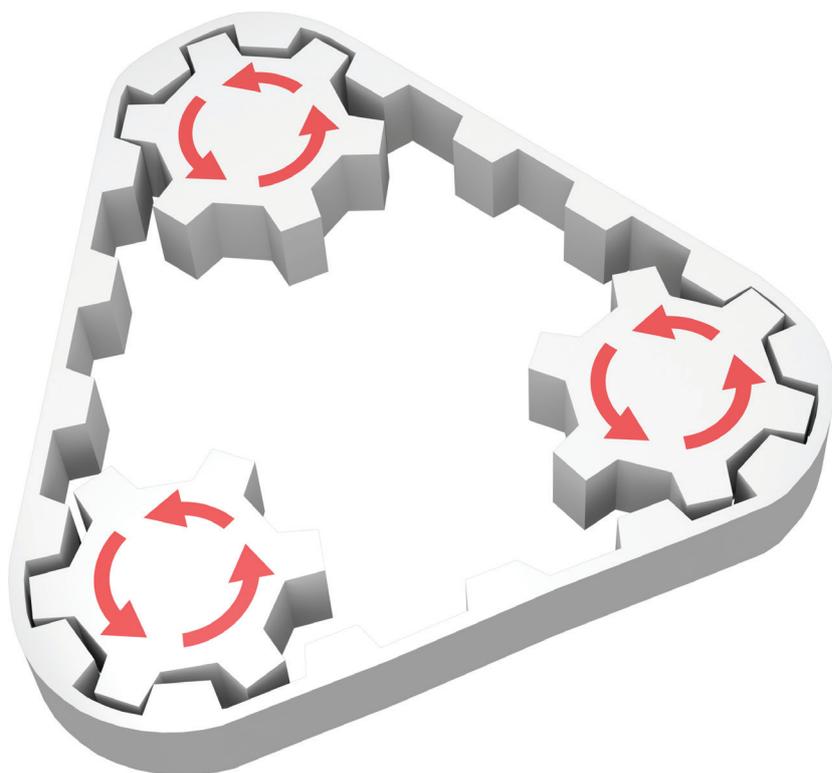




Juhana Vartiainen

To create and share

– the remarkable success
and contested future of
the Nordic Social-Democratic Model



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Preface

The Nordic countries share a number of distinguishing features. With their small economies, well-developed welfare states and organized labour markets, they have given rise to the concept of “the Nordic model”. This social model or models have occasionally been met with criticism: It has been claimed that they are characterized by over-inflated public sectors and excessive tax levels, as well as rigid labour markets caused by strong trade unions, comprehensive collective bargaining and regulations. In recent years the models have attracted positive global attention, since the Nordic countries have demonstrated good results in terms of growth, employment, gender equality, competitiveness, living conditions and egalitarianism when compared to other countries. This ability to combine efficiency and equality has spurred debate in politics as well as in social research.

The Nordic models are facing a host of new challenges, and cannot afford to rest on their laurels. The fallout from the financial crisis has entailed a stress test of Nordic institutions and traditional policy measures. External change in the form of increased global competition, climate problems, migration and European integration, interacting with internal change associated with an increasing, ageing and more diverse population, urbanization and rising expectations with regard to health services, education and welfare in general, will be a test of these models’ resilience. A core issue is whether the social actors will be able to encounter these challenges by renewing the institutions and policies without jeopardizing goals for a fair distribution, balanced growth, full employment and the political support for the models.

NordMod – Erosion or renewal in the Nordic countries 2014–2030?

NordMod2030 is a joint Nordic research project studying the impact that international and national development trends may have on the Nordic social models. The purpose of the project is to identify and discuss the risks and challenges that these countries will need to cope with in the years up to 2030. The project’s goal is thus to produce knowledge that can serve as a basis for designing strategies for reinforcing and renewing the Nordic social models.

The main report from the project will be submitted in November 2014. Until then, a number of sub-reports will be published and open seminars will be arranged in all the Nordic countries. The sub-reports will present specific analyses of selected topics, while the main report will incorporate all the findings and draw the main conclusions. All activities will be posted on the project’s website: www.nordmod2030.org.

- The first sub-reports describe the fundamental pillars of the Nordic models, challenges associated with future demographic change, changes in tax policies and how globalization affects the frameworks of the models. The goal is to analyse external and internal forces of change in the models.
- Country studies are undertaken in each of the five countries to describe development trends from 1990 to 2013. These country reports present analyses of changes in financial, social and political indicators associated with key objectives, institutions, policies and social outcomes in the national context. The country reports also provide input to the analysis of challenges facing the models in each of the countries.

- Finally, a series of thematic reports will be prepared on the basis of Nordic comparisons in the areas of integration, welfare state policies, the future of the collective bargaining model, climate challenges and democracy/participation. The discussion of issues related to gender equality will be integrated into all the reports.

Nordic research group

The research project will be undertaken by a Nordic research group consisting of two representatives from each country and is headed by Fafo. The paired researchers from the different countries will be responsible for the country studies, and will provide input to the design of the other country reports. Several researchers will also contribute to the other sub-reports.

Denmark: Lisbeth Pedersen (Research Director, SFI – The Danish National Centre for Social Research), Søren Kaj Andersen (Head of Centre, FAOS, Copenhagen University) and Christian Lyhne Ibsen (researcher, PhD, FAOS).

Finland: Olli Kangas (Professor, Director, Kela – The Social Insurance Institution of Finland) and Antti Saloniemi (Professor, University of Tampere).

Iceland: Katrín Ólafsdóttir (Assistant Professor, Reykjavik University) and Stefán Ólafsson (Professor, University of Iceland).

Norway: Jon M. Hippe (Managing Director, Fafo), Tone Fløtten (Managing Director, Fafo Institute for Labour and Social Research), Jon Erik Dølvik (Senior Researcher, Fafo), Bård Jordfald (Researcher, Fafo).

Sweden: Ingrid Esser (Assistant Professor, SOFI, Stockholm University) and Thomas Berglund (Associate Professor, University of Gothenburg).

In addition to this core group, other researchers will also contribute to some of the subreports: Richard B. Freeman (NBER, Harvard), Juhana Vartiainen (VATT), Jan Fagerberg (UiO), Line Eldring (Fafo), Anne Britt Djuve (Fafo), Anne Skevik Grødem (Fafo), Anna Hagen Tønder (Fafo), Johan Christensen (EU European University Institute (EUI), Florence), and others.

Project organization

The project has been commissioned by SAMAK – the cooperation forum for the Nordic trade union organizations and the Nordic social democratic parties. For the duration of the project period, SAMAK has also entered into a cooperation agreement with FEPS (Foundation for European Progressive Studies) concerning contributory funding. The commissioning agent (SAMAK) has appointed a reference group consisting of two resource persons from each of the Nordic countries. Although the reference group may provide input, the authors are solely responsible for the project reports. This means that SAMAK as an institution or the members of the reference group have no responsibility for the content of individual reports.

Oslo, April 2013
Jon M. Hippe
Project Director

1. Introduction¹

The idealized Nordic economic model is based on combining the benefits of openness and the market economy with the risk sharing mechanisms of the welfare state and labor markets regulated by collective agreements. This combination is not only a juxtaposition of two independent ingredients, but, instead, a whole in which the “market” part and the “social” part reinforce each other. As I emphasize below, many Nordic institutions and policy innovations can be and have been motivated by social objectives, but have also been remarkably well aligned with market-driven innovation, efficient mobilization of resources and economic growth. This argument goes for supply side policies like female labour market participation and the provision of human capital, as well as wage formation schemes that favour creative destruction and reduce local rent-seeking and thereby create appropriate incentives for innovation and growth. It also applies to social security and active labour market policies that make structural change and the associated personal risks palatable for the individuals and thereby even voters and trade union members. We shall elaborate on many of these themes below.

In the recent years, this “model” has attracted notable positive attention at least among economists and economic commentators.² During the Cold War years, there was less room for nuances between the competing solutions of liberal democracy and communism. In the Cold War discourse of Atlantic liberalism, a country like Sweden often served as a scary example of a half way post on the way to Communism, whereas for old-style Communists it represented class betrayal. The bipolar ideological conflict of the Cold War nurtured an ideology according to which the “market” and the “social” were seen as inherently inimical, or as two competing forces within a given political space. It is only more recently, in the more complex ideological environment of post-Communism, that the idea of capitalistic and Social Democratic values being reconcilable but perhaps even mutually reinforcing with each other has gained some acceptance.

Many of the more recent positive economic assessments of Nordic economic models are based on the observation that the Nordic countries are quite market-oriented societies, too, besides

¹ Paper prepared for the NordMod 2030 – ”Skape og Dele”-project. I am deeply grateful to Jon Erik Dølvik for perceptive comments and suggestions that have considerably improved the paper, and very grateful to Mika Maliranta who kindly provided me with the data from his recent comparative paper on productivity (Maliranta 2014).

² See Andersen, Honkapohja, Korkman, Söderström, Vartiainen (2007) and The Economist, special survey, February 1st, 2013.

topping international rankings of human development, equality and social justice.³ Product market regulation is liberal and protectionism has never been a potent political force. The Nordic economies are open ones and have not shied away from exploiting the global division of labour. On international forums, they usually are proponents of free trade and economic liberalism. Furthermore, they have since the crisis of the 1990s organized their macroeconomic policy pretty much according to the neoclassical orthodoxy: monetary credibility through commitment as well as long term fiscal rules. Through coordinated systems of collective bargaining, the Nordic pay structure has been more akin to the outcome predicted by classical textbooks than the pay structure seen in the liberal American labor market, i.e. that equal work is rewarded by equal pay, as enshrined in the theorem that labor is remunerated according to its marginal productivity.⁴

Thus, despite the fact that the Nordic economies are embedded in extensive and regulatory labour and welfare regimes, their functioning in many respects conforms better to the tenets of orthodox new classical economics than most other capitalist economies, possibly including the US.

Focusing on the capability of the Nordic economies to combine economic and social policies that contribute both to wealth and equality, this paper presents an economic interpretation and a historical description of why this happy development has been possible. Furthermore, it makes an attempt to identify the most important difficulties and “challenges” on the road ahead. In my view, the Nordic model is basically fine but its eventual problems have entirely to do with the model’s internal political viability.

Seen through the lens of economics and rational decision theory, the Nordic solution does indeed appear very attractive. It may seem as if the institutions of the Nordic economies have enabled these societies to resolve many of the tradeoffs and collective action problems inherent in market economies.

- They have been able to use the global market economy and the international division of labour, so that they all now belong to the group of wealthiest countries in the world. They have adapted to the market economy and not tried to work against it.
- This material success has been combined with a comparatively high degree of equality, due to a social ability to share the risks and redistribute the material returns that the

³ In another paper prepared for this project, Richard Freeman (2013) notes how the Nordic economic success is used in the US context by both Conservative and Liberal commentators.

⁴ An early paper establishing this pattern was by Holmlund and Zetterberg (1991). Freeman (2013) refers to an upcoming paper by Barth, Bryson, Davis and Freeman which points out the large dispersion of earnings in the US economy, not accounted for by observed productivity-related variables.

participation in the global market generates. This has even sustained the legitimacy of the market economy and a strong work ethic.

- A successful participation in the global economy presupposes public resources as well as industrial relations that are devoted to increasing and cultivating the nation's human capital. The supply of skills has not been left to the market alone.
- Industrial relations have reflected a willingness to work together, at the local micro level, within industries and even at the macroeconomic level. Labour market institutions have institutionalized conflict resolution and, at the local level in firms, created conditions in which both parties have strong incentives to improve productivity instead of investing resources in rent-seeking.

We shall elaborate on these Nordic “success” factors below. However, the main point of the paper is critical and questioning. In spite of these overwhelming accomplishments, there is in my view no automatic causal chain that would ensure that this success will continue. The mere fact that some institutions seem to be very successful – in the eyes of economists and social scientists in particular – does not *per se* imply that the political support for their further existence will persist.

In a nutshell, the argument of this paper is that the political values and aspirations that originally underpinned the evolution of the Nordic labor and welfare regimes often run into conflict with the policies required to ensure their viability in an era of global factor markets, aging societies and mass migration. In a similar vein, this paper argues that the changing environment and pressures for adjustment of the Nordic economies represent particular challenges and dilemmas to the political forces that see themselves as the true guardians of the Nordic model, that is, the labour movement in particular.

Thus, I will argue that the big challenges of the “model” are internal, and have little to do with the usual suspects of external “challenges” like globalization or the loss of manufacturing occupations. Instead, they are mainly related to the political capacity to realign the welfare systems with the changing population structure and sufficiently flexible labor markets. These core arguments of the paper are in Section 5, “The political disconnect”.

Often, the Nordic welfare regimes are seen as “challenged” by phenomena like rapid structural change and an increasing mobility of all factors of production, creating more inequality. In my view, the very emergence of Nordic labour and welfare regimes is due to such pressures. It is precisely because of increasing openness and the volatility due to structural change that the Nordic institutions have emerged and evolved. All such factors and trends potentially allow for a more efficient allocation of resources and thereby a higher level of material welfare. At the same time, they also increase the risks and uncertainties that individual economic agents will be exposed to. The Nordic model is precisely an attempt to socialize and cushion those risks. It would therefore be very irrational indeed for Nordic political systems to dismantle those welfare

institutions when they are most needed. Thus, ultimately, I believe the social call for Nordic welfare systems will be reinforced, provided their political systems can sustain collectively rational outcomes. That latter condition, however, can be far more demanding.

2. The Nordic deal

The evolution of the Nordic model of economic and social policy has been thoroughly described and analysed by political scientists, sociologists and economists and there is no point in repeating all that scholarship here.⁵ Let me just borrow and adapt a recent characterization, by the Norwegian scholar Jon Erik Dølvik, of the three main pillars of the Nordic welfare state and labor market model:⁶

- A strong and active State with an agenda of advancing international free trade and co-operation with the social partners, as well as an economic policy aiming at full employment and improvement of working conditions and living standards.
- A broad spectrum of welfare and social insurance mechanisms that shield the individual from loss of income, ensure minimum standards in employment relationships and promote a high labor market participation rate, as well as a public provision of services like education and other social services that promote equal living conditions as well as female labor market participation
- A regulated labor market based on both laws and collective bargains; strong labor market organizations bargaining on equal footing to facilitate local wage bargaining aligned with macroeconomic responsibility and the needs of the internationally competitive export industries; as well as a well-endowed active labor market policy that focuses on activating individuals and supporting skill formation and retraining in the face of structural transformations.

Dølvik's characterization is a positive and idealized one, in the sense that it represents what Nordic societies achieve and should achieve at their best. Yet it is not so far remote from reality either. The challenge is to maintain the viability of these three elements even in the face of shifting political loyalties and value systems. I shall return to this question in section 5.

Experimenting and learning to live with the market

The Nordic model is often described as a set of specific policies, such as high taxation, provision of public services, centralized wage settlements and extensive social insurance. In my view, a deeper understanding of the Nordic model should interpret all such policies as contingent reflections of a deeper political objective: to create value and to share risks. The specific policies

⁵ A recent account of the Nordic models, with some fresh insights about the role of economic expertise, is to be found in the special issue of *Comparative Social Research*, "The Nordic Varieties of Capitalism", Emerald Books 2012. Another broad review of the main features and evolution of the Nordic models in is found in Dølvik (2013)

⁶ See Dølvik (2013). The translation is my own adaptation, not completely word-to-word.

adopted have at different times reflected different circumstances and economic and political strategies. Thus, to take an example, wage setting has in Sweden, Norway and Denmark evolved from formal centralization of pay increases to more market-friendly modes of coordinated wage setting, yet both phases can be seen as rational adaptations to the circumstances of their day, with an underlying commitment to sustain full employment, decent remuneration and working conditions as well as macroeconomic labour market flexibility.

