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THE DECLINE OF SOCIAL DEMOCRACY

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Introduction

Social democracy today faces a troubled future. Electoral support is falling, the system of collective bargaining is in disarray, pressure is mounting to reduce welfare expenditures, income inequality is rising again and, most strikingly, the major social democratic parties are rapidly abandoning social democracy and embracing market liberalism. During the height of social democratic influence in the late 1960s and early 1970s, much of the debate over social democracy centered on the prospects for advancing toward socialism.[1] It is indicative of the current troubles of social democracy that the contemporary debate concerns the durability of social democracy's past achievements. Instead of profiting from the political collapse of Communism, their traditional competitor on the Left, social democrats today fear their own collapse will follow.

The essence of the political strategy of social democracy centered on the cumulative nature of political mobilization and legislative reforms (Esping-Andersen 1985: 3-38; Przeworski 1985: 239-248). The more workers were organized in unions and mobilized as voters, the less employers and governments would be able to resist workers' demands. Each victory in parliament or at the bargaining table, in turn, increased workers' strength and laid the groundwork for the next advance. No reform was revolutionary in itself, but the cumulative impact of incremental increases in workers' power would transform society in the long run. Moreover, the flexibility of capitalism seemed to allow social democrats to finesse the one major demand that defied compromise with non-socialist parties: the elimination of private concentrations of wealth. Never having sufficient political power to challenge private ownership of capital, social democrats sought instead to construct a system of incentives that would lead private businesses to allocate their capital in socially desirable ways without altering formal property rights. The Swedish social democrats adopted the term "functional socialism" to denote the program of "divesting" capitalists of the functions of ownership without challenging ownership per se (Adler-Karlsson 1967).

Skeptics have doubted the long-term feasibility of the social democratic strategy from the beginning. In 1899 Rosa Luxemburg described trade unions and, by extension reformists in the party, as engaged in "a sort of a labor of Sisyphus" (1970: 43) in which partial victories would be continually eroded by market forces. Contemporary conservative critics make the reverse argument that market forces have been steadily eroded by social democratic achievements with deleterious consequences for economic performance. For example, a recent review of the Swedish model by Erik Lundberg (1985) begins with the assertion that four decades of social democratic governments have produced a "cumulative rise in state intervention and in selective regulation of the economy, implying distortions of markets and of the price system...[and a] weakening of incentives to work, invest and save, as well as to start new enterprises" (2).

Does social democracy represent a potentially stable organization of advanced industrial societies, or a precarious compromise that is impossible to sustain over the long run? Our purpose in this paper is to provide what answers we can based upon an assessment of the difficulties that have emerged in the social democratic strongholds of Norway and Sweden.[2]

Social democracy can be characterized in multiple ways. In political terms, social democracy represents the building of workers' power through strong unions. The unions represent workers directly vis-a-vis employers and exert a strong influence over the party. The party, in turn, is (or used to be) the dominant actor in parliament. Institutionally, social democracy is distinguished by a large welfare state, encompassing and centralized trade unions and a system of routinized consultation and cooperation between government, union and employer representatives that has been given the label of "corporatism". In terms of policy, social democracy in Northern Europe is characterized by a commitment to wage levelling through solidaristic bargaining, the provision of basic goods and services to all as a right of citizenship, and full employment as the primary objective of macroeconomic policy. In the discussion that follows, we primarily address the viability of social democracy as a social and economic system rather than as a political movement, even though some of the most visible signs of distress are political. But before we consider the long term feasibility of social democracy, we briefly review both its past achievements and its current difficulties.

Past Achievements

A discussion of the current state of disarray of social democracy in Norway and Sweden must begin with its past success. Superficially, at least, there is little reason to say there was anything wrong with social democracy. By most comparative measures, social democratic governments in the two countries have done remarkably well in obtaining their objectives while maintaining conditions conducive to continual private investment and economic growth.

The primary goals of social democracy in Northern Europe have been to reduce the insecurity and inequality of income for wage-earners in a capitalist society. Insecurity has been reduced, above all, by the gamut of programs that constitute the welfare state, most notably public pensions and health care. Sweden is well known as having one of the largest welfare states in the world, as measured by government expenditures as a share of GDP: 61.3 per cent in 1988 (OECD 1989a: 20). The 54 per cent of GDP that is spent by all levels of government in Norway is low only in comparison to Sweden, Denmark and the Netherlands (OECD 1989b: 159) A significant share of the housing stock was built by municipal governments in Sweden and by state-subsidized cooperatives in Norway. A public day care system provides care for almost all children in Sweden; around half in Norway. Elderly are guaranteed a basic pension that is independent of their lifetime earnings or contributions to the pension system. Good health care is available to all. Adam Przeworski and Jeong-Hwa Lee (1990) estimate that a Swede with no participation in the labor force received the equivalent of $3,360 (1980 US dollars) from the government in 1981. A Norwegian in the same position received $2,930. In contrast, an American received $1,971 while a Japanese received only $1,164.

Insecurity was also reduced by a strong commitment to the maintenance of full employment. The most innovative policy was the active labor market policy, pioneered by the Swedes in the 1950s and copied by the Norwegians in the 1970s. The active labor market policy consists of a variety of measures designed to improve labor mobility: information to workers about vacancies and to employers about applicants, subsidies for relocation and, above all, vocational retraining. In the 1980s, Sweden was spending close to two per cent of GDP on active labor market policies, much more than any other country. But since Sweden was spending less on unemployment benefits, total expenditures on labor market policies was close to the European average (Layard, Nickell and Jackman 1991).

