power, but rather the other way around: in order to win elections, political parties from the whole spectrum of parties have to shift their policies in a social democratic direction as wage compression shifts the political center of gravity.
- It is not the case that only Social Democratic parties have been in power either. Since the 1960's in Norway, the 1970's in Sweden and the 1980's in Denmark, power has alternated between the left and the right. Prominent right and center governments like the Schlüter and Fogh Rasmussen governments in Denmark, the Willoch and Bondevik governments in Norway, and the Bildt and Reinfeldt governments in Sweden have ruled between one and two thirds of the years since 1980. Even though there has been significant changes to policies with shifting governments, the key ingredients of a generous welfare state has remained prominent in all the countries.

- The welfare state does not only offer redistribution, it also offers goods and services that may be difficult to organize through private markets only.
- Welfare state goods are inferior goods across social classes with different marginal benefits of public spending, but are normal goods within social classes for given marginal benefit.
- When average income increases, the demand for the welfare state increases as well.
- The preferences obviously also influence the political equilibrium, i.e. the programs it is optimal for the political parties to run on. Both right-wing and left-wing parties shift their policies in response to a shift in the income distribution brought about by wage compression.

4 Complementarity between capitalist dynamics and socialist security

It is a myth that socialist security via a comprehensive welfare state is a drag on economic development. On the contrary, social policy may stimulate capitalist dynamics via better social insurance, better health services, better education. Social policies level the playing field, improving the allocation of talent from all parts of society. Social insurance have important spill-over effects to financial stability. When the customers of the banks are insured, the banks are in part insured themselves. When workers obtain higher health, education and thus productivity, employers gain as well.

Equality is contagious:

- Equally rich countries are rather unequal in their income distribution and welfare spending where the countries with the smallest wage differences before taxes have the largest welfare states.
- Compared to the United States, the Scandinavian countries have twice as generous welfare spending, but only half of the US pre tax wage inequality. Although the contrasts might be less stark, the pattern where small wage differentials go along with large welfare states, holds across almost any group of developed countries. It is also visible over time.
- Welfare spending is both fueled by and fuels wage equality. The generosity of welfare benefits, on the one hand, mitigates wage differentials by empowering weak groups in the labor market; more wage equality, on the other hand, lifts the political support for generous welfare provisions by raising the income of the majority of the electorate.

- The complementarity between the two effects means that they add up to a social multiplier, enhancing differences across countries related to history, resources,
- The stability of the Scandinavian model can in part be explained by the good performance, and the good performance must have been helped by the stability of the model.
- The key is that both depends on the egalitarian aspects of the Scandinavian model that share the gains of good performance on almost all groups.
- Since the interactions between wage coordination, investments, and welfare spending all strengthen the egalitarian aspects of the model, it would not be possible to achieve the same egalitarian results by redistribution through the welfare state only.