The Nordics have boldly used the international division of labour to their advantage. They have never been protectionists and they have always embraced technological progress. However, they have also been egalitarian societies with strong social capital, embodied in mass political parties as well as popular movements that arose during the 19th century. This has led to a strong political will to use democratic politics to share the fruits of economic growth equitably and to share the risks inherent in participating in global capitalism.

The practical implementations have reflected both the “hard” need to thrive in global capitalism and the need to create a moral and political legitimacy for economic policy and labor market arrangements. Political acceptability has been important, but so have economic realism, macroeconomic stability and incentive compatibility.

This point is sometimes lost, in particular with respect to the innovative political initiatives of Swedish Social Democracy. The “same pay for same work” or “Rehn & Meidner” policy launched by the Swedish LO in 1950s was not primarily an expression of redistributive political aspirations. Instead, it was a practical political solution to the dilemma of maintaining both full employment and price stability in a situation of scarce productive resources. When the economy operates near full employment, as the situation was in postwar Sweden, a further expansion of the economy by fiscal policy creates bottlenecks and inflationary pressures in some firms in which profitability is good and the workers use their local bargaining power to increase their wages in local negotiations. As this jeopardizes price stability, the brilliant trade union economists Gösta Rehn and Rudolf Meidner emphasized the need for prudent fiscal and wage policies, coupled with uniform pay increases and a centrally stipulated peace clause. Thus, local rent seeking would be discouraged while uniform wage increases would enhance the process of creative destruction and productivity growth. Therefore the “equal pay for equal work” slogan was primarily an attempt to make this centrally agreed wage moderation politically legitimate, so that macroeconomic stability and economic growth would not be jeopardized by inflation and rent seeking.

In a similar vein, the famous wage earner fund project was an attempt to make the idea of profits more palatable to workers – and it was in fact a kind of logical next step after the Rehn & Meidner wage model. The collectively stipulated uniform wage increases and the abolition of local conflicts of course boosted profits in those firms in which productivity growth was above average. High profitability, however, can be necessary to create incentives – and, in the time of

credit rationing before the 1980s, even the liquid cash flow – for investment, and taxes on profits must for the same reason not be too high. Thus, those profits would serve a purpose, inasmuch as they would be used for new investment and innovation. But, so went the idea of Rudolf Meidner who proposed the wage earner funds, the worker must feel that these profits will be useful for him and not only the “capitalist” owner. Then the idea of funds that would gradually ‘socialize’ the capital stock of the nation was a logical conclusion.⁷ The profits would be at least indirectly appropriated by the worker, in the form of future higher wages and tax incomes, and the latch put on local strikes would appear less exorbitant.

The specific political driving force for this democratic reform project was Social Democracy, which at some point in time achieved a remarkable political hegemony in all the main Nordic countries save Finland and Iceland.⁸ This position of strength had both an electoral leg and a trade union one. It also sustained an attitude of social planning and macroeconomic responsibility. Thus, the Nordic working class fairly soon embraced parliamentary democracy and the labour movement used it to start the evolution of a universalistic welfare state. Nordic Social Democracy wanted to assume responsibility for society and economy as an entirety.

Trade unions and employers working for the common good

We mentioned the Rehn-Meidner argument according to which local rent seeking should be discouraged and uniform wage increases would enhance productivity growth. This was an intellectual idea, promoted by two creative and reformist thinkers, but it found a very fertile ground in the trade unions and Social Democratic politics. Nowadays, we take for granted that Nordic unions pay attention not only to their own sector and the concerns of their members in individual firms, but such a universalist orientation was a remarkable evolution in the Nordic trade unions, after the initial “Saltsjöbaden” type agreements of the 1930s.

For the trade unions, in the 1950s, this implied a willingness to look for solutions that ensured macroeconomic stability and high overall employment, instead of syndicalist aspirations of local dominance at the plant level.⁹ Although superficial accounts of Nordic industrial relations give a

⁷ The funds never came to pass since they incited a huge political opposition. In my view, they would have been the outer post of Socialism as achieved by democratic means, and, in this sense, they marked the upper limit of what Swedish Social Democracy could achieve. In the broad history of political ideas, it is a historical pity that this experiment of Democratic Socialism was not carried out. On the other hand, it is an irony that Nordic pension funds nowadays do control sizeable bits of the capital stocks of these countries (and even the global capital stock), and, in this sense, the Nordic worker does through her or his pension assets have a stake in the economy's capital.

⁸ In Finland, the agrarian based Center Party has been an approximately equally powerful partner in the buildup of the welfare state.

⁹ This well-known point was forcefully and early made by the French sociologist Gilles Martinet (1979).

lot of attention to the rise and fall of formally “centralized” wage bargaining, this more fundamental and responsible characteristic of Nordic collective agreements – imposing a peace clause from outside the firm and thereby ensuring proper incentives to invest and enhance productivity – has received a lot less attention.¹⁰

Even this part of the “model” can be motivated as an institution completely aligned with economic growth. Since collective agreements always rule out local industrial action, there was a strong incentive for the local labour market parties to engage in activities which improved productivity – instead of local rent seeking via a stronger bargaining position.¹¹ In the Norwegian context, there has even been talk of an explicit “micro model” for enhancing productivity. But this idea of creative destruction motivated even other initiatives in the labour market. In Sweden, the introduction of the Rehn & Meidner wage model subsequently prompted the Swedish government, in the 1960s, into creating a network of training centers and introducing schemes that subsidized the professional and occupational mobility of workers who would lose their jobs.

Using the political system for reforms, not revolution

For the political wing of the labour movement, it was natural to embrace universalism in a time in which the working class had achieved a natural electoral majority. Although Nordic Social Democracy chose the reformist way instead of an eschatological revolution, the Marxist spirit of a global and universal working class was a natural source of inspiration that underpinned a universalistic attitude towards the welfare state. Social Democracy represented the “people”, a majority of citizens as well as the coming generations. From early on, there was in the Nordic Social Democracy an idea of a fair society, with an emphasis on both “do your duty” and “demand your right”. Associated with this, there was a strong working line legacy in the early income security arrangements of the labour movement and the post-war welfare state. This was a far cry from any Utopianism or cult of leisure. As Dølvik (2013, p. 65) emphasizes, the idea was to equip the worker with skills and energies so that he (and later she) could participate productively in the labour market.

Historians and social scientists have traced the historical roots of the strong civil societies in the Nordic countries to the absence of serfdom and the emergence, in the 19th century, of large popular movements: the temperance movement, the sports movements, the various confessional Christian churches, and, of course the labour movement that gathered strength

¹⁰ In Vartiainen (2012), I present a sketch of the economics of Nordic collective agreements from this perspective.

¹¹ See the discussion of the microfoundations Nordic industrial relations in Dølvik (2013) and, for Norway in particular, Hernes (2006).

from the turn of the century onwards.¹² With hindsight, the Nordic Social Democratic reformism was a successful way of canalizing the aspirations of the working class towards reforming society instead of violent revolution.

The ingredients of this Social Democratic success recipe are quite well researched. They include a set of social policies such as sickness and unemployment insurance, maternity leave as well as old age and disability pensions. Another crucial element has been the public provision of health care and broad investment in education and skill formation, together with a socially motivated and democratic zoning and urban planning (see Dølvik 2013).

In the labour market, strong unions have used their power to shield the workers from the most extreme implications of competition, so that wages would not be bid down by competition between workers even when labour has been abundant. Instead, pay increases would be determined in centralized bargains, including task-specific minimum wages.

This has been complemented by a strong tier of peaceful company bargaining and cooperation focused on productivity and restructuring (see Andersen, Dølvik and Lyhne Ibsen 2014).¹³ Thus, an important but often overlooked aspect of the Nordic original deal was the emphasis laid on collective investment in boosting the supply of skills and labour. Contrary to many other western societies, the Nordics did not leave the supply side of the labour market to the market forces but pursued an active policy to mobilize labour by means of broad education, and social arrangements that facilitated participation in the labour market (see Dølvik 2013). In Norway, this took the form of local plant-level cooperation, facilitated by many local collective agreements at the company (see Hernes 2006).

In Sweden, this was explicitly linked to the Rehn-Meidner-argument: creative destruction would create unemployment in those firms and sectors that would not be able to keep pace with the average rate of labour productivity growth. Hence, it would be logical to create a network of active labour market policy services that would help workers to move to new occupations and even change geographical location. Indeed, from the 1960s onwards, such a network was created in Sweden (see Vartiainen 2012).

In the 1960s and 1970s, the universalistic attitude found another useful outlet in the empowerment of women and the mobilization of women into the labour force by means of social investment in child-care. This of course provided one more resource for economic growth, and at the same time fitted perfectly with the universalistic idea that women must become independent economic citizens with their own careers and sources of income.

¹² See Dølvik (2013), Alapuro and Stenius (2010) and Kettunen (2012).

¹³ Of course, all the Nordic countries are not identical in respect. The emphasis on local bargaining has been strong in Norway and weaker in e.g. Finland.

Experimenting and learning from mistakes and successes

As noted above, it is best to understand the Nordic model as a continuous quest for policies that lead to economic well-being, equality and the socialization of risks. This implies an attitude of political and social experiments and innovations. The solutions that were tried at some point in time need not work at a later stage. Also, it is important to learn from successes and mistakes.

Sweden in particular stands out as an experimenter. It was the first to explicitly introduce the “equal pay for equal work” idea as explained above. In the 1960s, this idea morphed into a more radical attempt to use the wage system as an instrument for redistribution, by letting wage increases for low wage groups systematically exceed those of high pay groups. This eventually led to acrimonious conflicts between the blue collar unions and the white collar and professional ones as well as a near collapse of centralized pay moderation (see Dølvik and Vartiainen 2002). This policy was abandoned, and later on even reversed, as Swedish wage setting eventually evolved into a direction of more decentralized and even individual wage setting within the confines of coordinated collective agreements bargained at the sector level. Similar developments could be seen in Norway and Denmark in the 1970s and 1980s, although with less dramatic turns of events (Andersen & al.2014).

The radical redistributive phase was a politically ambitious way of creating a more equitable distribution of income, in a time when all the redistributive mechanisms of the state were not yet in place. With hindsight, we can say that the state’s tax and social security mechanisms provide a far more efficient toolkit for implementing economic redistribution than a direct intervention into the wage process. However, the wage radicalism of the 1960s and 1970s was in its own time a perfectly rational attempt at a more direct regulation of wage distribution. The wage earner funds, described above, were another bold initiative.

During the 1990s and 2000s, Sweden, Denmark and Norway have gone on with institutional innovations in the wage bargaining institutions. Centralized wage setting has been replaced with pattern bargaining with a pay increase norm set by the manufacturing industry. In Sweden, collective agreements still rule the average pace of wage increases but allow much more room for company incentive systems and individualized pay setting within firms. In Denmark and Norway, collective agreements increasingly only stipulate minimum pay within occupational categories, leaving more freedom for negotiated adjustment and firm-specific personnel policies at company level (see Vartiainen 2012 for a description of Nordic collective agreements).

During the last 15 years or so, the Swedish experimenting zeal has been evident in many market-oriented innovations in the public sector. The dominant “Zeitgeist” being more market-friendly, such innovations nowadays concern outsourcing and privatization of schooling and health services. Swedes have allowed “free schools”, that is private schools that are entitled to a public subsidy. Furthermore, private provision of elderly care has been extensively tried as well. Evaluation studies are conducted and a debate rages on about the effects of such reforms. Some

of them will in due course probably be reversed. Yet this is one more example of the attitude of experimenting, which in the 1970s almost led to public ownership of capital assets and which now, in an era of economic liberalism, is expressed in privatization initiatives.

Intellectual optimism

Another, related characteristic of Nordic Social-Democratic “social engineering” has been an intellectual optimism, an attitude of positive curiosity towards the current economic expertise of each period. Even this was quite clear in Sweden, where the Keynesianism of economists like Bent Hansen from the 1940s onwards found a natural political agent in social democracy. But it was also visible in Norway, where the work of a great academic economist like Leif Johansen contributed to practical ideas of stabilization and economic planning. Social Democracy advanced its policies through committee reports, an ingenious institution where top academics and civil servants combined the current expertise in economic and social matters.

This scholarship-friendly approach has also been evident in the design of macroeconomic policy frameworks. Monetary policy has after the disastrous and uncoordinated deregulations of the 1980s been tied to the mast everywhere, and the Nordic countries were among the first to create such policy frameworks. The fact that they differ from each other is of less importance here.¹⁴ The same goes for fiscal policy, for which the Nordic countries have created rules and commitments that limit the government’s yearly discretion. Again, Sweden has perhaps adopted the most scholarly strict approach here, with a public sector surplus target agreed by the entire Riksdag (the Swedish Parliament) in 2000. In Denmark, a balanced budget target was adopted as early as 1992, but later targets were influenced by a more populist brunt, including commitments not to raise some specific taxes. Finland Denmark and Sweden are as of now bound by the European Community’s revised and sharpened fiscal frameworks like the EU “Sixpack”, and Finland as a euro member even by the sharper “Twopack” procedures. Norway has of course a politically particularly demanding policy environment, since the blessing of offshore oil and gas revenues also creates huge incentives for short-term political populism. So far, Norway has been quite successful in operating its budget rule that states that the “non-oil” structural deficit of the central government should equal the long-run real return of the Global Oil-based Government Pension Fund, assumed to be 4 percent per annum.

The scholarship-friendly approach is not limited to fiscal and monetary policy but has at times embraced even the development of wage setting and the links between wage formation and

¹⁴ Finland is an EMU founding member while Sweden and Norway let independent central banks operate inflation targeting. Denmark has an independent central bank, too, but its policy regime is based on pegging the krone to the euro, something that amounts to a kind of halfway house in the way to the monetary union. The odd man out is Iceland which up to the financial crisis of 2007 failed to establish any such framework around macro-economic policies, leading to wild oscillations and high inflation, culminating in the financial adventures and a financial bubble that burst in the 2000s (see Olafsson 2011)

macroeconomic policy. A fine example of this is provided by the Norwegian tradition of setting up tripartite committees, including representatives of social partners and leading academics as well as politicians. In the last twenty years, such committees have come forward with proposals and the proper design of wage bargaining institutions that would align pay policies with macroeconomic responsibility and micro flexibility at the local level.¹⁵

This scholarship-friendly reliance on current economic expertise is worth pointing out, since the tension between current Social Democratic politics and the now hegemonic labour-supply-cum-ruled-based-macro-policy economic orthodoxy turns out to be a potential point of friction that today mars the power aspirations of Nordic Social Democrats.

Industrial structures and policies have varied

In the Nordic national discourses, the path-specific industrial structures and innovation strategies loom large. The success of one's own economy is seen in terms of successful business strategies and industrial structures. Thus, Finns like to attribute their economic success to forests, metal industries and electronics, whereas Swedes praise their old and well established manufacturing firms as well as newer logistical and retailing operations like IKEA and H&M. Denmark has its flora of small firms, successful farmers and shipping and logistics companies. Norway traditionally relied on energy, fishing and shipping, but offshore oil and gas extraction as well as aquaculture have become new pillars of economic well-being.

Thus, seen as whole, the industrial structures and the specialisation patterns of the Nordic countries have differed considerably. In my view, the economic policy models have been less crucial in determining these specific industrial configurations. All the Nordic countries have been well managed and growth-oriented market economies, and it should not be surprising that they have succeeded in exploiting their endowments and comparative advantages.

There are clear differences as to the degree of state activism, though. Finland and Norway historically stand out for more state planning and selective and direct interventions of industrial policy¹⁶, whereas Sweden and Denmark have relied more on spontaneous market processes as drivers of modernization and industrial development. Finland in particular has clearly profited from an activist developmental State that together with banks and business corporations fostered capital accumulation in the manufacturing sector during the crucial Cold War years.

