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A Swedish Economic Policy -The Theory, Application and Validity of the Rehn-Meidner Model*

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Abstract

The macroeconomic principles behind the Swedish model were developed by two trade union economists, Gösta Rehn and Rudolf Meidner, shortly after World War II. The Rehn-Meidner model represents a unique third way between keynesianism and monetarism in its approach to combine full employment and growth with price stability and equity through the use of extensive selective employment programs, a tight fiscal policy and a wage policy of solidarity. This essay demonstrates the logic and comprehensive character of the Rehn-Meidner model, as well as the originality of its underlying economic theory. It also analyses the application of the model in Sweden during the post-war period. In the 1980s, the means of the model were largely abandoned. In the 1990s, the governments generally adopted the means of the model, but they were unable to combine low inflation with full employment. A renewed interest in the Rehn-Meidner model may emerge from recent declarations by the EU to prioritise full employment without giving up the objective of price stability.

JEL classification: E24; E31; E62; J23; J31; J62; O23

Keywords: Fiscal policy; Fair Wages; Productivity; Unemployment; Inflation; Labour demand; Labour mobility; Swedish model

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Introduction

The Rehn-Meidner model (henceforth R-M model) is a unique Swedish contribution to macroeconomics. In fact, the model is one of the few coherent visions of economic policy beyond Keynesianism. Even friendly observers of Sweden have failed to realise the scope of the R-M model where means and priorities of economic policy are concerned.

The R-M model is both an economic and wage policy programme and a theory of wages, profits, inflation and growth. I shall describe the content of the policy programme with an ambition to show its comprehensive character and reliance on market-conforming measures to achieve full employment, price stability, growth and equity. I will then outline the positive economic theory behind Rehn's and Meidner's policy model with a particular eye on the strategic role of profits in their theory of wages and inflation. The Rehn-Meidner theory is here compared with modern wage theories and with the so-called Scandinavian model (of inflation). However, the comparisons are more detailed elsewhere (Erixon, 2000) which also surveys the findings of the studies in the 1980s and the 1990s that put hypotheses of the model to test. In most cases, the comparisons with modern economics show the model in a favourable light.

One section is devoted to a discussion of the applications of the R-M model in Sweden. Not only foreign but also Swedish scholars have sometimes exaggerated the importance of the R-M model as a guideline of Sweden's economic policy (see Lindbeck, 1997, pp. 1291-2). But labour market policy and solidaristic wage policy would hardly have expanded to their current scope in Sweden if Rehn and Meidner had not placed them in a larger economic and political context.

I shall end my work with some comments on the validity of the R-M model. The model's relevance will be discussed in terms of new economic and political circumstances and priorities in economic policy. Although without any references to the R-M model, politicians in the EU countries are attracted today by its point that an ambitious employment policy is possible within the framework of a restrictive macroeconomic policy.

The Rehn-Meidner policy model is here identical to the original one with the exception of marginal employment subsidies. These subsidies were considered by Rehn from the 1970s as effective measures to combine full employment with price stability. On the other hand, wage-earner funds are not here understood as a component of the R-M model. This is primarily for the sake of convenience,[1] as one basic argument behind them was to appropriate 'excess profits' from solidaristic wage policy, a fundamental part of the R-M model. The funds' aim to increase labour's share of national income and wealth is also compatible with the model.

I begin by briefly describing the macroeconomic conditions and predominant economic policy ideas in Sweden at the time of the formulation of the R-M model. The description seeks to reveal the provocative character of the model in the age of Keynesianism but also the economic circumstances that shaped it.

1. Sweden's Overheated Economy in the Years Following the Second World War

Keynes' ideas about stabilisation policy gained widespread acceptance in the Western world in the years following World War II. In Sweden, the Keynesian revolution had begun earlier. Already in the early 1930s, the Stockholm School of Economics, including Gunnar Myrdal and Bertil Ohlin, had favoured an active employment policy. After the 1932 election victory, the Swedish Social Democratic Party, following an agreement with the Agrarian Party, pursued a Keynesian deficit policy which aimed to take Sweden out of the depression.[2] The Social Democrats formed all peace-time governments in 1932-1976, although in coalition with the Agrarian Party 1936-1939 and 1951-1957.

By the end of World War II, Swedish politicians and economists (including the Minister of

[1] There was some disagreement between Rehn and Meidner over wage earner funds, which is another reason why I do not deal with them as parts of the model.

[2] However a common conclusion by Swedish economists is that the favourable economic development in Sweden in the 1930s is explained by depreciations of the *krona*, an expansionary monetary policy and German rearmament, not by an expansionary fiscal policy (Lindbeck, 1975, p. 102). More basically, Swedish manufacturing had been reconstructed and rationalised in the 1920s (Erixon, 1997a).

Commerce in 1945-1947, Gunnar Myrdal) were convinced that the Western economy was on its way into a depression, just as it was after World War I. The labour movement devised a radical Keynesian post-war programme for full employment in 1944; Gösta Rehn was one of the experts on the committee that developed the programme. But the post-war depression failed to materialise. Rapid reconstruction of Western Europe, with the help of the Marshall plan, was very favourable to Swedish industry, which specialised in raw materials, semi-finished goods and investment goods. Also, having been held back during the war years, there was a rise in Swedish households' demand for housing and consumer durable goods. As domestic companies could not expand their production capacity fast enough to meet demand, Sweden's economy became severely overheated.

Inflationary tendencies in the early post-war period were reinforced by expansive economic policies. Monetary policy was not really used in Sweden to stabilise the economy until the mid-1950s since the country consistently pursued a policy of low interest rates. Fiscal policy was the prime instrument used to achieve full employment and economic stability from the end of the war to the middle of the 1950s. Although mainly counter-cyclical, fiscal policy (by general government) was consistently expansive, at least from 1947 to 1960 (Matthiessen, 1971, 176, and Lindbeck, 1975, 102-6). Leading Social Democrats' commitment to full employment meant that they avoided using fiscal and monetary restraints to stabilise the Swedish economy. However, in certain early post-war years, expansionary fiscal policy was not a part of a conscious strategy to maintain high aggregate demand.

The government introduced a number of *ad hoc* measures to curb inflation and its negative effects in line with the Beveridge plan and the labour movement's post-war programme. To eliminate foreign inflation, the Swedish *krona* (SEK) was revalued by 17 per cent in 1946. Domestic inflation was tackled in 1946-1948 by price controls, specific taxes on consumer goods (and petroleum), higher statutory corporate taxes, and regulations of the construction sector. However, demand remained high and imports increased sharply, which had an adverse effect on Sweden's balance of payments. Imports were regulated in 1947, the trade unions agreed to a wage freeze in 1949-1950 and the SEK was devalued by a full 30 per cent in relation to the US dollar in 1949.[3]

[3] The Swedish devaluation followed a devaluation of the pound sterling. As other countries followed the British example, the SEK was devalued with 13-15 per cent in relation to competing currencies.

Devaluation, together with favourable export prices under the Korea crisis, brought about a profit boom in Sweden's industries at the beginning of the 1950s, particularly in raw materials industries. Despite the high rate of inflation, the government avoided a revaluation of the SEK and attempted instead to dampen the overheated economy by regulations of the construction sector, price controls, stricter rules of inventory valuation, profit freezes and by levying duties and taxes on investments and exports. After the Korean crisis, the pace of price increases in Sweden slowed significantly as a result of a reduction in the international rate of inflation coupled with high and steady productivity growth in the country's industries. Yet, to mitigate the economic boom in 1955-1956, monetary restraints were combined with new duties on investments and increases in statutory corporate taxes and with a phasing out of the use of free depreciation allowances for machinery and equipment (Bergström, 1969, 66-7, 117-23; Södersten and Lindberg, 1983, 43; Jonung, 1993, 295-300).

Swedish economic policy may be dubbed Keynesian from the end of World War II to the late 1950s. Political decision-makers laid a strong emphasis on full employment, a state that was defined (as in other Western countries) in a more policy-demanding manner than in the 1930s. They pursued a counter-cyclical general economic policy (fiscal and monetary policies including exchange-rate policies) with a bias towards expansionism to maintain full employment and *ad hoc* measures to fight inflation and its negative effects (regulations, including incomes policy, devaluations and extraordinary fees and taxes). Besides, fiscal rather than monetary instruments were used to stabilise the economy in line with Keynes' recommendations in the *General Theory* (Keynes, 1936, p. 375).[4]

In the early post-war years, Sweden's politicians were convinced that in the Keynesian model they had at their disposal a superior political instrument for economic stabilisation. But the model had been designed, in spite of its advocacy of counter-cyclical measures, for an economy in depression and not for an overheated economy with virtually full employment.

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[4] Leading Social Democrats had different economic policy positions in the late 1940s (cf. Appelqvist, 2000), but all were Keynesian, as widely defined.

2. The Content of the R-M model

The two LO economists Gösta Rehn and Rudolf Meidner became more and more critical of the Keynesian economic policy in the early post-war period. A general policy of expansion lead to 'over-employment' including high absenteeism, high staff turnover and a greater risk of accidents at work. It also meant that full employment depended on inflation, and inflation negatively affected on resource allocation and growth. Moreover, Keynesianism was inflationary in its effects not only on aggregate demand but also its unpredictable and unintentional effects on distribution. An expansionary monetary and fiscal policy generates tensions between different wage earner groups and challenges the cohesion within the labour movement. A high demand for, and limited availability of, specific skills causes 'wage drift', i.e., pay in excess of those negotiated in central agreements.[5] Wage drift gives rise to demands for compensation from other groups of employees to maintain their relative wage positions: a Keynesian policy of full employment aggravates the conflict between wage earners who, respectively, benefit and do not benefit from market forces, resulting in inflationary wage-wage spirals.

Rehn and Meidner thought that Keynesianism was a threat even to full employment. Expansive monetary or fiscal policy causes inflation and current account deficits (note the fixed exchange-rate system and the limitations in capital mobility between countries in the early post-war period). These problems call for a contractionary economic policy, which, in turn, causes unemployment. Rehn and Meidner wanted to replace a Keynesian stop-go policy with a policy that permanently kept the rate of inflation under control.

According to Rehn and Meidner, in the context of Keynesian full employment policy, inflation cannot be curbed by means of regulations. Regulations can hardly be comprehensive, and from a growth and employment viewpoint it is often the 'wrong' companies and sectors that suffer their effects. Incomes policy agreements are difficult to achieve and also ineffective in an overheated economy. They will also threaten the independent position of labour market

[5] Wage drift accounts has accounted for about half the total increase in blue-collar workers' wages in Sweden in the post-war period (Calmfors and Forslund, 1990, 91-2; Holmlund and Zetterberg, 1991, 102; Nilsson, 1994, 9). The importance of central wage agreements in Sweden has sometimes been overstated in the foreign literature.

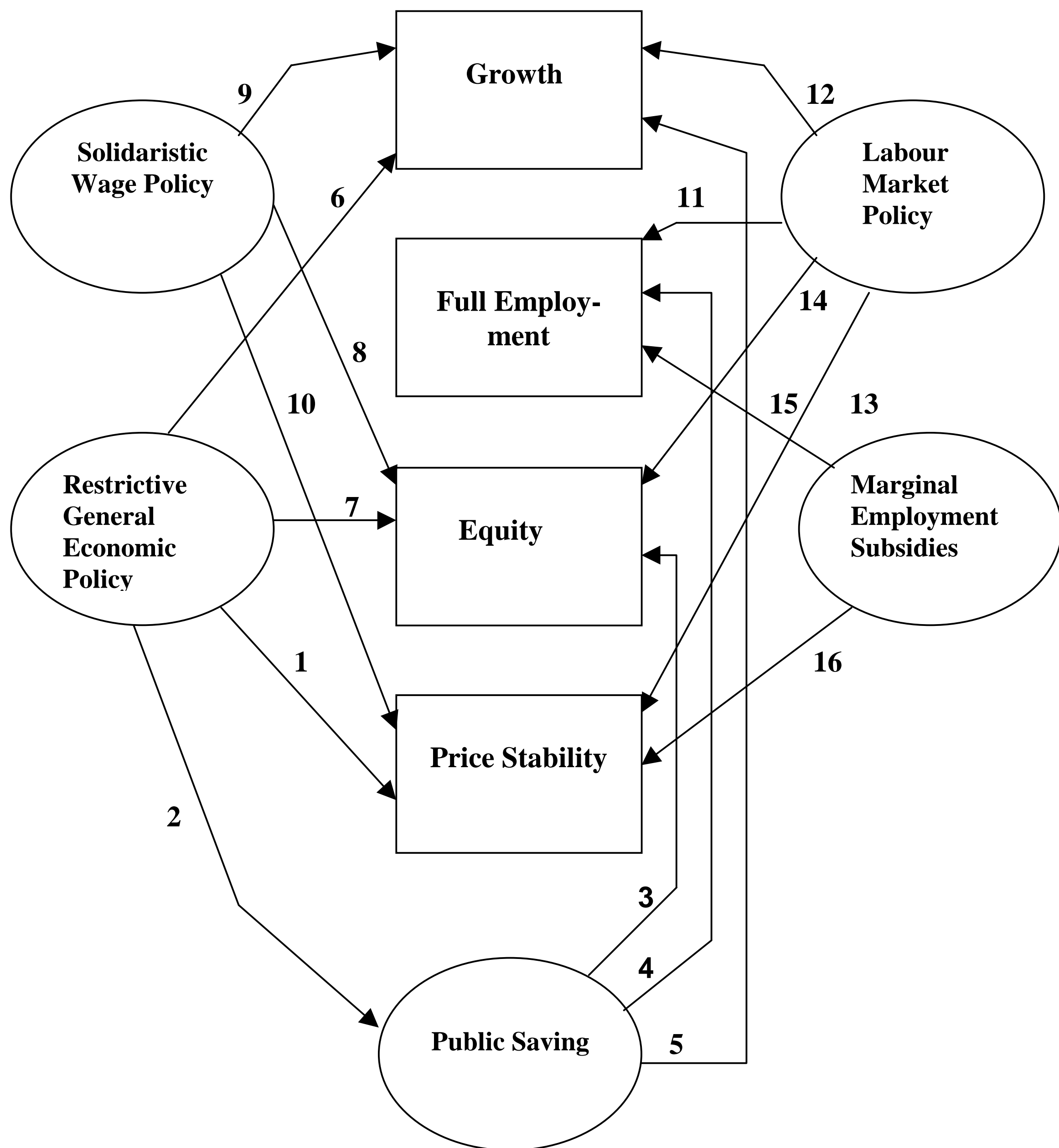
organisations[6] and weaken the legitimacy of trade unions in the eyes of their members. Declarations of ‘wage restraint’ are incompatible with the main task of a trade union, which is to achieve the highest possible pay rises for their members.