The active labor market policy kept open unemployment down by sending the unemployed back to school for vocational training.[3] The other part of the social democratic employment strategy was the use of macroeconomic policies to maintain full employment. The emphasis on employment reflected the trade union base of the social democratic movement. Full employment was valued because it increased both workers' security and workers' influence. The way to maximize workers' power inside the factory, the thinking went, was to maintain conditions where workers could always quit and obtain another job across the street if they were dissatisfied. In a comparative context, the Swedish and Norwegian commitment to full employment was extraordinary. Norway and Sweden kept unemployment below 2.5 per cent throughout the period when unemployment rates were rising above 10 per cent in much of Europe. Of the advanced industrial societies, the only other countries with as small an increase in unemployment during the decade following the first oil price shock of 1973/74 were Austria, Switzerland and Japan (Bean, Layard and Nickell 1986).

Inequality of income has been reduced through both fiscal policies and solidaristic wage bargaining, (Strøm, Stølen and Torp 1988, Hibbs and Locking 1991). Fiscal policy has reduced income inequality largely through expenditures in universalistic programs, rather than through progressive taxation or means tested programs. Nevertheless, the impact has been substantial.[4]. In addition, the union commitment to the reduction of wage inequalities through collective bargaining has had a strong impact on pre-tax wage dispersion, particularly in the public sector. According to Richard Freeman (1988), Sweden had the most egalitarian wage structure of any advanced industrial society. Norway and Denmark were tied for second place.

Finally, it should be observed that economic performance along other dimensions was not notably worse than elsewhere in Europe until the 1980s. Economic growth in Sweden has been lower than the European average through much of the postwar period, but Sweden began the period with a relatively high level of GDP per capita. Economic growth in the richer U.S. was even slower. Norway has grown exceptionally rapidly, surpassing the U.S. and all other advanced industrial societies in GDP per capita by 1985 (Summers and Heston 1988). In the early 1980s, much of the growth of income in Norway was due to rising revenues from exports of North Sea oil. Yet Norway grew rapidly prior to the discovery of oil. Moreover, Norway managed to escape the rise in unemployment (the Dutch disease) that accompanied the oil boom in the Netherlands and Great Britain.

Current Difficulties

It is easy to praise Scandinavian social democracy. If social democracy is so successful, one might retort, why is it in such disarray? Electoral support for the social democratic parties has fallen in both Norway and Sweden from its postwar peak. The Norwegian Labor Party received 46 per cent of the vote in 1969, but only 34 per cent in 1989. In 1968 the Swedish Social Democrats obtained 50 per cent of the vote. In 1991, votes for the Swedish Social Democratic Party fell below 38 per cent. The decline of votes for the

Norwegian Labor Party has been partially, albeit not entirely, offset by growing votes for the greenish Left Socialist Party. In Sweden the decline in votes for the Social Democratic Party was amplified in 1991 by similar losses for the other, smaller parties on the left. In both countries, the biggest gainers have been the most rightwing of the bourgeois parties. Moreover, the youngest voters are the most likely to vote for the right.

As social democracy has declined at the polls, the social democratic model of industrial relations characterized by highly centralized bargaining and a general absence of industrial conflict has completely disappeared in Sweden. The mortal blow to the Swedish centralized bargaining system appears to have been the withdrawal of the metal workers from the central negotiations in 1983. In the second half of the 1980s, centralized bargaining was resurrected, but without any obligation to refrain from industrial conflict in supplementary bargaining at the industry and local level. In 1990, the national association of Swedish employers (SAF) eliminated the possibility of centralized bargaining by disbanding its bargaining unit (Myrdal 1991).

In Norway centralized bargaining continues, albeit tentatively. Throughout the 1980s, locally bargained wage increases constituted a rising share of aggregate wage growth (Rødseth and Holden 1991). In 1988 and 1989, wages were frozen by an act of parliament. The first 1990 central agreement was rejected by the union membership in a ratification vote forcing the union leadership back to the bargaining table to renegotiate a new contract. By 1991, leaders of the Norwegian employers' association (NHO) were discussing withdrawing from all government committees concerned with centralized wage negotiations (Nordby 1991).

The sharpest evidence of the decline of social democracy is to be found in the current policies of the social democratic parties. Tax reform modelled after the Reagan tax reform in Sweden,[5] deregulation of the housing market in Norway, deregulation of financial markets in both countries, all testify to the increased support for free market policies in social democratic cabinets. The most dramatic deviations from past practices, however, are in macroeconomic policy and the question of entry into the European Community.

The commitment to full employment is gone. In 1988 unemployment in Norway jumped sharply to around 4.5 per cent. Three years later, the Norwegian unemployment rate had risen to 5.6 per cent (Central Bureau of Statistics 1991). Rather than stimulate demand in response, the Labor government has tied the Norwegian kroner to the ecu. In 1990, the Swedish Social Democratic government declared for the first time since coming to power in 1932 that price stability would henceforth be given priority over full employment (*Economist*, Nov. 17, 1990: 95). Between 1990 and 1991, Swedish unemployment doubled from 1.5 per cent to 3.0 per cent. Current forecasts are for unemployment in Sweden to continue to climb as high as 4.5–5.5 per cent (Central Bureau of Statistics 1991).[6] Such levels of unemployment may seem mild compared to most countries, but they are exceptionally high for countries whose unemployment rate scarcely exceeded two per cent for four decades. Politically, it is devastating. The promise of full employment was one of the pillars of social democratic electoral support. For the first time since the Norwegian Labor Party came to power in 1935, public opinion polls reveal that voters no longer think the Labor Party can do a better job than the bourgeois parties in fighting unemployment.

