Scandinavian Equality
A Prime Example of Protection Without Protectionism

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Going on his nine-month-long trip to North America in 1830, Alexis de Tocqueville[1] was curious about the impact of democratic equality. Summing up his impressions in *Democracy in America,* he was astonished:

Among the new objects that attracted my attention during my stay in the United States none struck my eye more vividly than the equality of conditions. I discovered without difficulty the enormous influence that this primary fact exerts on the course of society; it gives a certain direction to public spirit, a certain turn to the laws, new maxims to those who govern, and particular habits to the governed (Tocqueville 1835, 1840:3)

What did he see? Based upon his description, Tocqueville must have seen something that in many ways resembles the present Scandinavian model much more than the present American one. The contexts are of course very different, but on the abstract level the mechanisms are rather similar.

In this essay, I argue—in line with Tocqueville's observations—that Scandinavian equality also gives direction to governance, social consciousness, and economic behavior. I show how coordination induces wage compression in the labor market, which in turn leads to an egalitarian welfare state. Together they constitute an institutional equilibrium where equality is both cause and consequence. Faced with fierce competition on the world market, this equilibrium path has produced the smallest wage differentials, the lowest frequency of labor disputes, and the most generous welfare states in the world. It must be the prime example of protection without protectionism—where worker security and free trade has persisted together for more than sixty years despite shifting governments and varying external circumstances. [2]

Just as Tocqueville Saw It

Of the many observations that Tocqueville made on his trip to America, some clearly remind us of Scandinavia today. This is at least true for the following features.

Equality of Opportunity Induces More Equality of Income

Tocqueville explains how “the great are pulled down, while the small rise,” including the breakdown of the monopoly powers of small privileged groups by increasing entry into their areas (Tocqueville 1835, 1840:555). As a consequence, the highest wages decline. At the other end of the distribution, the lowest wages rise as workers with new rights “refuse their services when one does not want to accord them what they consider a just reward for work” (Tocqueville 1835, 1840:556). Being less dependent on their masters, “[t]he raise in wages they already have obtained renders them less dependent on their masters each day, and as they become more independent they can more easily obtain a raise in wages” (Tocqueville 1835, 1840:556).

As in Scandinavia today, the pay compression was strongest in the public sector: “In America, officials of secondary rank are paid more than elsewhere, but high officials much less” (Tocqueville 1835, 1840:203). He concludes that “democracy generally gives little to those who govern and much to the governed. The contrary is seen in aristocracies, where the money of the state profits all the classes at the head of affairs” (Tocqueville 1835, 1840:205).

All this has a modern mirror image in Scandinavia as wage compression and empowerment in private and public enterprises. The Scandinavian countries of Denmark, Norway, and Sweden have long competed in having the lowest levels of wage inequality in the world. The Scandinavian countries also have extraordinarily high degrees of social mobility. The comparison with the United States today is enlightening. While the wage gap between the bottom and the top is more than twice as large in the United States as in Scandinavia, the social mobility from the bottom to the top is more than 50% higher in Scandinavia than in the United States (Jäntti et al. 2006; Barth and Moene 2011).

Greater Equality Induces New Social Relations Between Bosses and Workers and Between Men and Women

In both public and private enterprises, equal opportunity alters the relation between master and servants: "it changes their spirit and modifies their relation" (Tocqueville 1835, 1840:546). Social cleavages decline and hierarchies are reduced. In addition, social mobility goes up. Neither poverty nor wealth is inherited to the same degree as before, implying that family background means less.

In addition, ''[t]he Americans understand the equality of man and woman," Tocqueville insists, and points to how the conditions for women improve. After discussing the many different aspects of American life, Tocqueville concludes, "if one asked me to what do I think one must principally attribute the singular prosperity and growing force of its people, I would answer that it is to the superiority of its women" (Tocqueville 1835, 1840:576).

Today we can say something similar about Scandinavia. There is little difference between workers and bosses and a high worker participation in decision-making in the workplace. Scandinavia is recognized for supporting work organizations that grant employees high levels of autonomy. The unusually flat work organization is evident from the contrasts experienced within Scandinavian companies establishing themselves abroad in an environment that expects more hierarchies and more commands.

Scandinavia is also known for “the superiority of its women.” The female workforce participation is record-breakingly high. The World Economic Forum measures gender equality by the gap between man and woman in economic, political, educational, and health spheres. The Nordic countries of Iceland, Norway, Finland, and Sweden are all among the top five in gender equality.

Social Beliefs and Collective Action Depend on Economic and Social Differences

More equality means more social care and stronger social consciousness. The moral norms change, for “as people become more like one another, they show themselves reciprocally more compassionate regarding their miseries, and the law of nations become milder” (Tocqueville1835, 1840:539). Less social distance means stronger social identification: “All feel themselves to be subject to the same weakness and the same dangers, and their interest as well as their sympathy makes it a law for them to lend each other mutual assistance when in need” (Tocqueville 1835, 1840:545). This creates a special state of social harmony, for, as Tocqueville said, by establishing “a state of society in which each has something to keep and little to take, you will have done much for the peace of the world” (Tocqueville 1835, 1840:607).

Social consciousness reduces collective action problems and facilitates local organization in accordance with common interests because “in democratic peoples, associations must take the place of powerful particular persons whom equality of conditions has made disappear” (Tocqueville 1835, 1840:492). Further, he claims that “similar conditions” produce “common opinions,” something that enables collective action. In this context, he emphasizes the role played by the media: “Newspapers multiply relative to the more or less repeated need for men to communicate together and to act in common” (Tocqueville 1835, 1840:493).

