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State and Economy: Sociological Perspective

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Recent work in economic sociology and related fields has challenged the familiar terms for analyzing the relationship between state and economy that have dominated much of the social science literature since Adam Smith ([1776] 1976). Contemporary scholarship rejects the assumption, traditionally shared by both advocates and critics of market allocation, that state and market are distinct and opposing modes of organizing economic activity (Block 1994; Evans 1995; Fligstein 2001). In this chapter, we intend to extend and develop this alternative perspective and also demonstrate its value in recasting established debates. We will make our case by focusing on three specific substantive arenas—developing and transitional societies, advanced industrial welfare states, and supranational economic governance.

Our perspective can be briefly summarized in three general propositions. First, state and economy are not analytically autonomous realms but are mutually constituting spheres of activity. Second, both states and economies are embedded in societies that have specific institutional structures, and this embeddedness plays a critical role in both economic and political outcomes. Third, this embedding is dynamic; it is often reshaped by institutional innovations that reshape the ways that states and economies intersect. In the next part of the chapter, we will explain these propositions and then introduce the substantive sections to follow.

A Different Conceptual Framework

For too long, debates on the relationship between economy and state have centered on a single question—how large or small a role should the state play in the economy? Implicit in that question is the dubious assumption that the state and economy are separate analytic spheres that can function autonomously. Against this assumption, we insist that the state and the economy should be seen as mutually constituting spheres of activity—neither of which can function without the other (see also Migdal 2001). One side of this mutual dependence is not controversial; states obviously depend on the economy for the flows of revenue that finance state activity (Tilly 1990). This dependence helps explain why purely predatory forms of government rule are relatively rare; even the greediest rulers tend to learn that without placing limits on their predation, production will contract because people need some assurance that they will be able to retain some of the fruits of their labors (Levi 1988).

The reciprocal case for mutual dependence is more contested. The economy’s dependence on the state tends to be flatly denied by free market theorists who argue that market economies function best with minimal government “interference” (Friedman and Friedman 1980; Hayek [1944] 1976). Economic sociologists have challenged this claim by arguing that even the most market-oriented economies depend on legal and political structures. Weber ([1922] 1978) argued that the unique form of “rational capitalism” that became dominant in Western Europe depended heavily on the effectiveness of laws of property and contract designed to ensure that profits were generated primarily through productive activity rather than through parasitical extractions (see Swedberg 1998). This lesson was recently relearned when the application of “shock therapy” to facilitate a rapid transition to capitalism in Russia produced not rational capitalism, but an explosion of criminality because the legal and political structures were too weak to channel entrepreneurial activity into productive channels (Woodruff 1999; King 2003).

Karl Polanyi ([1944] 2001) deepened Weber’s argument by showing that market economies rely on three critical inputs that cannot be supplied through market activity alone. He used the term fictitious commodity to characterize land, labor, and money because economic theorists must pretend that these items were produced for sale on the market in the same way as other goods (Block 2001). However, labor is simply the activity of human beings, land is nature divided into parcels,
and the money that circulates in national economies almost always relies on the “full faith and credit” of one or another government. In all of these cases, the necessary activity of regulating the supply of these fictitious commodities falls to government and encompasses different initiatives. Regulating the supply of money, for example, includes the creation of a viable currency, the activity of central bankers, and oversight over banks and other financial institutions that shape the supply of credit. Adjusting the supply of labor includes policies that influence the in-migration and out-migration of people, education and technology policies, and social welfare policies designed to provide resources to households and individuals without sufficient employment income. Finally, managing the supply of land encompasses environmental planning, transportation policies, farm policies, and other land use planning. To be sure, there is no assurance that government will manage these fictitious commodities wisely; the point is rather that there is no clear alternative to government action.

The idea of the mutual constitution of state and economy is often expressed in the shorthand that economies are embedded within social and political structures. Our intention here is to deepen the embeddedness argument by clarifying in what the economy is actually embedded. Our argument is that market economies are embedded within a civil society that is both structured by, and in turn helps to structure, the state.3

Civil society, in our view, encompasses both the variety of nongovernmental associational activities from trade associations and fraternal organizations to trade unions, protest movements, political parties, and the “public sphere” in which citizens form their political preferences (Ehrenberg 1999; Habermas 1989; Keane 1988, 1998). There is considerable variation across societies both in the density of associational life and in the particular ways in which civil societies are structured (Putnam 1993, 2000). But civil societies are deeply penetrated by law and other governmental practices; both the structures and the responsibilities of trade unions or trade associations are significantly shaped by legal rules and institutionalized patterns of interaction with government officials. Yet, ideally, civil societies retain sufficient autonomy from the state to place significant limits and constraints on the exercise of governmental authority. As many theorists have insisted, the viability of democratic institutions rests ultimately on the capacity for political mobilization by citizens in civil society (Ehrenberg 1999; Keane 1988).

The substance of civil society is the activity of real human beings with associational ties forged out of kinship, neighborhood, ethnicity, religion, class, and other identities. These individuals are simultaneously economic actors and political actors. In both realms, they rely on normative understandings that are ultimately grounded in the interactional order. Norms of reciprocity, for example, facilitate both economic exchanges and political transactions in which citizens provide votes and politicians promise to pursue policies that meet their needs. A dense civil society that encompasses both associational ties and normative understandings plays a central role in the effective functioning of both economy and state (Evans 1997b).