The second dramatic policy reversal concerns membership in the European Community. On July 1, 1991 the Swedish Social Democratic government submitted an application to join the EC. The Norwegian Labor Party is trying to avoid the issue, having fought and lost a bitter election over joining the EC in 1972. As Sweden proceeds with the application process, however, the pressure on Norway to apply for membership will greatly increase. The costs and benefits of membership for different groups within Norway and Sweden are too complex and controversial to review here. Suffice to say that membership is likely to force a reduction of some of the most important taxes in terms of revenue collection, notably the value-added tax. Membership may also accelerate the recent trend toward greater income inequality. It is sometimes said that one of the competitive advantages of both Norway and Sweden is the relatively low price of highly skilled technical and scientific labor. With open labor markets and much higher wages abroad, can the wages of multi-lingual engineers be kept from rising?

As Przeworski (1985: 239-243) observed, social democratic achievements are not irreversible. Past gains can be lost as a consequence of reversals at the ballot box, or declines in union strength. Of course, a society does not change radically just because the bourgeois parties manage to form the government or the social democratic parties adopt liberal economic policies. The decline of social democracy is likely to be gradual but cumulative in a way that mirrors its step-by-step rise. What went wrong?

The Long-Run Viability of Social Democracy

We divide our discussion into problems with welfare policy, wage determination and unemployment, centralized bargaining, capital controls and productivity growth.

Welfare Policy

The welfare state may prove to be the most durable social democratic achievement. Welfare policies remain politically popular. Moreover, welfare programs seem to have proven to be effective instruments for achieving the twin social democratic objectives of greater security and less inequality of income. That welfare policies have effectively reduced poverty and increased security for all citizens is uncontroversial. (The contrast with the United States in this regard is bracing.) That welfare policies have also increased the equality of income is less so. It is certainly true that the benefits citizens receive bear little relation to the taxes they contribute. Many have argued, however, that the direct redistributive impact of taxes and welfare expenditures is offset by a more inegalitarian pre-tax distribution of income. Yet, in a system where most wages are set through collective bargaining, the likely net effect of redistributive policies is to increase the equality of income because of the way that welfare programs improve the bargaining position of the lowest paid groups.

To see this, consider a model of social democracy as an n-person bargaining game. Leif Johansen (1979) argued that social democracy is best understood as a "bargaining society" where the allocation of income is determined through centralized negotiations among the major social groups. Thus, the bargaining framework is a natural one to use. Let the gains from bargaining be represented by a standard superadditive characteristic function with transferable utility, where $v(S)$ represents the total that could be obtained by coalition S without a central agreement and $v(N)$ represents the total payoff obtainable by the grand coalition of all groups. To keep things simple, we assume the core exists.

We model welfare programs as providing income and services received independently of employment, such as national health care, family allowances, subsidized housing, and so on. We ignore those welfare benefits that are received in place of employment. We also ignore the impact of taxes and transfers on aggregate production in order to focus on redistribution. The payoffs (after tax) for each individual are denoted x_i. Let x^* be the social wage that is guaranteed for all, t be the uniform tax rate on market income and s be the number of members of S. Then the core of the game with taxes and the social wage would be defined to be an allocation of payoffs to individuals $x_1, x_2, \ldots, x_n$ that satisfies

$$\sum_{i \in N} (x_i + x^*) = v(N), \quad \text{and}$$
$$\sum_{i \in S} (x_i + x^*) \geq (1 - t)v(S) + sx^* \equiv Q(S) \quad \text{for all } S \subset N.$$

The tax rate needed to finance transfer payments of nx^* depends on the particular coalitions that form. Since the game is superadditive, a division of the grand coalition into a large number of small coalitions may imply lower aggregate income and a higher necessary tax rate. We will assume that all possible coalitions S act on the basis of optimistic expectations in the sense that each believes that members of N not in S, written $N \setminus S$, will stick together. (Other assumptions regarding conjectures would serve equally well.) Then the average tax rate is $t = nx^*/[v(S) + v(N \setminus S)]$. Inserting this expression for t in the definition of $Q(S)$ and rearranging terms, we have

$$Q(S) = v(S) + \frac{s(n-s)}{v(N \setminus S) + v(S)} \left[\frac{v(N \setminus S)}{n - s} - \frac{v(S)}{s} \right] x^*.$$

Thus the minimal payoff a coalition must obtain is an increasing function of x^* for any group that can guarantee itself less per capita in the market $v(S)/s$ than the per capita income of their complement $v(N \setminus S)/(n - s)$. Conversely, the constraint is reduced as x^*

rises for a group with $v(S)/s > v(N \setminus S)/(n-s)$. By improving the outside option for low income groups, a uniform tax on income together with welfare benefits distributed equally to all pushes the final allocation in a more egalitarian direction.[7]

Yet all is not well with the welfare state. The cost of maintaining existing levels of benefits is growing faster than the economy. One reason is simply demographic and shared by all advanced industrial societies: the growing share of pensioners in the population. But it is not only the elderly who have placed increasing demands on the welfare system. In Scandinavia, like in the U.S., the number of single-parent families has increased sharply. The surge in women's participation in the labor force has led to a new and expensive demand for public provision of child care. Moreover, productivity gains are hard to obtain in the public sector and solidaristic bargaining has raised wages in the relatively low-paid public sector more rapidly than elsewhere in the economy.