All this is highly relevant for Scandinavia today. As I shall argue later, Scandinavia has the highest generosity of the welfare state in the world and has a high spending on public goods more generally. It has exceptionally strong collective organizations among employees and among employers. Even the number of newspapers is exceptionally high, particularly in Norway.

Each of the features mentioned here strengthens the impact of the others. This complementarity explains why the 1830 American model deviated so much from the contemporary aristocratic European model, and why northern European countries today deviate so much from other almost equally rich countries. Today the feedbacks between equality in the labor market and equality in welfare spending are particularly strong.

Equality in the Labor Market

A key concept to understanding Scandinavian redistribution in the labor market is coordination among unions and employer associations. A key to how it works is the system of wage determination. Wages are taken out of market competition and placed in a system of collective decision-making. From this, many features of the Scandinavian societies follow, including the small wage differentials and the big welfare states. What is most remarkable, however, is that these egalitarian features have emerged together with a high degree of capitalist modernization in the private sector of the economy, and with a high exposure to competition on the world market.

A Noncooperative Approach to Cooperation

In general, interest organizations and other groups of actors who have joined to achieve some common interests compete for power and for influence. They bargain with each other, and they interact in noncooperative ways. At the same time, they need to maintain their internal cooperative structure voluntarily; and they enter into new explicit and implicit coalitions that coordinate their actions. Most labor unions in northern Europe, for instance, are quasi-democratic institutions that consist of membership-based unions at the local level that are merged into larger associations.

Each separate coalition agrees to a course of action in a cooperative fashion, yet it plays noncooperatively toward other coalitions. The functioning of the system is therefore dependent both on the social organization—that is, what coalitions form explicitly as well as implicitly—and on the economic behavior of these organizations. To understand this interaction, we have to apply cooperative reasoning to the formation of coalitions but to use a noncooperative approach to predict the actions taken by each coalition toward other coalitions and other players. Which coalitions form depends on the noncooperative equilibrium; and the noncooperative equilibrium depends on which coalitions form.[3]

All this is important in order to grasp the major changes in the system of wage setting that took place in Scandinavia in the 1930s, and that have dominated developments ever since. The changes in Sweden and Norway were most distinct. In these two countries, workers of different types were initially organized in separate unions. All workers who were each other's substitutes in production had joined the same union. Organizing all substitutes in the same independent union maximizes worker militancy. It contributed to an unofficial world record in labor disputes as measured by the number of lost working days relative to the workforce, a record that Sweden and Norway shared between World War I and World War II. Unions were not the only guilty parties. Nowhere else did employers fight the unions with lockouts as fiercely as in Scandinavia in this period.

What triggered the change was the crisis in the world economy. This crisis did not hit all sectors equally. Construction workers, for instance, were highly paid, militant, and sheltered from foreign competition. When foreign demand collapsed, comparable to increasing competition in a globalized world today, workers in the export sectors, such as metal workers, accepted large wage reductions in order to stem the decline of employment. Construction workers came under no such pressure, in large part because of increased government spending on housing. Higher wages in construction, however, meant higher living costs for workers in the export sector. When construction unions called a strike in support of higher wages (in 1928 in Norway and in 1932 in Sweden), the National Confederation of Unions intervened to force the strike to an end.

The intervention of the National Confederation of Unions to end the strikes in construction was supported by the employers, who threatened with lockouts if the construction workers did not follow suit. The combined efforts of workers in the exporting industries and their employers were the initial steps in what can be thought of as an export-led implicit coalition in the labor market, which would become highly influential in the years to come. First of all, these efforts helped initiate a process of centralization of authority within the union movement in Norway and in Sweden, a process that again was encouraged and supported by employers. Second, they were important for the acceptance of the controversial “basic agreements” between the national associations of unions and of employers, establishing rules for collective bargaining, which were accepted in 1935 in Norway and 1938 in Sweden. Third, these efforts were instrumental in replacing wage bargaining at the industry level with direct negotiations over pay by the national associations of unions and of employers. Finally, as white-collar and professional union confederations joined the centralized negotiations, the impact of the export-led coalition was extended to include most of the working population in the private sector.

Organizing Complements Rather than Substitutes

The economic effects of coordinating wage setting depend on whether the coordination takes place among workers who are each other's complements or each other's substitutes. The separate demands for workers who are complements move in tandem because a wage increase for one group reduces the demand for all. In contrast, the separate demands for workers who are substitutes go in opposite directions because higher wages for one group implies more demand for the labor of the other groups. All this is important because coordination means that negotiators internalize externalities in wage setting.

With central negotiations, wage setting (in actuality) becomes coordinated between workers who are complements in total production. Coordination therefore leads to wage restraint and to employment expansion. The highest wages are held back more than the lowest wages. The central agreements are necessarily general. The details of how the agreement is to be implemented are decided by subsequent bargaining at the industry-wide and at the local level. Once the central agreement is signed, however, work stoppages are illegal according to the basic agreement. Wage increases at the local level are limited to what could be obtained without the threat of a strike.

Coordination across industries also reduces the ability of union leaders to pass on higher wage costs to market prices for goods that their members do not consume. Paradoxically, therefore, a strong and comprehensive union association has less effective monopoly power than a less comprehensive association. Less paradoxically, perhaps, unions simultaneously prevent the utilization of employers' monopsony power over the lowest wages. The exercise of monopsony power by employers can be particularly harmful for low-paid groups. Monopsony is not necessarily the result of having only one single employer. It is a natural result of search frictions that limit the short-run mobility among workers across firms and sectors (Card and Krueger 2000; Manning 2003). With search frictions affecting the flows in the labor market, employers may find it profitable to restrict their demand for labor in order to reduce the wage.

