

## **Narrow Interests or the Scandinavian Experience? The Institutional Foundations of Societal Investment**

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### **Abstract**

This paper uses the Olsonian logic of encompassing interests and the theory of bilateral monopoly from economics to build a formal model that explains policy outcomes observed in more coordinated market economies (CMEs), particularly those of Scandinavia. This simple model explains general patterns of social investment, and economic performance observed in these countries. Ambitiously, our theoretical model provides a broad unifying framework to connect existing literature in comparative political economic research, evaluates the efficiency of more coordinated arrangements to those of less coordinated economies, and demonstrates that coordinated arrangements are not merely different than those reached in the so-called liberal market economies but superior in terms of social welfare. Practically, our model suggests that current discussion in countries like Finland regarding the disposal of their model of central bargaining in favor of a more decentralized and uncoordinated system of wage bargaining would have unfortunate outcomes in the long run for all or most members of the society.

In 1982, when Mancur Olson applied his logic of collective action to the question of economic growth and stagnation in *The Rise and Decline of Nations*, he reached rather pessimistic view regarding the role that interest groups can play in promoting a growing economy. However, as Olson himself and later researchers like Michael Wallerstein and Karl Ove Moene (2003) have noted, the logic of collective action provided one potential loophole through which interest groups could play a more constructive role, while possibly explaining a variety of other social outcomes: interests could be encompassing.

Sufficiently encompassing or inclusive special-interest organizations will internalize much of the cost of inefficient policies and accordingly have an incentive to redistribute income to themselves with the least possible social cost, and to give some weight to economic growth and to the interests of society as a whole. (Olson 1982, 90)

Olson, however, was skeptical of the plausibility of this type of explanation, and was measured in his comments when discussing the plausibility that encompassing interests could explain the economic and social performance of the countries of northern Europe. Specifically, he was concerned about tendencies towards coalitional politics within the encompassing interest group, the possibly greater likelihood of information problems developing that prevent proper decisions from being made by encompassing groups, and the long terms consequences of these problems for the long terms stability of these encompassing groups (Olson 1982, 92; Olson 1986; Olson 1990, 76-77). Noting these concerns, Olson repeatedly urged more research on the matter. Following the specific efforts of Wallerstein and Moene (2003) to explore the manner the logic of encompassing groups could explain corporatist labor market function; we also take up that task.

Our analysis fuses an Olsonian economic logic with elements of the varieties of capitalism approach developed by Peter Hall, David Soskice and their colleagues (for an overview of this approach see Hall and Soskice 2001) in order to try to get some traction on one of the central questions of concern to students of comparative political economy in political science, and students of comparative economy in economics: How and why are the economies of Scandinavia so different from countries like the United States, Britain, and France, and how is it that the former countries seem so effective at promoting both healthy economies and healthy societies? Why does Finland have the best educational system in the world, why will a child born in Sweden be more likely to reach old age without ever having to face medical catastrophe, and why are Scandinavian firms global leaders in technological industries (Alvarez, 2004; Swenson 2002, 3; Leppänen, 2005, notes that, according to a number of institutes such as the World Economic Forum, Finland is a world leader in international competitiveness.). We

explain how the collective bargaining arrangements present in countries like Finland create policy outcomes and reveal how strong unions generally promote economic efficiency and welfare in Scandinavia. In addition we reemphasize the importance of researching further Olson's concern about coalitional politics within encompassing interests in northern Europe, while taking a step forward to address his concern's about information problems preventing ideal decisions by these interests.

Obviously, these questions are not new, but the breadth of questions we wish to answer at once is, we hope, contributive. Political science possesses a great deal of literature discussing the development and surprising macroeconomic success of the Scandinavian welfare states. This literature explores at great length the institutional correlates of this development and success, such as strong centralized unions, employer organizations, and centralized bargaining institutions (For Example Katzenstein 1985; Alvarez, Garrett, and Lange 1991; Rueda and Pontusson 2000; Pontusson, Rueda, and Way 2002). Others attempt to explain the peculiarities of labor and product market politics (Swenson 2002; Wallerstein and Moene 2003; Wallerstein 1999), While others focus on social insurance and other aspects of welfare state provision (Martin and Swank 2005; Swank and Martin 2001; Mares 2003). Only rarely do scholars attempt to develop concepts to try to encapsulate all of these phenomena such as Gøsta Esping-Anderson's seminal study, charting *The Three Worlds of Welfare Capitalism*. As such, these studies largely concentrate on more narrow macroeconomic outcomes than our study such as low wage differentials, wage restraint, low inflation, competitive and technologically savvy production regimes, and respectable economic growth. This study hopes to provide a simple model that provides a framework to expand and unify the scope of exploration in this literature from those

concerned with economic policy outcomes, social policy outcomes, and most other outcomes of concern to social scientists.