At the same time, it is no longer feasible to raise taxes significantly. Taxes as a share of GDP in the Nordic countries seemed to have reached their political, if not their economic, ceiling during the early 1980s. In fact, Swedish taxes have been reduced substantially in the past decade. Therefore, the rising cost of maintaining existing benefits has meant increasingly visible declines in quality and lower government investment. In terms of the model, the situation has changed from a world where x^* was chosen and t was adjusted accordingly, to a world where t is given and x^* adjusts. As x^* falls, the final distribution of income becomes less egalitarian. Moreover, as the quality of public services decline, people with sufficient wealth demand access to private alternatives. There is much discussion of whether or not private hospitals or private schools should be permitted. The danger, as

Hirschman (1970) argued, is that once people exit the public system, they will no longer fight for better public services, nor vote in support of high taxes.

The increasing cost of welfare benefits and the declining quality of public services raises anew the question of universalistic versus means-tested programs. In sharp contrast to welfare policy in the United States, social democrats have traditionally chosen universalistic benefits, i.e. benefits that go to all by virtue of citizenship, rather than benefits that go only to those in need. Universalistic programs have good features from both economic and political perspectives. From the economic viewpoint, universalistic programs avoid the bad incentive effects of policies which subsidize certain choices and punish others. The only way to protect children without discouraging two-parent households, for example, is to give child support to all parents regardless of marital status. From a political viewpoint, universalistic programs obtain levels of popular support that far exceed the support for programs whose benefits go only to relatively small groups. Consider the difference in political support for social security in the United States, as compared to support for means-tested welfare programs. Universalistic programs are expensive, however. As the pressure to limit costs increases, so does the pressure to limit benefits to those in greatest need. But as welfare programs come to consist of benefits targeted for particular groups, public support declines.

A different type of problem with the welfare system stems from dissatisfaction with the way in which benefits are distributed. Welfare benefits have to be rationed, since demand exceeds supply. Some benefits, such as pensions, are distributed on the basis of clearly defined rules. Others, like non-emergency medical procedures, are distributed with a large component of administrative discretion. Discretion is inevitable when an attempt is made to give priority to those in greatest need, since rules for every contingency are impossible to write. Discretion, however, easily appears to be arbitrary. Prospective hospital patients can jump to the head of the queue by finding a doctor willing to help. Parents can get their children put first in line for day care by convincing a municipal employee that their need is particularly acute. As it becomes common knowledge that the welfare system is capable of being manipulated, everyone feels that they must seek to manipulate the system as well to receive as much as the others.

Increased dissatisfaction with the cost and quality of welfare services has led to demands for reforms that introduce greater competition in the public sector. However, changes in the system of welfare provision that threaten to reduce the wages of welfare providers, increase their workload or remove their job security are fought by the public sector unions. Thus the bourgeois parties have an easier time championing welfare reform than the social democratic parties with their trade union base.

Nevertheless, the welfare state remains an achievement social democrats are justly proud of. While there is much controversy over the way in which welfare services are provided and whether welfare benefits ought to be maintained at their current levels, the core programs of the welfare state remain popular. Indeed, the threat that the political programs of the non-socialist parties pose to the funding of welfare services has become the most effective campaign issue for social democratic parties today.

Wage Setting and Unemployment

The central position of the trade unions in the social democratic movement is one of the most distinctive characteristics of Scandinavian social democracy. Many critics have argued that a market economy dominated by powerful unions is bound for trouble. To the extent that unions obtain monopoly rents by curtailing output and raising the price, allocative efficiency is impaired. If unions capture a share of the quasi-rents associated with sunk investments in plant and equipment, firms will invest less (Grout 1984, Moene 1990). If the unions' political influence leads to policies that maintain employment by accommodating union wage demands, the result will be accelerating inflation and possible lower employment (Calmfors and Horn 1985).

Yet the Nordic experience speaks against the view that the stronger the unions, the worse the economy. Precisely because the unions in Norway and Sweden were strong institutions in the sense of being large relative to the work force, highly centralized and closely allied with a party that was often (in the Swedish case always) in government, they accepted much responsibility for national economic performance. National-level bargaining reduces the ability of industrial unions to raise the relative price of output through wage increases (Calmfors and Driffill 1988). Centralized bargaining increases the willingness of unions to restrain wage growth in order to obtain investment, since the benefits of investment are typically received by members of more than one union (Wallerstein 1990). Institutional stability and centralization may increase the unions' time horizon, leading to a greater willingness to make short term sacrifices for long term gains (Przeworski and Wallerstein 1982, Rødseth 1986). Solidaristic bargaining encourages the building of new plants while it forces less efficient plants to close (Moene and Wallerstein 1992). Finally, the close alliance between the unions and a party either in government or soon to be in government leads as much to self-discipline on the part of the unions as it does to accommodating policies on the part of the government (Lange and Garrett 1985).

The past success of the social democratic system of wage determination in reconciling strong unions with macroeconomic stability and full employment presents a sharp contrast with the current disarray. The problem can be seen as one of equilibrium between the government and the institutions of collective bargaining. The system of collective bargaining worked as well as it did because it was supported by macroeconomic policies to maintain international competitiveness and full employment. Similarly, government macroeconomic policy depended for its effectiveness on the unions' ability to restrain wages through centralized bargaining.