Employers become more restrained in their exercise of monopsony power when they face unions that represent the collective interests of the local workforce. Thus union wage setting has similar implications as an exogenously set minimum pay. When employers face the collective interests of workers, they cannot gain much by attempting to reduce their employment levels in the hope of reducing the lowest equilibrium wages.

In sum, the direct impact of centralizing wage setting is to raise the lowest wages and restrain the highest. Coordinated wage bargaining leads to wage moderation at the top and wage increases at the bottom as the wage setters internalized more of the externalities including the total employment effects of wage restraint. In fact, it takes wages out of market competition implying that unions must find ways of sharing the gains from cooperation.

As unions are quasi-democratic institutions, it is difficult to distribute the gains in ways that would mimic the relative wages in unregulated labor markets. Thus fairness norms such as "equal wages for equal work" play a more prominent role. As long as the gains are distributed according to such fairness norms, the level of wage coordination determines the size of the gains and the units over which the fairness norms are applied. When wages are determined at the firm level, unions compress the distribution of wages within the firm. When wages are set at the industry level, unions compress the distribution of wages across firms within the industry. When wages are set at the national level, unions compress the distribution of wages across firms, industries, and occupations throughout the entire nation. The pattern is that more coordination becomes associated with less wage inequality.

In the 1950s, wage compression was adopted as an explicit goal of the unions in Norway and in Sweden under the title of “solidaristic bargaining.”

Supporters of Equality

One of the important groups that supported solidaristic bargaining from the start consisted of the employers (Moene and Wallerstein 1997; Swenson 2002). Hence wage compression was in fact supported by actors who had appeared to be skeptical toward equality per se. Yet employers were able to increase aggregate profits by reducing wage inequality relative to the wage schedule associated with decentralized bargaining and even relative to the wage schedule associated with a competitive labor market where employers set wages unilaterally (Moene and Wallerstein 1997). Thus employers much preferred to bargain with the “sensible” leadership of the union confederations rather than with the militant leadership of the shop-floor union bodies.

Another important group that supported the policy of wage compression was the leadership of unions with low-wage workers. Because the union movement was all-encompassing, both low- and high-wage earners had influence on union policy. While the policy of wage compression was controversial among the rank and file of unions of high-wage workers, it was enthusiastically supported by members of unions of low-wage workers. Thus the political coalition composed of the low-wage unions and employers prevailed in the 1950s; and it established the pattern of centralized and solidaristic bargaining that was to last until the 1980s in Sweden and that still exists in Norway today. The export-led coalition had, in fact, a flavor of the ends against the middle. High-wage unions, in particular those in the sheltered industries, were prevented from leaving the centralized negotiations by the threat of lockouts.

Both union power and countervailing employer power were important for the egalitarian outcome. It is unlikely that the low-wage unions and the leadership of the union confederation would have been able to force the high-wage unions to accept an egalitarian wage policy without the backing of employers and the threat of lockouts against unwilling unions. This balance of countervailing power emerged as each separate coalition agreed to their course of action and each played noncooperatively toward other coalitions. Yet not only were the explicit coalitions (formal organizations) important; implicit coalitions (alliances that easily could be established) were almost equally decisive. They worked as credible threats disciplining the behavior of other organizations.

The wage policy found support in the widespread preference of Scandinavian workers for a more egalitarian wage scale. It would be wrong, however, to think of the Scandinavian wage compression that started in the 1930s only as a result of a special commitment to equality. Rather, it should be thought of basically as a result of a conflict within the labor movement between workers in sheltered and in exposed industries. Coalitions that were established in defense of their own sector interests helped sustain a system of wage coordination that compressed wages more as a by-product. In the longer run, the compressed wage structure and the openness to world market competition facilitated the voluntary coalitions in the labor market that were necessary for the system to work. Thus the coordinated wage setting led to further wage compression in a gradual process of compression from above and from below. Over time, it generated the most egalitarian distribution of wages and salaries in the capitalist world.

The cumulative impact on the distribution of wages and salaries was dramatic. Douglas Hibbs claims that solidaristic bargaining extended the principle of "equal pay for equal work" from one industry to the entire economy, and then moved toward the goal of "equal pay for all work." Together with Håkan Locking he estimates that the variance of log hourly wages in the mid-1980s in Sweden was only one quarter what it was in 1960 (Hibbs and Locking 2000). That dramatic decrease did not include the equally prominent reduction of the wage differential between blue-collar and white-collar workers. Today the ratio of the wage for a worker at the ninetieth percentile of the wage distribution to the wage for a worker at the tenth percentile is about two to one in Sweden, Norway, and Denmark; these are the lowest ratios in the Organization for Economic Cooperation and Development (OECD). In contrast, the ninety-to-ten ratio is above five to one in the United States.