At the same time, our view rejects the idea that strengthening civil society and producing more “social capital” is sufficient to solve society’s problems (Smith and Kulynych 2002). We see the dynamism of civil society as a necessary but not sufficient condition for solving economic and political problems. For one thing, new policy ideas and proposals have to be created, disseminated, and legitimated. While this is more likely to occur in a society with a vigorous public sphere, there is nothing automatic about the process. Entrenched ideas can effectively preempt the policy space and preclude the development of new ideas. Moreover, economic or political elites often resist changing existing practices even in the face of considerable pressures from civil society. Hence, strategies that simply strengthen civil society can fall far short of meaningful social changes.

The triangular approach helps to overcome modes of thinking that attribute developmental successes or failures within particular societies to the operation of a single principle—for example, the scope given to market forces or the degree of state strength. It suggests instead that both developmental successes and failures should be understood in terms of the synergy or lack of synergy among civil society, economy, and the state. It implies multiple institutional routes to a successful economy and to effective governance (Block 1990). This approach also makes sense of the research findings of the growing body of literature that has analyzed the “varieties of capitalism”—the systematic variations in institutional practices among different contemporary market-oriented societies (Crouch and Streeck 1997; Hall and Soskice 2001b; Hollingsworth and Boyer 1997; Kitschelt et al. 1999; Orrù, Biggart, and Hamilton 1997). That these societies differ in labor relations, in the organization of the financial system, in the struc-
ture of corporations, and in systems for generating innovations is not the result of a purely economic or a purely statist logic; the differences are the result of the complex historical interplay among state, economy, and civil society.

There is no guarantee that such interplay will move automatically from one well-functioning “variety of capitalism” to another. Societies can suffer extended periods of institutional crisis in which any new initiatives are blocked by stalemate of competing social forces, and they can also experiment with policy directions that are ultimately abandoned because they lead nowhere (Polanyi [1944] 2001). There can be both positive and negative consequences of any specific form of embeddedness. The specific ways in which the economy is embedded in civil society and the specific institutional connections between civil society and the state can produce both dysfunctional and functional outcomes. It would also be misleading to portray embeddedness as static; something akin to the heavy hand of tradition limiting the options available to individuals. To be sure, the concept is intended to highlight the fact that individual economic action is always structured by certain understandings and institutional arrangements. But these understandings and arrangements are dynamic in market societies; there are considerable incentives for innovations and for the construction of new institutions to change the way that economic action is embedded.

Polanyi ([1944] 2001) sought to characterize this dynamism by arguing that market societies are continually being reshaped by two conflicting movements—the first is the movement for laissez-faire—to expand the scope of markets and the second is the movement for social protection to limit the scope of market forces. The movement for laissez-faire often demands the expansion and enforcement of the property rights of wealth holders, while the opposing movement frequently centers on securing social rights. Polanyi suggests that both of these movements operate through institutional innovations. The New Poor Law in England in 1834 was a triumph of the movement for laissez-faire; it sought to institutionalize a “free labor market” by eliminating outdoor relief and establishing the poorhouse as the only alternative to paid employment (Block and Somers 2003). Polanyi’s critical insight was that even those who insist that all they want is to allow markets to work depend upon state power and institutional structures to achieve their ends. Shortly after the New Poor Law, the other movement passed the Factory Acts that placed limits on the length of the working day and established a system of factory inspectors. In short, both movements changed the way that labor markets were embedded, and both altered the interface between civil society and the state.

Polanyi’s double-movement framework is open to a variety of criticisms. It probably overstates the strength of the movement for laissez-faire within some of the non-Anglo-Saxon “varieties of capitalism,” and the idea of expanding the scope of the market is problematic because all market arrangements require certain restrictions on who is allowed to do business and what can be bought or sold. Nevertheless, Polanyi’s formulation is still extremely useful in conveying that there are several different dynamics at play to change the ways that economic activities are embedded.

The key point is that embeddedness changes through institutional innovations. Sometimes this occurs largely on the terrain of civil society; through the creation of new associations or institutions intended to organize or coordinate economic activity (Fligstein 1990). But even in these cases, if the new forms are to endure, they have to be supported and legitimated by the state. Other times, the initiative comes through the state or by way of cooperation between actors in the state and actors in civil society (Evans 1995). But all of these innovations tend to reconfigure the state-economy relationship. Rather than seeing economic success as rooted in a particular configuration of states and markets, we emphasize the importance of this capacity for institutional reconfiguration to explain why some societies have been more successful than others in solving their political-economic problems (Evans 1995, 1997b; Sabel 1994).

In sum, our perspective offers a way to escape the familiar and often sterile debate between adherents of the “free market” on the one side and advocates of strengthening government regulation and public provision on the other. It directs attention instead to the qualitative issues of how and for what ends markets and states should be combined and what structures and practices in civil society will sustain a productive synergy of states and markets.

Three Substantive Areas

Our three propositions are of obvious relevance to the case of developing and transitional economies. The great success stories, including the extraordinary gains made by developmental states in East Asia—particularly Japan, South Korea, and Taiwan—cannot be explained either by “reliance
on free markets” or “state-sponsored accumulation” (Evans 1995; Wade 1990). The developmental state must itself be understood as an institutional innovation whose success is explained by the intricate relationships connecting state, economy, and civil society. But recently, development and transition scholars have increasingly focused on the more numerous cases of failure, since over the last 25 years, many countries have experienced disappointing growth rates and significant reductions in the provision of essential public goods. But here as well, the most promising prospects for improvement center on institutional innovations that engage civil society in the reconstruction of economic governance.