According to the Aukrust model (sometimes called the Scandinavian model) of wage-driven inflation in an open economy, the long-term rate of wage growth in the traded-goods sector is determined by the rate of productivity growth and the rate of change of the home country price of tradeables (Aukrust 1970, 1977). If there are constant returns to scale and international capital mobility, wage growth higher than the sum of productivity and price growth will cause capital flight and a reduction in employment in the traded-goods sector. If wage growth is lower than the growth of productivity and traded-goods prices, there will be a capital inflow, an increase in employment in the traded-goods sector and, eventually, labor shortages. Thus, the stability of employment in the traded-goods sector demands equality between wage increases and the sum of productivity growth and price changes. Equilibrium in the national labor market implies that wages in the rest of the economy grow at the same rate as wages in the traded-goods sector. In fact, according to Rødseth and Holden (1991), if one looks at aggregate wage growth over periods of, say, ten years, the Aukrust relationship fits the Norwegian data very closely.

In spite of the high level of centralization, the collective bargaining systems in Norway and Sweden did not provide self-regulating mechanisms for keeping wage growth in line with productivity plus foreign price growth under conditions of full employment.[8] While the central negotiators were sensitive to the need to maintain international competitiveness, much of wage growth in both countries occurred in supplementary negotiations at the local level. The union locals were forbidden to strike after the central agreement was signed, but other threats such as go-slow or work-to-rule actions remained available. In fact, the close collaboration between firms and unions at the local level in Scandinavia gives workers significant control over the work process that can easily be used to obtain local increases.

Locally bargained wage increases, or wage drift, is thus an important component of the Scandinavian system of wage determination, accounting for around half of the increase in total wages in the 50s and 60s. Steiner Holden (1989) has found that the amount added to wages at the local level is independent of both the wage increase obtained earlier through centralized bargaining central agreement and the rate of unemployment (within the limited range that unemployment varied prior to 1988). As wage increases negotiated at the central level declined in Norway in the 1980s, the share of drift in total wage growth has risen above 80 per cent (Rødseth and Holden 1991). This in itself has led to increasing conflicts between those unions whose members obtain drift and do not mind wage restraint at the central level and those unions whose members receive no drift and want compensation.[9] Studies of wage drift in Sweden by Bertil Holmlund and Per Skedinger (1990) and Douglas Hibbs and Håkan Locking (1991) conclude that drift partially offsets changes in the central agreement. As the centrally negotiated wage increase declines, wage drift increases. Since the LO cannot accept a negative wage increase in the national agreement, local bargaining sets a floor on nominal wage increases.

The preservation of international competitiveness, therefore, depends on sufficiently rapid productivity and foreign price growth to cover the wage drift plus some room for a centrally negotiated increase. When those external conditions failed, the maintenance of international balance required government intervention. The two most important instruments have been incomes policies (in Norway) and devaluations (in both). Reducing wage growth by government decree is politically acceptable in Norway only when used infrequently. Setting wages in parliament has never been accepted in Sweden. The attempt by the Swedish Social Democrats to impose wage controls in the winter of 1990 resulted in a parliamentary defeat and the resignation of the government. In addition, social democratic governments in both countries have tied the kroner to the ecu and declared that devaluations will no longer be employed to rescue firms when costs rise faster at home than abroad.

The new exchange rate regime is, in part, a consequence of the deregulation of domestic financial markets and the elimination of border controls on capital movement that have increased the cost of discretionary policies. But, of course, the liberalization of financial markets is not an exogenous event. A deeper reason, perhaps, lies with the weakening

(Norway) or collapse (Sweden) of the collective bargaining institutions. Devaluations are effective only as long as wages do not rise as fast as the price of tradeable goods. Underlying the successful use of monetary policy was the ability and willingness of the unions to restrain the centrally negotiated part of wage increases. In addition, since central bargainers generally demand a nominal wage increase which is then followed by additional increases negotiated at the local level, real wage restraint requires a moderate amount of inflation in the absence of sufficient productivity growth (Calmfors 1991). With the abandonment of an independent monetary policy, the entire burden of preserving full employment is placed directly on the unions. In practice, the self-discipline of the unions has been at least partially replaced by the harsher discipline of layoffs.

The Breakdown of Centralized Bargaining

Underneath the abandonment of the traditional social democratic promise of full employment lies the fragmentation of an increasingly heterogeneous union movement. Throughout Scandinavia, the unions have been successful in breaking out of their traditional strongholds and organizing in all industries and occupations. In the old days, (the 1950s and 1960s), the union movement was dominated by the confederation of blue-collar workers with close ties to the social democratic parties (known in both countries as the LO). Moreover, the LO was itself dominated by private-sector workers in exporting industries, the metalworkers in particular.

The situation is quite different today. While total union membership has grown (in Sweden) or remained constant (in Norway) as a share of the labor force, the relative size of the LO has shrunk. Only 60-65 per cent of union members in Norway and Sweden belong to the LO, down from 80-90 per cent in the early postwar period (Hernes and Marøen 1985: 10, Esping-Andersen 1985: 64, Strøm, Stølen and Torp 1988: 91–92). The fastest growing parts of the labor movement are the unions of white-collar and professional workers outside the LO. Moreover, the composition of the LO has changed, with public sector workers growing relative to private sector workers. In both countries, the metal workers' union had been replaced by the union of municipal employees as the largest union in the country.

As the LO has declined in relative terms, so has the centralized bargaining pattern associated with it. Centralized bargaining, in which wage determination throughout the economy took place within a framework negotiated by the LO and the national employers' confederation, allowed the unions to accomplish two goals. The first was to restrain overall wage increases in line with the requirements of the government's economic policy. The second goal was to reduce wage differentials.