Consequences of Equality

In addition to the reduction in wage inequality and its political implications, to which we return shortly, the coordinated system of wage setting had two important consequences. The first consequence was the virtual elimination of industrial conflict. From the countries with the highest levels of strikes and lockouts in the world in the interwar years, Norway and Sweden suddenly had the lowest levels of industrial conflict in the post-war period. The encompassing structure of unions and employer associations implied that both faced more of the costs of industrial disputes and work stoppages, making them more responsible. In addition, information among negotiators became more symmetrically distributed. There were no longer reasons for unions to call strikes in order to find out whether their firms actually could pay higher wages or not, nor were there reasons for the employers to call a lockout in order to see whether their unions had strike funds or not. The negotiators at the central level had perhaps less information than local negotiators, but the central negotiators had essentially *the same* information. It therefore became impossible for unions to price discriminate between employers with high and low profitability, and for employers to price discriminate between strong and weak unions—as could easily be the case with asymmetric information at the local level.

The second consequence was that conditions in the export industries were allowed to determine the growth of wages throughout the economy. This implied wage moderation and international market orientation. In practice, the centralized system of wage bargaining tied wage growth throughout the economy to the growth of wages in the export sector because the unions in the export sector, the metal workers in particular, were the largest and most influential unions within the national confederations. In this way, the system was conducive to free trade and globalization in accordance with the basic interests of the export-led coalition. It became the foundation for what was to be called pattern negotiations (*frontfagsmodellen*) where the unions in the export sector set the pace for wage increases for all other groups of workers—a typical free-trade institution.

The inherent wage compression also affected innovations and structural change, my next theme.

Equality and Creative Destruction

Wage compression directly encouraged the movement of capital from less productive to more productive activities, but the effect on the incentives for workers to change occupations was mixed. While wage compression would increase job loss in industries with low productivity and job creation in industries with high productivity, employers in highly productive firms lost the ability to attract workers with the offer of higher pay. The government, unions, and employers responded to the problem with an array of active labor market policies that subsidized the movement of workers from one industry to another with training programs and grants to cover moving expenses.

The compression of wage differentials affected the pace of modernization and economic development.

The Promotion of Development

Equalizing wages across Scandinavian firms and industries would promote economic development and efficiency by forcing wages up in low-productivity firms or industries and by keeping wages down in high-productivity firms or industries. In a decentralized bargaining system, wages vary according to the productivity of the firm and of the industry.

In contrast, in a system of coordinated wage setting, wages become relatively insensitive to the profitability of the enterprise. On the one hand, industries with low levels of productivity are prevented from staying in business by paying low wages. On the other hand, workers in industries with high levels of productivity were prevented from capturing much of the productivity differential in the form of higher wages. By reducing profits in low-productivity firms and by increasing profits in high-productivity firms, labor and capital would be induced to move from low productive to high productive activities, increasing aggregate efficiency as well as reducing inequality (Rehn 1952; Agell and Lommerud 1993; Moene and Wallerstein 1997,).

To see the implication more clearly, we can follow Schumpeter (1942) in attributing the dynamics of capitalist economies to what he denoted the process of creative destruction, where existing productive units are scrapped as new and more productive units are being created. Entering firms introduce new techniques and drive the least efficient of the existing firms out of business. When new techniques are embodied in new plants and equipment, technical progress entails continuing turnover of plants and firms.

A simple representation of this is contained in a vintage model (Moene and Wallerstein 1997). Newer plants are more productive than older plants, but the building of new plants is costly, so older plants are not immediately replaced. Once plants are built, however, investment costs are sunk and firms keep the plants in operation as long as income is higher than the variable production costs. Thus the age of the oldest plant in operation is given implicitly by the condition that current profits in the oldest plant in operation equal zero.

The wage bargaining system affects the firms' decision to build new plants through its effect on the market value of new plants. The higher the market value of new plants, the greater the number of new plants that will be built each period. Wage compression holds down wages in plants when they are relatively new but raises wages relative to local bargaining when plants are older. In other words, a coordinated wage compression prevents less efficient firms from paying lower wages than the most efficient ones. As a result, older plants are shut down earlier than they would have been with decentralized bargaining. At the same time, coordinated wage compression prevents workers in newer, more productive plants from obtaining higher wages. The result for firms is higher profits during the first period of a plant's life.

Whether or not coordinated wage compression is more efficient than decentralized bargaining in the sense of raising productivity, employment, and output simultaneously depends on the workers' average share of value added. When this share is below a certain threshold, coordinated wage compression uniquely increases efficiency (Moene and Wallerstein 1997).

The condition for wage compression to raise productivity, employment, and output can be expressed more intuitively as follows: Static efficiency requires equal wages for equal work so that workers are allocated efficiently across the existing plants. Dynamic efficiency requires that the average wage costs over the lifetime of the plant are sufficiently low to generate the profit-induced investments in new plants necessary for full employment.

In fact, both conditions seem to be met in Scandinavia by taking wages out of market competition and moving them into a system of collective decision-making by comprehensive union associations that care sufficiently about both jobs and pay. The principle of "equal wages for equal work" was easily achieved by applying union norms of equal treatment of all members. The other principle was equally easily met by the willingness to use wage moderation to achieve full employment.

Clearly, the possibility that so-called monopoly unions can enhance productivity and efficiency stands in sharp contrasts to textbook economics.

Beauty or Reality

Unlike what textbook economics claims, participants in decentralized labor markets have unequal power. Some local unions have monopoly power; some employers have monopsony power because insiders have in general more power than outsiders; and there are many frictions that prevent the law of one price from prevailing. The resulting individual wages,even for homogenous workers,vary depending on local conditions. Hence, decentralized wage setting does not produce equal wages for equal work and does not fulfill the criteria for static efficiency.