The two LO economists set forth their alternative to Keynesianism in a report presented to the 1951 LO Congress entitled *The Trade Union Movement and Full Employment* (Meidner and Rehn *et al*, 1953). Hereafter I equate the R-M model and the LO report, as the subsequent work of Rehn and Meidner did not add anything to the original model apart from Rehn’s proposal of marginal employment subsidies and Meidner's proposal of wage earner funds.

A salient purpose of the R-M model is to combine full employment with price stability. But the model also took as its point of departure other objectives of economic policy in the post-war period, namely growth and equity. The means and objectives of the model are shown in *Figure 1*.

[6] According to the 1938 Saltsjöbaden agreement, labour market conflicts in Sweden should be resolved through negotiated agreements and not by legislation. Statutory incomes policy is not compatible with the spirit of the Saltsjöbaden agreement.

Figure 1: Means and objectives in the Rehn-Meidner economic and wage policy model



2.1 A restrictive fiscal policy

The R-M model advocates a restrictive general economic policy to curb the rate of inflation (see arrow 1 in *Figure 1*). Rehn and Meidner prioritised fiscal rather than monetary restraints in the 1951 LO report, but later included revaluations as appropriate tools to achieve price

stability in an open economy.[7]

Rehn's and Meidner's central idea was that fiscal policy should be predominantly tight over the business cycle. Hence, their programme for stabilisation is more than a recommendation of fiscal restraint near full employment as in a Keynesian strategy. Another purpose of fiscal restraint over the business cycle is to create a public saving surplus (arrow 2). Public saving is an intermediate goal in the model. It is preferable to private saving in terms of income and wealth distribution (see arrow 3) but also to achieve certain employment and growth objectives in industrial policy (see arrow 4 and 5 respectively). These ambitions make public saving the least market-conforming component of the R-M model.

Rehn and Meidner also expected that a restrictive general economic policy would foster rationalisations in companies and structural change through forcing the closing of unproductive firms (arrow 6 in *Figure 1*). A further objective of the tight economic policy was to support the equity principles of their model (arrow 7). By keeping down wage drift, the policy reduces the risk of wages reflecting differences in profitability between companies rather than the content of work (as entailed by the solidaristic wage policy, discussed below).

2.2 Solidaristic wage policy

Solidaristic wage policy implies the same rates of pay for comparable work irrespective of the profitability of companies (arrow 8). The policy is sometimes confused with a policy of equal wages for unequal work. But it is governed by an ambition to establish fair wage differentials rather than wage equalisation in general. Wage differentials between different group of wage earners are permitted but they should reflect 'objective' differences in working environment, responsibility, experience and education, not short run profit (or labour market) conditions.

Solidaristic wage policy seems to be an example of a crude planning devices, typical for the

[7] Rehn's and Meidner's priority of a fiscal rather than monetary policy measures in stabilisation policy in the 1951 LO Report can be explained by the low-interest policy in Sweden, and by the fixed exchange rates of the Bretton Wood system, at that time. Further, their emphasis on tight fiscal policies is explained by the priority given to public saving in their model. Finally, Rehn and Meidner were probably influenced not only by the *General Theory* (see above) but also by Gunnar Myrdal who had argued for a combination of low rates of interest and high profit taxes on income-distribution and industrial-policy grounds (Myrdal, 1944).

early post-war period. The policy requires a systematic comparison of jobs by central trade unions, possibly in collaboration with central employer organisations. But it can be considered as an attempt to simulate a perfect market equilibrium. This is obvious in the case of identical jobs. But wage differentials in a long-run market equilibrium can also be seen as 'fair' since they reflect real differences in work content and worker qualifications.

The equity principle of solidaristic wages had already been adopted by LO in the 1930s. But Rehn and Meidner also considered solidaristic wage policy as a mean of attaining overall economic growth, primarily through structural change, and of alleviating inflationary wage-wage races (arrow 9 and 10 respectively).

Solidaristic wage policy, together with a restrictive general economic policy, threatens to obliterate the least profitable companies and industries. The threat leads to closures, which make it possible to transfer resources to dynamic sectors, or to rationalisations of the least profitable companies and industries. At the same time, solidaristic wage policy results in ‘excess profits’ in the most profitable companies and industries, which could have managed to pay more than the wages of solidarity. These profits will increase the self-financing capabilities of established profitable firms and strengthen the motivation to set up new companies in dynamic sectors. Further, larger profit differences due to solidaristic wage policy will strengthen the incentives to transfer resources from low-profitability sectors to high-profitability ones.

By solidaristic wage policy, a pull mechanism is replaced by a push mechanism, or better, a rationing mechanism, in labour markets. Labour mobility is kept up by the threat of unemployment in unprofitable sectors but also by larger inflows of vacancies in profitable sectors. These inflows of job applicants and vacancies will counter-balance the negative effects on structural change caused by weaker pay incentives. Rehn and Meidner’s preference for solidaristic wage policy was based on a conviction that wage differentials must grow large to create a significant labour mobility because of inertia in the labour market. Large wage differentials between sectors are unacceptable from a distribution viewpoint but also inflationary by causing wage-wage spirals.

Rehn and Meidner also assumed that the determination of fair wages would slow down inflationary wage races *per se*. They hoped that wage earners' demand to be keep up with pay rises for other wage earners would be less intense in the absence of challenging wage differentials (Meidner and Rehn *et al*, 1953, 96; Rehn, 1977, 216; 1980, 36, 39-40). Hence, central bargaining would lead to wage moderation in the R-M model, but only indirectly by creating the conditions for solidaristic wage policy.

2.3 Labour Market Policy

A restrictive general economic policy will, *ceteris paribus,* cause unemployment in some sectors of the economy, especially if profit conditions vary. Further, a tendency to 'structural unemployment' will show up when solidaristic wage policy is pursued. Rehn's and Meidner's main recommendation to nonetheless achieve full employment is labour market policy measures (see arrow 11).

The labour market policy can be divided into three parts, selective demand policy, supply-orientated measures and actions to improve the matching process on the labour market. Demand-orientated measures should have the smallest possible effects on aggregate demand and therefore be directed towards specific employee groups, companies and regions (particularly specific relief work and regional policy). The supply side of the labour market was to be affected by the introduction of relocation and retraining grants and occupational training programmes, while public employment services would adjust job applicants to vacancies. I consider the supply and adjustment oriented measures as the main elements of labour market policy in the R-M model since they also have other objectives than reducing open unemployment in the short run.

One objective of the supply-side and matching measures is to increase or reallocate the availability of labour and to improve the labour market's ability to make adjustments. Thus, labour market policy could stimulate economic growth as well by facilitating dynamic sectors' recruitment of labour (arrow 12). In addition, labour market policy is also an important weapon in the fight against inflation. Here, Rehn and Meidner emphasised not only that the alternative employment policy, i.e. an expansionary general economic policy, is inflationary

but also that labour market policy has an inflation-dampening effect (see arrow 13). Stimulation of labour mobility would moderate the rate of pay rises in sectors with high demand and bottlenecks in the form of labour shortages.

It is a wrong to conclude, however, that labour market policy should lead to wage reductions in the R-M model. Labour market policy prevents unemployment and therefore wage reductions (or rather reductions in the pace of wage increases) in a recession. Rehn and Meidner seem to assume that these wage-increasing effects of labour market policy are decisive over the business cycle. A restrictive general economic policy is *inter alia* meant to counter the inflationary effects of labour market policy.

Labour market policy also plays a role in the effort to achieve greater equity (Meidner, 1969, pp. 190-192). Significant wage differentials between sectors will emerge when dynamic companies try to attract labour by higher wages unless measures are undertaken to improve the mobility of labour (arrow 14). In particular, solidaristic wage policy is facilitated by means of government measures to speed up the transfer of labour from stagnating sectors to expanding sectors. By guaranteeing full employment, labour market policy should also change functional income distribution in favour of labour, thus increase wage earners' share of value added (Rehn, 1952, p. 47).

2.4 Marginal Employment Subsidies

Rehn's ambition in advocating marginal employment premiums was to combat unemployment and inflation by reductions in firms' marginal costs (see arrow 15 and 16 respectively). The proposal is entirely in line with the supply- and matching-oriented labour market policy. In the case of labour market policy, expansive companies are relieved of some of the cost of recruiting and up-grading their workforce. However, the intention behind marginal employment subsidies is to introduce a measure that has an immediate price-depressing effect.

Prices will be reduced by a marginal employment grant if product markets are competitive or if companies set their prices on the basis of marginal costs. The reduction in prices and the concomitant increase in employment would be greater for a marginal subsidy than for an intra-

marginal subsidy, for instance a general reduction in pay-roll taxes, of the same amount. A marginal subsidy will also increase employment and production more than the same amount of an intra-marginal subsidy in an open economy with given world market prices (cf. Layard and Nickell, 1980, 57-9, and Johnson and Layard, 1986, 946-9). Finally, a marginal subsidy could give new companies more encouragement to form new markets or enter established ones than would an intra-marginal subsidy (cf. Bishop and Haveman, 1981, pp. 300-317). A larger number of new companies could result in higher employment but also, then, bring a greater downward pressure to bear on prices.

Marginal employment premiums are not a Swedish innovation, either in practice or in theory. Rehn's contribution was to place the premiums in a stabilisation policy context. In fact, the proposal induced Rehn to suggest a modification of the R-M model when unemployment rose in Western Europe in the 1970s. He recommended the use of marginal employment subsidies together with labour market programmes and measures aimed at *raising* effective demand. This kind of economic policy would have brought the rate of inflation down lower than a purely Keynesian strategy for full employment (Rehn, 1982). Rehn also suggested in the 1980s that not only employment but also investments and production increases in general could be given a financial support.

I will use the notion of selective employment policy to cover (active) labour market policies and marginal employment premiums. (Both measures are considered as labour market policy in official Swedish statistics.) This notion can give the wrong impression that the employment policy of the R-M model is always directed towards specific firms, regions, sectors and wage-earner groups. Such targeted measures are not included in Rehn's final proposal of marginal employment subsidies. Subsidies should be offered to firms in all regions and sectors and for all kinds of labour. It is the conditional character of marginal subsidies - they are only offered to recruiting firms - that make them selective and therefore distinct from monetary and fiscal policy measures or general reductions in pay-roll and profit taxes.

2.5 The uniqueness of the R-M model

The R-M model was certainly a radical idea in the age of Keynesianism, particularly in a country which has been a precursor of the Keynesian revolution and from within a social movement committed to full employment. Two trade union economists dared to recommend a restrictive general economic policy and placed the priority of price stability on an equal footing with the priority of full employment.

The fact that the R-M model was formulated in an overheated economy determined its character. The purpose of labour market policy, including regional policy, was to eliminate the 'islands of unemployment' that was a result of a restrictive general economic policy and a solidaristic wage policy. Rehn and Meidner were not against a traditional public-deficit policy in periods of deep recession or of a counter-cyclical policy in general. But the model's advocacy of a tight fiscal policy goes beyond a qualified Keynesian recommendation that expansionary measures should be cautiously used, or even replaced by fiscal and monetary restraints, near full employment. Fiscal policy was to be predominantly restrictive throughout the business cycle to set the framework for stabilisation policy. The struggle against inflation was not to be called off even in periods of high unemployment; expansionary fiscal and monetary policies had to be complemented with inflation-dampening measures such as marginal employment subsidies.

But the R-M model is also unique in terms of its comprehensive view of economic policy. First, one of the model's advantages is that it embraces all the objectives of post-war economic policy: full employment, price stability, growth and equity. Modern macroeconomic models consider at most two objectives, often price stability and full employment.

Second, the R-M model deviates from most macroeconomic models by allotting at least two tasks to each instrument as illustrated by *Figure 1*. For instance, labour market policy has *four* objectives, to achieve full employment, to speed up structural change, to hold back price and wage increases caused by labour-market bottlenecks or high profit margins, and to facilitate solidaristic wage policy. And, according to the model, labour market policy has a further redistribution task - full employment shall alter functional income distribution in favour of labour by increasing its negotiation strength, both collectively and individually.

Third, the instruments of the R-M model are complementary in the sense that some measures must be introduced in the model to alleviate the side effects of other measures. For example, a restrictive economic policy and a solidaristic wage policy will generate unemployment unless complementary labour market policy measures are introduced. But more specifically, a partial application of the model is discouraged by the fact that some measures *are effective only* when used together with other measures. The principle of solidaristic wage policy must be supported by labour market policy measures and a restrictive economic policy to keep wage drift under control. Further, solidaristic wage policy will only put pressure on 'marginal' firms to rationalise if combined with a restrictive general economic policy. Labour market policy might be a necessary condition for a relationship between a solidaristic wage policy and structural change - labour resources can be released through solidaristic wage policy - but labour market policy may be needed to transfer the resources to expanding firms and sectors. There are other complementarities in the R-M model. Fair wages through solidaristic wage policy will not restrain inflation significantly unless a restrictive economic policy and a labour market policy are launched simultaneously. Moreover, profit margins cannot be reduced permanently by a restrictive general economic policy alone but must be combined with a policy for full employment.