Wage restraint and wage equality are controversial goals for a union to pursue, especially a union like the metalworkers whose core membership consists of highly skilled workers whose wages are being held back on both accounts. It is even harder when unions who represent higher-paid white collar and technical workers and support higher wage differentials start competing successfully for members among the upper echelon of blue-collar workers at the expense of the LO (Lash 1985). Yet the LO's ability to negotiate wage contracts that allow greater wage dispersion is constrained by the growing weight within the LO of public sector unions who represent relatively low-paid workers.

Consider again Johansen's (1979) image of social democracy as a "bargaining society', represented by a characteristic function with transferable utility, this time without a social wage. In a subsequent article, Johansen (1982) argued that the concept of the core required excessively acquiescive behavior. As before, let N be the grand coalition, S any subset of N and $(N \setminus S)$ the members of N not in S. An imputation (an allocation of $v(N)$) is in the core as long as no subset of actors can do better by withdrawing. More typically, Johansen argued, actors demand what they could obtain outside the grand coalition plus a share of the surplus that they create by joining. Thus, what we will call the Johansen core is defined to be an allocation of payoffs to individuals $x_1, x_2, \ldots, x_n$ that satisfies

$$\sum_{i \in N} x_i = v(N), \quad \text{and} \tag{1}$$

$$\sum_{i \in S} x_i \geq v(S) + \lambda_S[v(N) - v(S) - v(N \setminus S)] \quad \text{for all } S \subset N \tag{2}$$

According to the second equation, each group S demands what it could get outside the grand coalition, $v(S)$, plus the fraction λ_S of the surplus it brings to the coalition by joining, $[v(N) - v(S) - v(N \setminus S)]$. Note that the ordinary core is defined by equations (1) and (2) with $\lambda_S = 0$. It is clear that as the aggressiveness of the actors increases, that is as λ_S rises, the Johansen core may be reduced. Indeed, the Johansen core cannot possibly exist unless $\lambda_S + \lambda_{N \setminus S} \leq 1$. Otherwise the demands for a share of the surplus are incompatible.

How should the weights λ_S be determined? One possibility is to consider the λ_S's as being the product of bargaining between the coalition S and its complement $(N \setminus S)$ over sharing the surplus. That is, coalition S threatens to leave the bargaining table and bargains with the remaining players over how to share the surplus should it remain. In this case, we would have $\lambda_S + \lambda_{N \setminus S} = 1$. But under these conditions, the Johansen core is almost always empty. Equations (1) and (2) imply

$$\sum_{i \in N \setminus S} x_i \leq v(N \setminus S) + (1 - \lambda_S)[v(N) - v(S) - v(N \setminus S)]. \tag{3}$$

But if $(1 - \lambda_S) = \lambda_{N \setminus S}$, then equations (2) and (3) imply that the inequality signs must be replaced by strict equality:

$$\sum_{i \in S} x_i = v(S) + \lambda_S[v(N) - v(S) - v(N \setminus S)] \quad \text{for all } S \subset N. \tag{4}$$

Equations (1) and (4) constitute a set of $2^n - 1$ equations to determine n variables $x_1, x_2, \ldots, x_n$. A solution will not exist except in very special circumstances. In general, it is impossible to obtain a centralized agreement that is "renegotiation proof". All possible allocations leave some group worse off than they could be if they withdrew from the grand coalition and bargained over the terms of rejoining.

Such a multilateral bargaining model has become more applicable to Norway and Sweden as the number of actors on the union side has increased and as relations among the unions have grown increasingly competitive. In earlier periods, wage bargaining was dominated by the LO and the national employers confederation. Conflicts of interest among unions were tempered by a common political allegiance to the social democratic party. As new union growth has occurred outside the LO, and as the LO itself has become increasingly divided between private and public sector workers, these conditions no longer hold. The new unions are not political allies with the LO. They are often strenuously opposed to the LO's egalitarian goals and they compete with the LO for members. The unions have always argued with each other. Increasingly, however, they seem to bargain with each other in the same spirit as they bargain with employers. Under such conditions, no allocation is stable.

In sum, the union movement has become more heterogeneous and internally divided as union membership has grown at both tails of the wage distribution. In Sweden, centralized bargaining collapsed when the union and the employers' association in the metalworking industry withdrew from the centralized negotiations. Norwegian employers are internally divided over whether they should follow the Swedish example. The labor peace that Scandinavia has been known for since the 1930s has vanished. The number of industrial disputes has increased sharply as unions fight with each other as much as with management over their relative wage share. As centralized bargaining has declined, wage dispersion has increased, and the capacity of the unions to restrain wages in conditions of full employment has dwindled (Hibbs and Locking 1991).

Control Over Investment

Lack of control over investment is often seen as the Achilles heel of social democracy. Strong unions may be able to set wages, hiring and firing may be regulated by both the government and union contracts, but as long as capital formation depends on private investment, the argument goes, the ability of social democrats to create a more equal and more secure society is sharply restricted.

In fact, social democratic governments in both Sweden and Norway have employed an extensive array of policies to influence the quantity, timing, and sectoral allocation of private investment. During most of the postwar period, interest rates in Norway were kept below the market-clearing level and credit was rationed. There were special quotas as well as different interest rates for investment in housing, agriculture, fishing and in factories located outside the major cities. The Swedish approach relied more on the tax system. Swedish firms could escape all taxes on as much as 40 per cent of pre-tax profits by depositing the funds in special closed accounts. Money in the funds could then be withdrawn only upon approval of the government (Esping-Andersen 1985: 233). In Norway too, tax incentives for investment have been generous up till now.