The contemporary dilemmas of advanced industrial societies demand a similar kind of analysis. Here, the argument has centered on the welfare state with market liberals insisting that the overdeveloped systems of public provision in Western Europe have caused the slower growth and higher unemployment rates experienced by much of Europe as compared to the United States over the past 20 years. On the one side, defenders of the welfare state have insisted that generous public provision has been a critical part of a “Rhenish” variety of capitalism that has produced higher standards of living than the American model (Albert 1993). Yet at the current moment, the debate has reached an impasse. On the one side, a growing body of empirical work has failed to substantiate the claim that European economic performance has suffered because of generous welfare state provision (Huber and Stephens 2001; Lindert 2004; Swank 2002; Wilensky 2002; see also Huber and Stephens in this volume). On the other side, defenders of the welfare state have insisted that generous public provision has been a critical part of a “Rhenish” variety of capitalism that has produced higher standards of living than the American model (Albert 1993).

Finally, at the global level of analysis, the necessity of institutional innovation is increasingly obvious, as is the importance of analyzing the novel linkages among state, civil societies, and economies that shape the possibilities for effective global economic governance. The East Asian economic crisis of 1997–98 offered a glimpse of the fragility of current forms of supranational economic governance and exposed the potential for features of catastrophic proportions (Soros 2002; Stiglitz 2002). Moreover, we think these dangers are intensified by a current of opinion that espouses a contemporary variant of “market utopianism”—the belief that global market self-regulation can be the basis for a viable world economy. Avoiding a return to “depression economics” (Krugman 1999) depends on the ability of states and civil societies to shape new forms of global governance. While one can speak of a global civil society only as an emergent tendency, the bifurcation between the World Economic Forum and the World Social Forum—implied in their names—suggests the diversity of social forces that are attentive to these issues. Both of these organizations—in very different ways—represent efforts to escape market utopianism and construct new forms of governance. By definition, all of these efforts to construct global governance regimes are efforts at institutional innovation. But they come into direct conflict with the logic of global neoliberalism that imposes a kind of “institutional monocropping” that severely constrains the possibilities for innovation both within and across societies.

**Developing and Transitional Societies**

Development transforms political, economic, and social structures, creating new bases for productivity, ideally enabling people to “lead lives they have reason to value” (Sen 1999). Defined in this way, “development” is the archetypal problem for theories of state and economy. That development is first and foremost about institutional transformation rather than simply growth or the accumulation of capital is now accepted canon (cf. Rodrik et al. 2002; Evans 2002). Douglass North’s (1981) pioneering analysis of development among the original industrializers exemplifies the “institutional turn.” In North’s view of the expansion of markets, the state’s role in the provision of norms and laws defining and protecting property rights is central. By emphasizing the importance of informal social norms in fostering (or impeding) development, he also makes it clear that markets cannot be disembedded from society.

Like North, Polanyi and Gerschenkron exemplify an institutional perspective on the dynamics of development in the European context. For Polanyi ([1944] 2001, 146), “The road to the free market [in England] was opened and kept open by an enormous increase in continuous, centrally organized and controlled interventionism.” In short,
the construction of the “free market” was an institutional innovation that required the active involvement of the state. Gerschenkron (1962) extended the argument, showing that English institutional innovations were insufficient for “late developers” such as Germany and Russia. Lacking individual capitalists able to assume risks at the scale required by modern technology, these countries depended on the state not just to construct markets but to serve as investment banker and to bear entrepreneurial risks. 

In the period after World War II, even the rich nations of the North appeared to recognize that additional institutional innovation would be required to spread development to the South. Development became an ideologically explicit “project” (see McMichael 2000) because the nations of Asia, Africa, and Latin America faced substantial obstacles. The competitive gap between their economies and those of the industrialized North was larger than the one that European latecomers had faced. Their politically dominant local elites were wedded to agrarian structures that preserved privilege at the expense of productivity, and there was no reason to expect that more entrepreneurial elites would emerge “naturally.”

If manufacturing was going to take its place along side agriculture, local manufacturers needed public investments in energy production and transportation and protection from rich country imports. Private investors also faced a collective action problem. Investment in manufacturing would make more sense if other local entrepreneurs were making complementary investments that would provide needed inputs; otherwise, investment seemed quixotic. Albert Hirschman (1958) provided an elegant vision of the sort of institutional innovation that could shift prevailing social perceptions of economic opportunity. For Hirschman (1958, 35), eliciting entrepreneurship in the simple sense of “the perception of investment opportunities and transformation into actual investments” was the key problem. The state could help induce private capitalists to play their role not only by supplying infrastructure but by building confidence among individual entrepreneurs that their initiatives were part of a general, mutually reinforcing set of investment decisions.

“Hirschmanian” institutional strategies worked during the fifties and sixties, for “third world” countries as different as India and Brazil, stimulating the emergence of local industrial elites and resulting in impressive rates of economic growth. Nonetheless, by the end of the 1970s, development strategies in Africa, Latin America, and South Asia were faltering. Despite impressive industrialization (Arrighi, Silver, and Brewer 2003), imports grew faster than exports, creating balance of payments problems. At the same time, state expenditures outran revenues, creating fiscal problems and massive external debt. Industrial transformation was clearly insufficient to give most of the citizens of the South the full possibility of “leading lives they had reason to value.”

One of the reasons that the “development project” of the fifties and sixties failed to deliver was that its success required benign, capable state policymakers able to disentangle collective goals from the particular interests of elite private actors. Once the development project began to falter, this premise was quickly questioned. The ties that bound state actors to local elites and civil society appeared to be a perverse “antimarket” form of embeddedness rather than a means of generating entrepreneurship. State policies protecting local entrepreneurs from foreign competition led industrialists to focus on the unproductive quest for political favor rather than on competitiveness (Krueger 1974). At the same time, the development project was characterized as victimizing those who lacked strong connections to the state—most dramatically the peasantry (Bates 1981). At the extreme, predatory states like Mobutu’s Zaire were aggregations of self-interested elites grabbing society’s surplus for their own benefit without providing the collective goods necessary for growth or social protection.

