INSTITUTIONS AND MARKET PROCESSES

6 THE SWEDISH MODEL: WHAT WENT WRONG?

by Stephen Turner

1. An Introduction to The Swedish Model

Background

The Swedish model emerged as the product of a postwar "political settlement" between organized labor, business, and government. The fundamental objective of the model was to establish a social consensus on the appropriate balance between efficiency and equity. Each party to the general settlement recognized that without such a consensus, the pursuit of growth could itself fall victim to disruptive distributional conflict over the terms of economic adjustment (Lundberg 1985). Three areas of potential conflict were singled out for attention:

1. *Labor/Capital conflict* over the distribution of wages and profits

– The first objective of a trade union is to increase the real wages of its members. But in an economy such as Sweden's, in which almost 85 percent of the total labor force is unionized, unrestrained pursuit of this objective poses serious risks for national economic performance. Excessive growth in real wages damages competitiveness and profitability. A persistent decline in profitability leads, in turn, to lower rates of investment, growth, and employment.

2. *Inter-union conflict* over the relative wage structure

– The success of a union in advancing its members' interests is gauged to a large extent by its capacity to maintain or increase the relative wages of its own members. Union pursuit of this objective poses two potential threats to economic efficiency: (1) wage "leapfrogging", which drives up overall wage levels, yet leaves relative wages largely unchanged; (2) labor mismatches, which develop when the relative wage structure fails to adjust to changing market conditions.

3. *Conflict* over the *terms of structural adjustment*

– Creative destruction, the engine of growth in a capitalist economy, generates losers as well as winners. Outmoded firms are driven out of business; workers are displaced by changes in business organization, production processes, and by business failures; geographic regions suffer employment losses and economic decline.

Although such microeconomic transformations are essential for macroeconomic efficiency, potential losers have a powerful incentive to resist painful adjustments. Coalitions against change possess, moreover, two important advantages in their attempts to obstruct the adjustment process. First, inadequate understanding of the complex linkages between microstructural adjustment and macroeconomic performance serves to obscure the efficiency costs of resistance to change. And because the benefits of adjustment are widely dispersed, while the costs are highly concentrated, it is much easier to mobilize potential losers than to organize the disparate groups that would benefit from structural change (Olson 1982).

This paper has three main objectives: (1) to briefly describe the essential institutional features of the Swedish model of wage formation and structural change; (2) to evaluate the model in terms of its success in promoting a balanced development between the growth in real wages and productivity; (3) to suggest a few hypotheses to account for the disparity between the intended and actual performance of the Swedish model.

Wage Formation in the Rehn and EFO Models

In the early 1950s, economists from the LO (the Swedish Confederation of Labor) introduced an innovative model for regulating wage formation and structural change in an ambitious attempt to reconcile – and even improve – the tradeoff between union demands for greater equity and the economic requirements for greater efficiency. According to the Rehn Model, this dual objective could be achieved through the implementation of solidaristic wage policy and active labor market policy (Björklund 1984).

The concept of solidaristic wage policy implied, in its original formulation, "equal pay for equal work". Through centralized negotiations between LO and SAF (The Swedish Employers' Confederation) national wage rates would be established for each job category. These rates would then be applied throughout the economy, regardless of differences in productivity and profitability among individual firms.

Three main arguments were advanced in support of solidaristic wage policy. First, the elimination of wage disparities among comparable jobs would automatically promote greater equity through the reduction of income inequality. Second, by establishing a general principle for wage distribution, solidaristic wage policy would reduce the scope for inter-union wage rivalry and the corresponding risk of wage leapfrogging.

Finally, it was argued that a uniform wage structure would promote productivity growth and economic efficiency by producing a differential profits squeeze among efficient and inefficient firms. In theory, this would promote economic efficiency in three ways: (1) by reducing x-inefficiency in existing firms; (2) by accelerating the scrapping of outmoded capital and the forced exit of inefficient firms; (3) by providing an extra margin for expansion in highly efficient firms.

Although solidaristic wage policy offered a normative principle for regulating inter-union wage conflict, it offered little guidance on how to manage the conflict over the distribution of wages and profits. Widespread concern over the risk of excessive wage growth led, in the late 1960s, to the development of the EFO model of wage formation.

EFO established the maintenance of international competitiveness as the fundamental criteria for gauging the scope for overall wage increases. The model divides the economy into two sectors: the exposed K-sector and the sheltered S-sector. According to the model, equilibrium levels of international competitiveness and profitability can be maintained as long as real wage growth remains within the margin provided by the combination of K-sector productivity growth and the rise in the international price of tradeable goods.