In some respects, social democratic investment policies worked well. Aggregate capital formation was high, in spite of the extensive redistribution of income. In addition, government controls worked well in terms of counter-cyclical policy. The Swedish governments timed the release of funds to avoid overheating during upturns and to increase aggregate demand during recessions. In Norway, the counter-cyclical policy worked automatically. With credit rationing, fluctuations in demand resulted in changes in the length of the queue rather than changes in the quantity of investment.

Credit controls have worked less well in terms of the efficiency of investment however. Norway is distinctive in Western Europe for both the large share of investment in GDP and the low productivity of that investment. According to OECD figures, Norway ranked 19th of 19 advanced capitalist economies in terms of the growth of the productivity of capital in the business sector from 1960 to 1989 (OECD 1989: 120). In part, this is a reflection of the high rate of capital formation since the higher the capital-labor ratio, the lower the productivity of capital. If Norway had experienced an exceptionally rapid growth of labor productivity (which goes up as the capital-output ratio rises), one might attribute all of the low growth of capital productivity to capital deepening. However, the growth of labor productivity in Norway was close to the OECD average from 1960–1973, and below average since 1973. Thus, it is likely that the low productivity growth of capital in Norway reflects the extensive use of capital controls. In Sweden, policies to influence the allocation of private investment were far less ambitious, and the growth of the productivity of capital in Sweden was closer to the OECD average.

The relatively low productivity of investment in Norway was a natural result of the governments' use of investment controls to subsidize house construction and economic activities in rural areas, particularly agriculture and fishing. Governments intervene in credit markets because they have other goals than simply maximizing the efficiency of investment. Thus, the fact that government intervention reduced the aggregate productivity of capital does not indicate a policy failure, provided the political goal achieved was worth the foregone output. Nevertheless, the subsidization of capital inputs is an expensive way to maintain the rural population. To subsidize rural labor directly would be cheaper. Moreover, when credit is rationed, two groups are advantaged. The first are the most credit-worthy borrowers. With a fixed price of credit, banks maximize the safety of their loans. The second group that benefits are those with good personal or business connections with the banks' managers. Such a system does not maximize the allocative efficiency of capital.

The most serious problem with discretionary capital controls is the impetus it gives to rent-seeking behavior. In both Norway and Sweden, the threat of plant closures in the 1970s and 1980s generated demands for subsidies. Since the demands were often satisfied, they also contributed to a decline in the productivity of investment. Discretionary capital controls represent a clear case of concentrated benefits and diffuse costs. A union local will fight hard for a subsidy to keep its plant open. Workers elsewhere in the economy are unlikely to worry much about the marginal difference one bail-out represents. Public control over investment easily degenerates into public subsidies for unproductive plants.

The Decline of Labor Productivity Growth

Perhaps the most important but least understood reason for the multitude of current problems is decline in the growth of the productivity of labor that occurred after the mid 1970s. From 1960 to 1973, output per employed person in the business sector increased by 4.1 per cent per year in both Norway and Sweden (Table 1). In the period 1973–1989, average productivity growth was only 1.6 per cent in Sweden and 0.5 per cent in Norway. In the long run, wage growth is determined by labor productivity growth. Everything else is secondary. Thus, if Przeworski and Lee (1990) are right in their conclusion that social democratic rule reduces productivity growth, then the long run prospects of social democracy are dim.

Comparisons of productivity growth are complicated, however. Productivity declined everywhere after 1973, not just in Norway and Sweden. Table 1 presents some benchmarks to judge the relative performance of Norway and Sweden. Both Norway and Sweden have had lower labor productivity growth than the other European OECD countries since 1960. Yet Sweden has maintained a rate of productivity growth close to the OECD average both before and after 1973. Even Norway's low productivity growth since 1973 is not worse than productivity growth in the United States in the same period.

Table 1: Average Annual Growth of Output per Employee in the Business Sector

	1960–73	1973–89
Norway	4.0	0.5
Sweden	4.1	1.6
OECD Europe	5.0	2.3
OECD	4.1	1.5
United States	2.2	0.5

Source: OECD 1991, Table 43. The business sector in Norway excludes oil production.

Moreover, there are a number of potentially mitigating factors that are relevant in assessing the relative productivity performance of Norway and Sweden. Output per worker generally increases as unemployment rises, since firms shut down their least productive plants or lay off their least productive workers. Freeman (1988) presents data showing an inverse relationship between the rate of employment growth and the rate of productivity growth among OECD countries after 1973. Thus, at least part of the low productivity growth of Norway and Sweden (as well as the United States) since 1973 can be explained by the relatively large increase in employment during the same period. The Nordic countries of Norway, Sweden and Finland were the only countries in Western Europe to maintain positive employment growth in the period 1973–1984 (Freeman 1988: 70).

The second factor that may account for a significant part of the productivity growth differential between Norway and Sweden (and the US) with the rest of Europe since 1973 is that these countries began the period with above average productivity. Countries with lower levels of productivity can grow faster by copying or importing the technology already in use in countries that have higher levels of productivity. Dowrick and Nguyen (1989) present evidence of a stable negative relationship between initial per capita income and total factor productivity growth since 1950, both among the OECD countries and among larger samples. Dowrick and Nguyen estimate that Sweden's initial high level of per capita income reduced income growth in Sweden by 0.7 per cent per year between 1973 and 1985. The amount of 0.7 per cent per year represents the entire gap between the Swedish productivity growth and the average for European OECD members since 1973.