There was much merit to the critique, but the simplistic policy conclusion that some drew from it—that a return to laissez-faire was the solution—was clearly wrong. As the first generation of “development projects” were falling into disarray, new models of institutional innovation, equally removed from the utopian notion of disembedded markets, were appearing elsewhere. Following Japan’s footsteps, Korea, Taiwan, and Singapore were dramatically shifting their position in the world economic hierarchy, challenging Northern industrial supremacy with growth rates six times those of the Industrial Revolution. Even more impressive, the new model went beyond accumulation. Public investments propelled rapid rises in education levels and improvements in public health.

This new set of “developmental states” also involved tight connections between economy, state, and certain segments of civil society, but, as before, success required institutional innovation. While these innovations unquestionably depended on a unique confluence of local cultural and social struc-
tural features inserted into a particular geopolitical context, analytical features of broad relevance could also be extracted. Starting with Johnson’s (1982) analysis of Japan, a massive literature, extending from institutionally oriented political economy (see, for example, Akyüz 1999; Amsden 1989; Chang 1994; Wade 1990) to mainstream development economics (see Meier and Rauch 2000, chap. 9) and the international policy community (see World Bank 1997), generated a surprising degree of consensus as to what made the model work.

The “East Asian miracles” engaged intensively with global markets while connecting state and civil society in the form of “embedded autonomy,” the paradoxical ability to maintain autonomy from private elites while simultaneously developing close ties to them (Evans 1995). As in the earlier developmental project, state investment in essential modern infrastructure was combined with subsidies and selective protection against external competition. The big difference, as Amsden (1989) emphasizes, was the ability of the state to make its support contingent on local elites creating internationally competitive industrial capacity.

The possibility of being connected to, but still independent of, private economic elites depended in turn on the presence of capable, coherent state bureaucracies built on meritocratic recruitment and public service careers offering long-term rewards commensurate with those available in the private sector. These basic state characteristics predict more rapid economic growth, not just in East Asia, but across a broad range of developing countries (Evans and Rauch 1999).

None of this is to say that East Asia had discovered a formula that ensured a productive, dynamic relationship among economy, state, and civil society. As the financial crises of 1997–98 revealed, these developmental states can no more afford to rest on their institutional laurels than their predecessors could. To be sure, gains from the institutional innovations embodied in the “embedded autonomy” model still persist. Korea, Singapore, and Taiwan still continue to outperform a few countries in the global South (or, for that matter, in the North). What these East Asian cases offer is a double lesson. On the one hand, they show the magnitude of the gains that can flow from finding more effective ways of connecting state, economy, and civil society. At the same time, they make it clear that, unless the triangular relationship is periodically reinvented, even the most successful developmental performance will deteriorate over time. The challenge for analysts is trying to identify the next set of innovations, as, for example, in O’Riain’s (2004) work on the “developmental network state.”

“Transitional” Cases

Turning from developing to transitional countries, one might expect a very different set of findings and conclusions. Whereas relative insulation from global markets was one of the primary defining features of the state socialist countries that are now called “transitional,” the states and social structures of the global South are the product of centuries of integration into the capitalist world economy. The extent to which the experience of transitional countries reinforces conclusions drawn from the developing cases is, therefore, striking.

Russia, one of the two most important “transitional” cases, demonstrates the pitfalls of trying to implant markets without thinking carefully about how they will connect with existing states and social structures. Terrified that the Soviet party-state would somehow survive, Russian “reformers” and their Western patrons tried to impose the formalities of Western market rules as quickly and thoroughly as possible. The results did not just disappoint from the point of view of preserving social protection. They also failed to deliver productivity-enhancing economic transformation and produced perverse effects in terms of effective legal norms and social order (cf. King 2002; King and Szelényi, this volume).

China and Vietnam supply contrasting cases suggesting that constructing innovative institutional hybrids based on local social structures makes for a more effective transition. Increased participation in global markets and internal shifts to market economies have been combined with caution in opening up capital markets, stubborn preservation of prior state structures, and efforts to avoid the complete erosion of socialist civil society. The result is a distinctly hybrid triangular relationship that has produced (after some hiatus in the case of Vietnam) rapid rates of growth.

China and Vietnam show that market disciplines and incentives can be a source of new dynamism in systems that had been dominated by an overbearing state apparatus. But it is critical that the old state apparatus continue to supply enough discipline over market actors to prevent the emergence of a Mafia-style, predatory capitalism as in Russia. Nee (2000, 64) emphasizes the “crucial role of the state in establishing a market economy” in the
Chinese case. Indeed, one could argue that these two Asian transitional successes represent a variation on the earlier success of the capitalist “Asian tigers,” which were also examples of adding increased engagement with international markets to previously overbearing state apparatuses, while firmly preserving the state’s role.

The comparison of the world’s two largest countries—China and India—underlines the extent to which developing and transitional countries yield common lessons. In both cases, size and relatively robust (if not agile) state apparatuses have allowed partial adaptation to global market liberalism and improved their economic performance as a result. At the same time, these countries have escaped, at least up to now, the fate of “would-be overconformers” such as Argentina among the developing countries and Russia among the transitional ones.