Meanwhile, the economic literature pays too little attention to Olson's unanswered questions when attempting to explain the success of the Scandinavian countries. Often scholars attribute the development and successful function of these economies to exogenous factors such as culture, ideology, or luck that may soon run out (Alesina, Glaeser and Sacerdote 2001). Alternatively, more endogenous causes such as the disciplining effects of high vulnerability to international trade competition experienced by these nations are used to explain the performance of these economies (Olson 1990). Economic success is usually argued to be accomplished in spite of the strong unions and other encompassing organizations present in these countries. Attention, in general, tends to be more focused on specific macroeconomic variables such as variations in wages and levels of inflation than on the overall economy. (See, for example, Calmfors, 1990.)

We argue that understanding the contribution of the collective bargaining structure on more than one dimension helps to explain why the Scandinavian countries are doing so well. In fact, by approaching the institutional structure of collective bargaining as more than merely a wage negotiations tool, we can provide a more comprehensive question for the very question with which Olson (1990) struggled: "Why isn't Sweden worse off than it is?"

In so doing we provide three ambitious contributions to current research in comparative political economy, and policy debates surrounding the future of the collective bargaining arrangements in Scandinavia. First, and most importantly, we provide a formal theory connecting the collective bargaining framework of a tripartite bargain with the policy bargains struck in societies. Thus we shine light on the causal mechanisms that are likely lead to the

outcomes seen in the coordinated market economies of Northern Europe in a manner completely in line with economic theory and not dependent on ad hoc cultural or ideological explanations. Furthermore, we suggest that this explicit formulation of these coordinated and uncoordinated equilibria will provide a firmer theoretical foundation for future research in comparative political economy and the study of comparative labor union politics while connecting together much existing research.

Second, by formalizing this process that has hitherto been largely assumed or explored inductively, we evaluate the efficiency of these bargains theoretically and refute the argument that large encompassing interest groups engaging in these collective bargaining arrangements will strike economically inefficient bargains (a la Olson's concerns)

Third, and most importantly, we prove that encompassing and centralized bargaining arrangements will not only operate efficiently, but achieve Pareto superior outcomes in terms of general social welfare.

Therefore we explain with our simple model the divergent societal systems and political priorities towards social investment seen in Scandinavia generally, Finland and Sweden more specifically.

Drawing on these contributions we conclude that countries that currently have these collective bargaining institutions should, if maximizing their long run interests, do what must be done to maintain these institutions. There is little evidence from our model that would indicate that an alternative arrangement would respond better to the demands of international competitive pressure or general economic efficiency to provide a superior result for any group in the long run. Policies resulting in the breakdown of these arrangements will only result in short run gain for individual narrow interests (Olson 1982). As such, our conclusions highlight that the choice

between policy negotiated collectively and one negotiated via a more atomistic market is a choice between narrow interests and the Scandinavian experience.

*Model:*

In this model, two players, F and U, bargain over a set of goods using barter. In scenario A, F holds good w and U holds good h. The goods are (not perfectly) divisible. Efficient trade is possible if the following conditions are met:

1. The players have a double coincidence of wants – i.e. if F wants some of h and U wants some w, and if
2. these players are willing to pay enough of their own good to match the other player's reservation price. Finally, Farrell (1987), reminds us that
3. the players must have sufficient information regarding the other to avoid missing opportunities for trade.

Under scenario A, efficient trade is possible, but, due to the constraints, may not always occur. If the potential that players may have different discount rates is incorporated (see Ladha, 2005), then we have an even greater likelihood that traders will miss efficient trades or that the results will be biased in favor of the more patient player.