¹⁵ The first one, the so called "Kleppeutvalget", proposed what became the so-called "solidarity alternative". Subsequently, several commissions headed by the professor Steinar Holden proposed appropriate wage bargaining procedures to combine macro responsibility with micro flexibility. See NOU 1992: 26, NOU 2000: 21 and NOU 2013: 13.

¹⁶ See Vartiainen (1999 and 2012) for an analysis of the Finnish developmental state and Mjøset and Cappelen (2012) for the Norwegian development model.

This has slowly morphed into an active policy of innovation, so that Finland's GDP share of R&D activities now is the highest among EU countries (see Fagerberg & Fosaas 2014).

However, all Nordic countries have implemented policies to support innovation activities, although this has been particularly pronounced in Finland and Sweden and less so in Norway.¹⁷ When compared to other European countries, the Nordic innovation systems stand out for resources and capabilities. All except Norway boast R&D in GDP shares on top of the European league, all have a well- educated workforce and, for example, all lead the way in Europe as to the share of people who use the internet (Fagerberg & Fosaas 2014).

All have also been highly reliant on international trade. Denmark has been an economy of small and medium size entrepreneurship, with a strong food-industrial complex, pharmaceutical industry, shipping, renewable energy and energy-saving products and numerous niche products.¹⁸ It is also a net exporter of oil. Sweden and Finland have relied more on exports by large and technologically advanced companies. Sweden is famous for its old multinational companies in transport vehicles, machinery, electronics, pulp and paper as well as pharmaceuticals. Up to the WWII, Finland was dependent on forest industries but it could from the 1950s onwards develop sizable metal and chemical industries, too. In the 1990s, thanks to the pull of Nokia, it also became a European champion in electronics. Norway remains reliant on exports based on natural resources and cheap hydro-power, fisheries and shipping, but has become a leading global energy supplier with an advanced offshore industry and has developed a fast growing aquaculture industry.

In my view, this diversity serves to underscore one key point: the Nordic success does not really depend on any specific industrial configuration. If these countries have really focused on investment incentives, human capital, responsible industrial relations and sound macro policies, they would probably have prospered even if their "natural" resources bases and geographical locations had been less advantageous.¹⁹

By the same token, successful and globally integrated economies like the Nordic ones need not unduly worry about the specific industrial configuration that lies ahead. Global market forces, coupled with market-friendly economic policies, will in due course squeeze these economies into

¹⁷ See Fagerberg and Fosaas (2014).

¹⁸ See Dølvik, Goul Andersen and Vartiainen (2014).

¹⁹ A similar argument is made by Hayek (1960), who points out that we too simplistically attribute the industrial revolution to specific technical innovations, and tend to neglect the role of appropriate social and political institutions that both encouraged innovation and were conducive to their successful commercial diffusion.

a pattern of specialization that fits their comparative advantages. Or so would at least a neoclassical economist believe.

3. The divine coincidence of Socialism and Capitalism

In short, the Nordic labour movement has wanted to transform society in order to create economic well-being for everybody, by using institutions that were morally and politically acceptable for the worker and the common man but have also sustained a successful participation in the global division of labour.

The remarkable thing about the resulting outcome is that it was, in spite of its Socialist labels, so well aligned with the logic of a thriving market economy as well as with capital accumulation. The Nordics have been successful capitalisms as well as Socialist welfare states, both at the same time.

This section takes a repeated look at the Nordic policies, but this time from another perspective: that of neoclassical economics and growth theory. The idea is that the Nordic policy innovations that were motivated by ideals of equality, shielding individuals from risks, and getting workers their share of the pie, also seem to score very well if the aim is to create rapid economic growth and an efficient market economy.

Social security substitutes for missing markets

In the light of modern welfare economics, it is possible to interpret social security as a rational arrangement that maximizes the well-being of individuals. The key is the combination of openness and risk sharing. The global division of labour is a huge source of wealth for small nations able to build a decent educational system and an initial industrial base. However, it is also a huge source of uncertainty. Global markets are volatile and create a lot of individual risks. There are no insurance markets for all uncertainty that individuals would like to get protection against. Insurance against unemployment and prolonged unemployment will not come forth in a competitive market, nor will everybody get private health insurance. A private school system will easily lead to segregation and a child cannot buy insurance against having poor parents or being borne in a wretched neighbourhood. These arguments are well researched, and there is broad economist opinion, at least in Europe, supporting social security and public provision of health and education services.

In a more fundamental sense, income redistribution insures the individual against the bad luck of having drawn a poor lot as to genes and parenting environment. Here, one can invoke a simplified Rawlsian argument: looking from behind a veil of ignorance about which person in society he/she will be, a rational and risk-averse person would choose a society of equality and income redistribution.

Making structural change possible as well as attractive

In addition to the timeless argument about the rationality of social security and redistribution, the Nordic model's success has depended on being conducive to economic growth and structural change. This happy coincidence has many aspects. The Rehn & Meidner idea of equal pay for equal work – which in practice mostly amounted to uniform pay increases across sectors, firms and occupations – is in complete harmony with the idea of efficient pricing of labour and the purpose of enhancing economic growth via creative destruction. The uniform wage increases would wipe out inefficient firms and create extra profits in the more efficient ones, allowing them to expand and ensuring a high level of investment. This was not just an empty theoretical notion. It has been shown that productivity growth was indeed in the 1950s and the 1960s boosted by the application of the Rehn & Meidner principle.²⁰ The same mechanism has been consistently important in the other Nordic countries. A pronounced example of productivity growth through creative destruction was Finland's remarkable recovery, centred on the ICT sector, after the slump of 1991—1993.

Even this mechanism can be linked with sophisticated mechanisms suggested in economic theory. The Dutch economists Coen Teulings and Joop Hartog (1998) have shown how a delegation of wage bargaining to higher level organizations is an optimal institution in an environment in which organized local labour market parties are often subject to macroeconomic shocks. Then a collectively agreed wage increase and industrial peace can make the aggregate wage system more flexible, without destroying the local incentives for investment. Without collectively agreed pay increases and a peace clause, the firm would not know whether its productivity-enhancing investments would in turn lead to additional wage claims (rent extraction) by the local unions.

Such mechanisms may be less important in today's globalized world in which even individual functions within a firm can be outsourced and the wage growth of individual industries is perhaps not such a key target variable as in a less internationally mobile world. However, there is no reason to think that these basic pillars of the Nordic wage model – centrally agreed peace, national co-ordination of average pay increases – would become obsolete.

In addition to this very specific mechanism, the growth-friendly pact was completed with supply-side oriented active labour market policies that encouraged mobility and mobilization of labour and skills. Again, Sweden was the prime example of this. In the 1960s, simultaneously with the application of the Rehn & Meidner model, the Swedish government developed a network of training centres and started subsidizing the moving expenses of migrant workers. Active labour market policies eventually became characteristic for all the Nordic countries. As of now, it is Denmark which stands out with a ratio of active labour market policy expenses to

²⁰ See Hibbs and Locking (2000).

GDP of 2.3 per cent, more than double that of Finland and Sweden.²¹ Hence, public strategies to develop and adjust the supply of labour and skills have been a longstanding feature of the Nordic models. Such policies were reinvigorated under Social Democratic -led governments in the 1990s, but faced with new challenges in the wake of the eastward enlargement of the labour market in 2004/7 and the subsequent euro-crisis the design and effectiveness of such policies have become more politically contested in recent years.²²

Finally, even this argument can be seen as a rather general one. Structural change creates ex ante uncertainty, since no one can really foresee the allocation of resources and incomes that economic growth entails. The existence of a government willing to redistribute gains and invest in the workforce amounts to a policy insurance even with respect to the effects of major structural changes.²³

Political support of open markets

The third pillar of this divine coincidence is the feedback loop from the redistribution of risks to the political support of openness, globalization and market forces. The very fact that risks were shared and the fruits of the global division of labour were redistributed, contributed to the political support of further openness. This created a virtuous circle, so that the Nordic countries have not succumbed to anti-technological and conservative industrial policies that support sunset industries and not to protectionism either. As Korkman & al. (2007) write,

“The Nordics have been embracing both globalization and the welfare state, and we argue that the security offered by collective mechanisms for sharing risks has been instrumental in enhancing a favourable attitude to globalization and competition. This key characteristic of the model must be preserved – in order to maintain an economic and social climate which is conducive to future welfare and growth.”

Thus, the social acceptability of the Nordic solution can also function as an insurance against dysfunctional and populist economic policies. In my view, the protectionist tones of current US politics and the support for ailing industries are fuelled by increasing inequality and the shabbiness of social safety nets.²⁴

²¹ http://www.oecd-ilibrary.org/employment/public-expenditure-on-active-labour-market-policies_20752342-table9, read on February 23rd, 2014.

²² See Andersen & Petersen (2014), the Danish country report for NordMod-2030.

²³ This mechanism is emphasized by Jäntti, Saari and Vartiainen (2005).

²⁴ This point is argued at length by Raghuram Rajan (2012), an economist with Chicago credentials and now chief of India's central bank. Thus, the idea of social safety nets supporting market-friendly economic policies is not limited to Nordic Social Democrats.

4. Performance

In this section, we shall take a brief look at outcomes. According to the discussion above, we should be especially interested in the Nordic economies' capability to sustain productivity growth as well as an equitable distribution of income.

Long run productivity growth has certainly been a success and all the Nordic countries now belong to the group of richest countries in the world. **Figure 1** depicts the labour productivity growth of the business sector²⁵ of four Nordic countries.²⁶ This Figure shows the fine long run performance of the Nordic countries, when compared to the United States that is often taken as a benchmark of a successful market economy. Figure 1 even highlights development after the turn of the millennium. Finland and Sweden boasted strong productivity growth up to around 2007. For Norway and Denmark, the productivity performance during the last 15 years has been less spectacular.

²⁵ In view of the extreme difficulty of correctly measuring public sector productivity growth, this should be our preferred measure. I am grateful to Mika Maliranta for providing me with the data for the ensuing Figures.

²⁶ Note that all the ensuing figures present indices, and they cannot be used to compare productivity levels between countries or sectors.

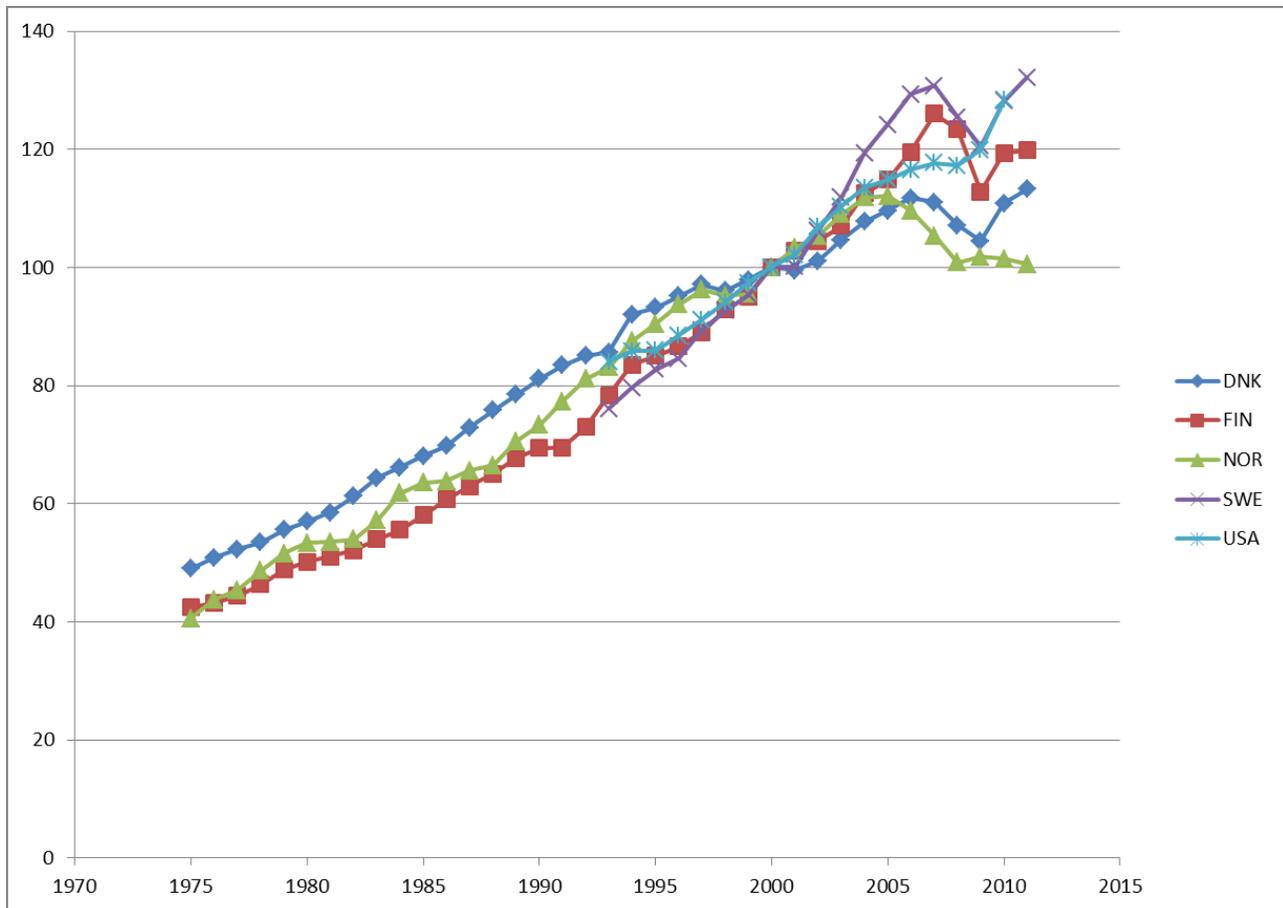


Figure 1. Index of labour productivity in the business sector, the Nordic countries and the USA. 2000=100. Source: OECD.

Productivity comparisons are full of pitfalls, though, since overall labour productivity growth is a synthetic variable, that is, a weighted average of productivity growth over sectors of different sizes plus inter-sector structural shifts. In the following six Figures, we present a more detailed picture of productivity growth for the Nordic countries plus Germany and the USA, separately for the business sector, manufacturing and the service sector. Each set of graphs comes in two varieties. The first, “uncorrected” graph (Figures 2,4,6) is an index of average labour productivity growth. These graphs contain the information on productivity growth within narrowly defined industrial sectors, weighted for each country with the share of each sector, plus the effects of shifts between sectors. Thus, a high productivity growth according to these graphs can be a result of the fact that a country specializes in industrial sectors that have a higher than average productivity growth, or the fact that its labour moves from low productivity industries into high productivity ones, or the fact that its industries are able to sustain a high labour productivity growth.