On the contrary, a large empirical literature shows a clear tendency of rent sharing in a decentralized wages setting, suggesting that there is unequal pay for equal work in the absence of unions (Krueger and Summers 1988; Groshen 1991; Gibbons and Katz 1992; Barth, Bryson, Davis, and Freeman 2010). When this is the case, unemployment easily results. Employers underinvest in new plants as the local workforce tries to expropriate more rents by being less collaborative. Due to such holdup problems, dynamic efficiency can easily be violated as well.

Taking wages out of market competition means eliminating the different sources of unequal power and replacing them by wage leveling. As stated, Schumpeter's process of creative destruction is fueled by wage compression, implying that equality induces innovation because it suggests higher profits in the most modern enterprises. Average productivity can go up for a given employment level. For instance, each vintage of capital gets "fatter" while the difference between the most productive vintage and the least productive vintage in operation declines.

Without wage compression, the complementarity between heterogeneous firms and heterogeneous workers might imply a sorting of the most productive workers into the most productive firms. A competitive wage structure would then have a distribution of wages where it would never pay for a firm with lower productivity to compete for workers with higher ability. In some cases, when for instance there is no learning from higher-qualified to lower-qualified workers, the large wage differentials associated with sorting can in fact be efficient. But this is obviously not fair because the distribution of wages easily becomes more unequal than the distribution of talent and of qualifications (Moene and Wallerstein 1997).

While wage compression eliminates part of these magnified wage differentials, at the same time, average productivity may increase. A similar reasoning also shows that wage compression leads more enterprises to approach international markets (Willumsen 2011). Entering international export markets entails fixed entry costs. Thus only the most productive firms find it profitable to go international. Wage equality, however, makes it more profitable for the most productive firms to invest the necessary entry cost to compete abroad. In fact, a compressed wage structure enables more of the firms to enter global markets, and the productivity threshold that divides domestic producers from producers for global markets becomes lower. In this sense, wage equality induces globalization.

Equality in the Welfare State

Equality in the labor market spills over to egalitarian public policies. Internationally, there is a general pattern showing that countries with more wage equality tend to have more generous welfare states (Barth and Moene 2011). For instance, the Scandinavian countries have twice as generous welfare spending as the United States but have only one-third of the U.S. pretax wage inequality. This equality–generosity pattern runs counter to the most prominent theories of welfare spending such as the seminal papers by Romer (1975), Roberts (1977), and Meltzer and Richard (1981), which all predict that higher pretax inequality should be associated with more, not less, generous welfare spending. In contrast, the welfare state seems to be least developed where it is the most needed.

The negative association between wage inequality and welfare spending is a special case of what has been denoted "the Robin Hood paradox":

Poverty policy within any one polity or jurisdiction is supposed to aid the poor more, the lower the average income and the greater the income inequality. Yet over time and space, the pattern is usually the opposite (Lindert 2004:15.).

The Equality Magnifying Effect

To understand the equality–generosity pattern across countries and over time, and particularly the Scandinavian position in this pattern, it is important to notice that in most countries, pure redistribution of resources has not been so important for the expansion of the welfare state as some claim. It is rather the provision of services and, in particular, the protection against risks that has been the driving force (Baldwin 1990; Barr 1992). Welfare policies that, in addition to providing a more fair distribution, cover social demands for which the market fails to provide are much more likely to be both legitimate and popular. This is particularly relevant for social insurance against loss of income due to sickness, unemployment, and old age (Moene and Wallerstein 2001, 2003; Barth and Moene 2011).

In Scandinavia, countrywide universalism of welfare provision—the provision of basic welfare goods for everybody as a citizen's right—was also an important issue, even for employers. To keep highly productive employers from undermining the policy of wage restraint by offering workers generous benefits (which were harder to monitor at the central level than wages), the Swedish employers' confederation lobbied the government to nationalize the provision of healthcare and pensions (Swenson 2002).

Even though everybody was covered by these schemes, they were offered on better terms for the poor than for the rich in the sense that the expected contributions relative to the expected benefits were much higher for high-paid workers than for low-paid workers.

Now, how does the political support for welfare spending relate to the distribution of wages in the labor market? The political competition over voters' support depends on the interests of the majority of voters. These interests, however, are shaped by the pretax distribution of wages. A more compressed wage distribution, for a given mean, makes the majority of workers richer, which in turn raises the political demand for welfare spending on commodities and on services that are normal goods for households. In particular, the political demand for social insurance against the loss of income due to unemployment, disability, sickness, and occupational injury tends to rise as wage inequality declines (Moene and Wallerstein 2003; Barth and Moene 2011). In this way, more wage equality fuels the political demand for a generous welfare spending.

There is also another important effect of equality that Tocqueville observed, as hinted at earlier in this chapter. Equality makes people more like one another. Equals show more reciprocity, feel stronger social identification with each other, become "more compassionate regarding their miseries," experience similar weaknesses and dangers, and "their interest as well as their sympathy makes it a law for them to lend each other mutual assistance when in need" (Tocqueville 1835, 1840:545). If this is right, these kinds of social identification easily translate into a higher political demand for welfare generosity.

Political parties compete to attract voters with such interests. When the distribution of wages becomes more compressed, the attitudes within political parties toward welfare spending become more in favor of expansions. Both the Left and the

Right shift their welfare platforms toward more generosity. In a separate study of political party programs in twenty-two countries, we find that higher wage equality generates an overall Leftward shift in welfare state programs, yet somewhat more in Left-wing parties than in Right-wing parties (Barth, Finseraas, and Moene 2012).