Entry, Exit, and Structural Adjustment

Most accounts of the Swedish model have focused almost exclusively on the labor market institutions established by the Rehn and EFO models. But a more comprehensive examination reveals that the norms regulating wage formation can work effectively only if supported and reinforced by norms promoting a rapid pace of structural change. It was this combination – of solidaristic wage policy and the free entry and exit of firms and technologies – that held out the promise of increased equity and enhanced efficiency. It was this combination that seemed capable of ensuring a balanced development between growth in real wages and productivity.

The entry of new firms and technologies – and of market competition to eliminate the outmoded ones – are essential conditions for ensuring adaptive efficiency in any economy (Pelikan 1985 and Hanson in this volume). But due to the impact of solidaristic wage policy, these conditions assume an even greater importance in the Swedish model. By driving up wages at the bottom end of the payscale, solidaristic wage policy accelerates the rate at which marginally efficient production techniques and business firms become unprofitable and thereby reduces the scope for economic adjustment through wage flexibility.

Every society must address the conflicts that arise between economic pressures for market-driven structural change and political pressures for state "control" over entry and exit. The Swedish model developed as a collective attempt to mediate these conflicts. At the core of the model was a political settlement that established the roles to be played by organized labor, business, and the state in shaping structural adjustment.

Extensive state intervention in production and investment decisions was ruled out from the start. Open competition in contestable markets – not state industrial policy – was to sort out the winners from the losers. State policy was designed to facilitate adjustment indirectly, in two ways. First, active labor market policy would ease the burden of adjustment – and thus minimize resistance to that adjustment – by providing retraining and job placement services to individual workers displaced by structural change. Second, rapid welfare state expansion growth would not only reduce the social costs of adjustment, but also promote a more equitable distribution of the fruits of growth. From the outset, therefore, rapid public sector expansion was seen as a way of reducing political resistance to adjustment (Martin 1984).

The Swedish model assigned to organized labor an indirect but essential role in the adjustment process. I have already noted the ways in which solidaristic wage policy promotes rationalization and structural change. Equally important, and less often discussed, is the critical role of the unions in facilitating the rapid introduction of new technologies, and in freely accepting a correspondingly high rate of labor mobility.

Primary responsibility for adjustment decisions was retained by the owners and managers of private business firms. This responsibility carried with it risks as well as rewards. The concept of the welfare state did not apply, at least originally, to the welfare of business firms.

2. An Evaluation of The Swedish Model

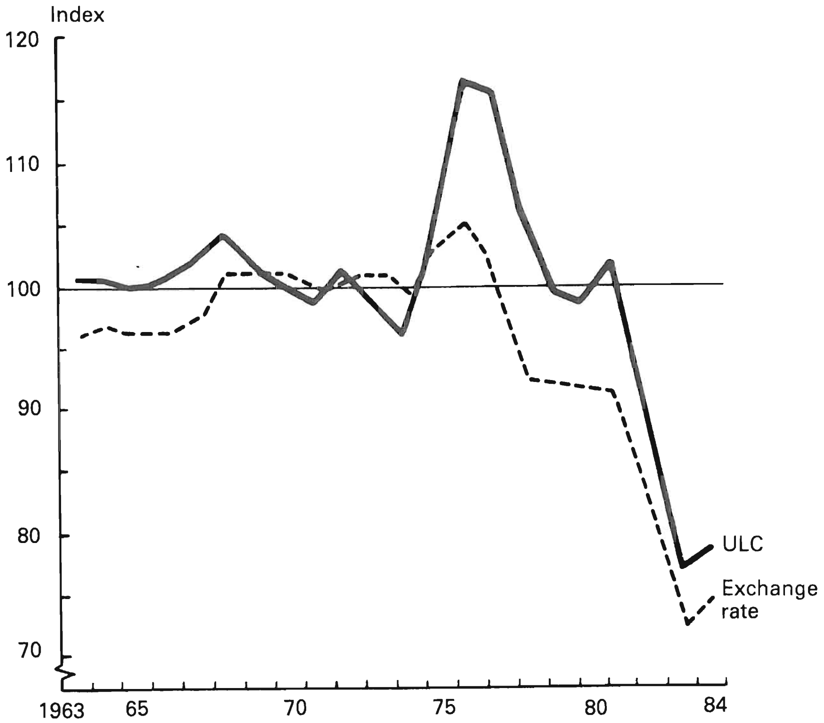
An evaluation of the Swedish model must begin by addressing a puzzle con cerning Sweden's economic performance. Economic theory suggests tha there is a positive causal relation between wage moderation, internationa competitiveness, and full employment. In examining Sweden's economi performance over the past two decades, however, we find considerable evi dence of excessive real wage growth and of a substantial decline in inter national competitiveness; yet throughout this period, Sweden's performanc on unemployment has consistently ranked among the best in the OECD. Be fore suggesting a potential answer to this puzzle, we must examine the ev dence on trends in wage formation and competitiveness.