Fourth, the R-M model has the advantage of linking together both short and long-term analysis by assuming that labour market, fiscal and monetary policies all influence growth. Here, the model avoids the one-sided Keynesian view of a positive relationship between profit and demand on the one hand, and productivity growth on the other. Rehn and Meidner did not deny that a restrictive general economic policy might reduce productivity growth if private investments are hampered or if static scale advantages exist (Rehn, 1982, 4-5). But according to their model, a restrictive economic policy may quite simply result in high productivity growth through rationalisation and structural change.

Of course, none of this proves that the R-M model is still relevant for decisions about economic policy. But we can only address this once we have appreciated the model in its own right, in terms of its logic and all-embracing character.

3. Wages and Inflation in the R-M model

3.1. The central role of profits

In the R-M model, the main purpose of the tight fiscal policy - foremost an increase in indirect taxes - is to force down profits and profit margins. Rehn and Meidner expected that a general profit squeeze would speed up rationalisations and structural change. They were also convinced that profits are the significant driving force in the process of inflation. High profits lead to a substantial amount of wage drift, in turn triggering demands for corresponding wage increases from groups that have not benefited from the effects of free market forces. Profit margins should also be squeezed in the medium and long term *inter alia* to establish a permanent downward pressure on the rate of inflation. Rehn's and Meidner's idea was that labour market policies and other selective employment measures would prevent price reductions under a restrictive general economic policy being met by nominal wage reductions. A possible comment is that profit margins in a single country can be depressed by a full-employment policy without the support of a tight fiscal policy; the possibilities to mark up wage increases due to labour market policy are limited in an open economy (see Erixon, 2000, pp. 38-42).

The 1951 LO report does not state why profits and profit margins are of central importance in wage formation. Rehn has explained himself in other works, for instance in an article he wrote together with Bent Hansen (Hansen and Rehn, 1956). The focus is here upon firms' competition for scarce labour. In fact, the marginal productivity theory is fundamental in the Rehn-Hansen article. Wages are determined in a competitive labour market by prices, adjusted for the degree of monopoly, and physical marginal productivity. A positive demand shock (or a higher marginal productivity) will lead to wage drift since there are anticipated profits from employing more workers at the initial wage rate.

Hence, wage drift is explained by marginal profits, not by average (actual) profits in the Rehn-Hansen article. This theoretical approach results in a 'Rehnian paradox' when marginal employment subsidies are included in the R-M model. From the Rehn-Hansen perspective, the aim of a tight economic policy is to squeeze marginal profits. But marginal employment subsidies are an instrument to *increase* marginal profitability. The 'Rehnian paradox' can only be reduced if wage drift is largely determined by *actual* profits. In fact, Rehn and Meidner

have discussed other connections between profits and wages than the one in the marginal productivity theory.

There are some ambiguities in Rehn's and Meidner's discussion of the relation between actual profits and wages, but the thrust of my presentation follows the overall spirit of the model. I will concentrate upon those explanations by Rehn and Meidner in which companies and managers, not wage earners, are the main actors. Further, in all explanations except one, higher profits will lead to wage increases by intensifying companies' competition for labour hence, the relation is associated with an 'upward' shift in the labour demand function.

In the first line of argument, higher actual profits extend the *self-financing capacity* of companies that in turn stimulate labour demand. There are two possible mechanisms in the R-M model. First, higher actual profits lead to higher investments, as companies' capital costs are reduced. Second, higher actual profits intensify *non-investing* companies' competition for labour since they get greater financial opportunities to offer higher wages to key employees who threaten to leave because other companies are recruiting.

The second Rehn-Meidner argument for a positive relationship between profits and wages is based on the notion of *X-inefficiencies*. Managers of the companies will reward themselves and their employees higher wages than their efforts merit when actual profits are high. Hence, high profits make employers more careless with regard to wage payments (cf. Hansen and Rehn, 1956, p. 89).

These explanations of a relationship between actual profits and wages are distinct from the ones in modern bargaining and fair wage-effort theories. In the latter theories, the 'wage-setting' curve, not the labour-demand curve, shifts upward when profits become higher. In the bargaining theory, higher profits will automatically induce wage increases through a 'rent-sharing' agreement between employees and employers (Cristofides and Oswald, 1992, and Blanchflower, Oswald and Sanfey, 1996). In the fair wage-effort theory, higher profits accruing to the firms' owners will provoke higher wage claims; wage earners' interest in fair wages is not only based on concerns for wage distribution but also for functional income distribution. These claims can be satisfied since employers are afraid that workers otherwise will work less (Akerlof and Yellen, 1990).

Relative wage preferences, including concerns for functional income distribution, are equally important in the R-M model. In addition, a hypothesis by Rehn and Hansen that high profits make employees more eager to exploit the wage-paying capacity of companies is similar to the fair wage-effort theory. Another hypothesis by Rehn and Hansen that higher average productivity through technical improvements will benefit employees as an 'institutional habit' can be associated with the rent-sharing view (Hansen and Rehn, 1956, pp. 89-90 and 96-97). In fact, Rehn was strongly influenced by the bargaining theory in the 1980s (Rehn, 1982).

Yet, I will insist on that the positive relation between actual profits and wages is essentially explained in terms of labour demand and X-inefficiencies in the Rehn-Meidner wage theory. Besides, the hypothesis in the fair wage-effort theory that employers accept higher wage claims since they are afraid that employees will otherwise punish them by a worse performance has no correspondence in the writings of Rehn and Meidner. In their wage model, firms' willingness to offer wages above the competitive level when profits are high reflects that they are X-inefficient.

My interpretation of the relationship between profits and wages in the R-M model does not deny that the model contains 'wage setting' elements. Wages are kept up in a recession, and also in the medium term, by labour market policy. Further, central bargaining and the strength of organised labour are important wage determinants in the model regardless of being conditional for solidaristic wage policy. But market forces are still fundamental in the R-M model. Labour market policy measures are induced by unemployment tendencies in a 'free' labour market. Furthermore, central wage negotiations and trade-union strength basically determines the possibilities for disadvantaged groups to get the same wage increases as 'wage drifters' (see below).

The relationship between profits and wages is challenged by solidaristic wage policy in the R-M model. But it is a misunderstanding to say, as do economists in the trade-union and bargaining theoretical tradition, that labour market forces are completely superseded by solidaristic wage policy. In fact, there are strong tensions between wage policies and market forces in the R-M model. The incentives for dynamic firms and industries to offer high wages are not weakened by solidaristic wage policy - the policy will even raise their financial ability

to pay high wages. Further, a short-run relation between firm performance and wages can appear in countries with wage solidarity because of labour-market rigidities. Solidaristic wage policy demands not only central bargaining but also restrictive fiscal policies and mobility-enhancing labour market programmes.

The validity of the R-M model is not really at stake when the short-run relationship between profits and wages is analysed. For instance, observations of a weak relationship in Swedish industries, at least until the 1990s, may reflect the effects of solidaristic wage policy, highly flexible labour markets or a combination between these phenomena (Erixon, 2000, 58-62). The R-M model excludes none of these interpretations. However, studies of wage differentials between firms and industries in Sweden and other countries showing a *long-run* relation between profitability and wages (Blanchflower, Oswald and Sanfey, 1996, and Arai, 1999), restrict the validity of the model, which at bottom is a competitive model or a model of solidaristic wages. These empirical results have been seen as evidence of the rent-sharing or fair-wage effort theories. Defenders of the R-M model can only refer to the X-inefficiency theory that firms act frivolously when profits are high or to the possibility that, after all, the studies uncover transitory rather than permanent forces.

3.2 Relative wage preferences and wage-wage spirals

The hypothesis of a positive relationship between profits and wages forms the basis of the Rehn-Meidner inflation theory. Positive demand shocks will lead to higher nominal wages in competitive labour markets since they will result in (anticipated) gains from recruiting labour and also in higher actual profits that will intensify wage competition among firms. Wage drift will later be followed by collective wage increases reflecting that trade unions concern abourt relative wages and the fact that wage increases through market forces are partly captured by the collective wage process.

The assumption that wage earners (and their unions) care about relative wages is fundamental in the R-M model as in the *General Theory* and the modern theory of fair wages (cf. Akerlof and Yellen, 1990). Wage earners compare themselves with wage earners in dissimilar occupations, either within the same firm or in other firms. Rehn and Meidner claimed that incomes policy will be undermined in an overheated economy by the combination of wage

drift and compensatory wage claims and by the fact that relative wage preferences are easier to satisfy when unemployment is low and actual profits are high. In good times, it is *inter alia* tempting for trade unions to resist participating in incomes policy agreements and for employers to accept wage increases above the levels of profit maximisation (see the X-inefficiency theory).

A similar compensation for wage drift will also occur in the Scandinavian model (the EFO-model in Sweden). Wage increases in the exposed sector are spread to the sheltered sector by virtue of the market mechanism and relative wage preferences. Wage increases in the sheltered sector can be passed on to the consumers through mark-up pricing (Edgren, Faxén and Odhner, 1973).

But there is a crucial difference between the Scandinavian and the R-M models. The Scandinavian model is actually a theory of wage and price changes and of equilibrium profits. Wage-wage-price spirals are prevented in the model by the assumption that prices in the wage-leading exposed sector are given (at a given exchange rate) and that wages in the sector is determined by these prices (if productivity is constant). In contrast, wage-wage-price spirals will occur in the R-M model. Rehn was worried in the 1960s and early 1970s that the attraction of the Scandinavian model among leading Swedish politicians would lead to (galloping) inflation due to lax economic policy (Rehn, 1977, p. 223).

The question is why the economy exhibits continued wage rises and inflation in the R-M model instead of 'equilibrium inflation' (or rather one-time changes in prices and wages) as in the Scandinavian model. The R-M model never deals explicitly with the reasons why, when its equilibrium is disturbed, an economy changes from a condition of wage and price rises to a condition of galloping inflation. A wage-wage spiral will emerge if employees in the open sector succeed, wholly or partly, to re-establish the wage lead they initially gained through wage drift. I will give two possible theories for this kind of wage development. If these theories are refuted, the R-M model must rely on the economy being exposed to constant disruptions that never allow wages and prices to converge to equilibrium.

A reasonable hypothesis is that mark up pricing also takes place in the open sector, at least in parts of it. Thus, companies in the exposed sector will accept new wage increases, as they are

able to pass them over to customers. An alternative hypothesis is that companies in the exposed sector are forced to accept wage rises or even take initiatives to wage increases that cannot be passed on. In the 'voluntary' case, the behaviour of companies may reflect a lack of information about market conditions, or that the initial profit increase provides scope for 'unearned' rewards for the employees (see the argument on X-inefficiencies).

It seems, however, that the above arguments offer a weak case for a sustainable wage-wage-price spiral. The process is counter-balanced by monetary restraints unless an accommodating economic policy is pursued. The room for mark up pricing must also be limited in the open sector. Besides, the firms in the open sector will gain information about market conditions and refuse to give 'unearned' wage increases to employees when their profits are depressed.

The existence of counteracting forces in the wage-wage-price process does not exclude the existence of such processes, at least temporarily, in a country like Sweden. The Rehn-Meidner assumption of destabilising macroeconomic shocks, unless they are immediately remedied, should not be rejected without a careful empirical test.

4. The R-M model in Practise

There are two aims in my survey of Swedish economic policy in the post-war period. First, I want to find out to what extent the R-M model was actually applied in Sweden. Second, I will use the R-M model as a point of reference when analysing and evaluating Swedish economic policy.

The comparison between the R-M model and the practice of Swedish economic policy is based on my interpretation and not on a systematic analysis of Rehn's and Meidner's view of contemporary economic and wage policies. This strategy is not without complications even if the model is relatively unambiguous and the founders never abandoned its central ideas. The model cannot possibly be used as a yardstick under all political and economic conditions. As conditions change, the usefulness of the Rehn-Meidner policy model may diminish. But the model can *a priori* be used as a normative benchmark for analysing Swedish economic policy

in the post-war period.

It is difficult to formulate any definite and wholly reliable answers to the question of whether the R-M model was practised or not in Sweden. First, the model consists of five instruments: a restrictive general economic policy, labour market policy, marginal employment premiums, solidaristic wage policy, and public saving. The model has not been applied in all its respects during any post-war period of time. Second, the recommendations in the R-M model have sometimes coincided with those of other models - economic policy only appeared to be inspired by the R-M model, making it often difficult to distinguish the true motives and rudders of economic policy actions. Third, in certain periods, macro policy reflected the difficulties of Keynesian 'fine tuning' rather than an application of the R-M model - a restrictive economic policy was an indication of a wrongly directed Keynesian policy. Yet, despite these reservations, it is possible to discern a 'Golden Age' for the R-M model, from the end of the 1950s until the first oil crisis.

4.1 The Golden Age

Sweden showed a relatively good macroeconomic performance in the Golden Age. It is true that neither GDP per capita growth, nor production growth in manufacturing, were exceptionally high in an international perspective, especially from the mid-1960s to 1972 (Historical Statistics, OECD, 1982, table 3.2 and 3.5). But the country succeeded better than most other OECD countries in combining low wage and price rises with low unemployment from the end of the 1960s when the international rate of inflation increased (Historical Statistics, *ibid.*, table 2.15, 8.11 and 9.8). The Phillips curve became relatively favourable for Sweden, despite a decline in mobility in the Swedish labour market at the end of the 1960s.

Productivity (value added per hour) growth in manufacturing was high, although not exceptional, in Sweden compared with other OECD countries in the Golden Age (Erixon, 1991, 245). Structural change in manufacturing was rapid in Sweden in the 1960s and early 1970s particularly compared with large OECD countries (Fries, 1983, pp. 143-7, Nilsson and Zetterberg, 1987, pp. 17-9, and Andersson *et al*, 1998, pp. 3-4 and 9-10). The extent of structural change is calculated here as an index of movements in employment between

industries.