Clearly it might matter which party or block wins the election, but all parties run on programs that are already adjusted to the wage distribution—to new welfare programs that are still likely to differ across political parties. No wonder that even rather conservative parties in Scandinavia today have become ardent defenders of the welfare state. It is impossible to win elections without a positive attitude toward welfare spending because it is so popular among a majority of voters. The political demand is also fueled by other factors including the income level of the country and economic risks that voters are exposed to such as those generated by fluctuations in the world economy.

In fact, globalization can fuel and be fueled by welfare spending. On the one hand, societies that are particularly exposed to global competition tend to have bigger welfare states, while, on the other hand, globalization is more popular in societies with big welfare states with generous social insurance. The small open economies in northern Europe are typical examples.

Empowering Weak Groups

Pretax equality induces welfare spending, but does welfare spending induce higher or lower pretax equality? One channel goes via empowering low-paid workers. Everybody with pressing economic needs is weak in negotiations and might have to take the first available job. Access to social insurance makes such groups less vulnerable. Their pressing economic needs become less pressing when more of their needs are covered by welfare state arrangements. Thus welfare benefits strengthen weak groups in the labor market as their fallback position becomes better. Low-paid workers therefore become able to command a higher pay and to improve their relative wage.

Welfare benefits may also set a floor below which wages cannot fall. As a consequence, welfare spending may eliminate bad jobs or turn some bad jobs into good jobs. While a low wage may discourage effort, a high wage may work as a positive encouragement. In accordance with traditional efficiency wage arguments, employers might increase wages in order to raise profits by inducing higher efforts.

Yet in low-productivity jobs, it is also possible to raise profits by *lowering* wages as long as work efforts go down relatively less than the relevant wages. Powerful employers may gain by obtaining a larger share of a smaller pie. This low-wage trap can be costly not only to the workers but also to society at large. Production goes down and poverty increases, as profits go up. Employers simply gain by employing human resources inefficiently. With a generous welfare state, this strategy becomes less attractive as the possibility to offer low wages declines. The result is again a compression of the wage distribution from below—what Erling Barth and I denote the wage-equalizing effect.

There are also specific features of each social policy that feed back to economic performance and the distribution of earnings. Some of the effects can be surprisingly strong. The rise of subsidized child care in Norway from the 1970s is a good example. By exploring exogenous variation across municipalities, using a comprehensive set of register data, Havnes and Mogstad (2011) show how child care can have large positive effects on children's adult outcomes. Measured by the outcomes later in life, public child care is both productivity enhancing and redistributive. It produces more education, a stronger labor market attachment, and more equality in labor earnings. The effects are particularly strong for girls and for children of disadvantaged families. It seems that good access to subsidized child care levels the playing field by increasing intergenerational mobility and by closing the gender wage gap in a way that raises total productivity.

How Equality Multiplies

Combining the equality magnifying effect and the feedbacks in the form of the wage equalizing effect we have two links with distinct causal impacts. Together they constitute a simple description of a political economic equilibrium that incorporates the mutual dependence between wage setting and welfare spending. More wage equality leads the majority of voters to support a more generous welfare state. More generous welfare benefits in turn reduce wage inequality by strengthening weak groups in the labor market. More equal wages fuel welfare generosity and a more generous welfare state fuels wage equality, stimulating further welfare generosity and further wage equality in a cumulative process. In the long run, it adds up to a sizable equality multiplier.

Erling Barth and I have estimated the multiplier by utilizing variations across eighteen OECD countries over a period of twenty-six years to identify the two separate effects (accounting for obvious erogeneity problems and by paying due attention to the fact that countries differ in so many other ways than welfare spending and wage inequality). The effects are strong and robust. Our best estimate shows an equality multiplier of 1.5, implying that exogenous changes are magnified by fifty percent in the long run (Barth and Moene 2011). The estimate does not change much by using only subsamples of countries, indicating that it does not rely on any specific groups of countries.

We have also estimated the equality multiplier by another data set that covers the separate U.S. experience over a longer period, from 1945 to 2002. The results are similar, but the magnitudes are a bit smaller with an (in)equality multiplier around 1.3. According to our estimates, the United States experienced a cumulative process of wage compression and welfare state expansion from 1945 to around 1970 as the equality multiplier magnified overall equality. From the 1980s until today, the U.S. multiplier has worked in reverse (as an inequality multiplier) magnifying overall inequality. In this period, the United States has experienced a cumulative process of increasing wage dispersion and stagnating or even declining welfare spending.

In general, our social multiplier seems to magnify structural differences in wage setting, production, and resources. The direction of change depends on the initial stimuli, and the magnitude of change depends on both the size of the stimuli and the strength of the feedbacks.

Inequality Gets Noticed When It's Small

Because the Scandinavian countries today have the smallest wage differentials in the world and the most generous welfare states, it may come as a surprise that people there are obsessed by the belief that inequality is steadily on the rise and that domestic levels of poverty are going up. This type of false consciousness should, however, not come as a shock—it is a natural effect of a high level of equality on public spirits and social psychology.

Our psychological capacity to register changes depends on existing differences. When existing differences are small, it becomes easier to recognize rising inequality as compared with a situation where the existing inequalities are large. Similarly, our social reactions to increasing inequality are stronger when differences are small. In other words, we perceive and react to higher inequality in the light of present inequalities. Our reactions to a given increase in disparity are inversely related to its importance. Small differences are important when the absolute differences are small. In this way, existing inequality works as a transformer that magnifies the small and diminishes the large. In egalitarian societies, even the smallest inequalities get noticed, while in inegalitarian societies the greatest inequalities pass by unnoticed.