China and India are certainly not models that are easily copied or that are without pitfalls. The success of China’s new romance with markets has depended in part on having inherited the advantages of a very egalitarian income distribution and exceptional provision—relative to its income level—of collective goods. How long the fruits of this inheritance will persist is unclear. Growing disparities between urban and rural areas and between the southeast coast and the interior of the country cannot help but create equally serious social tensions. Combined with the diminishing legitimacy of the ruling party and the normative confusion introduced by trying to maintain “capitalist Leninism,” the sustainability of China’s current trajectory cannot be assumed. The case of India is similar. Prior to the current move toward market liberalism, the cumbersome and confusing, but surprisingly effective, carapace of India’s secular democracy managed to sustain political stability for half a century. The anxieties, uncertainties, and increased inequality inherent in the risky and less protective contemporary relations between state and economy may be as much of a threat to India’s political system as increasing social disparities are to China’s. Certainly, the dramatic recent examples of communal violence and the increasingly sectarian tone of political debate in India suggest that further reinvention must be on the agenda.

**The Politics of Institutional Innovation**

If developmental success requires continual reinvention of the triangular relationship connecting state, economy, and civil society, it is both an institutional problem and a political problem. Despite the fact that democracy is one of the central pillars of current global ideology, current models of economic governance in the global South do not lend themselves to building more effective connections between civil society and the state. The political model being purveyed globally combines the assumption that global markets are the best source of political discipline for profligate states with the oddly “statist” assumption that external “statelike” institutions of global governance, rooted in the societies and power structures of the industrial North, will be the most effective agents of institutional change in the countries of the South.

The results have been efforts to impose “cookie cutter” versions of advanced country institutions. This “institutional monocropping” (Evans 2002) ignores the basic logic of embeddedness. It does produce occasional “honeymoons” during which the enthusiasm of rich-country investors generates a brief spurt of financial flows, but there is little evidence that this works as a strategy of growth, to say nothing of a strategy of development. Again, Argentina offers a particularly dramatic case. Neither the economic discipline imposed by a complete opening to competition from foreign goods and investors, nor the “credible commitment” by the state to maintain the value of the currency, sufficed to convince private local or global elites to make investments that would expand local productive activities.

What is the alternative? Since we have already seen that the developmental state is a political tool of diminishing effectiveness, is there a possibility that civil society could bolster the inadequate disciplinary capacity of markets and states? More specifically, is the idea of some kind of bottom-up “democratic discipline” a utopian prospect? Despite the rhetorical hegemony of electoral democracy, the state of democratic institutions at the national level is discouraging. Since policy autonomy is limited, electoral success hardly guarantees success in forging new policies or in reconfiguring the triangular relation of state, economy, and civil society. Growing popular disengagement from the electoral process is a natural result. If one believes that the solutions are “more market,” this political disengagement is not a problem. In fact, market liberals are suspicious that democratic politics will lead to populist pandering that diverts resources to unproductive welfare expenditures or outright corruption. If, however, we start from the assumption that engagement with civil society is central to both the effective functioning of the state and to develop-
mental success (cf. Migdal, Kohli, and Shue 1994; Evans 1997b), then the anemic character of contemporary democracy is a real problem.

Yet there are some promising experiments at the local level. At least two disparate cases, the state of Kerala in India and the city of Porto Alegre in Brazil, have gained attention for successfully implanting deliberative democratic institutions. These institutions in turn have worked effectively to discipline state elites, reducing corruption and increasing the effectiveness of service delivery (see Heller 2001; Fung and Wright 2003; Baiocchi 2003). Unfortunately, there is no evidence that these innovations can be extended to have analogous effects on private elites, and it is not clear how they might be “scaled-up” to provide more general solutions to the “discipline” problem. Nonetheless, they remain hopeful exemplars in a panorama where institutional imagination seems to have atrophied. It would, indeed, be ironic if, in an era of globalization, the local ended up being the locus of needed institutional innovation.

Overall, developing and transitional cases underline the proposition that taking embeddedness seriously means rejecting simple “high modernist” formulas for the organization of states and markets (Scott 1998). The disappointing results of the current wave of institutional monocropping suggests that formulaic impositions on the global South are likely to undermine already precarious levels of social protection without producing any compensating acceleration of growth rates. In contrast, there are numerous examples in which innovative institutional changes at the national level in the global South have restructured the relationship of state, economy, and civil society in ways that have accelerated development. Early post–World War II “developmental states” worked for a time. East Asian developmental states worked better and longer. The odd hybrid capitalism of China and Vietnam has also produced impressive results. None of these institutional forms is a lasting solution. They must all be seen as temporary platforms on which to construct the next set of innovations.

This vision of institutional innovation raises an obvious question. Does it apply only to the global South and transitional countries, or is it a general frame? Our contention is that it applies equally well to the advanced industrial North, even though societal goals are defined less in terms of “development” and more in terms of preserving and expanding the quality of life associated with the “welfare state.”

**Welfare States**

In developed societies, debates over the welfare state closely parallel arguments over the optimal development strategy for developing and transitional societies. On the one side, market liberals insist that state provision of welfare interferes with the effective functioning of markets (McKenzie and Lee 1991; Friedman 1999). On the other, proponents of welfare state development generally focus on the negative social and political outcomes when societies depend on market processes alone to allocate income (Kuttner 1996; Piven and Cloward 1997). But for more than a century of this debate, both critics and advocates of welfare state provision have shared the underlying premise that states and markets are analytically separate realms each with its own autonomous logic. In the 1970s, this shared dualism produced some convergence in the arguments of market liberals and left-wing defenders of the welfare state. Market theorists argued that an “excess of democracy” had led politicians to expand welfare state spending beyond sustainable levels requiring significant cutbacks to restore the economy’s health (Bacon and Eltis 1976; OECD 1977). Analysts on the left argued that the conflicting logics of legitimation and accumulation had produced an unsustainable expansion in public provision that necessitated either severe retrenchment or a definitive break with the logic of capitalism (Habermas 1975; O’Connor 1973).