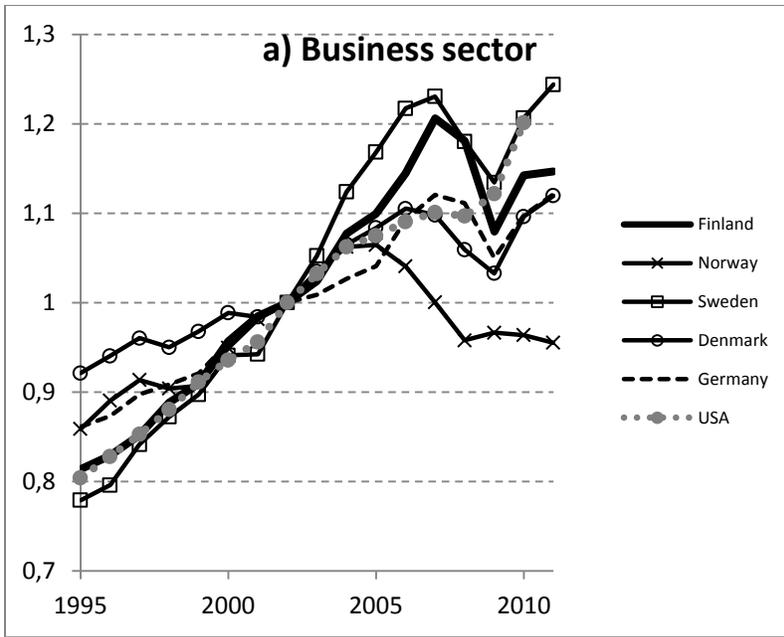


Figure 2. Labour productivity growth, business sector

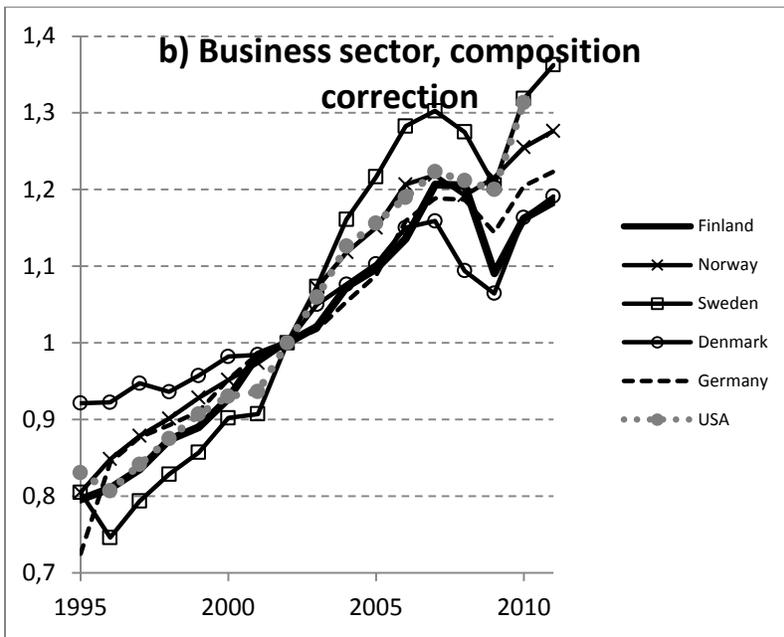


Figure 3 Labour productivity growth, business sector, corrected for composition.

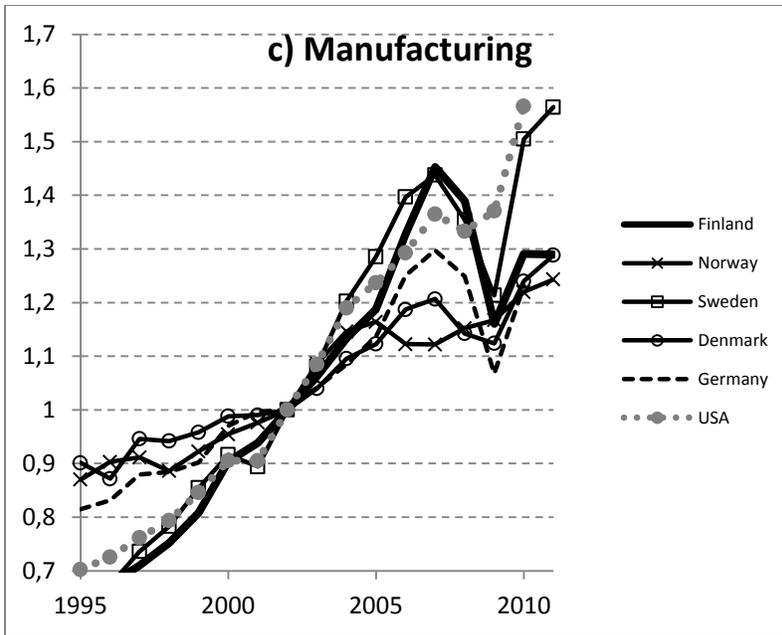


Figure 4. Labour productivity growth, manufacturing

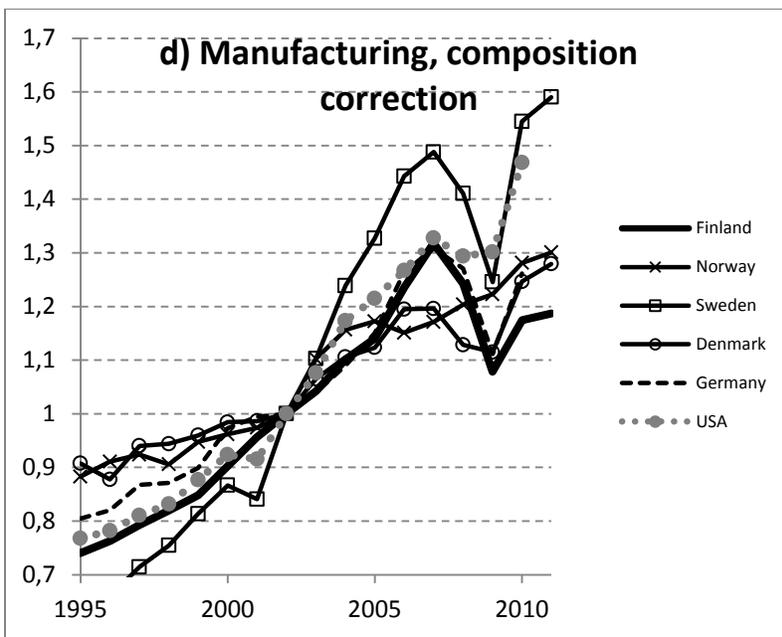


Figure 5. Labour productivity growth, manufacturing, corrected for composition.

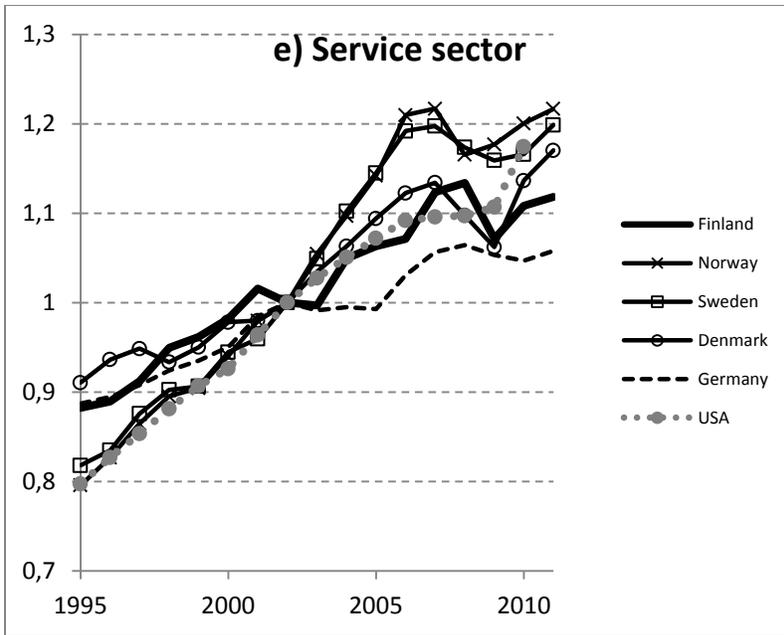


Figure 6. Labour productivity growth, service sector

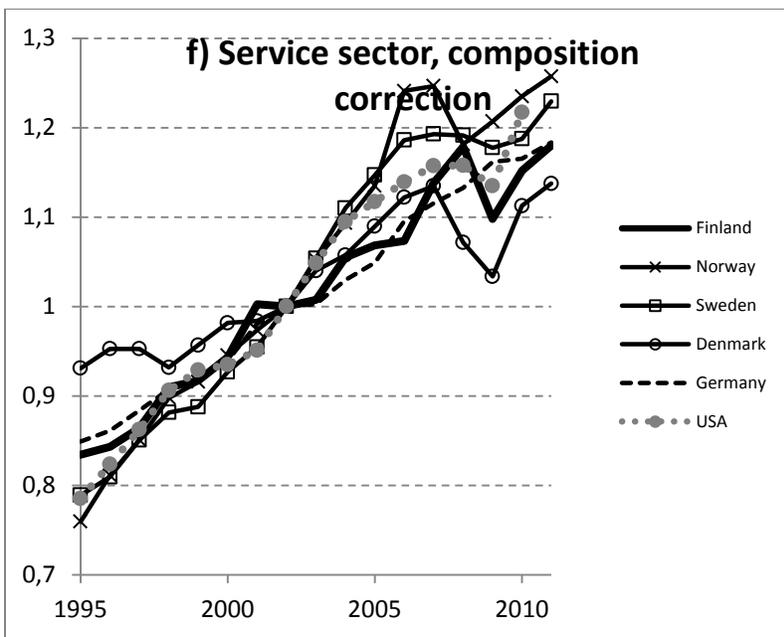


Figure 7. Labour productivity growth, service sector, corrected for composition.

The second set of “corrected” graphs is done so that the industrial composition of each sector is set to a constant one that corresponds to the average of these six countries, and productivity growth then only reflects the economy’s ability to sustain productivity growth within each sector. Then the fact that a country has a larger high-productivity industry share or a migration of labour into high-productivity industries would not improve the productivity index as used here. In other words, Figures 3, 5, and 7 should reflect the economy’s ability to generate productivity growth with innovations within each sector, and be immune to structural change.

Some observations stand out. For the entire business sector, Sweden seems to stand out regardless of how one measures and Denmark has a more lacklustre performance. For the entire business sector, the composition correction makes a large difference for Norway, which suggests that the country’s innovative capability is good but the economy is biased towards industries that have lower than average productivity growth.

For manufacturing, somewhat similar observations apply. There is a general breakpoint in manufacturing productivity growth around 2007 –2008, and it is of such magnitude and generality that it can probably not be explained by the faltering boom alone. Sweden does generally well and Denmark less well. For Norway, the correction now does not make a big difference, which suggests that Norway’s manufacturing has done reasonably well in any case, and the Norwegian economy’s lacklustre overall productivity growth may reflect the growth of a low productivity service sector, possibly based on increasing immigration. Note, however, that Norway’s service sector productivity growth has in itself been in the high end of the Nordic countries (see Figures 6 and 7).

It is tempting to speculate on the determinants of the poorer productivity growth performance of Denmark in particular, and even Norway as to the general business sector.²⁷ These two countries have been quite successful in maintaining low unemployment, on the other hand. It is therefore possible to hypothesize that these observations go hand in hand. Denmark is renowned by its “workfare” labour market policy that is quite effective in pushing people into jobs, even into low-paid service sector ones. Even in Norway unemployment has been lower than in Sweden and Finland, and the employment of immigrants has under the last years increased considerably. In Finland and Sweden, by contrast, the share of low paid jobs is low and unemployment has been consistently higher than in Denmark and Norway. This may in turn go hand in hand with the relatively better productivity development. To put it naively, some of the low skill people who would in Sweden and Finland be unemployed would in Norway and Denmark be employed in low paid jobs²⁸ – or at least this could be an interesting guess at this

²⁷ A similar trend is seen in Germany, which has had extensive job growth in recent years especially in the services sector.

²⁸ Actually, quite a number of Swedish youth have been employed in Norway in recent years.

stage. According to Eurostat, Finland and Sweden were the two EU countries with the lowest share of low wage earners in total employment.²⁹

Even the within-industries productivity growth of Figures 3, 5 and 7 can be further investigated. It depends partly on innovations within firms and partly on the process of creative destruction. Above, we emphasized that productivity growth via creative destruction was a logical implication of a tight Rehn & Meidner type wage model. An older piece of evidence on this is the paper by Hibbs and Locking (2000), which neatly showed how productivity growth was boosted by the adoption of the “equal pay for equal work” wage policy – and subsequently hampered by the radical phase of ambitious redistribution.

More recent studies confirm the role of creative destruction. Figures 8 through 11 show the contribution of creative destruction in the labour productivity growth of the Nordic countries, again separately for the broad sectors of the economy. Creative destruction can be measured as the difference between an industry’s productivity growth and the average productivity growth of the firms within that industry. This difference is then a result of the disparition or shrinking of those firms and establishments that cannot sustain a high enough productivity growth, and the expansion or entry of other firms.³⁰ Interestingly, Denmark’s poorer performance is visible even in this measure.

²⁹ The shares were 6.9 and 2.6 for Finland and Sweden, respectively, against 7.7 for Denmark and 17.0 for EU-27. A low wage earner is here defined as a person whose hourly earnings fall short of two thirds of the national median. See http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-SF-12-048/EN/KS-SF-12-048-EN.PDF, read on March 26th, 2014.

³⁰ See Böckerman & Maliranta (2012) for the method.

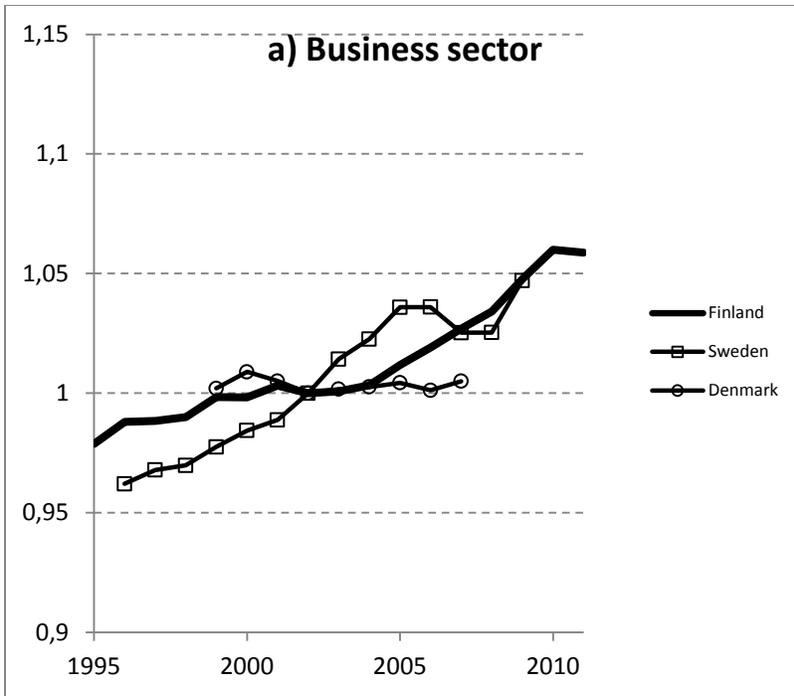


Figure 8. The contribution of creative destruction to productivity growth in the business sector.

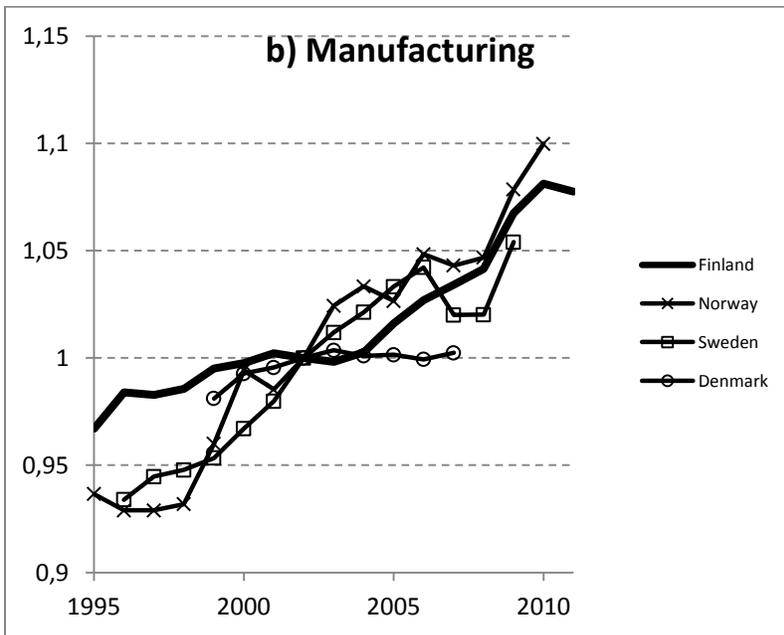


Figure 9. The contribution of creative destruction to productivity growth in manufacturing.