Expanding the set of goods to be traded to  $N > 2$ , in scenario B, boosts the potential for efficient trade by increasing the probability that conditions 1 and 2 are met. The likelihood of finding a double coincidence of wants is greater with a larger basket of trades. Additionally, with a broader spectrum of divisible goods, each player has a better opportunity to find some combination of his own goods that can be tradable for a combination of the other player's goods. (see Brams and Taylor, 1996 for some examples)

Scenario C is identical to scenario B except that it adds a central authority that serves as an impartial bargaining clearinghouse with the ability to use incentive mechanisms to induce both parties to reveal their true values for all goods under negotiation. (See Farrell, 1987, for details on incentive mechanisms used by central authorities in bargains.) Scenario C increases the probability that condition 3 is fulfilled. If the central authority, as assumed, can correctly determine the true values for all goods, then she can identify the Pareto hull of efficient trades and can ensure that parties negotiate within that area. Thus, if trade is possible, scenario C will produce it.

The above model indicates the contribution that the collective bargaining structure makes to the traditional firm versus union format. Collective bargaining structures, because they are not restricted locally, increase the dimension of policy issues traded. Bargaining over, for example, wages and working hours, restricts the players to a two-dimensional bargaining space, making it unlikely that all three of the conditions will be met. Expanding the range of issues, as under scenario B, increases the range of mutually agreeable options.

The inclusion of the government into the bargaining structure also helps to expand the range of issues available for negotiation on the bargaining table. Individual firms and unions can bargain over issues under their own control, i.e. wages, working hours, vacation time, and working conditions. Exogenous issues cannot play a role in their negotiations, because they cannot credibly claim to control them. Collective bargaining structures, with the role of the government, can bring these issues to the table. Thus, the range is expanded to include such elements as prices, taxes, subsidies, etc.<sup>1</sup>

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<sup>1</sup> SAK, the Finnish collective bargaining institution, notes that elements involved in the bargaining include reduced unemployment levels, reduced inflation, improvements in working life and in the social security system. The SAK webpage states that „While wage increases have been moderate, the purchasing power of employees has increased due to restraint in pricing policy.“ (<http://www.sak.fi/englanti/index.shtml>)

The inclusion of the government into the bargaining structure also helps avoid some of the problems with bilateral bargains, as under scenario C. Farrell (1987) notes that bilateral bargains without a central authority can suffer in efficiency if there exists incomplete information. In other words, mutually beneficial agreements can be missed if either party errs in his or her assessment of the other party's reservation price or wage. Farrell argues that central authorities can use incentive mechanisms to induce both parties to honestly reveal their true values, thereby increasing the chances for an efficient exchange.<sup>2</sup>

The above model presents the relative advantages of the coordinated market system as a result of the increased market basket available for exchange and division in a barter economy. The inclusion of the government in this system helps to facilitate exchange both by providing an increased number of goods to the bargaining table – goods that would otherwise have been unavailable to the bargainers – and by serving as a clearinghouse for trades, to enhance the likelihood of efficient trade.

It is interesting to note that, by using the coordinated market system for the reasons detailed above, the system also gains the benefits of having the major players in the system holding – as a result of their group sizes - encompassing interests in society. This difference between the group sizes between the collective bargaining institution and the decentralized bargaining yields large differences in behavior motivated by interest in the two systems. Olson noted that the presence of narrow interests in decentralized systems will be detrimental to the system, because individual firms and unions in a given country will behave rationally, taking or giving when it is beneficial to themselves. If, for example, a firm is 1% of a country, it has little incentive to contribute to that country as a whole, because it will bear 100% of its contribution and reap only 1% of the gain. Therefore, a contribution to the society as a whole will only be

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<sup>2</sup> We assume an unbiased government.

made if the expected gains outweigh the expected costs. Similarly, a firm (or union) has incentives to take actions (demand tariffs, etc) that benefit itself even if these actions cause a loss to society, because it will take 100% of the gain and bear only 1% of the loss to society.

Collective bargaining structures are notably different in this respect. By forming collective entities, firms and unions constitute majority interests in the society. Subsequently, every gain or loss to the nation will be felt by the collectivities as well, providing incentives to either improve, or at least not harm, the society. Firms, accordingly, will be less likely demand costly tariffs that hurt the profits of other firms in the nation. Unions will be more likely to focus more on retraining than on costly redundant labor demands. Thus, we should expect to see greater investment in education, health care, and research and development in nations that have collective bargaining structures, because these investments will also benefit the firms and the unions.