But these formulations produced wildly inaccurate predictions. Western European nations have long spent far more than the United States on welfare state provision, and there have been few signs that the gap is narrowing (Huber and Stephens 2001). For a while, it was possible for analysts to argue that the Europeans were using a variety of protectionist measures to insulate their economies from the efficiency-reducing consequences of high welfare state spending. But during the 1980s and 1990s, processes of “globalization” eroded some of Europe’s key protectionist measures. In theory, as investors within Europe were freed from controls that restricted their ability to send capital abroad and as trade barriers were reduced, those nations with large and expensive welfare commitments would start paying a more visible price for their inefficient choices. Facing floods of imported goods from more dynamic economies and steady outflows of investment capital in search of higher
rates of return, these societies would be forced to reign in welfare spending to increase economic efficiency (Scharpf [1991] was a pioneer in anticipating the strains that globalization would place on European welfare states). However, a series of studies has found that the very large gaps in welfare spending between the United States and Western Europe persisted into the second half of the 1990s (Huber and Stephens 2001; Wilensky 2002). One study designed to test the specific impact of globalization concludes that “the preceding analysis offers little evidence for the conventional view that rises in capital mobility are systematically related to retrenchments, rollbacks and neoliberal structuring of the contemporary welfare state” (Swank 2002, 117). Furthermore, there is little support for the claim that welfare state generosity depresses rates of economic growth (Lindert 2004).

These findings highlight the need for an analysis of welfare state spending that begins not from a state-economy dualism, but from the recognition that state and economy are mutually constituting. In such a view, welfare state spending is not treated simply as a cost that is imposed on the economy, but as a key input into core economic processes (Block 1987a). Recent work in the “varieties of capitalism” literature has begun to fill out this argument. Germany and Sweden are examples of societies that have focused their manufacturing economies on diversified quality production (DQP)—sophisticated products that require high levels of employee skill and commitment. It follows that high levels of welfare state spending for pensions, for unemployment, and for training and retraining programs are a critical ingredient in the labor-management cooperation that is necessary for DQP (Esteven-Abe, Iversen, and Soskice 2001; Hall and Soskice 2001a; Soskice 1999; Streeck 1992, 1997). These cases stand in stark contrast to less generous welfare states, such as the United States and the United Kingdom, where DQP plays a far less important economic role. But even in the less generous welfare states, public provision plays a critical role in the effective functioning of the economy. For example, outlays on public old-age pensions can be understood as a form of productive investment because reducing economic insecurity for the elderly has positive consequences for prime age workers. It simultaneously reduces the economic burden of caring for their aging parents and provides a palpable feeling of security about their own futures. Both of these effects probably help sustain higher levels of cooperation between employees and management (Block 1990, 82–85).

But if welfare states provide key economic inputs, then the welfare state conversation should not be restricted—as it often has been—to the richest developed societies. One would expect to find strong pressures for expanded public provision in developing societies, and this is, in fact, the case. Successful late industrializers such as Taiwan and South Korea have been expanding their welfare states, albeit not always following European or North American models (Aspalter 2001; Tang 2000). And there is a growing debate about how poorer developing nations can do more to stabilize income among the poorest population groups, as it has become more apparent that this income instability is itself an obstacle to development (Lustig 2001). The irony is that the “stabilization” policies imposed on developing nations by the World Bank and the International Monetary Fund are responsible for some of the greatest income shocks experienced by households in the developing world (Lustig 2001). As we will touch on later, this is another important reason why the current structures of global governance are now the subject of fierce contestation.

Explaining Welfare State Development

Moving beyond the dualist analysis of welfare states also requires rethinking the conditions under which welfare states developed. Both critics and defenders of the welfare state often invoke a class power explanation in which welfare state provision is seen as a victory of the organized working-class movement—either directly when carried out by social democratic parties or indirectly, when implemented by parties struggling to contain the influence of working-class movements (Korpi 1983). Telling this history without recognizing the central role of working-class movements would be deeply mistaken (Hicks 1999), but recent work has begun to complicate the story considerably. One complexity is to recognize that while the initiative for welfare state development has usually come from working-class movements or political leaders, business interests—both directly and indirectly—have often played active roles in shaping the particular institutional forms of welfare state provision (Mares 2001; Swenson 1997, 2002). Another complexity is to recognize the ongoing processes of adjustment and adaptation through which successive political administrations modify the design and organization of particular welfare state programs.
Often this works through party alternation; when the party that had been in opposition comes into power, it might repeal some elements of its opponent’s welfare state initiatives and retain others—producing over time a kind of evolutionary selection mechanism (Glyn 2001; Pierson 1996).

Both of these complexities are consistent with placing civil society at the center of the analysis of welfare states. It is not one group—labor—but the array of different groups in civil society—including labor, business, and other interest groups—that has produced varying arrays of public provision in different societies. But it is also in the public sphere that societies make judgments about which welfare state programs are working, which require redesign or repeal, and which are the best ways to finance welfare provision. It is probably through such debates within the public sphere, for example, that most European societies have opted to fund their expensive welfare states in ways that do not place a heavy tax burden on business interests. But it has also been through ongoing consultations among peak organizations of business and labor that business groups have come to understand some of the productive consequences of welfare state programs. Hence, it is within a particular civil society that diverse groups come to perceive their own particular interests. The consequences can be intense social polarization over welfare state spending as well as effective and durable class compromises.