It seems also that the R-M model was a lodestar for economic policy in the Swedish Golden Age. The Social Democratic government pursued a vigorous labour market policy in the recession years of 1957 and 1958. In the 1960s, there was a substantial increase in labour market policy (including regional policy) measures, mostly from the middle of that decade. At the time of the first oil crisis, expenditure on active labour market policy (including regional policy) measures totalled 2.4 per cent of GDP. The percentage was higher in Sweden than in the other OECD countries (Johannesson, 1991, and SOU 1993:43, p. 125).

The direction of labour market policy was also compatible with the R-M model. From the end of the 1950s to the beginning of the 1970s, the greatest increase was in adjustment and supply-oriented measures, i.e. measures which aimed to stimulate occupational and geographical mobility - the proportion of the Labour Market Board's budget (excluding cash assistance) spent on these measures increased from 15 per cent in 1960 to one third in fiscal year 1973/1974. The Labour Market Board's proportion of government expenditure also increased constantly in the period from 1960 to 1973; in the 1950s this percentage had varied with the business cycle.

Monetary and fiscal policies were counter-cyclical, at least until the mid-1960s.[8] But general economic policy was more restrictive from the end of the 1950s to the beginning of the 1970s compared with the preceding post-war period, fully in line with the R-M model where fiscal policy is concerned (Matthiessen, 1971, 176, Lindbeck, 1975, 104, Jonung, 1993, 298-303 and 346-8, and Calmfors, 1993, 45). The monetary and fiscal policies in the recessions of 1966-1968 and 1970-1972 were, from a Keynesian viewpoint, far too austere. Fiscal policy in these recessions was, respectively, close to neutral and deflationary. It was labour market policy not Keynesian stimulation policy that prevented a significant increase in Swedish unemployment. Rehn praised the government for countering the tendencies towards higher unemployment

[8] A system of investment funds had already been introduced at the end of the 1930s, but was not used as a stabilisation policy tool until the mid-1950s. Companies were allowed to make deposit deductions from their profits (up to 40 per cent) for placement in special investment reserves. Some of these deductions (almost half of them in the Golden Age) had to be placed in interest-free accounts in the Central Bank. These frozen reserves could only be regained following an assessment on stabilisation policy grounds. The investment funds were a successful Swedish innovation in stabilisation policy. But they were primarily instruments in a Keynesian strategy to shift investments from boom periods to recession periods more than indications of a R-M model influence.

with an active labour market policy instead of an expansive fiscal policy (Rehn, 1977, 223). The Minister of Finance, Gunnar Sträng, declared in the middle of the 1970-1972 recession that employment policy must by necessity be selective since a Keynesian stimulation policy inevitable would lead to inflation and competitive disadvantages in an open economy (Budget Bill 1971, 19-20, and the Revised Budget Bill 1971, 11).

The co-ordination of wage negotiations in the mid-1950s gave the LO the opportunity to pursue a solidaristic wage policy. From the early 1960s until the mid-1970s pay equalisation between and within industries and plants and between the sexes was more far-reaching in Sweden than in other OECD countries (Ohlsson, 1980, and Hibbs and Locking, 2000).[9] There was not only a widespread pay equalisation among blue-collar workers but also, in the 1970s, among white-collar workers (Jonsson and Siven, 1984, 430-1). Market forces alone cannot explain this radical reduction of wage gaps in Sweden, thus central bargaining and wage policies must have been important.

A quantitative study has shown that wage equalisation between industries and plants in Sweden led to a significant increase both in blue-collar labour productivity and in output in the private business sector. Hence, the study confirms a theory that structural change is enhanced by solidaristic wage policy (Hibbs and Locking, 2000).[10]

The public sector's share of total savings increased sharply in Sweden, from 35 per cent in 1962 to 44 per cent in 1972. No other OECD country had a corresponding increase in public saving. Further, in the 1960s and the early 1970s, there was a decline in actual rates of return and the profit share of value added in Swedish manufacturing. In fact, the fall in profit rates and profit shares was sharper in Sweden than in other OECD countries according to estimates based on national accounts. *Table 1* shows that the trend coefficients for gross profit shares in manufacturing was higher in Sweden than in eight other OECD countries in 1955-1972 - see

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[9] The adjustment of women's wages to men's wages was, however, as comprehensive in Denmark and the Netherlands.

[10] The R-M model would not have been challenged, however, by the absence of a positive relationship between solidaristic wage policy and structural change. The model says only that this wage policy is an equally efficient instrument as large wage differentials to obtain structural change, but still a better alternative in terms of income distribution and price stability.

the first column (cf. Erixon, 1987, 49-54; 1991, 285-93). The profit decline (and increase in public saving) in Sweden was entirely in line with the R-M model.

Table 1: **Gross operating surplus as a ratio of gross value added in manufacturing, trend coefficients for 9 OECD countries in 1955-1997**

	1955-72	1955-90	1955-97
Sweden	- 0.6 (-9.3)	-0.2 (-2.6)	0 (0.1)
Denmark	- 0.1 (-1.5)	0 (0.6)	0.2 (4.2)
Finland (1)	- 0.4 (-1.8)	0 (0.6)	0.2 (3.0)
Netherlands	- 0.5 (-4.6)	- 0.3 (-3.0)	0 (0.2)
West-Germany	- 0.5 (-7.3)	- 0.5 (-13.6)	- 0.5 (-17.7)
Great Britain	- 0.3 (-8.0)	- 0.1 (-2.3)	0 (0.1)
The United States	0 (-0.2)	0 (0)	0.1 (2.8)
Canada	- 0.3 (-4.5)	0 (-0.9)	-
Japan	0.2 (2.0)	- 0.4 (- 7.3)	- 0.5 (-11.1)

Notes: (1) Initial year: 1960.
T-statistics in brackets.
Sources: OECD, National Accounts - volume II and Eurostat, database.

Hence, it would appear that the R-M model was applied in Sweden from the late 1950s to the early 1970s. But thus far I have not shown that economic and wage policy was really influenced by the R-M model or that all parts of the model were implemented during the period.

The Social Democratic government was undoubtedly influenced by Rehn’s and Meidner's ideas in the field of labour market policy (Rehn, 1977, 222-4, and Erixon, 1997b, 640). This policy was not new, either in Sweden or in other countries, but Rehn and Meidner linked it directly to stabilisation and growth. Price stability and (in the 1960s) structural change became important arguments for more expenditures on labour market policy in general and on supply-oriented measures in particular.

Similar conclusions may be drawn in the case of the solidaristic wage policy. Already in the 1930s the LO adopted the principle of a wage policy based on solidarity. The Swedish trade union movement also accepted at an early stage that international competition and structural transformation could eliminate companies and even entire sectors. However, the R-M model provided the LO with arguments that their own wage policy could accelerate structural change and that its negative effects on employment could be lessened by labour market policy measures.

But the attempts to introduce a uniform evaluation of job content and conditions in the Swedish labour market in the Golden Age were not successful. In the absence of a consensus about fair wage differentials, the LO gave a special priority to the low wage-earner brackets in general from the late 1960s. In practice, solidaristic wage policy followed the principle of equal pay for *un*equal work as much as the original principle of equal pay for equal work (Arai, 1994; Hibbs and Locking, 2000). The LO argued that the policy indirectly satisfied the ideal of solidaristic wage policy - actual wage differentials between occupations were too large to be explained or justified by 'objective' job differences. A similar commitment to wage equality in general was made by the central private white-collar union cartel, PTK.

Economic policy in the Golden Age did not satisfy the principles of the R-M model in all respects and practice of the model during certain recessionary periods was not intentional at the outset. Fiscal policy was generally expansive from the end of the 1950s to the beginning of the 1970s, just as in the immediate post-war years, rather than predominantly tight as recommended by Rehn and Meidner. Further, the deflationary effects of macro policy in the 1966-1968 and 1970-1972 recessions mainly reflected the difficulties of implementing Keynesian fine-tuning and not the influence of the R-M model. The previous economic booms were counteracted too late by restrictive policies, worsening the effects of the subsequent recessions. Hence, the combination of general restraints and active labour market policy programmes in the recessions is by and large explained by a misdirected counter-cyclical economic policy (cf. Matthiessen, 1971, 205-23, and Tson Söderström, 1990, 63-7). This policy combination is also explained by the government's fear of public budget deficits, miscalculations of aggregate demand and attempts to reduce current account deficits inherited from the boom periods. The late Golden Age was characterised by far too great an extent a

Keynesian 'stop-go' policy, with alternating economic-political priorities, to fully meet the requirements of the R-M model. Further, the use of price controls in the early 1970s to avoid inflation was controversial from a Rehn-Meidner viewpoint.

The tendency for profitability to decrease during the Golden Age was not the result of a tougher economic policy, as in the R-M model, but of keener international competition and ever-deeper international recessions. After all, the tendency toward profitability decline was an international phenomenon. Wage adjustments to keener international competition (and deeper recessions) might have been prevented by a labour-market policy of full employment in Sweden as predicted by the R-M model. But full employment also prevailed in other OECD countries with low expenditures on labour market policy. Further, the decline in the rate of return in Swedish manufacturing is *halved* if profit taxes are accounted for (Erixon, 1987, 38-9).[11] Thus, Swedish economic policy (including taxes on profits) actively *counter-balanced* the tendency to a profit decline, particularly for large companies and capital-intensive industries (Södersten, 1971, 324-5, 329).

Finally, the government's decision to meet deficits in the current account, and in the capital account, during the peaks of the mid and late 1960s by restrictive monetary and fiscal policies, rather than a devaluation of the SEK, was not influenced by the R-M model. (Devaluations had been made in Denmark, Finland and Great Britain in 1967.) Sweden's unwillingness to devalue is better explained by the absence of *major* external balance problems (and the presence of large currency reserves).

The sharp increase in public savings in Sweden in the 1960s was not a result of a restrictive economic policy. This upswing is largely explained by the introduction of a compulsory service pension scheme, the so-called ATP system, though Rehn's argument for collective capital formation greatly influenced the final shape of the ATP system (Meidner, 1988, 465).

The high productivity growth and rapid structural change in Sweden in the Golden Age are

[11] The reduction in effective profit taxes was primarily due to depreciation allowances and the investment funds. It seems however that the tendency to a slower profitability decline in the 1960s and early 1970s because of reductions in effective taxes also appeared in other OECD countries (Erixon, 1997a, 52, cf. Södersten and Lindberg, 1983, 30-2, and Hoeller *et al*, 1996, table 9).

probably explained mainly by factors other than solidaristic wage policy. The importance of macroeconomic policies has already been questioned; the tendency towards a profitability decline in Sweden was not the result of economic policy. But the growth theory behind the R-M model seems yet to be confirmed by productivity developments in the 1960s and early 1970s. High productivity growth in Swedish manufacturing is largely explained by a tougher international competition leading to extensive rationalisations (including mergers) and eliminations of low-efficiency plants. In the Golden Age, there was a large potential for rationalisations and a large number of low-effective production units in many industries. Rationalisations and closures had been postponed in the 1950s because of high profitability levels reflecting, *inter alia*, weak competitive pressure from countries which had participated in World War II (cf. Rydén, 1971, 198-206, and Wohlin, 1970, 109).

To summarise, it is possible to demonstrate a direct relationship in terms of labour market policy and solidaristic wage policy between the R-M model and the economic and wage policy pursued in Sweden over a 15-year period beginning in 1957-1958. Further, public saving became more important and profits fell in this period as advocated by the model, and the general economic policy during the last two recessions was shaped as if the model had been used. But public saving, a profit decline, and a contractionary economic policy in the recessions were not the result of a strict application of the model. Moreover, a Rehn-Meidner policy of fair wage differentials was associated with a radical policy of general wage equalisations from the late 1960s.

4.2 Departures from the R-M model in the 1970s and the 1980s

As with other small Western European countries, Sweden was exposed to substantial external pressure from 1973 to 1982 in the form of two oil crises, a restrictive economic policy in major OECD countries and intensive competition from both Japan and the NICs. Sweden’s export specialisation in input and investment goods was also disadvantageous in a period of deep international recession. But just as in other OECD countries, Sweden then experienced a prolonged period of high economic activity in the 1980s.

Though Sweden’s macroeconomic performance worsened there is little evidence of a specific

Swedish economic disease from the mid-1970s to 1990. The Swedish inflation rate rose above that of the Golden Age and also that in (West) Germany, but it stayed very close to the OECD and EU average until the late 1980s. Further, Sweden managed to avoid high unemployment, and accompanying hysteresis effects in the labour market, in the second half of the 1970s and the early 1980s when unemployment rose in the EU countries (*inter alia* in Denmark). The trade-off between unemployment and inflation was therefore still favourable for Sweden in an international perspective at least until the very last years of the 1980s.

As in other OECD countries, productivity growth in Sweden was lower in the period from the mid-1970s to the early 1990s than in the previous period. Labour productivity growth in manufacturing was also lower in Sweden than in competing countries; the Swedish productivity lag was modest, however, if Japan is excluded from the group of competing countries (Erixon, 1991). Structural change in manufacturing (see the measure above) slowed down in Sweden in the 1970s and became even less rapid than in large OECD countries such as West Germany and the United States. The picture of structural change in the 1980s is ambiguous. From 1978 to 1988, structural change in manufacturing became more rapid in Sweden than in other OECD countries with the exception for the United States and Canada. At the same time, the transformation of resources to R&D and human-capital intensive industries seems to have been relatively slow in Sweden (Hansson and Lundberg, 1995, 79-82, 146-8; Edquist, 1991). Sweden's relative welfare position in terms of GDP per capita gradually deteriorated in the 1970s and the 1980s. The country moved steadily down from fifth to ninth place between 1973 and 1990 in GDP per capita (in purchasing power parities) among OECD countries (OECD National Accounts, Volume I, 1998, 162).