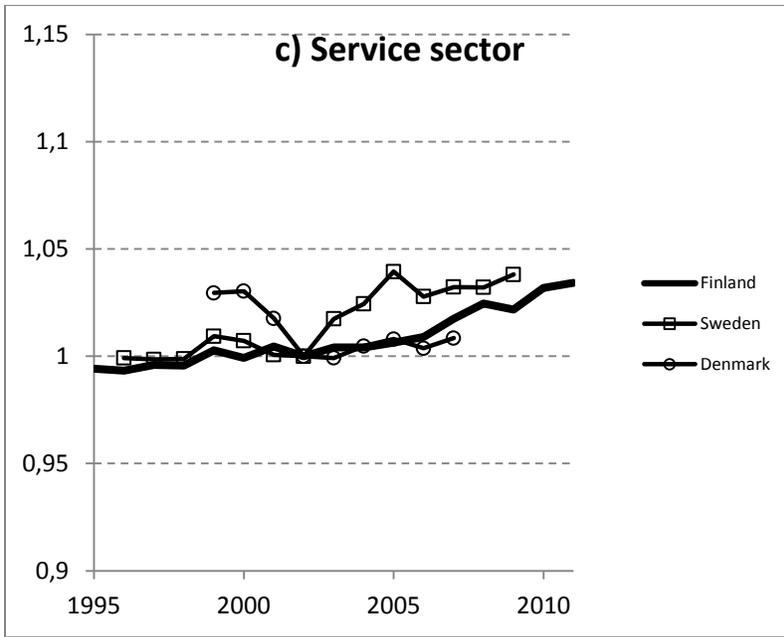


Figure 10. The contribution of creative destruction to productivity growth in the service sector.

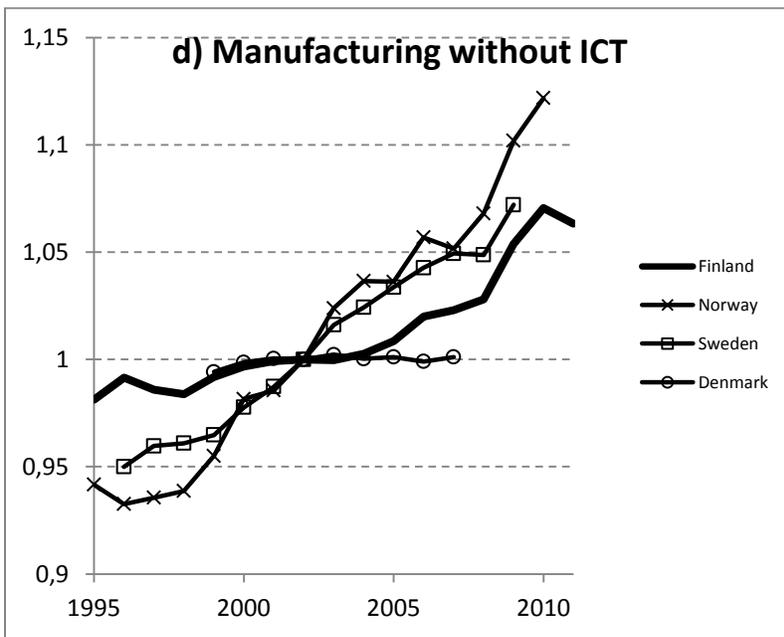


Figure 11. The contribution of creative destruction to productivity growth in manufacturing without ICT.

In the long run, it is of course productivity growth via innovation and only that which determines our living standards. In that regard, the long run performance of the Nordic countries is good (see Figure 1) and there is no reason to suppose that they would start lagging behind the other advanced countries, provided they can keep their focus on human capital formation and continue to subject themselves to the harsh discipline of the global market economy.

Possible compositional effects, in the long run, are probably of lesser significance. If a country is successful in integrating low skilled immigrants, that success may be reflected in the overall productivity figure but would often still imply a good welfare performance, since the influx of low skilled people does not *per se* affect the productivity of higher skilled incumbents.³¹ Furthermore, productivity does not alone determine the growth of incomes. During the last twenty years, we have also seen how the spectacular productivity growth of the ICT sector in Sweden and Finland has been consistently accompanied by a decline in the sector's relative prices (which translates into deteriorating terms of trade on the national level). A country may have a stellar manufacturing performance, but the Baumol mechanism cannot be avoided internally either. A country with a high productivity manufacturing is likely to have an expensive service sector, too.

The other pillar of the Nordic model is equality. I will not dwell on this at length here, since it is covered in many other papers of the NordMod project as well as Dølvik, Goul Andersen and Vartiainen (2014), Fritzell, Bäckman & Ritakallio (2011) and OECD (2011). Suffice it to say that inequality is increasing somewhat even in the Nordic countries, but these countries are still quite equal ones in international comparison, although perhaps less exceptional than what they once were. The dispersion of wages has increased slowly from the late 1990s onwards (see Chen, Förster & Llena-Nozal 2013). This trend is probably influenced by technological change and changes in the global division of labour, but also by growth in unorganized, low wage service branches and weaker redistribution systems. Gini coefficients of disposable incomes have been slowly increasing, too, although the financial crisis and recession after 2008 temporarily led to reverse movements as capital incomes deteriorated. Inequality of household disposable income increased clearly in the period 2007—2010 in Denmark and Sweden but there were hardly any changes in Norway and Finland (see Dølvik & al. 2014). Even in the Nordic countries, the very top of the income distribution seems to do extremely well. To sum up, the Nordic countries are not immune to the global trend of increasing inequality, but they still stand out as equal countries in international comparison.

³¹ If low skill work and high skill work are of complementary, increased supply of low-skilled workers may actually boost the productivity of higher skilled employees. The hazard is that inferior wages that make low productivity jobs more profitable may also create lock in effects that hamper overall productivity growth. It is better to have low skilled people in work than unemployment, but it is important to invest in skills and ensure that low paid jobs do not become impassable for disadvantaged people.

A note on macroeconomic performance

This paper is concerned with the Nordic model's long run performance and political viability and not business cycles, but some notes about the Nordic countries' recent macroeconomic performance are in order.³² The recent macroeconomic performance of the Nordic countries is mixed.³³ Sweden, Finland and Norway had severe recessions and banking crises in the 1990s. After that, they all boasted quite good macroeconomic performance up until the financial crisis and recession. After the banking crises of the 1990s, their financial systems were in better shape and more cautious than those of many other countries and their banks were not primarily involved in the banking troubles that became apparent in Europe and the US after 2007. Fiscal policy had after the fiscal retrenchment efforts of the 1990s been subject to more stringent long term rules than before, and that limited eventual mistakes with too loose a fiscal stance during the boom of the first decade of the millennium. Besides the conspicuous financial collapse in Iceland, Denmark is an exception here, since its fiscal policy was rather loose during that period, largely because of electorally motivated tax cuts and easier access to credit, and this contributed to an asset and real estate bubble.

Thus, subsequently, Denmark has suffered more from the current recession than Sweden and Norway. Even Finland has had a dreadful economic performance lately, mostly because of a conjunction in time of two major economic shocks. The immediate cause of the recession is the huge export demand shock, hitting Nokia and the country's main export industries – ICT, metal and pulp and paper—, so that exports fell by 21 per cent in 2009. At more or less the same time, a more underlying transformation began to set limits to the scope of countercyclical fiscal policies: the Finnish working age population (15-64) started to shrink. This demographic transformation hits Finland earlier and more abruptly than other Nordic (or indeed EU) countries, and it puts a higher limit on the growth rates that are achievable. It does not immediately constrain demand, of course, but it makes it much riskier to engage in large-scale fiscal stimulus, since large deficits cannot easily be met by large surpluses when future growth rates are lower than before³⁴ and there already is a sizable sustainability gap in public finances.

³² See Dølvik, Goul Andersen and Vartiainen (2014).

³³ See Dølvik, Goul Andersen and Vartiainen (2014) for a more thorough description.

³⁴ Future long term trend growth rates are forecast at 1.5-2.0 per cent, which corresponds to the projected labour productivity growth rate, since the labour input will not grow according to current demographic and migration projections. Since unaccounted age-related expenditures (up until 2030) amount to about 2-3 per cent of GDP, and there is an initial deficit of about 1 per cent of GDP in the general government expenditures, the constraints for fiscal policy are stringent.

5. The political disconnect

The neoclassical interpretation of the Nordic model as outlined above is a theoretical idealization, of course. However, it does provide an argument as to why rational voters in the Nordic countries would want to embrace the combination of market liberalism and strong distributive and protective institutions. Thus, there is much to like for neoclassical economists in the Nordic models.

Yet economists do not dispose over voters or political parties, as little as the Pope disposes over divisions. The argument that I want to pursue here is the following. The Nordic labor movements were crucial in creating the Nordic labor and welfare arrangements in a historical situation in which the constraints implied by the economic environment were quite different from those of today. Thus, the political objectives and currents of thought that motivated the mostly Social Democratic labour movements in the 1950s through the 1970s were formed in circumstances that are no longer present. Furthermore, those motivations and ideas did not then nor do they now sit easily with the impeccable neoclassical economic interpretation outlined above.

Therefore, the labor movement finds it harder to generate the political support for the kind of reforms of the welfare state that are necessary to ensure its survival. With aging and more heterogeneous populations, globalization and open European labour markets, the Nordic welfare states will be subject to growing pressures in the decades ahead (see Fløtten et al 2013). In my view, these pressures need not be insurmountable, but they need to be addressed by extremely well-designed and responsible policies, and there is a real uncertainty as to whether the political will and the appropriate political coalitions will emerge. Thus, in my view, the Nordic welfare state is mainly threatened politically from inside, not economically from the outside. The Nordic model certainly appeals to social-liberal and well trained economists, but it is not sure whether it can garner enough salt-of-the-earth electoral support for responsible economic and social policies that would ensure its future viability.

Why so? When the labour movement created the welfare arrangements, it was not motivated by the theoretical arguments presented above. The labour movement would only partially have recognized the “neoclassical economics” -interpretation of social security and structural change.

The main sources of political energy were the struggle for higher wages and the creation of social insurance systems, including pension rights. Now it might superficially seem that these two endeavours are at present precisely as relevant and pertinent as they were 50 years ago. However, the current economic environment and constraints implied by the current global capitalism and current demographic phase are very different from those of the 1950s through the 1970s. This implies that the political and trade union strategies ingrained in the bone-marrow

of Nordic Social Democrats need to be realigned with the challenges currently facing the Nordic models, and this realignment may be quite painful .

What do I mean by this, more concretely? There are several ingredients to this argument:

- The economic rationale for the unions' wage struggle has changed, since labour's bargaining position under price stability is quite good. The main challenge is to contain the trade union movement's internal contradictions and ensure proper coordination, so that excessive wage pressure does not hamper the potential for employment growth.
- The globalization of the capital market has changed the bargaining setup between labour and capital. As capital looks for the same rate of return everywhere and can easily move from one location to another, it is unlikely that labour can expropriate more than the share achieved elsewhere, unless productivity is superior. Thus, the very workers' movement idea of using collective power to extract concessions from capital becomes superfluous.
- In a typical Nordic economy mostly dominated by "representative" middle-class individuals, the politics of sustaining welfare state arrangements cannot be based on expropriating capital owners or soaking the few "rich" but must be met by policies that balance the rights of individuals with corresponding obligations. The costs of welfare policies cannot be passed over, either to wealthy capital owners or future generations.
- In the Social Democratic "Golden Age", from the 1950s through the 1980s, the successful introduction of public services and social insurance schemes seemed a result of sheer political will and collective working class efforts. Yet it also coincided with a happy demographic phase in which increasing cohorts of taxpayers made the public sector budget constraint seem moot. This has changed, and will change further in the years ahead. Thus, a much more responsible budgetary approach is needed. This is of course a challenge for all political parties, and Social Democracy has from the 1990s quite a good record of responsibility –but if the challenge is not met, it is the Social Democratic extensive welfare state that will suffer.
- In an aging society, there is an objective need to boost labour supply, by almost any means: education, activation policies, pension reforms and policies facilitating sustainable labour immigration. Many of such policies sit uneasily with parts of the labour movement's political constituencies. Encouraging the supply of labour is not as natural for trade unions and Social Democrats as it is for right-of-centre politicians.
- The handling of international labour mobility within the single market and the facilitation of immigration have become central elements of policies to bolster welfare state sustainability, often colliding with central concerns of the trade unions.

Let me elaborate on these factors. When the welfare state was created, the labour movement mobilized its power resources to extract the resources needed for social policy expansion. The labour movement's own lore interprets this as a "struggle", which it indeed was, to some extent

at least. The struggle consisted in using workers mass power resources to mete out something from capital owners, in the form of higher wages, as well as political pressure for using the tax system and the state to provide resources for public services and social security. It was seen as a question of obtaining something for “us”, the people, from “them”, the privileged.

Indeed, this struggle seemed very successful, since all these welfare state arrangements were put in place, without hampering sound public finances. With hindsight, however, we know that the generosity of the policymakers’ choice set was to a large extent a result of expanding employment. It was possible to expand employment, since there was a flow of internal migration from the countryside into the modern economy and eventually the employment of women provided an additional endowment that had earlier been untapped. Demography was also a big underlying factor. With each cohort of adult workers larger than the previous one, there was an expanding base for increasing public undertakings. This made a big and lasting impression on Social Democratic voters and activists: with a political will great enough, everything seemed possible.

There was also a real need and social call for muscular trade unionism. The “golden age” of the 1950s through the 1970s was a time when a migration of “surplus” labour from the countryside’s primary production into modern manufacturing and service sector jobs was still ongoing.³⁵ Such a large and increasing supply of people creates a downward pressure on wages, which the Social Democratic trade unions could legitimately and successfully resist. Thus, there were real gains for workers in using their collective power resources to extract higher wages. In an economist’s jargon, the workers would in the absence of unions have had difficulties to obtain even a pay level that meets their marginal product. This made union struggle perfectly rational and feasible. The unions’ great achievement was to establish minimum pay standards and centrally agreed pay increases, so that the competition for jobs would not lead to an arbitrage on wages towards a minimum level of subsistence.

Today, the playing field is different. The trade unions are well organized and most of them have bargaining resources that make them at least equal partners with the employers. The challenges are now different. There is an influx of cheap labour from EU neighbouring states. This creates similar pressures, since it threatens to create a new layer of low-paid work. For the trade unions, this poses new dilemmas. Short of better options, the new entrants have every right to compete on the Nordic labour markets and they are on the whole a welcome resource in a time of an increasing dependency ratio. However, they can also undermine the social norms underpinning the original deal in the Nordic labour markets. They create pressure for lower wages, and it may become attractive in the eyes of many trade union members just to try to limit that new source of labour supply – something that in turn would present trade union leaders with a dilemma.

³⁵ This process of migration and modernization is now reaching its end phase in China, and we have started to observe wage increases even there.

Thus far, the main reaction among Nordic unions have been to welcome the new EU labour migration and call for stronger wage floors and measures against abuse of migrant labour, but tension has certainly risen at many workplaces (see Dølvik, Eldring and Visser 2014).