Welfare state institutions are also a paradigmatic case of the dynamic process by which the boundary between civil society and the state is constantly being renegotiated. For example, a common type of unemployment insurance—the Ghent system—that gives responsibility for the administration of funds to trade unions has been an important element in achieving high rates of union density in certain countries (Swenson 2002). More generally, specific welfare state programs often help to construct political constituencies that then serve as major defenders of the same programs in electoral contests. At the same time, welfare state programs—from the earliest public health initiative in Western Europe—can also be seen as part of the process by which states seek to influence and control the behavior of citizens (Foucault 1977; Scott 1998). Most recently, theorists of the “new paternalism” have recycled a very old theme—the desirability of states structuring assistance in ways that would wean recipients away from bad habits such as sexual promiscuity and lack of work discipline (Mead 1986; Block and Somers 2003). In short, virtually every new welfare state program produces new institutional connections between state and civil society.

Recognizing the economic functions of welfare state spending and the embeddedness of welfare regimes within civil societies makes it seem highly unlikely that Western Europe will soon shift to the U.S. model of far more limited welfare state spending. However, it is also a mistake to ignore the significant indicators of stress within contemporary welfare states. Some of these stresses have already been addressed through incremental retrenchment efforts designed to contain costs, particularly for pension programs. In other countries, particularly Germany, strains on the pension system are already serious, and major reforms will be necessary to put the system of old-age pensions on a sustainable basis (Hinrichs 2001; Huber and Stephens, this volume). But beyond these immediate economic pressures, there lie deeper problems. The European welfare states were consolidated in the 1940s, 1950s, and 1960s when the industrial working class was still growing and married women were working primarily in the home at domestic tasks. When these trends were reversed in the decades that followed, the tension between the existing forms of the welfare state and social needs increased (Block 1990; Esping-Andersen 1999). Three of these tensions are particularly important.

First, the “industrial” welfare state started from a basic homogenization of social life; programs were based on the idea that people move through the life course in basically similar patterns. Postindustrial developments, however, tend to produce a pluralization of social life (Offe 1996) with greater unevenness in work careers and increasingly complex patterns of family life. Second, the contraction of industrial jobs combined with obstacles to the growth of the service sector have led to substantially higher unemployment rates in much of Europe and the expansion of marginal and temporary employment. This has created new dangers of a marginalized population—often young—at risk for social exclusion (Esping-Andersen 1999; Rosanvallon 2000). Third, even some of the most advanced European welfare states have been slow to develop the range of services and supports needed to support the movement of women into paid labor. Esping-Andersen (1999) has argued that this neglect has been a factor in declining European birth rates that will ultimately place more strain on welfare state financing.7

These changes have also weakened some of the established normative supports for the welfare state. The pluralization of both work trajectories
and forms of family life has undermined the appeal of universal programs that provide a single set of benefits to all recipients. While some view these strains as indicators of the impending death of the European welfare state, they can also be seen as challenges that will produce a renewal of welfare state policies.

**Possibilities for Institutional Innovation**

While our argument here is necessarily tentative and speculative, we want to suggest that the last years of the twentieth century and the early years of the twenty-first century might ultimately be recognized as beginning a major new epoch in welfare state history. This new epoch is suggested through the emergence of new normative foundations for welfare state spending, the appearance of new policies, and a process of institutional innovation. To be sure, this remains a terrain of struggle; some of the innovations and new ideas have been embraced both by market liberals who are hostile to the welfare state and by theorists and politicians who favor one or another “third way” between market liberalism and social democracy (Giddens 1994, 2000). Hence, the situation continues to be in flux; these innovations could foreshadow a renewal of the welfare state as well as a deeper crisis.

One of the new normative justifications is an emphasis on “social inclusion.” The concept focuses attention on those individuals and households whose lack of access to key resources makes it difficult to function as full members of society. Since a just society must pursue policies to facilitate social inclusion, the key policy issue becomes how to distribute resources to minimize social exclusion. This rhetoric has made inroads even in the United States; in his 2000 presidential campaign, George W. Bush made extensive use of the Children’s Defense Fund’s slogan—“Leave no child behind” to convey his message of “compassionate conservatism.”

Another new normative justification has emerged out of feminist concerns with the “ethic of care” (Tronto 1993). The argument is that the quality of care of dependent populations such as children, the elderly, and the infirm is a crucial social indicator. With the shrinking of the traditional housewife role, societies experience a growing “care deficit” (Hochschild 1997). Since neither the market nor bureaucracies are reliable mechanisms to produce quality care, new arrangements are necessary to reduce this deficit (Jenson and Sineau 2001; Meyer 2000).

These normative arguments are being widely debated, and they have generated new policy initiatives that could prefigure welfare state renewal. On the issue of social exclusion, France has transformed its system of family allowances that had its origins in right-wing and Catholic doctrines. Some of the child allowance funding is now used to finance a guaranteed minimum income program designed to combat social exclusion among the youthful unemployed (Levy 1999). This is part of a more general move toward substituting income-tested benefits that place far less strain on government budgets than universal benefits. Advocates of income-testing programs argue that they can redistribute income without producing the stigma or degradation that was historically associated with means-tested programs. This logic of income testing is further developed in benefit programs that are integrated into the tax systems such as the Earned Income Tax Credit in the United States or the Canadian Old Age Security and Child Tax Benefits (Myles and Pierson 1997). These are variants of the negative income tax where recipients who fall below a certain income level receive a government transfer—a negative tax payment.

Some analysts have followed this idea to its logical conclusion and have argued that the future of the welfare state lies in the provision of an Unconditional Basic Income (UBI) to all citizens (Standing 2002; Suplicy 2002; Van Parijs 1992). By providing everyone with a subsistence income, governments would eliminate the need for a wide variety of specific insurance programs designed to protect individuals and households from such contingencies as unemployment, family dissolution, and disability. While UBI is still extremely controversial, the debates around it have produced new visions of how the welfare state might evolve.