There were breaks with the R-M model in the seventies and eighties but the departure was by no means definitive. The scope of active labour market policy was extensive, irrespective of the level of economic activity and the colour of the government. The Social Democratic government tried to bridge the 1974-1976 international recession by a combination of labour market policy and a Keynesian deficit policy (see below). The emphasis on labour market policy continued under non-socialists governments between 1976 and 1982. Expenditure on labour market (including regional) measures went up from 2 percent of GDP in fiscal year 1974/1975 to 3.7 per cent when unemployment rose in 1977/1978. Following a slight reduction, a record share was achieved during the recession of the early 1980s (4.2 per cent in

fiscal year 1983/1984).

Overall, the direction of labour market policy can also not be criticised from the perspective of the R-M model. Possibly some subsidies to firms aimed at ‘securing jobs’ in the mid-1970s, above all assistance for stockpiling and company training to avoid dismissals, were too defensive to be fall within the framework of the R-M model (see however Rehn’s defence of the policy, Rehn, 1977, 226). This defensive labour market policy was a complement to the Employment Security Act (one of the so-called Åman Laws) which was applied from 1974. But the share of the supply and adjustment oriented measures of active labour market policy increased steadily in the 1970s with a break only in the middle of the decade. The proportion of demand-oriented measures increased in the economic slump of the early 1980s through extensive relief work programmes. But these programmes were rapidly cut back in favour of measures which targeted ‘problem groups’ in the labour market during the next economic upswing (primarily the so-called youth work teams). In line with the R-M model, the proportion of labour market policy measures aimed at stimulating supply and adjustments in the labour market increased in the boom years of the 1980s.

Other selective instruments than labour market policy were put to use from the mid-1970s. The non-socialist coalition government gave extensive non-permanent assistance to individual companies in depressed industries, mainly mining, steel, and shipbuilding. Industrial grants totalled SEK 42 billion from 1975 to 1983, about 37 per cent of expenditure on labour market and regional policy in that period (Johannesson, 1991, table 1).[12] The massive industrial support in the 1970s and the early 1980s has been used as an argument against the R-M model by its detractors. But Rehn and Meidner did not argue in favour of a policy which preserved jobs, they argued for market conformist subsidies in a strategy for price stability and structural change. Subsidies to unprofitable industries had been rejected by Rehn and Meidner in the case of solidaristic wage policy.

The general economic policy, including exchange rate policy, was too expansive from 1973 to 1990 according to the R-M model. A ‘profit boom’ occurred in Swedish manufacturing in 1973 and 1974 caused mainly by an international price increase in raw materials and high

[12] In comparison with both Norway and Finland, Swedish industrial assistance appears to have been more extensive and selective (Carlsson, 1983).

international demand for investment goods. The profit and export boom was not mitigated by a revaluation of the SEK. As expected under the R-M model, the profit and export boom caused a 'wage cost crisis' through extensive wage drift and 'collective' demand for compensation in 1974-1976. The wage cost crisis contributed to a severe downswing in the rate of return and in profit shares in Swedish manufacturing in 1975-1977. Similar cost and profitability crises occurred in other OECD countries (with weaker trade unions and less solidaristic wage policy than Sweden) especially if they had experienced a sharp increase in profits in the previous years.

The wage cost crisis in Sweden in the mid-1970s supports a sceptical view of incomes policy. The higher rate of inflation after the first oil crisis produced an agreement between the political parties and employers' and employees' organisations on moderating the rate of pay increases, referred to as the Haga agreement. Under this agreement direct taxes on households would be reduced at the same time as employers' contributions were increased. The tax transfers of the Haga agreement aimed not only to limit wage rises but also to bridge the recession by stimulating private consumption. According to the Rehn-Meidner view, the failure of incomes policy was largely attributable to high profits, the attendant wage drift and centrally-negotiated wage increases following from relative wage preferences.

The Social Democratic government attempted to bridge the recession after the first oil crisis with a Keynesian deficit policy - a policy that included a reduction in VAT in 1974 and a tax transfer (see above).[13] Next, the non-socialist coalition government devalued the SEK, once in 1976 and twice more (by about 16 per cent) in 1977. The deficit in the current account had increased sharply in Sweden in the mid-1970s as oil prices rose and domestic demand pressure became fairly intense.[14]

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[13] The Keynesian elements of the bridging policy in 1974-1976 have been strongly exaggerated by Swedish economists and politicians. In fact, the rate of inflation was lower in Sweden than in the EU and OECD on average (OECD Historical Statistics, 1982, table 8.11). Fiscal policies were neutral or even contractionary in 1975-1976 according to estimates of autonomy ('structural') components of the general and central government budget (Frank, Ohlsson and Vredin, 1993, p. 43, Price and Muller, 1984, table 2, p. 37 and Calmfors, 1993, p. 45). These estimates are probably surrounded by large uncertainties. But it seems that the size and character of labour market policy, not the counter-cyclical fiscal policy, was the unique element of Swedish economic policy in the mid-1970s.

[14] The devaluations were possible, as Sweden had decided to leave the European currency cooperation, the so-called Currency Snake, in 1976 (Sweden had joined the snake after the collapse of the Bretton Wood system.) Now, the SEK was linked to a weighted basket of currencies. The weights were determined by the countries'

The Keynesian aspects of the bridging policies of 1974-1976 and the devaluations 1976-1977 could possibly pass through the eye of the Rehn-Meidner needle. Their model was not designed for a deep recession and, moreover, the SEK was devalued in 1976-1977, when there was a large deficit on the current account, and a record low level of profitability in Sweden compared with other OECD countries and previous post-war periods. But fiscal policy was too expansive during the recovery in 1979-1980, which helped create a growing central and general government budget deficit – the structural budget deficits were not eliminated until 1987 (OECD Economic Outlook, December 1994, table 29 and 30. Cf. Frank, Ohlsson and Vredin, 1993, 43.) Although monetary policy became increasingly restrictive, as in many other OECD countries, real rates of interest were *negative* from the first oil crisis to the second oil crisis in 1979-1980.[15]

Hence, Sweden managed to avoid high unemployment in the second half of the 1970s and the early 1980s by applying labour market policy measures together with a defensive industrial policy and an expansive fiscal and monetary policy.[16] At the time of the second oil crisis and the recession of the early 1980s, doubts were raised in Sweden about a Keynesian policy aimed at maintaining aggregate domestic demand. But this reassessment did not result in a stricter application of the R-M model. The main purpose of the 'new' economic policy was to eliminate current-account deficits by strengthening cost competitiveness as well as transferring resources to the private sector (essentially the open one) by stimulating industrial profits. The reorientation of Swedish economic policy was mainly explained by the profitability crisis and the large losses of market shares for Swedish export industry in the second half of the 1970s, the losses largely attributed in the Swedish debate to the 'wage cost crisis'.[17]

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importance as competitors to Sweden. The US dollar was given a double weight due to its use as a mean of payment on the world market.

[15] Furthermore, the restrictions on the investment funds were lifted in the middle of the 1970s which, in conflict with the R-M model, meant there was a general profit subsidy.

[16] However, in the recession of the early 1980s, fiscal policies did not become more expansive than in the previous boom until 1982 (Calmfors, 1993, 45, and OECD Economic Outlook, December 1994, table 30). The non-socialist government pursued tax increases and reductions in public expenditures to reduce the public debt not only in the height of the boom, but also in the subsequent recession.

[17] The importance of the rise in relative unit labour costs (RULC) in the mid-1970s for the losses of Swedish market shares has been exaggerated by leading economists, businessmen and politicians. Only one third of the

A devaluation of the SEK by the new Social Democratic government in 1982, and to some extent by the non-socialist government the year before, were the main expressions of this new economic policy. The devaluation policy was the cornerstone of the Social Democrats' 'Third Way' (Erixon, 1989, and Jonung, 1999, 191-4). The devaluations by 10 and 16 per cent respectively, taken together with a strong dollar and an international economic upswing (the Reagan boom), lay behind a remarkable profit recovery in Swedish manufacturing in the first half of the 1980s. The rate of return and profit share in Swedish industries became high by international and historical standards in the middle of the 1980s (Erixon, 1991, pp. 281-93, 365).

The profit-oriented stabilisation and growth policies did not constitute a clear break with the Keynesian model, as one of their aims was to increase aggregate demand (net exports and private investments), but were not consistent with the R-M model. The devaluation in 1982 was far too large - Swedish cost competitiveness had already been restored through the 1981 devaluation - and the subsequent fiscal policy not tight enough to meet the requirements of the R-M model. Besides, the SEK was not revaluated in the mid-1980s in spite of favourable external circumstances presented by the absence of a deficit in the current account. A revaluation should have prevented an export-led overheating of the economy.

The profit-oriented strategy along the 'Third Way' could also have dampened economic growth. There is scope in the R-M model for a hypothesis that the profit boom delayed structural change and weakened companies' motivation to rationalise and introduce new products, technologies and work organisations. Productivity growth in Swedish manufacturing was relatively low in the boom years of the 1980s. The transformation pressure was too weak according to the government Productivity Council (Produktivitetsdelegationen, 1992). In addition, the devaluations may be an important explanation for Sweden losing market shares in the 1980s, despite a favourable cost position. High profitability in the traditional export industries weakened companies' and the capital market's incentives to invest in dynamic sectors (Erixon, 1989 and 1991).

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losses is explained by the 'wage cost crisis' (cf. Erixon, 1988).

Measured by the Rehn-Meidner yardstick, the economic policy of the latter 1980s was also too expansive. Automatic depreciations of the SEK, through its strong link to the dollar, maintained cost advantages for Sweden and high profits in the country's exposed sector. Swedish overheating was amplified by a domestic product demand and asset-price boom caused by a deregulation of the credit market and a tax system which made household saving unattractive. Fiscal policy (by both general and central government) did become more restrictive, and together with built-in stabilisers it eliminated the deficit in the public sector's financial saving in 1987. Public sector financial savings from 1987 to 1990 were equivalent to 4-5 percent of GDP, a much higher share than in other OECD countries with the exception for Finland. But if the lower rate of household saving and the ongoing export boom are taken into consideration, fiscal policy was not restrictive enough to balance the credit deregulation and the absence of a sufficiently tight interest-rate policy by the Swedish Central Bank.[18]

The lax general economic policy during 'the long peak' of the 1980s was combined with 'voluntary' incomes policy measures, price controls and profit freezes like those immediately after World War II. Incomes policy was, in conjunction with the 'offensive' devaluation of the SEK in 1982, the most important element of the Social Democratic 'Third Way'. The goal was to prevent inflation and ensure that the improvement in Sweden's competitive strength was not dissipated by high wage claims. Among other things, the government managed in the mid-1980s to negotiate an agreement with the employers' and employees' organisations on a wage ceiling. 'Voluntary' incomes policy was facilitated by the fact that blue-collar wage claims were still co-ordinated in practice. At the highest point of overheating (1990) the Social Democratic government attempted to introduce an income-policy package including price and wage freezes and also a ban on strikes. The proposal was sanctioned by the LO, particularly by trade unions in the export sector.

But incomes policy could not prevent overheating in the second half of the 1980s (and in 1990). The policy was an ineffective instrument, from the Rehn-Meidner perspective, as

[18] Keynesians at that time, at the LO as elsewhere, turned the R-M model upside down by their rejection of contractionary fiscal policies and their support of selective measures to restrict activity levels in the most overheated sectors. Like the Brooking economists, the LO economists accepted in the late 1980s that Sweden, with the high priority it gives employment, must have a somewhat higher rate of inflation than other countries (Bosworth *et al*, 1987). This kind of 'equilibrium inflation' strategy was already criticised by Rehn and Meidner in the 1951 LO report (Meidner and Rehn *et al*, 1953, pp. 80-82).

monetary policy (including exchange rate policy) was too expansive and fiscal policy was not sufficiently restrictive. Excess aggregate demand led to extensive wage drift and collective demands for compensation despite promises of wage restraint made by the employees' national organisations, breaking through the wage ceiling that had been accepted by the central labour market organisations. The odds against the success of the 1990 incomes-policy package were high: the measures were introduced under severely overheated conditions, and a wage freeze and strike ban would also have hit the wage earner groups at the end of the Swedish wage-wage spiral – the public sector employees. But the proposal failed to get through Parliament, triggering a government crisis and the resignation of Kjell-Olof Feldt, the Minister of Finance.

Sweden's low level of unemployment in the 1980s reflected the priorities set out in the R-M model, but only parts of the model were applied in practice. The main explanation of Sweden's low level of open unemployment during the long peak is excess aggregate demand (possibly in combination of weak hysteresis effects since open unemployment had effectively been abolished in the preceding period). Consequently, Sweden's low rates of unemployment were obtained at the expense of a relatively high rate of inflation and it could therefore not be explained by trade-union wage moderation (cf. Calmfors, 1993, 44-53, and Lindbeck, 1997, 1308-9).[19] Neither is Sweden's low unemployment in the 1980s explained by labour market policies. In fact, expenditure on labour market policies as a ratio of GDP (and the percentage of the labour force in labour market programmes) declined steadily from the mid-1980s to 1990 (Calmfors, 1993, 28-9, and SOU 1993:43, table 3.1 and 3.2). By Rehn-Meidner standards, the mix between general economic-policy and selective employment measures was hardly optimal in the 1980s.

The most obvious challenge of the R-M model in the eighties was the departure from solidaristic wage policy. The trend towards a smaller wage spread in the area covered by agreements between the LO and the Swedish Employers' Confederation (SAF) had ended by the middle of the 1970s, and, in the mid-1980s wage differences between and within

[19] The importance of central wage bargaining (cordinated wage moderation) for the low rates of unemployment and the favourable Phillips curve and Beveridge curve, i.e. the product of the number of vacancies and the number of unemployed, in Sweden in the 1970s and 1980s has probably been overestimated by foreign economists (see, for instance, Jackman, Pissarides and Savaro, 1990, 477-83).

industries and plants *increased* sharply. Wage gaps grew not only among wage earners with different jobs but also for some with identical jobs and skills, which constituted the real challenge of the R-M model (Ohlsson, 1980, Faxén, Odhner and Spånt, 1988, 54-6, and Hibbs and Locking, 1996 and 2000).