Moreover, the “Golden age” was a period of credit rationing and regulated international financial transactions. This implied that at least in the short run there was some latitude for influencing the functional division of income between labour and capital. The issue of whether the national capital owners would invest or consume their profits could also be constructively discussed. Even that mechanism reinforced the unions’ view that increasing living standards could be obtained by collective struggle and political means. In today’s global financial markets, there are very few mechanisms that facilitate channeling of financial surpluses into investment in national production and jobs – except perhaps for collective pension funds, but even they would best diversify their risks by investing mostly outside their own countries.³⁶

Furthermore, the monetary regime was up to the 1990s an inflationary one. Finland and Iceland in particula, and later on even Sweden suffered from bouts of inflation and successive devaluations. With inflation running at 5 to 10 per cent, there was an obvious need for workers to use collective agreements to safeguard the living standards. To some extent, of course, this was based on a nominal illusion, since the large pay increases of the inflationary 1970s and 1980s were eroded by price increases and devaluations. However, they certainly made the worker appreciate muscular trade union struggles.

A new economic environment

Consider now how the economic environment has changed, and changed in a way that makes many of the traditional strategies of the labour movement insufficient or less suited to resolve the problems facing the Nordic models towards 2030.

We now live in completely globalized capital markets. There is no shortage of capital for investment, provided the investment generates a rate of return comparable to the rate of return to investments in other parts of the world. Consequently, there is hardly even any short term scope for raising real wages by workers’ action. If the real wages become too high compared to productivity, investors may simply move their activities elsewhere.³⁷ Like in the 1950s, however,

³⁶ Indeed, the large Nordic pension funds have sought to cut the weight of domestic investments in their portfolio. This makes perfect economic sense, since a large national investment portfolio would imply that a national recession would not only increase unemployment but even lead to cuts in pensions payments.

³⁷ Indeed, the standard neoclassical economic model implies that the real wage cannot at all be influenced by trade unions. If the economy’s aggregate production function $F(K,L)$ is neoclassical (homogenous of degree one) and the international interest rate (rate of return) is given, then the neoclassical properties of $F(K,L)$ imply that even the real wage is given. If the workers try to establish a higher real wage, capital will bleed out

there is a case for unions preventing the risk of downward wage bidding arising from growing labour immigration.

Furthermore, price stability has been established. This implies that the purchasing power of the individual core worker is already fairly well protected. Indeed, some economists have suggested that it may well be too well protected. It is always costly to initiate conflicts, and this means that the real wage can in the new price stability regime stay “too” high with regard to employment.³⁸ Thus, instead of heroically asking for higher wages, the energy of the trade union official must now be used to contain excessive wage claims by the rank and file or by other unions, and to counter downward pressures on wages at the fringes of the labour market. While the flow of workers from primary production has long time ago dried out and the wage bargain of the individual core workers is anyway buttressed by the existence of social security standards that shield the worker from the need to bid down her or his wage, the main challenge of Nordic unions is to find ways to retain the wage floor in a situation of rising labour migration. With the exception of Finland, unions have also increasingly accepted the firm’s objectives of more scope for individual pay adjustments, albeit within the macroeconomic constraints set by nationally coordinated collective agreements.

Consider also the fact that all the Nordic (as well as European) countries are entering an era of unfavourable demographics. The dependency ratio will increase, and in the worst cases (Finland has the bleakest prospects in this respect, followed by Norway) even the size of the labour force might shrink in absolute terms (Fløtten et al. 2013). This creates a huge problem for any economy with a large public sector and a high share of public sector employment. As a rough rule of thumb, the demand for public expenditure is correlated with population growth and the age structure, whereas the supply of public resources correlates with employment.

The aging phenomenon increases the need for spending associated with the elderly, simultaneously with a growth rate of tax revenues that is constrained by modest employment growth. Thus, the advantageous demography of the Golden age politics is reversed, most pronouncedly in Finland.³⁹ With stable or shrinking worker and employee cohorts, no bold reforms seem to be affordable unless through “hard to achieve” reallocation of public resources or increased taxes. The latter appears to be politically difficult in an era where international tax

and employment shrink until the real wage is reestablished at its “correct” level. This is related to the analysis of NAIRU, see below.

³⁸ This argument is beautifully made by Steinar Holden (1994, 1997).

³⁹ It is a cruel irony that Finland now pays the bill for an earlier policy failure: in the 1960s and 1970s, about 400 000 Finns of working age emigrated to Sweden and the country now to a large extent “lacks” the children of that group. This partly explains the fact that aging hits Finland more abruptly than other Nordic or EU countries.

competition and national competition for voters constrain the room of manoeuvre for politicians. Furthermore, even outstanding public debt becomes more difficult to deal with, since growth rates are constrained by the fact that the labour input does not grow at all or grows very slowly.

This is the essence of the sustainability gap. It cannot be met with productivity growth only, since productivity growth is in the long run completely incorporated into real wage growth, and wages are in turn the biggest component of public expenditure. Thus, the only robust and sustainable way of meeting the aging problem is to sustain a high enough employment growth. This, in turn must translate into policies that increase the labour market participation rate or increase the working age population via immigration, as well as policies that lead to a structurally lower rate of unemployment. Higher immigration is a means to boost employment in the short and medium run, but as immigrants also get older and often tend to have a lower – or faster decreasing -- employment rate than natives, high immigration also increases the need for efficient activation policies (see Djùve & Skjjevik Grødem 2014).

Put in economists' jargon, incentives to work must be sharpened. There is an underlying problem in all extensive welfare states as to the price of leisure. For an individual, leisure is cheap, since shifting down one's labor input does not lead to a commensurate drop in income and living standards. Even a person who does not work at all can achieve a reasonably decent living standard – at least in international comparison – by being entitled to social transfers and using publicly provided goods and services. However, going from work to non-work is much more expensive for the public purse, since the individual does not anymore contribute by her or his income taxes and pension contributions and becomes a net consumer of public resources. Thus, there is a large discrepancy between the private and social cost of leisure. In line with the traditional “work line” in Nordic social policy, there is therefore simply no alternative to stringent labour supply policies. In the very long run, there may indeed arise a discrepancy between a Nordic culture that seems to have become more individualistic and materialistic, and the continuous fiscal need of the local and central governments, which will certainly not be compatible with a society keen on leisure.

Of course, this challenge can in principle be met. The problem for the Nordic labour movements is that it requires policies that many trade unions and Social Democratic voters do not like. Let me comment on some of these contested policy areas.

The “activation turn” in unemployment and health insurance

From the 1990s onwards, all the Nordic countries have engaged in policies that put more pressure on the unemployed and people outside the labour force, in order to encourage and compel them to work. Labour market policy, social policy as well as taxes have been redesigned to increase labour supply. Income tax rates have been lowered, and unemployment insurance

has become more stringent, so that a lower “employment tax rate”⁴⁰ has been achieved. Although it is on the political surface often associated with non-socialist politics, this return to old virtues was in fact to a large extent pursued already under the Social democratic come-back in office in the 1990s. At the same time, more or less compulsory activation and conditionality of transfer payments have been introduced. Denmark is often singled out as the “toughest” Nordic case in terms of workfare and activation, but the political orientation is common to all the Nordic countries.⁴¹

The activation policies aim at increasing employment rates and they are a logically correct response to the looming strains on public finances. Although all mainstream parties seem to support the “work line”, a problem for Social Democracy is that the pursuit of consistent activation policies at some point becomes difficult to reconcile with the original values of the labour movement that sees itself both as a guardian of the individual right to proper income security and the ultimate guarantor of the social insurance institutions. Especially during downturns, when activation requirements affect broader groups, parts of the traditional working class do often experience these policy schemes as humiliating. The conditionality and workfare schemes do simply seem to imply distrust in the individual’s willingness to work. My (speculative) hypothesis is that this aspect of activation policies is a central reason why many workers turn their backs on Social Democracy and start to vote for the emerging right-wing populist parties.

Pension reforms

The Nordic countries have – perhaps except for Finland – been European pioneers in adjusting pension schemes to longevity. Still, as seen in many countries, pension reforms tend to create a similar acrimonious challenge for the labour movement. As expected longevity increases, increasing the pension age is an entirely logical way of dealing with the problem. Yet many working class voters and trade unionists have also regarded the established retiring age as a result of hard won struggle and feel let down when pension rights are circumsised, especially because the ability to continue working often differs with class. Increased longevity which reduces annual pensions for early retirees has according to latest studies also become more correlated with income and education. Similarly, many early retirements schemes have been readily used by tired

⁴⁰ By the “employment tax rate”, economists mean the share of the gross wage increase that an individual shifting from non-work to work will lose because of increased income tax and slashed social transfers.

⁴¹ We have described and analyzed these policy changes more closely in Dølvik, Goul Andersen and Vartiainen (2014, forthcoming). See also Fløtten et al (2014, forthcoming), NordMod-report on welfare state policies, which discuss activation policies and welfare state sustainability.

working class people, and abolishing such schemes has proved politically very controversial among trade unions and working class voters.⁴²

Increased immigration

A greater inflow of migrant labour can in principle directly offset the negative aging effect on public finances, provided the immigrants' employment rate is high enough. Achieving a high enough rate of employment is not trivial, however, as suggested by the modest employment rates of several immigrant groups in the Nordic countries. In all the Nordic countries, some of the non-Western immigrant groups show particularly low employment rates (see Djuve, Skjevick and Grodem 2014). It also presents Nordic policymakers and the labour movement with the uncomfortable, definitely "un-Nordic" and non-universalist idea of establishing a more selective or targeted immigration policy. For example, many East Europeans have been doing quite well in the Nordic labour markets. Regardless of origin, even immigrants get older, so that the long-term net effects on public finances are uncertain and highly dependent on the immigrant populations' sustained inclusion in working life.⁴³

The labour market prospects of refugees and proper labour market migrants are of course quite different. People who have emigrated in order to work constitute a selection that is far better equipped to be employed than what is the case with refugees. Yet even in that case, recent studies from Norway have shown a surprisingly high propensity, for some groups of labour migrants that entered Norway in the 1970s, to enter disability after 10 to 20 years of work (see Røed, Bratsberg & Raaum 2010). The effect of increased immigration on public finances is complicated and different studies come to different conclusions. A rather general assessment is that immigration is very unlikely to be "the" solution to the Nordic societies' aging-related public deficits.⁴⁴ Yet it can help somewhat, if things do not go wrong.

These conclusions are also highly dependent on the chosen time frame. Immigrant women may have low employment rates, but initially they often have high fertility rates, which in turn in the very long run may contribute to sustainable public finances. This of course presupposes that the primary education system effectively integrates the children of migrants.

The success of integrating immigrants in the labour market depends not only on the characteristics of immigrants but crucially also on how well designed the labour market policies

⁴² Two prime examples are the Danish "after-wage" (efterlønn) and the Finnish "unemployment pension pipeline", both of which are now to some extent being phased out.

⁴³ A recent Norwegian report by top academic experts (NOU 2011:7), commissioned by the Norwegian Government, analyzed these questions in debt. It was followed up by a detailed study by Statistics Norway. Both studies cast doubts about the net fiscal gains. See also Ekberg (2009).

⁴⁴ See Ekberg (2009) for Sweden, for example.

and social policies in general are, regardless of whether they are applied to immigrants or natives. In all the Nordic countries, it is nowadays mostly thanks to net immigration that the labour force can grow at all. For example, employment has in Sweden grown by about 225 000 people from 2010 to the end of 2013. About half of that growth is accounted for by increased employment for people born outside Sweden.⁴⁵ In Norway, more than 2/3 of net employment growth, after year 2004, is accounted for by EU labour migrants (NOU 2013: 13). Finland's population of working age will during this decade shrink by about 0.3 to 0.5 % per annum, but it would shrink by considerably more without positive net immigration.

Thus, although immigration is no panacea and expert opinions differ, there is a sound economic case for exploring whether increased immigration, coupled with well-designed activation policies, can contribute to the economic viability of the Nordic welfare states. Of the Nordic countries, Sweden has since 2007 operated the boldest policy, by abolishing all restrictions of firms' overseas recruiting from outside the European Union.

This issue, however, is almost bound to create frictions with the labour movements, since many unions and low wage workers resist or are lukewarm to active policies to encourage immigration.

There are several "layers" to these arguments that need to be sorted out, and workers and unions can be against increased immigration for both bad and good reasons. Immigration is often resisted on the grounds that there "already" is domestic unemployment and that there is therefore no "need" to import workers from overseas (or raise retirement ages). This argument is false. Unemployment is not a result of the labour force being simply too large. Instead, unemployment should be seen as a loss that in the medium-long run depends on the frictions of the labour market (see the discussion below on the NAIRU). An increase in the size of the labour force, without a change in its skill composition, will therefore not lead to higher unemployment. In due course, although not from day one, the larger labour force will be absorbed in employment.

However, the employment and unemployment rates do depend on the composition and skill-structure of the workforce, and large scale immigration of low-skilled people, often with problems related to language and literacy, can pose problems even for well-designed labour market policies and even public finances. Furthermore, although labour force growth will in the long run be absorbed into employment, the mechanism by which this happens is likely to involve a temporary slowing down of wage growth. Thus, even if Nordic unions are in general benevolent and realize the need to increase the workforce, it is often precisely their members that feel the increased competition for jobs and a downward pressure on wages. Now, such fears are often overblown, also, but there are good reasons to strengthen wage floors to prevent exploitative wage dumping. When less skilled immigrants enter the workforce, they do not affect

⁴⁵ See National Institute of Economic Research (Konjunkturinstitutet), Konjunkturläget december 2013.

the intrinsic productivity of the incumbents, so there is no reason to assume a permanently lower pay outcome because of immigration. However, skill complementarities can lead to wage effects that can go in any direction. The mostly optimistic assumptions of neoclassical economics have to do with the long run and trade union members live “in the short run”, that is, now. So it is not surprising that frictions arise as to increased immigration.

My hunch is thus that the rise in Nordic immigration may have contributed to the alienation of workers from Social Democracy and to the rise of populist right parties.

Constraining wage claims to cut the equilibrium rate of unemployment

Since 2008, Nordic unemployment has risen, except in Norway, because of the decline in demand prompted by the financial crisis and the subsequent euro crisis. In Finland this has coincided with structural problems related to the ICT-cluster and the paper and wood industries. As the Nordics – except perhaps Finland so far – seem to recover well, the cyclical component of unemployment is likely to decrease. Even during the financial boom in the 2000s, however, Sweden and Finland did not manage to bring unemployment below 6 to 7 percent – numbers far above the “traditional” 3 per cent unemployment that many Nordic citizens consider acceptable.

A major task in the years ahead will therefore be to bring down the equilibrium rate of unemployment, i.e. the rate of unemployment that is consistent with price stability. The modern theory of monetary policy and equilibrium unemployment, due to the work of Richard Layard and his associates, sees unemployment as a means of containing wage claims that would jeopardize price stability.⁴⁶ The simplified theoretical idea goes as follows. There is a positive relationship between wage claims by the workers (they may be individual or collective, but the qualitative conclusion is the same) and the employment rate: the higher the employment rate, the higher are the wage claims that create a bargaining equilibrium in the labour market. This is illustrated by the “wage claim” curve in **Figure 12**. In that figure, the horizontal axis measures the rate of employment, and the horizontal distance between 100% and the rate of employment is then the measure of unemployment.