Tocqueville said all this much more elegantly: "When inequality is the common law of a society, the strongest inequalities do not strike the eye; when everything is nearly on a level, the least of them wound it" (Tocqueville 1835, 1840:513). This appears to me a sharp observation. If it is right, it has important implications. When the smallest differences get noticed, egalitarian societies become more socially stable than they otherwise would have been. Or, as Tocqueville said: "The desire for equality always becomes more insatiable as equality is greater" (Tocqueville 1835, 1840:513). In other words, the social preference for equality is strongest when inequality is lowest. When the smallest differences get noticed, egalitarian societies can also maintain high work incentives with small wage differentials. Incentives are in this way self-calibrating (Loewenstein and Moene 2006).

Incentives are connected to relative rewards. In situations where rewards normally are large, one cannot expect higher effort by a small rise. In situations where rewards normally are small, however, people might be willing to work hard to achieve a small improvement that helps one move up in the local ranking of remunerations. Tocqueville did not say this explicitly, but he came pretty close when he said that every citizen "always perceive[s] near to him several positions in which he is dominated, and one can foresee that he will obstinately keep looking at this side alone" (Tocqueville 1835, 1840:513).

When the smallest differences get noticed, globalization is less of a threat via the traditional mechanisms of factor price equalization. Globalization may imply, however, that it is no longer the smallest differences that get noticed but rather the largest. The first thing to get globalized may simply be the reference group. When reference groups are global, the local self-calibration of incentives easily gets weaker.

In sum, the income distribution in egalitarian societies becomes relatively stable through the filtering of social perceptions, reactions, and complaints. Equality and efficiency are maintained by the restlessness of citizens, or as Tocqueville said about people's attitudes toward equality: "They see it from near enough to know its charms, they do not approach it close enough to enjoy it, and they die before having fully savored its sweetness" (Tocqueville 1835, 1840:514).

What Are the Lessons?

In contrast to what I have argued earlier, many economists implicitly claim that the Scandinavian model is a recipe for trouble. Wage differences are too small, taxes too high, welfare states too generous, and unions too strong—they might say (and some of them say it loudly). Despite these seemingly harmful excesses, the Scandinavian countries have for decades been doing quite well by accepted measures of economic performance.

What is seen as a recipe for serious economic trouble to a substantial part of the economic profession seems in Scandinavia to be consistent with high growth, low unemployment, low inequality, and a fairly efficient allocation of resources. Thus there must be some lessons both for economics and for politics that can be drawn from the

Scandinavian experience with the egalitarian policies of protection without protectionism. I conclude by listing some of them from a methodological perspective.

All–Else–Being–the–Same Is Misplaced

One reason why many economists get it wrong is their overuse of the all-else-being-the-same("cæteris paribus") assumption. Considering each special feature of Scandinavia's equality in isolation, one easily overlooks how the impact of a simultaneous adjustment in all of them can be quite different from the sum of a partial change in each. To get it right, one has to consider them jointly within a consistent framework that allows mutual adjustments.

Clearly one has to focus on both the benefits and the costs—not just the costs. Social policies can be highly productivity-enhancing. Social policies and participation (by collective interest organizations) can complement the working of a market economy; and well-functioning markets make social policies and participation more, rather than less, feasible.

Not Deviations from a Natural U.S. Model

The wide dissimilarities in institutions, social organizations, and economic outcomes among countries should not be interpreted as deviations from one natural U.S. model. To understand why people in almost equally rich societies are working under different rules, we need to account for how policies, institutions, and behaviors interact in a general equilibrium. A more partial approach, that neglects institutional complementarities and social spillovers, does not capture such mechanisms and may easily misinterpret the Scandinavian experience and the viability of an equitable society in general.

Rightly interpreted, the general equilibrium effects can be quite different from the sum of the partial equilibrium effects. For instance, the high taxes in Scandinavia (a feature that is often exaggerated) finance a generous welfare state, empower weak groups, help compress the wage structure, turn bad jobs into good jobs, and so forth. To consider the narrow impact of high taxes in isolation from these other effects would lead us astray.

Similarly the process that started with the rising female labor participation in the 1960s had wide-ranging general equilibrium effects. As the woman joined her husband as wage laborer, the household naturally demanded more public care for children and for the elderly. The gradual expansion of the welfare state made it easier for yet more women to enter the workforce.

Equality May Require Double Redistribution

Many economists are obsessed by cost efficiency but neglect the equally important problems of political implementation. But good policies are not always good politics. In Scandinavia, redistribution takes place via wage compression in the labor market and, on top of that, via welfare spending. For an egalitarian economist, it may perhaps be too much of a good thing. Why twice?

If one takes a democratic implementation seriously, both optimal policies and good politics depend on the income distribution in society. As I have argued here, many features of the Scandinavian societies, including the small wage differentials and the big welfare states, follow from the arrangements that take wages out of market competition and place them in a system of collective decision-making. The egalitarian public policies are endogenously determined by the political competition over the votes of a majority of citizens who have already been made similar to each other via the compression of their labor earnings.

The resulting equilibrium of double redistribution is simple. While wage compression affects welfare policies, welfare policies empower weak groups in the labor market and improve their position in the wage distribution, which again affects welfare policies. The interconnections are strong. Equality generates more equality, adding up to a sizable equality multiplier. It is highly unlikely that one would have achieved a similar equality of disposable income simply by voting over taxes and benefits for the entire income distribution in one setting. The path matters.