Wage equalisation had come far in Sweden - and for that reason it was difficult to achieve the same wage equalisation in the 1980s as in the sixties and seventies. But the possibilities of pursuing a solidaristic wage policy were compromised in the mid-1980s when central wage bargaining between the LO and SAF came to an end. Wage differentials probably also widened as a result of greater differences in profit among industries, *inter alia* through devaluations of the SEK,[20] as expected in the Rehn-Meidner depiction of the wage process in a 'free' market system.

Some Swedish politicians and economists began to label the solidaristic wage policy as inflationary and unemployment enhancing in the 1980s and 1990s. The criticism was sometimes poorly targeted as the original notion of solidaristic wage policy does not cover a policy of equal pay for unequal work or a compensatory wage policy to preserve a relative-wage position for groups that had fallen behind due to wage drift. In fact, solidaristic wage policy can explain why the contraction of high-wage industries in the crises of the late 1970s and the early 1980s led to less frictional unemployment in Sweden than elsewhere, as the compressed wage differences between industries in Sweden made it easier for wage earners to accept employment in other industries (Erixon, 1985, 27; cf. Summers, 1986, 370-80).

I have regarded the 1970s and, particularly, the 1980s as decades of a Swedish departure, although not an absolute one, from the R-M model. Fiscal and monetary policies were too expansionary, resulting in a strong reliance on incomes policy, and the governments did not give priority to public saving. Solidaristic wage policy was challenged by decentralised bargaining and profit booms in the 1980s but wage (and income) differentials were still small by international standards at the end of the decade. Further, labour market policy is a salient explanation of why Sweden did not take the road to massive unemployment in the 1970s and early 1980s. Some Swedish economists accused labour market policy, especially relief work,

[20] This development can explain, together with white-collar unions' priority of low-paid groups in central negotiations, why the Swedish Metalworkers' Union chose to abandon cordinated LO negotiations in 1983.

of being inflationary and, therefore, for being harmful for employment as well - the policy leads to higher wage claims and lower intensity of job search (Calmfors and Forslund, 1990, Holmlund, 1990, Calmfors, 1993). But expenditure on relief work and 'defensive' demand-oriented measures directed to firms was only approximately half of total expenditure on active labour market policy in the 1970s and early 1980s. Matching and supply oriented measures (including labour market training) and measures targeting problem groups in the labour market were probably less inflationary (see Forslund, 1994, Calmfors, 1995). Besides, the avoidance of open unemployment in the mid-1970s and the early 1980s prevented hysteresis effects on Swedish labour markets.

The R-M model was not really challenged by the growing political ambitions in the 1980s to improve resource allocation, increase the supply of work and transfer resources from the public to the private (particularly the exposed) sector. The model had been an alternative to regulation models of the early post-war period and, further, it gave no particular support to public sector growth. In addition, Sweden's marginal tax reform of 1990-1991 has similarities with the proposal for marginal employment subsidies. However, underlying the 'structural' and supply-side policies of the 1980s (and the 1990s) there is a fundamental faith in the rationality of the market system and relatively lukewarm interest in income distribution issues, out of keeping with the underlying principles of the R-M model.

4.3 The End of Full Employment

Under a Social Democratic regime in 1991, a period of exceptionally high economic activity and booming stock markets in Sweden turned into a deep recession. The recession deepened in 1992-1993 under a Conservative-led coalition of non-socialist parties. Sweden experienced a more drastic decline in investments and GDP growth than all OECD countries except Finland in 1991-1993. Swedish GDP growth was even negative for the three years. Total employment was reduced by more than 12 per cent from 1990 to 1994 (approximately 575 000 jobs disappeared) – only Finland suffered a larger decline. Employment in manufacturing fell by almost one fourth in the period. With only modest recovery until 1998, Sweden fell from ninth place in 1990 to nineteenth place in 1997 on the OECD ranking list of GDP per

capita.

By 1993, open unemployment had risen above 9 per cent and was only approximately 1.5 percentage point lower than the EU average according to standardised OECD data. Swedish unemployment remained at this high level until 1998 in spite of a Social Democratic government from autumn 1994, an international recovery and a Swedish export boom. Hence, Sweden, the very example of a full employment economy, had joined the group of countries with massive unemployment.

The high unemployment rates, the low GDP growth and the reduction in employment were the overshadowing macroeconomic failures of Sweden in the 1990s. The rate of inflation was significantly lower in Sweden than in the EU on average between 1992 and 1999. (The Swedish relative rate of inflation has been particularly low since 1996.) Further, labour productivity growth in manufacturing in this period was higher in Sweden than in other OECD countries, with the possible exception for Finland, Turkey and Ireland (Monthly Labor Review, 2000, no. 1, table 45). In 1998-2000, there was also a strong recovery in Swedish GDP growth and a rapid decline in unemployment. In the summer of 2000, the rate of open unemployment is only slightly above the goal for that year set up by both non-socialist and Social Democratic governments in the mid-1990s (4 per cent). However, Sweden is far from the low unemployment rates, and particularly, the high employment levels (and participation rates) of before the deep recession in the early 1990s. At the end of 1999, only one fourth of the decline in employment in the first part of the 1990s had been regained.

From the angle of the R-M model, the serious macroeconomic problems in Sweden in the early 1990s were grounded in the preceding boom. The model assumes that a state of full employment cannot be long-lived if achieved through high aggregate demand - serious overheating, as the one in the 1980s, will inevitable lead to cost and profitability crises. It seems that this view is confirmed by Swedish experience. In 1988-1991, there was a significant increase in Swedish relative unit labour costs (common currency) and decrease in the rate of return and profit shares in Swedish manufacturing. Further, the dramatic employment decline in manufacturing in 1991-1993 largely reflected ‘over-employment’ tendencies and the low priority of rationalisation for firms during the boom of the 1980s. The willingness *and* potential to raise labour productivity by lay-off was exceptionally high in

Swedish industries in the recession of the early 1990s.

Hence, there is good evidence for a 'doctrinaire' explanation that the severe macroeconomic problems in Sweden in the early 1990s arose out of a departure from the R-M model in the antecedent boom. But the hypothesis must also be founded on other arguments than those attributed to the model above. The depth and effects of wage cost crisis in 1989-1991 should not be exaggerated. The losses of market shares for Swedish exports were not remarkable from a historical perspective, and they reflected, to a certain extent, the commodity structure of Swedish manufacturing - the significant automobile industry experienced large losses of market shares (which also hit its domestic sub-contractors). Besides, Swedish relative unit labour costs (common currency) were still clearly below the levels of the 1970s (and the 1960s) and gross profitability levels in manufacturing were significantly higher in the deep recession of the early 1990s than in the recessions of the mid-1970s and early 1980s.

High domestic demand of the late 1980s, which had primarily benefited the construction industry and the private service sector, was reversed in the early 1990s, a process caused *inter alia* by rising interest rates (which also hit manufacturing). Real estate, construction and financial companies in particular were seriously hit by declining demand and asset prices, and by higher capital costs. There was an exceptional increase in firm bankruptcies in 1991-1992, especially as an excessive number of new businesses had expanded with high debt ratios in the preceding decade. Liquidations, and financial problems of surviving firms, led to a deep Swedish bank crisis, at that time comparable only to the Finnish one. The financial crisis was soon resolved, but the rise in real rates of interest paved the way for an exceptional increase in Swedish household saving rates in the first half of the 1990s (OECD Economic Outlook, December, 1999, table 26).

Higher real interest rates were an international phenomenon caused by a tight monetary policy in Germany when the country was reunited. But in 1990, long-term interest rates became more than 5 per cent higher in Sweden than in Germany. (The DM had a strong position in international financial markets.) The relatively high level of real interests in Sweden reflected the financial market's lack of confidence in the SEK, probably due to Sweden's high rate of inflation in the 1980s. (This hypothesis is compatible with a Rehn-Meidner critique of economic policy in the 1980s for being too lax.) The tendency to increased real rates of after

tax interest was reinforced by the marginal tax reform of 1990-1991.

Social Democratic policy in the beginning of the crisis

In May 1991, the Social Democratic government tried to restore lost confidence in the SEK by linking it to the ECU. The government also pursued a more or less neutral fiscal policy despite a downturn in the economy and the effectiveness of fiscal policy at fixed exchange rates and perfect capital mobility according to macroeconomic theory. The cuts in public expenditure under this fiscal policy reflected efforts to appease the financial market, but were also in line with theories about public crowding out. Fiscal policy by *general* government was expansionary in 1991 but less so than in most other OECD countries.

Thus the Social Democratic government had forsworn the chance of pursuing both a policy to stimulate domestic demand and a policy to increase competitiveness through devaluations. A Keynesian policy for full employment was finally abandoned in Sweden in the early 1990s when the Social Democratic government accepted the criticism of an 'accommodating' economic policy. The new policy was meant not only to please international capital markets but also to reduce inflationary expectations in labour markets. The Social Democratic government wanted to reduce interest-rates, prices and wages by convincing capital and labour markets than an expansionary fiscal and exchange rate policy would not be undertaken. However, the government often painted a too dark picture of Sweden's relative rate of inflation in the past. Further, economic policy in the second half of the 1980s can be accused on Keynesian grounds of not having been counter-cyclical enough.

The Social Democrats could no longer devalue, but they were also concerned to avoid a savagely contractionary fiscal policy with its attendant high unemployment to restore Sweden's competitiveness and reduce the relative rate of inflation in the course of a recession. The government looked to incomes policy to restrain prices and wages. Already when overheating in Sweden's economy reached its peak, the so-called Rehnberg Commission was formed to persuade the employers' and employees' organisations to adopt wage restraint. The commission managed to bring into being genuinely comprehensive labour market agreements in 1991-1992. The Social Democrats and the LO gave the Commission credit for the low pace of wage increases (in 1992), but from a Rehn-Meidner perspective, it was low labour demand

and high unemployment that did the main job.

The non-accommodating policy of the Social Democrats in the early 1990s was not in itself a break with the R-M model. For example, it would have been possible to claim by reference to the model that Swedish growth and price stability was promoted by a hard-currency policy. But Swedish scholars maintained that the Social Democrats abandoned their priority goal of full employment in favour of policies to fight inflation - when the R-M model seeks to attain both full employment and price stability. The argument about a downgrading of the priority of full employment is primarily based on programmatic statements in the Budget Bill of January 1991 (cf. Lindbeck, 1997, 1303, Jonung, 1999, 69-85 and 211, and Johansson, Lundborg and Zetterberg, 1999, 2-4) and also on the practice of employment policy (SOU 1993, 43, pp. 38-9, 47). Expenditure on active labour market policy increased in the final year of the Social Democratic government but in absolute numbers this increase was more modest than the increase in cash assistance and it was not sufficiently extensive to prevent a major increase in unemployment in 1991.

But it is difficult to assess whether the Social Democrats broke in the early 1990s with the priority given to full employment in the R-M model. The emphasis on price stability in official documents in the early 1990s mainly reflected the government's still being occupied with the negative effects of overheating rather than with an approaching recession (cf. the Budget Bills of 1990, 12 and 1991, 1-8). A temporary priority of price stability (and the external balance) had also been made at several occasions by Social Democratic governments in the Golden Age. The signs of a new (non-accommodating) economic policy in Sweden in the early 1990s mainly reflected a more pessimistic view of the restrictions and negative effects of alternative strategies rather than a downgrading of the priority goal of full employment *per se*. The paradigm shift was in turn explained by the prevailing view of Sweden's macroeconomic performance in the past and by the globalisation of capital markets speeded up in the Swedish case by the abolition of exchange controls in 1989 and manifested during a period of turbulence in foreign exchange markets.

The modest size of the active labour market programmes in 1991 indicated that the government was not yet prepared to meet the tendencies towards massive unemployment. The Social Democrats had no time to design an employment strategy before losing the election in

the autumn of 1991. It is uncertain whether they had been influenced by Swedish economists blaming labour market policy for forcing up wages, though the refusal in 1990-1991 to meet the acute employment problems with extensive relief work suggests this. But the R-M model is not wounded by evidence that relief work, or even labour market policy *per se,* is inflationary. The key point in the model is that the combination of labour market policy and a restrictive fiscal policy leads to a more favourable trade-off between inflation and unemployment than a strategy where an expansive economic policy is combined with incomes policy measures (see subsection 2.3, and Erixon, 2000, pp. 68-9). In any case, the Social Democrats were out of the ministerial offices before having chosen a mix of economic policy measures suited for a serious employment crisis.

The R-M model on the 'One Way'

The new Conservative-led coalition government adopted a non-accommodating strategy in greater depth, at least in theory. The 'One Way' (the words Carl Bildt, the new prime minister, used to contrast his policy to the 'Third Way') was really an extension of the Social Democratic policy of the 1990s, which involved structural reforms (including deregulations and cuts in public transfers and taxes), a fixed exchange rate and a tight fiscal policy. But the non-socialist government created a new norm: harmonisation with the EU. The previous Social Democratic government had applied for EU membership, but the new government pursued a more deliberate policy aimed at, among other things, adjusting Sweden's tax burden to the European tax profile. The purpose of reducing VAT in 1992 was not primarily to counter the recession, but to better fit the tax profile in the EU countries. In addition, the rules on convergence to a monetary union in the Maastricht Treaty in 1991 reinforced government confidence in a restrictive fiscal policy and a fixed exchange rate.

It is paradoxical that the 'Only Way' resembled an economic policy strategy that not only the economists and non-socialist politicians, but also Social Democratic politicians and trade unionists considered antiquated, namely the R-M model. A restrictive fiscal policy was part of both these strategies. A Rehn-Meidner style criticism of the Social Democrats' 'Third Way' was also expressed by the non-socialist parties. Anne Wibble, the Minister of Finance, referred explicitly in her rejection of devaluation policy, and in her arguments against reducing

payroll taxes, to the need for transformation pressure to accelerate growth in Sweden.