On the other hand, there is only one real wage that is exactly compatible with the firms’ internationally determined minimal profit rate. This is illustrated by the horizontal (profit constraint) line in the same Figure. The only rate of unemployment that completely balances the claims of workers and firms is at point L^* which corresponds to an unemployment rate of $U^*=100\%-L^*$. This rate is the NAIRU, the rate of unemployment that is needed to sustain a stable inflation rate. If the economy is overheated and unemployment shrinks below the NAIRU,

⁴⁶ This standard model of labour economics is exposed in Layard, Nickell and Jackman (2005)

the workers are eager and able to increase the real wages in order to reap their share of the rising fortunes. This higher wage tends to exceed the profit constraint of the firms, and the firms must therefore increase their prices to restore profitability. This in turn incites the workers to increase their wages even more, so that an inflationary spiral, like seen in the Nordic countries in the 1980s, is initiated. If the firms in question depend on exports, they might not be able to raise their prices, but their competitiveness will erode and they will lose markets shares, not unlikely what happened with countries like Spain and Greece before the financial crisis.

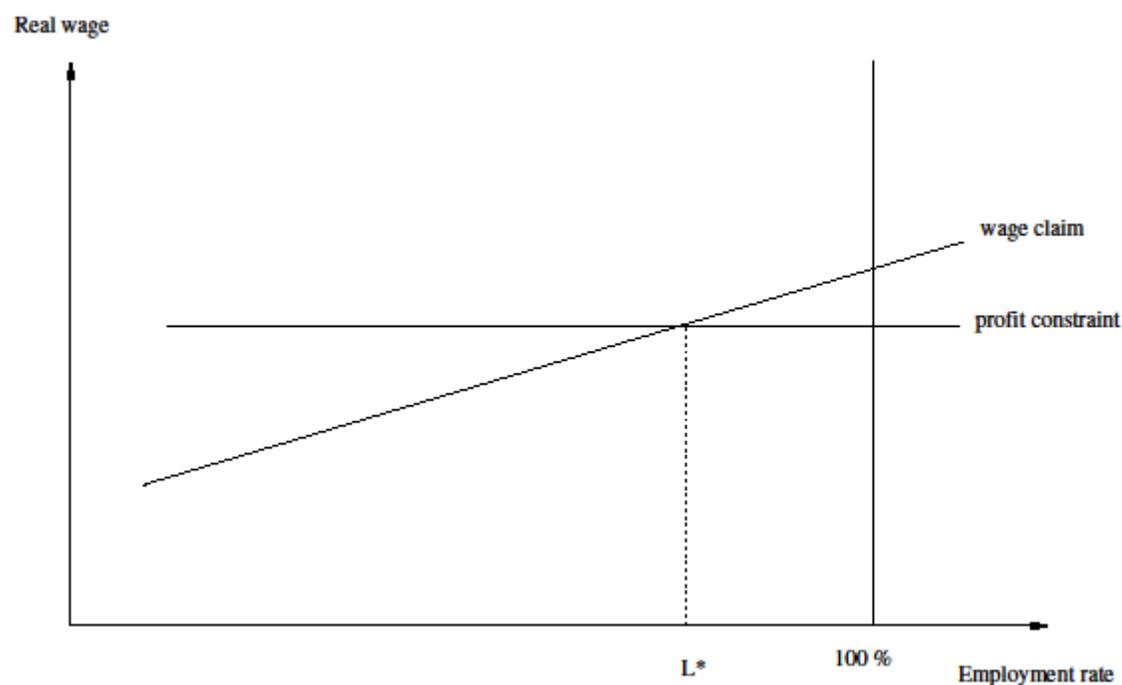


Figure 1. The determination of equilibrium employment and unemployment

Therefore, whatever the specific mechanisms, if unemployment shrinks below the NAIRU, an unstable situation is created, and this must in one way or another be brought to a halt with restrictive monetary or fiscal policy, as Sweden and Finland did in the early 1990s, and Denmark and Norway somewhat earlier.

Similarly, of course, in a recession in which wage pressure is low, it is difficult to meet the inflation target and the central bank wants to stimulate the economy with low interest rates until unemployment has shrunk to its equilibrium level.

Although this is rarely clearly spelled out by politicians and decision makers, some variant of this underlying model lies at the heart of modern monetary policy (and, in the case of an EMU

member like Finland, should underlie even fiscal policy). With given institutional arrangements, social security, taxes and employment protection legislation, unemployment cannot consistently shrink below its NAIRU level. By the same token, mere demand management cannot consistently sustain an unemployment rate below the NAIRU.

For applied macroeconomists at ministries of Finance, this is standard stuff, but it is even today hard, especially for Social Democratic politicians, to explain this way of thinking to their voters. In order to cut unemployment on a lasting basis, one cannot simply “create jobs” by subsidizing manufacturing industries or by increasing the public sector payroll. Such measures will in due course lead to higher wage claims and deteriorating public finances, which then compel policymakers or central banks to contract the economy again. These mechanisms are difficult for Social Democratic politicians and even trade union economists to deal with in the public space.⁴⁷ To cut unemployment permanently, the policymakers and trade union leaders must affect the position of the wage claim curve – i.e. by supply-side measures that affect workforce skills and the behavior of labour (looking for jobs) and trade unions. Such measures can range from improved coordination of wage setting and more efficient activation and training policies to outright cuts in unemployment insurance generosity and other benefits, as witnessed especially in Germany in the early 2000s but also in Sweden and Denmark in recent years. Even if co-operation between large unions helps, it is probably not enough to take the economy to an unemployment rate of 3 per cent, which seems to be the socially and morally acceptable state of affairs to which many labour politicians long back.

The empirical estimates of NAIRU rates are of course extremely imprecise, since they are unobserved entities that must be gauged out of employment and price-wage-inflation data. The conventional estimates usually track the actual unemployment rate quite clearly, since wages and prices are sticky and even a large increase in the unemployment rate does not automatically trigger a sharp downward movement in the wage growth rate. The OECD estimates of the structural unemployment rate are as depicted in **Table 1**. Despite the uncertainty, there seems to be a general impression among Nordic economists that structural unemployment is higher in Sweden and Finland than in Norway, Denmark and Iceland.

Structural unemployment creates a big political obstacle for Social Democratic politicians who want to co-operate with the unions in fulfilling ambitious unemployment goals. If the unions do

⁴⁷ In one of my earliest reminiscences of Swedish politics, I recall Olof Palme completely obliterating his Conservative opponent Ulf Adelsohn in a televised debate between the two party leaders in 1985. “Ulf Adelsohn, tell me how high is the “necessary” unemployment”, thundered Palme, who went on winning the election of 1985. In 1985, the Layard - Nickell theory of unemployment was still a novelty within economics and Adelsohn had no sharp arguments to counter Palme’s attack. Yet even as of today, Social Democratic leaders have an uneasy relationship with the notion of equilibrium unemployment. The debate clip can be watched at <http://www.svtplay.se/klipp/134259/debatt-palme-adelsohn-1985>.

not go along with substantial wage moderation, low unemployment might be very difficult to achieve. If the NAIRU model is true, the traditional appeal of “creating more jobs” by expansive fiscal and monetary policy or outright industrial policy interventions cannot affect the equilibrium level of unemployment in the long run. While this is often a source of frustration for Social Democratic policies and tension with the unions, non-Socialist administrations will more readily invoke the “harsh” supply side measures that according to economists do work in pressing the wage curve downwards.⁴⁸

	Denmark	Finland	Norway	Sweden
Structural unemployment	5.7	7.2	3.3	7.0

Table 1. The 2014 structural unemployment rates for the Nordic countries according to estimates reported in OECD Economic Outlook May 2013.

Modern economics and the labour movement

Such frictions are not only a product of the political imagination but are instead a result of real changes in the economic environment and the corresponding policy constraints. While the labour movement in the Golden age adopted an optimistic view of the scope for achieving reforms through political willpower and working class mobilization, there was an underlying favourable constellation of generous demographic trends and a more politically malleable “capital” side of the deal. Today, capital is without fatherland, as Marx wrote, so that very little extra can be appropriated from “capitalists” (at least at the national level).⁴⁹ Furthermore, the aging population and a more or less stagnating workforce imply that no reform can be financed just by rolling the cost onto future generations. Financing of reforms have to be achieved either through reallocation of public resources – which is politically hard to gain acceptance for – or through increased taxation, which is also a hard sell. The very success of the Nordic labour movements has made the Nordic countries into truly middle class societies. As there are far too few seriously rich people for any political strategy that would address the sustainability gap by “soaking the rich” only, the politicians will more and more often face the difficult choice between cuts in some services in order to boost others, or raising taxes on the middle class.

⁴⁸ Yet even governments of the Left have at times clearly undertaken such reforms, as was the case with the controversial Harz reforms, introduced by the Red and Green government of Germany a decade ago.

⁴⁹ The extreme profits in the international finance sector may, however, make a case for stronger taxation and regulation of that sector at the international level. Applied to the EU level, such measures could perhaps contribute to development of a fiscal stabilization mechanism in the EMU.

Put crudely, the conclusion is that everything that the middle class voter wants, the same middle class voter will have to finance via higher taxes or cuts in other expenditures. It is this big transformation that the Social Democratic movement has not fully internalized nor accepted. The viable and responsible economic policies of the 2000s – boosting labour supply, disciplining wage claims, raising retirement ages and facilitating immigration – are difficult for any political party, but they may be particularly difficult for Social Democrats to internalize and turn into an operative political program that successfully mobilizes working class voters.⁵⁰

This also reverses the happy scholarship-friendly optimism of the earlier period. Modern economics has largely absorbed the New Classical ideas of forward looking agents as well as the theory of a vertical (long term) Phillips curve, as embodied in the Layard - Nickell model exposed above. According to prevailing economic theory, it is therefore impossible to boost employment and economic growth on an enduring basis by demand management alone. The deterioration of the dependency ratio therefore elevates the issues of labour supply and activation to the very centre of economic policy debate. The Nordic welfare states are critically dependent on maintaining the high employment rates they have become known for, but that is likely to be an uphill battle in societies that become more heterogeneous in terms of skills and attitudes to work, especially for women. Of course, the Nordic Social Democratic parties and labour unions have been longstanding supporters of the “work line” in welfare and labour market policies, and were central in its revival in the 1990s. It was often under their watch that the knowledge base as regards proper labour market policies was improved. In Finland, for example, the Lipponen administration (1995-2003) promoted studies of labour supply and work incentives, and the Social Democratic administration of Göran Persson created IFAU the Swedish Institute for Labour Market Policy Evaluation, in 1997. Unfortunately for Social Democracy, the results of such scholarly research often frustrated the optimism of Social Democrats as to the returns of active labour market measures like training.⁵¹

Thus, the Social Democrats have in government often tried to confront these issues head on. Yet, in my view, the entire “supply side” policy orientation simply has an edge that is more easily accepted by parties and voters to the Right than with Social Democratic supporters. It confronts the labour movement with difficult dilemmas in striking the right balance between “carrots and

⁵⁰ Of course, one should not particularly single out Nordic Social Democracy in this respect. President Obama has according to many commentators a similar challenge in publicly addressing the economic constraints faced by the middle class voters. And so have non-Socialist Nordic parties.

⁵¹ See Calmfors & al. (2002) and Forslund & Vikström (2011). The first-mentioned study came to rather somber conclusions as to the effects of active labour market policy programs, whereas the latter one could point to some moderate policy successes as well. Similar studies have been conducted in Denmark and Norway with resembling results, see NordMod-reports by Andersen & Petersen (2014) and Fløtten et al (2014).

sticks”. Such dilemmas are often easy to shy away from, entailing the danger that necessary adjustments are postponed so long that there is no way around major overhauls as experienced by the Red-Green government in Germany in the early 2000s. By consequence, modern economics is not such a natural friend of Social Democracy as Keynesianism once was, and it is far more difficult for Social Democrats and unions to retain their role as agenda setters in the same way that Gösta Rehn and Rudolf Meidner once did.

The ugly face of nationalism

The labour movement was internationalist in its original orientation, and continued to be so in the Golden age of welfare politics. Lately, the internationalism has turned sour as many workers have listened to the siren spells of the populist far right. Many manufacturing workers, e.g. in Finland during the crisis, have become frustrated about the reluctance of modern policymakers to support ailing industries. The rise in immigration has apparently also alienated parts of labour constituencies. This has raised nationalism to the political arena, as witnessed by the surge of right wing populist parties. Especially in Denmark and Finland, Social Democracy has been severely weakened by ascending welfare-chauvinist parties, but similar tendencies are witnessed in Sweden and Norway.⁵² In Finland, many left wing politicians are receptive to the idea that social insurance is a national asset, reserved for people born in Finland. Thus, the dangers of “social tourism” are often extolled, and a “realistic” attitude towards immigrants who allegedly want to exploit “our” generous social security is recommended. However, the same politicians would hardly characterize Finland’s social safety net as too generous when it is discussed unconnected from the issue of immigration. Such unreflective nationalism should be resisted. Of course, there are real economic dilemmas here. Labour migrants do not migrate in order to live off Social Security, but they might get stuck in unemployment if they discover that the social insurance income they are entitled to exceeds their potential earnings. Restricting immigration would be a flawed political conclusion about such problems. Instead, immigrants should be seen as a kind of acid test about whether the social insurance and income support systems, together with activation policies, are properly designed. In my view, if they do not work for immigrants, it is questionable whether they work for natives. More appropriate solutions should be sought in the direction of a decent wage floor, generous training efforts, ungenerous but decent income support as well as vigorous activation efforts and.⁵³

Should the labour movement turn nationalistic and chauvinistic to a large extent, it will in my view lose the game. With aging societies and a deepening international division of labour, there

⁵² For example, recent polls indicated that Sverigedemokratene and Fremskrittspartiet attract considerable shares of union voters in Sweden and Norway (LO-aktuelt 2013).

⁵³ These issues are discussed in the Norwegian committee report NOU 2011:7, which recommend that wherever possible, social policies ought to be more oriented towards provision of services and activation than passive transfers.

is simply no future in nationalist fantasies. To safeguard the Nordic systems of social security and labour protection, they must be made compatible with increased international mobility. Besides ensuring a wage floor that prevents low wage competition and makes work pay, it must be possible for immigrants to be part of the host country's social security system after a reasonable period of working. Yet these issues will most likely continue to be sources of contention for all mainstream parties, and especially for Social Democracy which tends to lose most voters to the populist parties.⁵⁴ On the other hand, the efforts to counter wage dumping and exploitation of foreign workers offers a new opportunity for the labour movement to prove its solidaristic credentials and develop strategies that combine justice in the labour market with inclusive and migration-proof welfare policies built on longstanding "work line" principles.

Being hostage to public sector unions?

A final caveat for the Social Democrats' policy capability arises from their dependence on the trade unions. I suggested above that many of today's policy challenges are such that governing political coalitions at times also will have to challenge the unions. Governments of all colors need autonomy and capacity to resist the demands of strong interest groups, including the trade unions, and even in the heyday of the Nordic labour movements there were sometimes harsh conflicts between its union arm and its governing political arm. In today's fierce, continuous party competition over voter support and poll rankings, Social democratic parties appear more vulnerable to conflicts with the allied unions than parties that primarily rely on support from other constituencies. As the latter evidently feel less obliged to heed union demands, they can sometimes also find it easier to strike difficult compromises with the unions. For example, the Swedish Alliance government was in 2013 able to strike compromises with the unions as to young workers' lower introductory wages and a reversal of the contested differentiation of unemployment insurance fees. This was probably partly because it had other bargaining chips in its drawer, partly because an election campaign was coming up in which the Moderate party would need considerable labour votes to remain in office.⁵⁵ The Social democrats' dependence on union support can become especially acute when it comes to reforms in public services. In many instances there is a conflict of interest between the taxpayers, the users of public services, and the public sector unions, which is particularly difficult for Social Democrats to address. When the labour force is approximately stagnant, it is important to improve the organisations of

⁵⁴ In an upcoming report for this NordMod 2030 project, Djuve and Skjevik Grødem survey welfare-chauvinistic attitudes in the Nordic countries. They clearly exist although they are not dominant.