The most widely used indicator of the impact of wage pressure on comp titiveness is the measure for relative unit labor costs (ULC). The distincti feature of this measure is that it not only captures the effects of relative changes in real wages, but also incorporates productivity growth and exchange rate movements. Figure 1 displays the trend in relative ULC for the period 1963-84. Three points deserve emphasis. Until the mid 1970's, Sweden's relative ULC were generally stable and exhibited no long-term tendency towards a loss of competitiveness. Second, relative ULC rose dramatically between 1974-77. Finally, due to the effects of repeated currency devaluations since 1977, Sweden's relative ULC have dropped sharply since that time. In 1985, they were almost 20 percent below the level of 1970 and about 35 percent below the peak of the "cost crisis".

Three Interpretations of the "Cost Crisis"

The explosive increase in relative labor costs in the mid 1970's is known in the Swedish debate as the "cost crisis" (Ds Ju 1979). The sharp rise in labor costs triggered a dramatic fall in Swedish competitiveness, as market share plunged by about 15 percent between 1974 and 1977. The cost crisis

Figure 1 *Sweden's Relative Unit Labor Costs (ULC) 1963-84*
Index 1970 = 100



Source: Calmfors et al. (1985).

marked the onset of a prolonged period of stagnation in Swedish industrial production and economic growth.

Many economists have argued that the cost crisis signaled the collapse of the Swedish model. According to this argument, the model worked relatively well in moderating wage growth in an era of rapid economic growth, but is ill suited to a period characterized by a slow productivity growth and worldwide economic stagnation. Under these changed conditions, the Swedish model has proven incapable of effectively regulating inter-union conflict over relative wage shares and the labor/capital conflict over wages and profits (Calmfors 1985).

Although this argument appears persuasive at first sight, it has been subject to two very different types of criticism. The first contends, essentially, that the Swedish model is alive and well; the second claims that the collapse of the model can be traced as far back as the mid 1960's. Let us examine each of these arguments in turn.

According to the first argument, the cost crisis is best seen as a single deviation from a well established pattern of moderate wage settlements. Furthermore, the much touted "wage explosion" had very little to do with the rise in Sweden's relative ULC. Although Swedish hourly wage rates rose rapidly during this period, the rise was only marginally greater than in competitor nations. The real problem was due to a combination of an exogenous productivity slowdown, a rise in the exchange rate, and a substantial increase in non-wage employer fees (SIND 1982). Proponents of this view argue, moreover, that widespread support for the equity provisions of the Swedish model has been essential in facilitating union acceptance of an unparalleled degree of downward real wage adjustment (Erixon 1985).

Advocates of the second, more critical view, adopt a long-term "structuralist" perspective in evaluating the impact of Swedish wage trends on international competitiveness and economic performance. Erik Dahmén and Pehr Wissén have been among the most forceful advocates of this position. They argue that since about the mid 1960's, Swedish real wage gains have persistently exceeded the rate consistent with long-term economic equilibrium. The deleterious effects of excessive wage gains were initially obscured, however, by an endogenous acceleration in aggregate productivity growth (Dahmén 1980, Wissén 1982, Bentzel et al. 1980).

The aggregate productivity figures improved in the late 1960's as a result of reductions in x-inefficiency and, more importantly, due to a sharp increase in the scrapping of machinery and the forced exit of the least efficient firms. The initial surge in productivity growth made it possible to maintain Sweden's relative ULC and to fulfill, ex post, the EFO guidelines for wage formation. But these aggregate indicators proved to be highly deceptive. They failed to capture the gradual erosion in Sweden's international competitiveness and the alarming contraction in the size of the K-sector.