Suspicion of incomes policy was shared by Rehn-Meidner and the non-socialist coalition government. Besides, more than any earlier government, this one counted on an active labour market policy to combat growing unemployment. In budget year 1991/1992, expenditure on active labour market policies as a ratio of GDP rose to 4.4 per cent, a larger proportion than ever before (SOU 1993, 43, table 3.1). The largest increase was in labour supply and adjustment measures, especially labour market training, as advocated in the R-M model (if employment subsidies are ignored). Even the non-socialist politicians who thought that the R-M model was obsolete made an exception of labour market policy.

But there are differences between the 'Only Way' and the R-M model. The tax relief for owners of property and for incomes from capital introduced to improve growth hardly followed the equity principles of the R-M model, as well as being an ineffective means of stimulating growth according to the model. Further, the non-socialists' employment policy was too passive to satisfy the objectives of the model. The objective of full employment appears to have been downgraded in priority somewhere along the 'Only Way' (cf. the Revised Budget Bill of 1992, 2). However, the serious obstacles encountered by economic policies must be taken into account.

The policy of the 'One Way' failed its main task: to create confidence in the SEK. There was a substantial increase in the general government budget deficit in 1992, making it highest in relation to the GDP in the OECD (with the exception of Greece) in the following year. The budget deficit reflected the deep recession (built-in fiscal stabilisers) but an expansive fiscal policy, despite ambitions to pursue an opposite policy, had a bigger effect on the deficit in 1992. Among other things, commercial banks were offered huge grants in the aftermath of the deep financial crisis in Sweden 1991-1992.

The Central Bank failed to prevent a major outflow of capital from Sweden during the currency crisis in November 1992 even though it introduced record increases in the marginal interest rate (to a peak of 500 per cent at one point) and a package of crisis measures agreed by the non-socialist coalition government and the Social Democratic opposition. The politicians attempted to reassure the capital market by bringing down payroll taxes and making cuts in the

transfer systems. But the measures were ineffective with the result that Sweden had to abandon the fixed exchange rate system.

Reducing payroll taxes meant a general subsidy of profits which was a blow to the R-M model. In addition, the government proposed in the autumn of 1993 a further reduction in taxation on capital and profits, measures that hardly go hand in hand with the growth policy of the R-M model. Besides, the transfer to a flexible exchange rate system reduced the opportunity of exposing companies to a transformation pressure - a country with a low productivity growth maintains its competitiveness by a depreciation of its currency. In one year (1993) the SEK was depreciated by 25 per cent against the currencies of competing nations, similar to that at the beginning of the 1980s, when the SEK was devalued twice. In fact, the depreciation of the SEK is the main explanation, together with high unemployment, of why profits shares in manufacturing rose to record levels in the mid-1990s (above 41 per cent in 1995).

It is harder to point to a break with the R-M model in other aspects after the currency crises in 1992. The inflation targets defined by the Central Bank of Sweden as a means of creating stable macroeconomic conditions (2 per cent inflation with a permitted departure of 1 percentage point in both directions) are clearly in line with the R-M model, although perhaps too strict and connected with a too passive employment policy to be in keeping with the spirit of the model. The priority given to full employment in the model may presumably have justified a more expansive fiscal and monetary policy in the two final years of the non-socialist government. Fiscal policy by the consolidated public sector (general government) was only cautiously counter-cyclical in 1993 and 1994 despite high rates of unemployment and a marked fall in both the absolute and relative rates of inflation. The combination of inflation targets, EMU convergence rules and the doubts about Sweden by financial actors served as effective brakes on fiscal policy.

But the absence of a tight fiscal policy is one explanation of why Sweden did not experience the high levels of unemployment of its neighbour country Finland in the mid-1990s. Another explanation is the extensive use of selective employment programmes in Sweden. Labour market policy had escalated further under the non-socialist government in 1993 and 1994. The proportion of the labour force in labour market programmes reached a record rate of 5.3

per cent in 1994. Without this policy, open unemployment would, in statistical terms, have been as high as 13-14 per cent instead of 8-9 per cent. Labour market training was given a smaller weight at the expense of demand-oriented job introduction (ALU) projects (Ackum Agell, 1995, pp. 70-73). But training was still the most important component of labour market policy with the possible exclusion of targeted demand-oriented measures for youth that had expanded in 1993 (The Budget Bill of 1995, table 5.4 and Forslund and Krueger, 1997, fig. 6.2). Further, the government introduced a system of marginal employment subsidies in 1994 although the proposal was more limited than Rehn had envisaged, among other things, by being temporary and by offering too small subsidies. A Conservative-led government's practice of selective employment policy was the major victory for the designers of the R-M model in the decade of non-interventionist policies.

A New Social Democratic Policy

As in the early 1980s, rising unemployment became a political burden for a non-socialist government. The left parties won the election in September 1994 and the Social Democrats formed a new government. Yet, the new government considered reductions in the public deficit and debt as its main task, pursuing an exceptionally tight fiscal policy during a period of record high unemployment and exceptionally low household demand. The contraction of general government fiscal policy in Sweden in 1994-1998 was unmatched among OECD countries (OECD Economic Outlook, December 1999, table 31). Fiscal restraints were supported in Parliament either by the Center Party (the former Agrarian Party) or by the Left Party (the former Communist Party).

Fiscal policy from 1994 definitely constituted a break with earlier economic policies pursued by the Social Democratic party even if leading representatives saw it as an exceptional response to massive unemployment. The Social Democrats' argument was that fiscal restraint, though exacerbating unemployment in the short run, would eliminate it in the long run. This argument is not rooted in the R-M model or in its underpinning Keynesian model. In fact, the removal of fiscal restraints in 1999 and 2000 indicates that Swedish fiscal policy has deliberately become pro-cyclical.

The new Social Democratic government feared in the mid-1990s that an expansionary fiscal policy would be a threat to the inflation targets of the Central Bank and thus lead to contractionary monetary policy. (However, the Central Bank was not formally independent until January 1999.) Further, the government had the same ambition as the former non-socialist one to reduce long-term interest rates by deflecting expectations that inflation in Sweden would increase. The difference between Swedish and German long-term interest rates rose again in 1994-1995 (after a decline in 1991-1993), which induced the Central Bank to raise its short-term interest rates in 1994-1995. The government saw the large public deficit as the main obstacle to higher confidence in Sweden. It also wanted to convince a sceptical capital market that the Social Democrats, in spite of their traditional commitment to full employment, had no plans to slacken fiscal policy. The government probably assumed that large public deficits would result in expectations of a depreciation of the SEK since high rates of relative inflation would weaken Swedish competitiveness. The Social Democrat leadership was also particularly anxious to meet the requirements of the Maastricht treaty as the party had been engaged in the campaign for a membership in the EU in 1995.

The 'One Way' and the Social Democrat crisis strategy in the mid-1990s were almost identical. They both recommended fiscal restraints and cuts in public expenditures rather than higher income taxes to simultaneously reduce the size of the public sector. But the Social Democrats were more able to implement the policy than their predecessors since the party was seen by large groups in Sweden as a guarantor of full employment. Fiscal restraint was also facilitated by their claim that it was fairer than their non-socialist counterparts'. For instance, the Social Democrats canceled proposals by the former non-socialist government of making exceptions from the principles of the Employment Security Act and further reductions in taxes on corporations and shareholders. Instead, it pursued a VAT reduction for food products and levied a (modest) temporary tax on higher incomes, the so-called *värnskatt.* Further, the Social Democrats argued for their strategy by claiming that their deflationary measures would chiefly hit the economy in 1996-1998, during an expected recovery. A similar recommendation to postpone necessary cuts in public transfers had been made by the Lindbeck commission (SOU 1993:16, p. 188).[21]

[21] In fact, there is evidence that the tightening of fiscal policy in Sweden was more extensive in 1996-1998 than in 1994-1995 (OECD Economic Outlook, December 1999, table 31).

This is not the place for a detailed discussion of the theoretical sources of the new Social Democratic policy.[22] The Mundell-Fleming model of perfect capital mobility and floating exchange rates (which is a good approximation of Sweden since 1992) supports a critique of fiscal policy as an ineffective mean of affecting economic activity levels. The theory underlying the new Social Democratic policy also resembles the (anti-Keynesian) theory of a natural rate of unemployment, according to which a restrictive economic policy leads to lower inflation but only to lower unemployment in the short run. Massive unemployment is not the natural state of the economy in this theory unless it can be shown that labour markets are extremely rigid.

The government did not argue, as did the OECD, that the rise in Swedish unemployment in the 1990s largely reflected a rise in 'equilibrium employment'. But the Social Democrats seemed yet to support a hypothesis that a significant part of unemployment was 'structural', caused by inefficient labour markets and wage bargaining systems. In 1995, the government decided to reduce unemployment benefits and planned for new labour market legislation. These proposals can be looked upon as parts of a strategy to shift the 'wage-setting' curve downward, by reducing reservation wages, and increase the flexibility of the labour market (see the Revised Budget Bill of 1995, p. 31). In the election year of 1998, however, unemployment (and other social) benefits were raised to its earlier level (from 75 to 80 per cent) under the pressure from the LO and an increasingly popular Left Party. (The restoration of replacement rates was also explained by improvements in the public budget during the previous years.) The government suggested rather modest modifications to the unemployment insurance system in 2000. It did not propose any restrictions on the duration of unemployment

[22] The theory behind the Social Democratic economic policy has never been explored in detail. Both the two Budget Bills, the so-called convergence programme (Ministry of Finance, 1995) and the government's proposal for growth policy in 1995 (Government Proposition 1995/96:25) assumed that a restrictive fiscal policy would lead to lower expectations of inflation and therefore to permanently higher employment levels and economic growth. However, the government did not describe the underlying mechanism. It probably expected (see my interpretation above) that international capital markets would make the assessment that the risk of a depreciation of the SEK is reduced by a restrictive general economic policy since cost competitiveness is strengthened by a lower rate of inflation. The accompanying reduction in long-run rates of interest would then lead to higher private investments. The government's strategy assumes implicitly that investments are largely stimulated by low rates of interest, an assumption that is not unambiguously supported by the empirical literature. The strategy must also assume that the gap in interest rates between Sweden and other countries (particularly Germany) is of outmost importance for Swedish investments. Another difficulty with the Social Democratic strategy is that investments are primarily a function of *real* rates of interest; the effects of fiscal and monetary restraint on real interest rates are ambiguous. In fact, the theory of a natural rate of unemployment, supported by influential Swedish economists in the 1990s, denies that macroeconomic policies have long-run effects on production and employment (cf. Svensson, 1995).

benefits but proposed some other measures to stimulate individual search efforts, including that the maximum compensation level should be raised but only for the first five months of unemployment (Swedish Government, 2000).

Since the mid-1990s, the Social Democratic government has been worried about the pace of nominal wage increases in Sweden compared with competing countries. (See figures on Sweden's relative unit labour costs in manufacturing expressed in national currencies, Industrins Ekonomiska Råd, 2000, 12).[23] Therefore, the government has advocated a return to coordinated wage bargaining. The greater ambitions of incomes policy in the Social Democratic crisis strategy compared with the non-socialist 'One Way' is illustrated by the suggestion of tripartite wage negotiations in the mid-1990s. The plans were not realised but the Social Democrats did manage to set up a government wage mediation body in 2000.[24] Further, trade unions, *inter alia* in the LO, made commitments to 'voluntary' incomes policy in the second half of the 1990s. For example, the aim of maintaining Swedish competitiveness by nominal wage moderation governed a joint wage agreement between trade unions and employer organisations in Swedish manufacturing for the 1998-2000 period (Industrins Ekonomiska Råd, 2000).

The priority of full employment in the R-M model may probably have called for a more expansionary fiscal policy than the Social Democratic one. Moreover, selective employment policy was extensive but may yet be considered as too passive from the viewpoint of the R-M model. The percentage of the labour force in labour market programmes decreased from 5.3 per cent in 1994 (under a non-socialist government) to 4.4 per cent in 1995 and was then

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[23] The government's view of Swedish wage formation was based on a joint document from the labour market organisations, including the LO, the so-called Edin report. The report stated that annual nominal wage increases (adjusted for productivity developments) must be the same as in other European countries. European wage increases in Sweden will ensure real wage increases and lead to a greater confidence for, and therefore, to an appreciation of the SEK (Edingruppen, 1995, 33-4). In the Edin report, there is no wage norm similar to the one in the Scandinavian model, namely a constant (relative) profitability in the medium term. In fact, it recommended, in contrast to the the Scandinavian model *and* the R-M model, that profit shares in the exposed sector must increase in the long run, thus the appreciation of the SEK must not be too strong (Edingruppen, 1995, p. 34). There is no room here for the Rehn-Meidner theory that productivity increases are prevented (and inflation stimulated) by high average profits.

[24] Some inconsistencies arose through the Social Democratic efforts to achieve wage moderation by some kind of incomes policy. At the same time, prominent representatives of the government had been open to deregulations of the labour market. Further, the Prime Minister, Göran Persson, had declared at many occasions that Sweden should avoid low-wage competition in world markets.

maintained at this lower rate in the following two years. Further, the demand-oriented ALU projects continued to expand, making them larger than the labour market training programmes in 1996 and 1997. It is possible, however, to justify the Social Democratic use of immediate employment-creating programmes by reference to the depth of the employment crisis and the fact that inflation has been almost wiped out in the Swedish economy. Besides, in 1998, labour market training one again became the prime instrument of Swedish labour market policy.

The government introduced a form of marginal employment subsidies in 1995 – firms that recruited unemployed people were given financial assistance. Neither this or the corresponding non-socialist proposal one year earlier seem to have had a significant impact on either the rate of inflation or the level of employment (Anxo and Dahlin, 1996, and Johansson, Lundborg and Zetterberg, 1999, 111-27). The Social Democratic scheme can, as the non-socialist one, be criticised on Rehn-Meidner grounds for being temporary and too small. The former was limited by its non-universal character, that is, subsidies paid only to unemployed persons.