Policies and Institutions Must Fit Together

The Scandinavian social model can be distinguished by its major institutions—a large welfare state and an encompassing associations of unions and of employers—and by its institutions' policies—the provision of basic welfare goods for everybody as a citizen's right and wage leveling through solidaristic bargaining. In addition, there is at least one other important institution—the arrangement of routine consultation among government and interest organizations that is committed to a policy of full employment (Moene and Wallerstein 1993). Together they constitute an institutional equilibrium. If institutions and policies do not fit together in this way, they easily erode each other's impact.

Take the commitment to full employment, for instance: Is it sustainable? Can it be enforced? The commitment can be understood as a mutual gift exchange between unions and the government; although wage moderation enables the government to follow a full employment policy, the promise of full employment in exchange for wage moderation is important for the unions to implement wage restraint. This makes it easier to finance the generous welfare state because high employment rates fuel generosity because generosity becomes cheaper; and as fewer people need to use the system, relative to the employed population, the less expensive it is per employed to provide the taxes necessary for higher generosity (Barth and Moene 2012). Government commitments to full employment in countries with a different union structure are often not credible.

Protection Without Protectionism Is Feasible

Systems that combine social policies with a free access to international markets have been politically contested on the Left as well as on the Right. Both would insist that radical social reforms and good market performance are substitutes, not complements. While Leftist economists may insist that partial social victories are continually eroded by market forces (Luxemburg 1970:43), Right-wing economists may claim that market forces are steadily eroded by social reform (Lundberg 1985).

Neither view is proven correct because social equality and worker security have persisted in the small open market economies in Scandinavia for decades. The egalitarian features have emerged together with a high degree of capitalist modernization in the private sector of the economy, a high level of innovation, and a strong export orientation by producers. As a result, economic growth has been on par with the United States.

In the United States, rising inequality has gone hand in hand with social cleavages and with lower welfare for at least one-third of the population. In contrast, most of Europe has experienced only a modest rise in inequality but a sharp rise in unemployment. The Scandinavian countries, however, have in the same period combined social equality with good macroeconomic performance and full employment. Hence, protection without protectionism is possible.

Evolution, Not Intelligent Design

Scandinavian equality was implemented gradually whenever a social victory was possible. Thus it is not the result of intelligent design but rather of social and economic evolution. Societal arrangements that are not designed but implemented gradually tend to be more stable toward shocks and toward disturbances than those that originate at the drawing table.

In the case of the small open economies of Scandinavia, the general equilibrium of a large welfare state and encompassing interest organizations should be viewed as an equilibrium of free trade institutions. The arrangement provides for a fair sharing of the necessary costs of globalization because, for instance, the sharing of the costs of social insurance required that workers be willing to take jobs, exposed to international competition, on terms that are profitable for employers.

Gradually implemented policies, institutions, and behaviors that fit together and strengthen each other may look ex post facto as if societal arrangements come in packages with different social and economic organization, while they in fact are the results of adjustments in a process of trial and error. In Scandinavia, the results of this evolution seem to negate the commonly presumed conflict between inequality and unemployment and between inequality and good economic performance in general. A system of governance and incentives has evolved leading private businesses to act in socially desirable ways without altering property rights and without protectionism.

Learning from Other Countries Is Not the Same as Imitating Them

One may wonder whether the Scandinavian lessons are only relevant to small, homogeneous, and affluent societies with an extraordinary commitment to equality. On one level, the answer must be no. The affluence and homogeneity are products, not prerequisites of the model. Yet whether a similar leveling of the playing field has clear relevance for countries that are heterogeneous, conflict-ridden, and poor today is an open question. In poor countries, there can be additional problems of implementation because of the high level of surplus labor (see Moene and Wallerstein 2006 for a discussion).

Neither should one jump directly from the Scandinavian experience to conclusions about what can be achieved by policies that are sufficiently pro-labor. Again, policies are endogenous and institutions need to be maintained. It should also be noticed that Scandinavian equality consists of small wage differentials and big welfare states; it is not a change in the functional distribution of income between wages and profits. Scandinavian social democrats tend to think about capitalists as "saving machines."

While the scope for learning is large, the benefits from imitating might be small for other countries with different histories and initial conditions. The initial conditions that favored the equitable development in Scandinavia throughout the last century include for instance features that are unheard of in most developing countries today. In Scandinavia, there was a high level of educational attainment in the adult population; the state apparatus was efficient and basically honest and most importantly, the countries should not be known for the strength of unions only—employers also achieved an extraordinary level of organization. All these aspects helped in sustaining the wage compression via the ends-against-the-middle-coalition in the labor market and the huge expansion of the egalitarian welfare state via democratic political competition.

Even though no local system is exportable to other , all countries can learn much more from each other than what seems to be the case today. They can also learn from the long process of trial and error in the Scandinavian countries.

Notes

1. Elster (2009) provides an elegant discussion of Tocqueville's contributions more generally.

2. This chapter arose from research conducted under the auspices of the ESOP, a research center funded by the Research Council of Norway. I'm grateful for comments from Mary Kaldor, Trine Nickelsen, Atle Seierstad, and Joseph Stiglitz.

3. One way to analyze these interactions is to combine cooperative and noncooperative game theory— cooperative games for the formation of coalitions, noncooperative games for the equilibrium actions. The theoretical literature is sparse on these issues except for the contributions by Leif Johansen (1982), and by Debraj Ray and various coauthors further elaborated in Ray's recent book from 2007. See also Moene (2011).

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