⁵⁵ The Alliance government had prepared a reform of compulsory and public unemployment insurance that would have destroyed the Swedish Gent system and most likely would have led to a sharp decrease in trade union membership. This was never presented to the Parliament, but it was probably a useful bargaining chip in the administration's dealings with the trade unions as to remuneration of introductory jobs. At the end of the day, the government proposal was dropped, perhaps also because the Moderate party had to take into account its dependence on union votes.

central and local government and to look for new solutions that would enhance public sector productivity and allow for reallocation of public employment according to shifting needs and priorities. Such issues are difficult for any party but particularly so for Social Democrats, who regard themselves as the prime guardians of both the users and the providers of public services.⁵⁶

Education: swimming with the stream

Analyzing the relationship between creation and sharing of economic wealth, I have in this paper challenged Social Democracy and tried to tear open, in a candid way, several points of friction between the current economic orthodoxy and the labour movement's traditional politics. Such frictions have to do with labour supply measures, activation, immigration and the unions' influence on structural unemployment.

In contrast to the issues review above one policy area in which Social Democracy can really swim with the tide is education and the formation of skills. The Nordics have usually done well in international comparisons of population skills, recently manifested in the OECD PIACC-report⁵⁷ on adult literacy, numeracy and ICT-skills, where Finland was in the top and Sweden and Norway followed suit, while DK was a bit behind. Even among people without higher education, Finns with high school had better basic skills than Spaniards and Italians with tertiary education (college degrees). Further, the Nordics are on top as to the tertiary education share of population, and especially so among women. PISA comparisons also suggest that countries with comprehensive primary school systems tend to do well, something that reinforces the very Nordic idea of a universalistic and publicly provided primary education. A strong link between such a school system and social mobility has also been established in the case of Finland: as shown by Pekkarinen, Uusitalo and Kerr (2009), a comprehensive school reform that abolished traditional tracking and created a unitary primary education system also led to an almost dramatic drop in the correlation of children's incomes with that of their parents.

⁵⁶ In Finland's parliamentary election of 2007, for example, the National Coalition Party somewhat shamelessly built its electoral platform on a promise of increasing the salaries of nurses employed in municipalities. The ensuing pay rises probably increased the wage pressures after 2007, contributing to the serious loss of competitiveness after 2007. An example of a similar pandering to public employees was the unanimous decision taken in the Finnish parliament 2008 to create a job protection of 5 years for municipal workers in the case of mergers of municipalities. While such protections should be part of the Nordic approach, 5 years is clearly excessive in a time of public sector restructuring.

⁵⁷ See <http://www.oecd.org/site/piaac/Skills%20volume%201%20%28eng%29--full%20v12--eBook%20%2804%2011%202013%29.pdf>

Yet, the latest PISA trends do indicate that even the Nordics are facing troubles in this field, especially Sweden, but also Norway and Denmark, partly reflecting high drop-out rates from secondary schools and vocational training. Such problems may be related to the growing immigrant populations (and, in Sweden for example, to youth unemployment). Therefore, given the close relationship between employment rates and education, this may indicate tougher challenges ahead as to maintaining high employment rates, low NAIRUs, and the high productivity growth traditionally marking the Nordic countries. Such policy challenges notwithstanding, this is a policy area that is still fertile for proponents of the Nordic model and one in which the original, universalist aspirations of Nordic Social Democracy are well in sync with the emerging policy consensus: education is the key to success, and comprehensive primary school systems tend to do well.

6. Conclusion

This survey started with an extremely positive assessment: the central ideas and institutions of the Nordic model are in principle perfectly well aligned with the requirements of a thriving market economy. There is even a mutually reinforcing dynamic. By various mechanisms, the sharing of power and income as well as the creation of skills has contributed to the Nordic countries' economic successes. That success, together with equitable outcomes, has in turn contributed to the political popularity of economically viable and realistic policies.

However, in section 5, I argued that many points of political friction are likely to arise. Although the values underlying the Nordic models in many respects originate from the labour movement, the policy repertoires and instruments of the labour movement are not always well aligned with the economic and social policies needed to ensure the Nordic model's future viability.

The conclusion of my review so far is that the core values of the Nordic model are still well aligned with growth and employment friendly economic policy, but that tensions arise because political systems and the labour movement as well as key producer groups tend to become wedded to specific policy tools and established institutions.

One interpretation of my account could be that Nordic Social Democracy has pulled off a complete victory in the competition between social orders. Everybody now embraces the basic idea of the Social Democratic welfare state, and the non-Socialist parties have gained their political upper hand by renouncing any attempts to roll back the basic deal – therefore attracting more labour votes. Because there is a sound economic logic in the Social Democratic welfare arrangements, and strong competition about voters who care for the model, no political coalition will want to roll back the welfare state. Although political coalitions might shift and no one party will be hegemonic, responsible policies will prevail and the attractive characteristics of the Nordic societies will persist. In this interpretation Social Democracy has somehow become victim to its own success, since everybody has become Social Democrats. This does not mean that Social Democracy has become redundant. A credible Social Democratic alternative is a prerequisite for real party competition about the broad voter groups who want to retain the Nordic model, and is thus indispensable to bind the non-Socialist parties to maintain the model.

The fact that the present needs of economic policy do not always rhyme well with Social Democratic bone marrow reflexes does in no way automatically imply that other, non-Socialist parties will be up to the task. The way to manage rising immigration is contested in all camps, and it is difficult for political parties of all persuasions to argue for labour supply boosting measures, higher retirement ages and reallocation of public resources. There are ample examples of such difficulties in all the Nordic countries. Time will tell whether these arrangements are politically sustainable, in the sense that there is sufficient political support to undertake the

adjustments needed to preserve their basic tenets. Opinion polls continue to show robust political support for Social Democratic welfare and labour market institutions of the Nordic countries. The real acid test, however, lies in whether the Nordic voters will be comfortable with – and the Nordic politicians will be bold enough to stand up for – the high levels of taxation and the stringent work line policies that are necessary to maintain the viability of these institutions. In this respect, there might be a more serious cultural challenge in store, as more and more Nordics apparently want to have both an individualistic and materialistic life-style and the social protection of institutions that cannot be financially secured if the future generations turn out to be very leisure-oriented. If the Nordic countries do not manage to maintain their high work ethics and employment rates, they will most likely have to choose between even more stringent work line policies or the dismantling of parts of the safety nets and public services.

Still, I am reasonably optimistic about the positive scenario being borne out. The Nordic countries tend to have stronger public finances than other European countries, and they have historically, often in the wake of crisis, been able to address their economic problems with adequate shifts in economic policies and incremental adjustments of their social models.⁵⁸

While especially Sweden and Denmark have gone a long way to address the effects of aging, other countries have still work to do in this area. One measure that summarizes the farsightedness of economic policy quite well is the fiscal sustainability gap.⁵⁹ Countries that can proactively meet the challenge of aging with adequate labour supply policy would display a low sustainability gap, whereas countries that have short sighted policies would show a large one. According to the European Commission last sustainability report from 2012, Sweden's gap is estimated at 1.7 per cent and Denmark's at 2.6 per cent. These are quite low figures by European standards. Finland's gap, however, is as big as 5.8 per cent, as estimated with a similar methodology. Thus, it is clear that even the Nordic countries and Finland in particular have work to do.

It is also possible to imagine different and less attractive trajectories. Firstly, the ascension of nationalistic parties may simply turn out to be too powerful. At some stage, either an intellectually weakened Social Democracy or frustrated right-of-centre parties will start

⁵⁸ For example, the Nordic banking sectors have – except in Iceland and partly Denmark – not been much affected by the financial crisis of 2009. This should probably be attributed to the fact the Nordic financial sector agents still have fresh memories of the banking crises of the 1990s and not to any inherent superiority of Nordic bankers.

⁵⁹ Technically, the S2 sustainability indicator is the amount of fiscal improvement, measured as per cent of GDP, that would in advance, in the absence of new reforms, ensure that the country's public debt does not explode over time when the effects of aging kick in.

compromising with the nationalists.⁶⁰ In practice, this may imply policies that are dysfunctional for growth and public finances: departures from international engagements, a return to protectionism, restricted immigration and protection of ailing manufacturing. For all the Nordic countries, however, I would consider that an unlikely scenario. It would probably also prove short-lived, since such policies would soon lead to a dead end as to growth and fiscal sustainability.

Another, more likely scenario would involve a gradual weakening of the general will to sustain a universalistic welfare state. Although the right-of-centre parties – that are likely to play an important role in many Nordic parliaments in the years to come – have clearly stated a willingness to keep the welfare state there, they might nevertheless in the long run just be less resistant to gradual tendencies that unwind the universalistic social contract. Schools and health care in particular are important. A destructive spiral could, in my view, start if the fiscal needs of the government are not properly catered for. If, say, the public providers of primary schooling and health services are short of resources and cannot sustain proper standards – e.g. due to ill-founded tax-reliefs –, the most well to do people will start looking for alternative solutions such as private schools and private providers of health care, as already seen in Denmark and Sweden to considerable extent. If that continues, the upper middle class will increasingly turn to these private providers while the public provision becomes some kind of pauper standard. In such circumstances, with the well-to-do middle class paying both their taxes and for their private tuitions, they may well start to ask whether they get a fair enough deal for their tax money. I certainly do not think that this must happen, but it is something that could happen.

Again, it seems, it is a muscular and economically realistic middle-of-the-road policy that is the best shield against such scenarios. Public services must keep their standards, even if that might at times presuppose policies that not all Social Democrats like – for example, a stricter definition of what the public sector provides, or a tougher stance as a public employer, or experimenting with outsourced service production if that can spare costs, even against the will of public sector unions. As well as, of course, a strict resistance towards populist tax revolts.

If the political will to operate a responsible economic policy is there and if the central and local governments as well as the pensions system stay financially robust, I see no basic obstacle for a continuous success of the Nordic welfare states.

Many of these outcomes hinge on a proper balance of forces between the unions and the government, as well as the unions' own co-ordinating capability. Responsible co-ordination of union wage claims is indispensable to ensure that the internationally exposed manufacturing

⁶⁰ In the Norwegian example, where Fremskrittspartiet has become part of a conservative government coalition reliant on centrist support in parliament, it seems thus far that it is the nationalists that have to bend to the centre.

unions set the wage increase norm. This is particularly important for Finland, where the ceding of the exchange rate mechanism implies that its competitiveness within the Eurozone directly depends on its unit labour costs. It is ironical, though, that Finland is precisely the country in which no consensus about such a wage norm currently exists, in contrast to Sweden, Norway and Denmark.

Equally important is probably that the unions – in cooperation with the government and employers – manage to retain decent wage floors in order to ensure that work still pays and that low-wage competition is not allowed to erode the “high productivity-deal” underlying the Nordic models. Conversely, the unions will also have to accept the need for stringent labour supply policies. A tough work line is needed, but it is best designed in consultation with the unions, not in confrontation. This requires governments that do not embrace everything the unions want, and can at times resist their claims – but are ultimately willing to work with them. Nordic societies have been forged as compromises, and their ability to cope with future challenges will most likely hinge on their capacity to continue so.

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NordMod2030 – publications and reference group

The project's URL is <http://www.fafo.no/nordmod2030/index.html>

Published and forthcoming publications

It is initially planned 13 sub-reports before the main report is to be presented at the SAMAK Congress in November 2014. The various reports are as follows:

- Sub-report 1: The Nordic models' pillars (published)
- Sub-report 2: Nordic population changes (published)
- Sub-report 1: Nordic tax policy (published)
- Sub-report 3: Changes in external conditions (published)
- Sub-report 4: Country Study of Iceland
- Sub-report 5: Country Study of Norway (published)
- Sub-report 6: Country Study of Finland (published)
- Sub-report 7: Country Study of Denmark
- Sub-report 8: Country Study of Sweden (published)
- Sub-report 9: Decent work– the future of the collective agreement (published)
- Sub-report 10: The welfare model (multiple papers)
- Sub-report 11: Inclusion and integration challenges
- Sub-report 12: To create and share – the remarkable success and contested future of the Nordic Social-Democratic Model
- Sub-report 13: Innovation and innovation policy in the Nordic region
- Sub-report 14: Democracy and participation
- Main report

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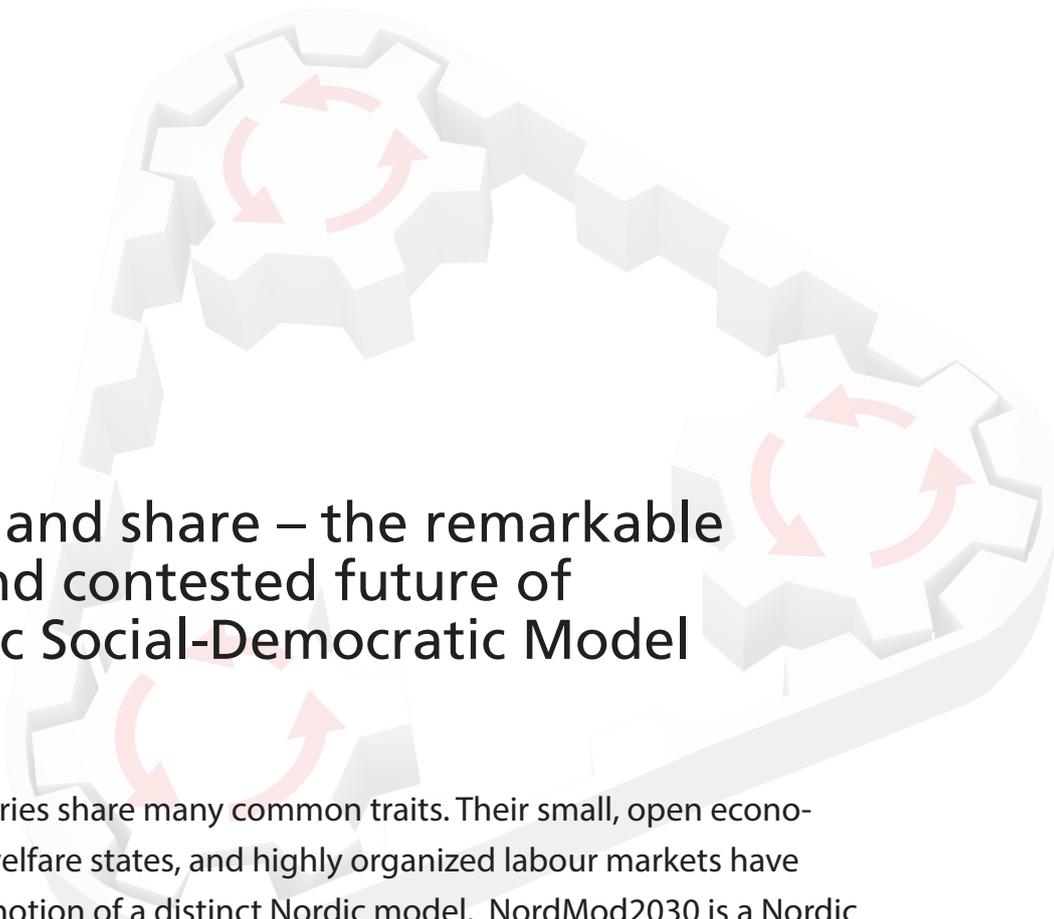
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To create and share – the remarkable success and contested future of the Nordic Social-Democratic Model

The Nordic countries share many common traits. Their small, open economies, generous welfare states, and highly organized labour markets have given rise to the notion of a distinct Nordic model. NordMod2030 is a Nordic research project, assigned to identify and discuss the main challenges these countries will have to cope with towards 2030. The purpose is to contribute to the knowledge basis for further development and renewal of the Nordic models. The main report from the project will be delivered in November 2014. In the meanwhile the project will publish a number of country studies and thematic, comparative reports which will be subject to discussion at a series of open seminars.



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