The R-M model is compatible with the Social Democratic view in the 1990s that Swedish unemployment to a certain extent reflected rigidities in labour markets, caused, *inter alia*, by high unemployment benefits. In fact, the model does not deny the importance of push mechanisms for labour mobility (see the solidaristic wage policy). But intensified wage competition by reductions in unemployment benefits is hardly a preferable strategy due to its effect on income-distribution, growth and the position of organised labour. Besides, Rehn and Meidner were ‘orthodox’ Keynesians, or Post-Keynesians rather than Neo-Keynesians, in their scepticism of the possibility of preventing large macroeconomic imbalances by real wage flexibility.

According to the R-M model (and the Scandinavian model), relatively high nominal wage increases in Sweden in the second half of the 1990s did not reflect any failure of the wage bargaining system but an adjustment to exceptional macroeconomic events. Record high profitability levels in Swedish wage-leading sectors must lead to significant market-induced

wage increases and compensatory wage claims from wage earners who had fallen behind.[25] In fact, international capital markets seem to have accepted that the pace of wage increases in Sweden in the second half of the 1990s was a part of an adjustment process rather than a structural problem – the SEK appreciated dramatically against the currencies of competing countries in 1995-1996 and the following depreciation tendencies have been weak.

The Social Democratic crisis strategy seems to have been successful. The public deficit disappeared in 1998 and even turned to a significant surplus in 1999. The stable SEK and the narrower gap between German and Swedish long-run rates of interest in the second half of the 1990s (the gap even disappeared in May 2000) showed that the government managed to raise confidence in Sweden. Higher confidence and inflation rates near the lower limit of the Central Bank's target interval also made room for a slackening of monetary policy in the second half of the 1990s. The recovery in growth and employment in 1999-2000 may also indicate that the Social Democrats were right in claiming that production and employment would recover through a restrictive fiscal policy in the course of time. On the other hand, the current recovery may reflect the development of a 'new' dynamic economy or cyclical phenomena, unrelated to economic policy in the 1990s, and even the *ease* of fiscal policy in 1999 and 2000. It is definitely too early to make a reliable evaluation of Swedish economic policy in the 1990s.

High and steady rates of unemployment under a Social Democratic regime in the second half of the 1990s were in themselves a break with the R-M model even if new restrictions on economic policy are accounted for (globalisation of financial markets, EMU convergence rules and domestic inflation targets). But, at the same time, it is possible to talk about a revival for the model in the 1990s as far as the means of economic policy are concerned. The Social Democratic government applied an extreme version of the model in 1994-1998, combining an ambitious labour market policy with an exceptionally tight fiscal policy. In addition, the government formulated in 1999 an explicit restriction on fiscal policy – the public deficit must show a surplus over the business cycle, namely 2 per cent of GDP. The restriction satisfies the goal of low inflation in the R-M model. However, the ultimate target of the Social Democrats was to achieve low rates of interest (by raising confidence for Sweden on capital markets and

[25] The wage adjustment process was slow, however, which was expected from the viewpoint of the R-M model. The high rate of unemployment indicated that labour demand and the strength of organised labour was still weak.

reducing the risk of monetary restraints by the Central Bank), not, as in the R-M model, to squeeze profits in the medium term and give priority to public saving.

It seems further that the Rehn-Meidner theory of transformation pressure was confirmed in the 1990s. The exceptional labour productivity growth in 1992-1995 in Swedish manufacturing is largely explained by rationalisations and - although to a lesser degree - by the elimination of ‘marginal’ production units. Rationalisations and elimination of unproductive firms were induced by the deep Swedish recession in the early 1990s, and because of the weak transformation pressure in the 1980s much room was also provided for productivity gains (Erixon, 2000, p. 80). The sharp reduction in ‘over-employment’ in the early nineties also contributed to high Swedish productivity growth, an explanation completely in line with the R-M model. The reasonable hypothesis that labour productivity growth in the 1990s was promoted by high unemployment is not rejected by the model. But the model emphasises the positive growth effects of full employment since selective employment policies will contribute to a general profit squeeze and also give incentives to the introduction of labour-saving technologies (Erixon, 2000, p. 43).

The productivity performance of Sweden in the 1990s cannot fully be explained in terms of the Rehn-Meidner theory. Productivity (and production) growth in Swedish manufacturing was almost as high in the second as in the first half of the decade despite higher profitability levels. A possible defense of Rehn’s and Meidner’s theory is that high productivity growth may have been maintained because of new technologies and intense global competition, as suggested by the fact that labour productivity growth in manufacturing was also high in other OECD countries in the latter 1990s (Monthly Labor Review, 2000, no. 1, table 45).

My account of the application of the Rehn-Meidner policy model in Sweden in the 1990s has deliberately been given an ambiguous and indeterminate profile. The ambiguity derives from the fact that governments have generally adopted the means but not the goals of the model. Tight fiscal policies, extensive labour market programmes, public saving (in the medium term) and even marginal employment subsidies were all parts of the Social Democratic strategy in the latter half of the 1990s.[26] Further, while revaluations are no longer possible, the

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[26] The tendency to larger wage differentials among blue-collar workers in the Swedish private sector was

government has considered strengthening the SEK as an intermediate goal. On the other hand, full employment was a long run rather than a short run target of economic policy in the 1990s.

My description of the application of the R-M model in the 1990s has been vague on some points since the original version was not formulated during a deep recession. Using the model as a blueprint for economic policy during the deep employment crisis in the 1990s is comparable to applying the *General Theory* in a protracted boom. The modified R-M model, characterised by a combination of Keynesianism and selective employment measures (see subsection 2.4), is undeniably a better point of departure when analysing and evaluating Swedish economic policy in the 1990s.

5. The Validity of the R-M model

A common conclusion in Sweden today is that the R-M model is obsolete. The art of social engineering that the R-M model undoubtedly represents came under increasing public suspicion already in the 1980s. More specifically, opponents of the model referred both to negative experiences of the model and to new economic and political circumstances. One objection is that the model is unable to cope with the current unemployment problems in the EU member countries.

Globalisation tendencies in the post-war period are the main 'structural' argument against the R-M model. The increased overseas production by multinational corporations and mobility of capital, it is argued, limits the scope for a national policy aimed at curbing profits. Such policy will result in capital outflows, especially if other countries try to attract capital by profit tax exemptions. Moreover, internationalisation of labour markets is said to have narrowed the scope for solidaristic wage policy. Wage earners in high demand have greater opportunities today of moving to countries with greater wage differentials. Further, there is no institutional or political support today for a co-ordinated policy of fair wages, particularly on the EU level. This argument is often linked to the effects of new technologies and work organisations: the

reinforced in the first half of the 1990s. (There are no statistics available yet for the second half of the decade.) Wage dispersion increased most between industries and plants, thus fairness, in the terms of the original notion of solidaristic wage policy, was compromised (Hibbs and Locking, 2000, figure 1).

trends towards more differentiated and flexible jobs have made it more difficult to define identical work and, therefore, uniform wage standards.

Globalisation and information technologies are the main driving forces behind 'the new economy.' A widespread opinion is that this economy is more productive, more resistant to inflation tendencies and also more associated with large wage and income differentials than 'the old economy'. The R-M model claims that 'unfair' wage differentials are inflationary and possibly also growth damaging since rationalisations, and even innovations, may be delayed by weak transformation pressure. The model seems to be repudiated by American experience in the second half of the 1990s. Large wage differentials did not prevent the United States from having low rates of inflation despite low unemployment and also higher GDP growth than other OECD countries (except Turkey and Ireland).

Another, although related, structural argument against the R-M model is based on the growing importance of services and human capital. The OECD and the IMF have claimed that wage differentials between sectors must expand to create new jobs in countries like Sweden. The service sector has lower productivity than manufacturing and must hence pay lower wages. The EU Council made a similar recommendation for its member states in the mid-1990s - real wages should decrease in some sectors of the economy to create jobs (the Council of the European Union, 1994). According to Swedish economists, Sweden lagged in developing a private service sector in the 1960s and 1970s because of solidaristic wage policy; the service sector could only expand through an expansion of the public sector. Moreover, they claim, Swedish investment in human capital was inhibited, even in the 1980s, by the fact that individuals were offered a too small wage premium (cf. Henrekson, Jonung and Stymne, 1996, 265-77 and Lindbeck, 1997, 1295 and 1311).

Some components of the EU project are difficult to reconcile with the R-M model. Proclamations of social partnership and macroeconomic dialogues by the EU in the 'White Paper' (Commission of the European Communities, 1993) and at the Cologne Summit in June 1999 have been based on the idea that overall wage moderation will boost European competitiveness and profitability. Rehn and Meidner thought that such incomes policy actions are either inefficient measures in the struggle against inflation or obstructive for the development of an advanced industrial sector.

The argument that the R-M model is less relevant in a situation of high unemployment has been made by a heterogeneous group of economists. The group consists of Keynesians, who favour co-ordinated actions among EU member states to raise effective demand, and also of economists who advocate reductions of real wages (after taxes), either by structural reforms in labour markets or by reductions in corporation taxes. Both perspectives can be supported by studies showing that labour market policy programmes were both ineffective and insufficient measures to combat unemployment in Sweden in the 1990s (Ackum Agell, 1995, and Forslund and Krueger, 1997).

Internationalisation has undeniably limited the application of the R-M model, particularly in a single country. But tight economic policy to depress average profits need not exclude measures to increase marginal profits. Rehn's marginal employment subsidy proposal is a direct incentive for companies to expand in the country. The policy is non-inflationary if the 'Rehnian paradox' is absent, i.e. if wage inflation depends on average profits and profit margins rather than on marginal profitability. Of course, Rehn and Meidner did not deny that there are limits on the possibilities to hold down average profitability in a single country.

A further defence of the R-M model is that globalisation of financial markets challenge a pure Keynesian strategy, rather than a model which relies on supply-oriented measures in product and labour markets. An expansionary fiscal policy to obtain full employment is possible in a single EMU country but the strategy demands significant public saving over the business cycle as advocated by the R-M model. Besides, co-ordinated expansionary fiscal policy actions by EMU countries might be needed to reduce unemployment but they can lead to monetary restraints by the ECB to preserve the value of euro.

It is also too early to declare the death of solidaristic wage policy. Labour market mobility across borders is still limited. Further, the reduction in the 'wage premium' for higher education in Sweden from the late 1960s to the early 1980s is mainly explained by market forces, especially by an increase in the supply of highly-educated labour, rather than by wage policies (Edin and Holmlund, 1995. See also Lindbeck, 1997, 1281). And more important, the R-M model allows for wage differentials based on differences in job content, competence and education. But Rehn and Meidner would probably have claimed that the current wage levels

for IT specialists and R&D personnel are ‘distorted’ short run phenomena which must be met by extensive educational and labour-market programmes to eliminate excess labour demand. A possible amendment (or objection) to the R-M model is that it may be necessary to offer specific tax favours to key individuals in the business sector, especially in high-tech industries where work is often associated with strong positive external effects.

A possible response on Rehn-Meidner grounds to theories about a new economy is that the tendency to larger wage differentials in the U.S.A. came to an halt in the 1990s when the country showed an exceptionally high GDP per capita growth. It is also too early to exclude the possibility of inflationary wage-wage spirals in the U.S. economy. Further, smaller wage differentials between the ‘unqualified’ service sector and other sectors in Sweden may be explained by smaller differences in basic skills in the country.

The hypothesis that solidaristic wage policy has eliminated new firms before having reached their potential profitability levels is plausible. No Swedish research has been conducted in this field, among other things because of the difficulties of reconstructing a history of firm failure. In any case, the ‘activist’ R-M model does not exclude public R&D grants, vocational training, marginal employment subsidies and infrastructure investments, *inter alia* in information technologies, to counter-balance any negative effects of solidaristic wage policy on new fragile firms.

It cannot be denied that the one-sided emphasis on price stability and wage moderation in the EU and its member states prevented the application of the Rehn-Meidner economic policy in the 1990s. Yet I contend that the R-M model silently sneaked in by the back door in the decade. I have already uncovered the revival of the model’s instrument in its home country in the 1990s (in section 4). But it is the discourse on economic policy at the EU level that sets out the best cases of and prospects for a renaissance of the model. The ‘White Paper' recommends active labour market policy measures such as support for vocational training and improvements in employment services. Further, the Amsterdam Treaty of June 1997 proclaims, as does the ‘White Paper’, that employment policy must be pursued within a stable macroeconomic policy framework, i.e. the policy shall not challenge the objectives of price stability. This view has a direct correspondence in the R-M model. The Luxembourg EU Summit in November 1997 placed employment high on the political agenda, inspired by

Swedish labour market policy. The Lisbon Summit in March 2000 prioritises the aim of full employment and the use of active employment policy measures, *inter alia* training of workers to help them cope with new information technologies. Finally, the EU commission has sanctioned proposals of marginal employment premiums in Sweden and other member countries, though the proposals have hitherto been quite limited in size and scope.

There is some truth in the statement that the R-M model is an insufficient and inefficient instrument to combat massive unemployment. The model was formulated during the early post-war boom, which also determined its character. Labour market policy was intended to eliminate the 'islands of unemployment' resulting from a restrictive fiscal policy and a solidaristic wage policy. But Rehn and Meidner were not against Keynesian public budget deficits in periods of deep recession even if they advocated that fiscal policy be predominantly restrictive through the business cycle. In fact, Rehn recommended measures aimed at raising effective demand when unemployment is high, though in combination with marginal employment subsidies and labour market programmes: the R-M model does not postpone the fight against inflation to periods of obvious overheating.

The R-M model is a macroeconomic project which aims to combine full employment with price stability. Other stabilisation policy models have been discredited in the last three decades because they either gave priority to one of these objectives or they failed to achieve these objectives simultaneously. The R-M model is, in reality, one of the few economic policy visions that, therefore, have not lost its credibility. Recent declarations by the EU that full employment must be prioritised without giving up the objective of price stability have put the model into the searchlight again.

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