The loss of competitiveness is reflected most clearly in a persistent drop in Swedish market shares that began about 1965, and in the emergence of balance of payments deficits towards the end of the decade (Carlsson 1981, Bergström 1982). Falling competitiveness gradually eroded K-sector profitability. The drop in profitability led, in turn, to a sharp increase in business failures and defensive mergers, and to a reduction in new business entry and investment in capacity expansion (Jagrén in this volume, Du Rietz 1975). In response to rising wage pressure and heightened international competition, firms shifted investment towards rationalization and cost reduction. This not only triggered a sharp drop in K-sector employment but also reduced the pace of K-sector capacity expansion (Calmfors 1979).

This structuralist perspective suggests that even in the period 1963-73 – which is usually regarded as part of the golden age of the Swedish model – the increase in real wages was incompatible with equilibrium levels of competitiveness and profitability. Although the cost crisis of the mid 70s clearly intensified the underlying structural problems, this was not the fundamental source of the severe stagnation in industrial output and economic growth that Sweden experienced in the late 70s. The cost crisis simply delivered the knockout blow, as it were, to a highly vulnerable Swedish industrial sector.

A Solution to the Puzzle

The structuralist analysis of trends in wage growth and international competitiveness appears to offer the most compelling interpretation of the effectiveness of the Swedish model in achieving a balanced development between wages and productivity. It also suggests a plausible solution to the puzzle noted above. In the short term, full employment could be maintained in the face of excessive wage increases due to a rapid elimination of x-inefficiency. As the scope for rationalization was gradually eliminated, K-sector employment fell quite rapidly, but this did not trigger a corresponding increase in unemployment. Indeed, even in the wake of the cost crisis, Swedish unemployment never rose above 3.5 percent.

This extraordinary record on unemployment is explained largely by the impact of massive government policy interventions. Among the most important were: (1) a substantial expansion in the use of active labor market policy; (2) industrial policy initiatives to shore up firms and sectors threatened by collapse and, perhaps most importantly; (3) an explosive increase in public sector employment. (See Deiaco and Murray in this volume on Swedish public sector expansion.)

3. What Went Wrong

As we have seen, the evidence suggests that the Swedish model proved incapable of limiting real wage gains to the margin compatible with stable profitability and international competitiveness. In one sense, this result is hardly surprising. Experience with incomes policies of all types have been generally disappointing throughout the European economies.

But the Swedish case is nevertheless unusual. A relatively small number of highly centralized unions represent the overwhelming majority of the Swedish workforce. Mancur Olson (1982) classifies such unions as "encompassing organizations". According to Olson, this type of organization differs in a key respect from more narrowly based collective interests. These organizations "not only have the incentive to at least consider the effect of its policies on the efficiency of the society, but also an incentive to bargain with other substantial organized groups in the interest of a more productive society".

Olson's claim is fully consistent with the readiness of Swedish labor unions to support institutional norms designed to increase economic efficiency and minimize the risk of excessive wage gains. Yet despite these unusually favorable organizational conditions, institutionalized wage restraint could not be maintained. What went wrong?

My preliminary answer is based on two general hypotheses, which are derived from my current research on the postwar evolution of the Swedish model. It suggests that the problems of the Swedish model can be traced first, to basic ambiguities in the institutional norms and second, to the breakdown of social consensus which supported these norms. These problems can be grouped in two main categories, which I will term "problems of interpretation" and "problems of enforcement".

Problems of Interpretation

The first problem of interpretation stemmed from the difficulties in defining "solidaristic". The original conception – equal pay for equal work – proved to be of limited value, due to intractable difficulties in establishing what actually constitutes "equal work". By the mid 1960's, solidaristic wage policy had acquired a second distinct meaning. In its new guise, it meant that overall wage dispersion should be substantially reduced, irrespective of differences in work requirements or worker qualifications (see Björklund in this volume).

Since the early 1970s, the concept has undergone a further transformation. "Solidaristic" has come increasingly to mean that wage settlements for any group of workers must apply to all workers. This implies that the relative wage structure, which is now characterized by an exceptional degree of wage compression, should not be altered in response to changing market conditions (Martin 1984).

What are the implications of this evolution in the interpretation of "solidaristic"? The central problem can be simply stated. The original balance between equity considerations and efficiency requirements has been altered in favor of the former. A compelling case can be made for the proposition that a policy of equal pay for equal work contributes to economic efficiency. But despite rhetoric to the contrary, a similar case cannot be made for these alternative interpretations of solidaristic wage policy. To the extent that it does not conform to changing market conditions, a sharp reduction in overall wage dispersion is likely to create serious problems of labor mismatches. And the "solidaristic" commitment to a preservation of such a wage structure prolongs and exacerbates the underlying problems.