Thus, whether or not social democracies have experienced lower productivity growth remains an open question. Productivity has been unambiguously low in Norway if oil production is excluded. Yet per capita income (including oil revenues) rose faster in Norway between 1973 and 1985 than any other OECD country (Dowrick and Nguyen 1989). Swedish per capita income growth has lagged behind the rest of Europe, but the difference may be explained by such factors as Sweden's initial wealth and full employment policies. Nevertheless, voters do not control for initial levels of wealth or the growth of employment when comparing real wage growth at home and abroad. The popularity of social democracy has suffered from stagnant real wages, whether or not social democratic policies are to blame. Nowadays, when employers complain that high taxes, welfare benefits and the egalitarian wage scale have curtailed productivity growth by undermining workers' incentives to work, they get a sympathetic hearing.

Conclusion

Social democracy in Norway and Sweden can be credited with a number of achievements, and some of them may prove to be permanent. The elimination of severe poverty and the granting of health care, housing and a modest but decent income as a right of all citizens stand out as important accomplishments. The contrast between the poor neighborhoods of any large city in the United States with the poorest urban areas of Norway or Sweden is dramatic. The welfare state may be trimmed, but it is unlikely to be cut to American levels. The active labor market policies that were developed in the 1950s in Sweden and adopted in the 1980s in Norway remain popular. The social democrats were perhaps the first to assert that the most important economic resource of a country is the health and training of its work force, and that part of their program endures. Nevertheless, social democracy is in retreat. Both the egalitarian distribution of income and the security of income that distinguished social democratic societies from other advanced capitalist democracies are declining.

Social democracy flourished for decades. Why is it so fragile today? Most explanations of social democracy's decline focus on exogenous changes common to most advanced industrial societies, such as the decline in blue-collar industrial workers as a share of the electorate (Przeworski and Sprague 1986), the decline of mass production (Pontusson 1991b) or increased international capital mobility (Steinmo 1990). The most direct exogenous change, however, is the creation of a single market within the EC. Both Swedish and Norwegian firms fear that closer internal integration within the EC will lead to higher trade barriers against outsiders. Already accustomed to foreign investment, Swedish firms rushed to protect themselves by buying plants inside the EC. The resulting massive capital flight out of Sweden provides the most compelling explanation for the abrupt decision of the social democratic government to apply for membership. Once Sweden joins, it is difficult for Norway to remain outside. Almost 25 per cent of Norway's trade is with Sweden, and most of the rest is with other European countries (OECD 1991: 461–462). Membership in the EC, however, requires that Norway and Sweden abandon central elements of their social and economic policy, such as industrial subsidies (Norway), high value-added taxes and discretionary monetary policy.

Yet, the decline of social democracy is not entirely due to external causes. The collapse of the centralized bargaining system in Sweden happened before Sweden applied to join the EC and tied its currency to the ecu. The abandonment of full employment as the overriding macroeconomic policy goal in both Norway and Sweden may be as much a consequence as a cause of the decline of centralized bargaining.

Social democracy is, in part, a victim of its own success. The children of workers who get university educations and professional jobs do not have the same loyalty to the social democratic party, nor the same interest in redistributive policies, as their parents. When the society is wealthier and people have greater material security, they value social insurance programs less.

Finally, when the unions succeed in organizing workers in all occupations and sectors of the economy, the union movement becomes as divided as the entire society. With unions less able to hold down wages in line with macroeconomic stability, governments of both the right and the left increasingly rely on unemployment to restrain wage growth. The fundamental bargain whereby the unions provided real wage restraint in exchange for government policies to prevent unemployment has broken down. The result is a decline of the institutions and policies that made social democracy distinctive.

Notes

[1] See, for example, John Stephens (1979), Walter Korpi (1978, 1983) or Gøsta Esping-Andersen (1985).

[2] Other recent studies of social democratic decline include Hernes (forthcoming), Fagerberg, Cappelen, Mjøset and Skarstein (1990), Pontusson (1991a) and Swenson (1991).

[3] Some studies have questioned the extent to which active labor market policies affect unemployment. It is argued that the direct effect of reducing unemployment is offset by an indirect effect of encouraging higher wage demands. See Calmfors (1991) for a review of the literature.

[4] Data collected around 1970 indicate that taxes and transfer payments reduced the Gini coefficient by 36 per cent in Sweden and 23 per cent in Norway (Hicks and Swank 1984). In contrast, fiscal policy reduced the Gini coefficient by 4 per cent in Germany, 9 per cent in France and 14 per cent in the United States.

[5] A similar but less radical tax reform was proposed by the Labor government in Norway in Spring 1991.

[6] The unemployment figures for Norway and Sweden do not include laid off workers who are enrolled in the various labor market training programs.

[7] Hibbs (1987) derives a similar result from a different mechanism. He constructs a model in which redistributive increases in taxes and transfers reduce the unions' shadow price of equality and therefore promote relatively equal pre-tax wage settlements.

[8] Useful discussions of wage determination in Norway and Sweden can be found in Flanagan, Soskice and Ulman (1983) and in the papers on Norway and Sweden in Calmfors

(1990).

[9] In the latest bargaining rounds in Norway (1990-1991), a two-tier centrally negotiated wage increase was introduced. Those unions that normally obtain drift got roughly half of the increase given to unions that receive no drift.

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