Olson himself notes this potential (1982, 89) but later dismisses it as prone to collapse under the weight of intra-coalitional struggles. In his analysis of the Swedish system, he downplays the role of encompassing interests and focuses more on the benefits of open trade and the reduction of implicit redistributions. (Olson, 1990) While we agree that within-group fractions are possible and merit further attention, we feel that Olson has overlooked a fruitful element in the social efficiencies of nations with collective bargaining systems. We argue that, when combined with the benefits gained by increased trade potential, the variable of encompassing interests plays a role in contributing to the differences in efficiency and welfare.

The factor of risk also plays a role in creating the differences between collective and decentralized bargaining systems. Risk of competition hinders relationships between firms and unions. Firms and unions could, in theory, have a mutually beneficial relationship, but the

presence of competition from other firms, or unions, causes problems. If, for instance, firm A and B are otherwise identical, and if firm A cooperates with its union and that firm B does as well, but holds one factor cost lower (lower wages or higher working hours), then firm B's profits will be higher than A's. (In this case we assume transactions costs of moving labor between firms.) In this scenario, inter-firm competition will inhibit cooperation between the firms and their unions. Increased profit for either firm will come not from an improvement in production, but at the expense of the employees.

Collective bargaining imposes same wages and other agreements on all like firms. Note, importantly, this arrangement does *not* reduce competition between firms, it merely keeps the competition based upon factors such as technological improvements and superior products. Cost reducing tactics, in which the costs are passed along to the consumer in terms of lower wages or longer working hours, are not used in competition under collective bargaining.

Combining the above two dimensions, we see an increase in efficiency. Firms demand skilled labor. Individuals will be willing to get an education necessary for a given job, because unions can reduce their risk of redundant education through factors such as retraining. Costs of education are low, because the encompassing interests of employers and unions provide incentives for them to invest in education, yielding an improved education system.

The benefits gained from a system in which encompassing interests are combined with a reduction in risk, when combined with the results of the model, below, provide a strong understanding of the real advantages of the collective bargaining system.

*Response to Likely Criticism*

It is important to explicitly state what we are not saying in this paper. First, this analysis does not discuss the process by which these collective bargaining arrangements come to pass. While much work has been done constructively debating the expansion and the retrenchment of the welfare state, wage bargaining, and a variety of other aspects of the more socially generous states of Northern and Central Europe we do not explicitly deal with these matters here. This paper is solely concerned with explaining how collective bargaining arrangements lead to the diverse distributional priorities of societies, and the merit of these arrangements in terms of economic efficiency and societal welfare.

There is some justification for this decision. As Swenson notes, the disposition of employers and individual unions toward different collective bargaining equilibria will largely depend on the strategies they will be able to pursue their goals in those different environments (2002: 21). Thus, in order for us to make arguments about the interests and rational choices that led to a given equilibria it will help to get a firmer grasp of what the equilibrium looks like, how it works, and what types of interests are served. As such, this analysis should be seen as a first step towards grappling with these questions.

Second, in the current stage of our research we are not considering these arrangements to be endogenous. As such the paper currently has little to say about the collapse of these institutions in countries outside of Scandinavia or the problems that these institutions have experienced within Scandinavia. However, we do suspect that the model developed here may help point in specific directions for future research. In particular, there is still the concern raised by Olson regarding coalition politics *within* encompassing interests of unions and firms. Individual qualities of the bargains reached within employer organizations and labor unions may

largely set the path of growth or decline of encompassing interests, with various possible determinants (Olson, 1986).

Third, we are not denying the substantively significant role to be played by government and government partisanship in the development of distributional priorities, or the flavors of welfare capitalism that develop in different economies as discussed in Esping-Anderson's three worlds of welfare capitalism (Esping-Anderson, 1990). Rather, we are attempting to get at what we argue are the root mechanisms responsible for the kind of social investment found in Scandinavia.

In fact, as previously noted, there is reason to suspect that, as has been suggested by other authors, that party politics could make the government a less unbiased arbiter, and be an interesting area for further research within the framework presented here.

#### *Policy Implications*

The practical implications of our model are rather obvious. The choice between the two collective bargaining equilibria here suggest that these encompassing interests are critical for producing the constellation of interests and incentives necessary to produce the Scandinavian experience: high social investment in education, health, and welfare, low levels of wage dispersion, long-term investment in future productivity, and comparative advantage in technological industries. As such, social actors in these countries should be wary of calls to break apart de facto tripartite negotiation, or their encompassing organizations.

#### *In Lieu of Conclusion: Future Directions*

- Formal theory
- Empirical Analysis
- Derivation of Testable Hypotheses

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