The second "problem of interpretation" was in determining the sustainable level of real increases. We have already touched upon this problem in connection with the structuralist interpretation of Swedish wage formation. As we have seen, the EFO guidelines for regulating the distribution of wages and profits proved to be highly deceptive. Full employment and rapid aggregate productivity growth were interpreted, incorrectly, as indicators of wage moderation and economic stability. In the short term, each could be achieved despite an excessive growth in real wages and a persistent decline in competitiveness and profitability.

Problems of Enforcement

Closely related to these problems of interpretation were two problems of enforcement. A critical assumption in the Swedish model is that the norms regulating wage formation and structural change will be respected – or can be enforced – at the micro level. This has proven to be a dubious assumption. Local level actors – including labor unions, business firms, and regional governments – have often succeeded in circumventing the institutional norms of the Swedish model. High levels of local level "wage drift" have repeatedly contradicted the restraint exercised in centralized settlements; local opposition to rapid structural change has led to extensive political intervention in the entry and exit process.

Wage drift represents the portion of total wage increases that is achieved, not through centralized negotiations, but through subsequent local settlements at the level of individual firms and work establishments. It accounts on average for roughly half of total wage increases; in many years, it has far exceeded the centrally negotiated settlement.

A certain degree of wage drift is essential for economic efficiency, in order to adapt the centralized settlements to the highly diverse conditions at the micro level. Yet wage drift also introduces an unpredictable and potentially explosive element to Swedish wage formation. The Swedish model assigns to centralized representatives of LO and SAF the responsibility for ensuring a moderate rate of average real wage increases. But wage drift is a micro-level phenomenon, beyond the control of the central negotiators.

The most compelling explanation of wage drift is offered by Schager (Eliasson et al. 1985a). His recent labor market studies show that there is a direct relation between vacancy time and wage drift. The explanation is obvious: firms are forced to grant higher local level wage increases in times of relative labor shortages. What is thus far unexplained is why vacancy times – and wage drift – both increased sharply in the late 1960's.

Schager has himself suggested that the rise in vacancy times might plausibly be explained by the sharp drop in geographical mobility that also occurred at this time. In order to work as intended, the Swedish model requires that workers threatened by structural change are willing to accept an eventual job loss and are prepared to relocate in order to find a new job. What is needed, in other words, is a kind of geographically mobile reserve army of labor. If this reserve army is not available, wage drift cannot be sufficiently contained – and the centralized wage negotiations cannot be enforced.

The decline in the rate of geographical mobility was closely related to a second problem of enforcement – concerning the terms of structural adjustment. The Swedish model implicitly accepted market pressures as the final arbiter in determining the pace and direction of structural change. A broad social consensus on the benefits to be derived from free entry and exit formed a pivotal element in the model itself. This consensus extended originally to the "losers" in the adjustment process. Workers, firms, and regions that were displaced by structural change were expected to accept the verdict of the market – and not seek state protection from painful adjustment pressures.

This consensus was shattered in the late 1960's. Local level actors, alarmed by the accelerating pace of rationalization and the emergence of regional imbalances, began to actively challenge the institutional norms regulating the adjustment process. Unholy alliances – between unions, firms, and local government – emerged with a united demand for greater political control over entry and exit. The institutional norm supporting market-driven structural change came increasingly under attack.

Government responded with a variety of regional and industrial policy initiatives. Although the scope of policy intervention was initially quite limited, it expanded throughout the early 1970s and reached massive proportions towards the end of the decade (Carlsson 1983). These policy initiatives were invariably launched as programs designed to "pick the winners". The record indicates, however, that they have functioned primarily as a means to "bail out losers" (Eliasson and Ysander 1983).

Selective industrial policies did succeed, in combination with a rapid increase in public sector employment, in limiting the rise in unemployment. But this achievement extracted a high cost. Government intervention to protect stagnating firms and regions – and to provide alternative employment in public sector services – meant that the institutional norms regulating wag formation and structural change could no longer be strictly enforced.

In the "old" Swedish model, government assumed no direct responsibility for maintaining full employment or for controlling the pace and direction of structural change (Eliasson 1985b). Indeed, both the Rehn and EFO models implicitly accepted a certain degree of (short-term) unemployment as an unavoidable feature of a dynamic economy. An increase in unemployment served, moreover, as an essential market signal indicating that real wages might be out of line. By breaking this institutional norm and assuming direct responsibility for employment outcomes, government intervention policy not only contributed to a decline in labor market mobility, but also eliminated an essential market signal and sanction needed for the smooth functioning of the Swedish model.

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