On the care issue, the focus of new policies is on developing debureaucratized forms of service delivery (Block 1987b, 29–33; see also Rothstein 1996) either by creating new and more decentralized public agencies or by using state funds to encourage the expansion of nongovernmental organizations. These latter initiatives are distinct from the privatization schemes advocated by market liberals who want to extract the government from responsibility for providing services. The difference lies in the recognition that continuous government budgetary commitments will be necessary to assure quality care for those with only limited incomes.

One of the most interesting of the initiatives has been the development of the “social economy” in the province of Quebec over the past 15 years.
(Levesque and Ninacs 2000; Mendell 2002; on community development initiatives in the United States, see Simon 2001). This is a broad effort to strengthen economic development through new institutions including social funds that support investment by cooperatives, nonprofits, and small businesses. Most relevant to the current discussion is that activists have mobilized in support of service delivery through employee cooperatives and other nonprofit agencies in a period of intense budgetary pressures on the provincial government. As a result, child care and home health assistance are increasingly being provided through new forms of collaboration between the public sector and networks of newly created employee cooperatives. From these kinds of examples, one can extrapolate a vision of the welfare state based on a new division of labor between government and a revitalized civil society (Castells and Himanen 2002; Unger 1998; Archibugi 2000).

To be sure, in the first years of the twenty-first century, these possible signs of welfare state renewal have not been the main focus of media or scholarly attention. The big story—almost everywhere—continues to focus on the powerful economic pressures to limit welfare state expenditures and a growing public disillusionment with the ability of politics and government to make significant changes. But if our emphases on the productiveness of welfare state spending and the long-term capacity of civil societies to produce institutional innovations are even partly correct, then it is important to take seriously scenarios of welfare state renewal—as unlikely as they may seem in the short term.

Supranational Institutions and Global Governance

In the contemporary “post-Westphalian” world, analysis of the interaction of state and economy can no longer be confined to the level of the nation-state. Nor can the analysis of the associational structures of civil society be confined to the national level. Just as markets must be analyzed at both global and national levels, governance is now embodied in “statelike” institutions, not just at the national (and subnational) levels, but at the supranational level as well. Likewise, the social groups and organizations that make “civil society” a political actor operate transnationally as well as nationally. A multilevel perspective on state and economy complicates the analysis, but contemporary dilemmas cannot be comprehended without such a perspective.

The multilevel dynamics of state and economy play themselves out in different ways in different regions of the world. In the South, global markets and global governance looked like institutional impositions controlled by others long before cross-border ties were described as “globalization.” The states of the North have a different relation to the global political economy. In addition to their economic and political-military power as individual states, they exercise a disproportionate share of control over global governance institutions. The intricate ties binding Northern state apparatuses to the private elites that run global corporations further accentuate the different ways in which North and South confront the multilevel dynamics of the global economy.10

Despite the complexity and variation, the themes that have been central to our analysis of both rich and poor countries reemerge again in a multilevel analysis as useful general lenses of the triangular relation among state, economy, and civil society. It is sometimes argued that national markets are always embedded, but that global markets really are beyond institutional control. But this is a mischaracterization; the emergence of global markets has been fundamentally dependent on the creation of an impressive array of new global governance institutions. Markets do not just “spring up” at the transnational level any more than they did at the national level. They depend on an intricate array of political and legal innovations. To be sure, global governance institutions are even more likely than national ones to be biased and inadequate, and even more difficult to connect to civil society in ways that are effective.

The dilemmas of the Polanyian “double movements” play themselves out most dramatically at the global level (cf. Silver and Arrighi 2003), as do the dynamics of institutional innovation. Possibilities for institutional innovation depend on interaction among local, national, and global levels. The process of construction of new global institutions exemplifies (for better or worse) the process of institutional innovation. In their current form, the most powerful of the global institutions are an increasingly important impediment to institutional innovation at the national level. At the same time, renovated global governance institutions could be a potentially powerful stimulant to institutional innovation at other levels. It is hardly surprising that global governance institutions have become targets of transnational mobilization by such a variety
of civil society groups (Evans 2000; Khagram, Riker, and Sikkink 2002).

Nation-States and Global Governance

A multilevel analysis should still start with the nation-state. Far from being “irrelevant” or “eclipsed,” state institutions at the national level continue to play a key role in the operation of global markets, even as those same institutions are being transformed by the global markets that they helped create. While the global market liberal regime may inadvertently end up fatally weakening the nation-state, this is not its political agenda (cf. Sassen 1998). Constructing markets and securing the property rights of global corporate actors still requires enhancing certain kinds of governance capacity at the national as well as at the global level.

The dependence of global corporations on their home states (Wade 1996) ranges from the most general tasks, like protecting the value of the currencies in which their major assets are held, to concrete mercantilist tasks like extracting legal concessions from other countries in which these corporations invest. The key assets of these corporations are often intangible, which increases their need for state support in securing returns from their property (Arrow 1962). Even a powerful home state apparatus is not likely to suffice; willing and able state apparatuses in those countries where they market their goods are also necessary (Evans 1997a).

Nor is there any logical reason to expect that opening markets to international competition will reduce the necessity for domestic regulation. As his pithy title—Freer Markets, More Rules—indicates, Steven Vogel’s (1996) analysis of the consequences of increased openness in advanced industrial countries suggests the opposite. Vogel shows that the process of increasing the exposure of national industries such as telecommunications and banking to greater international competition actually involves more elaborate rules that ultimately are enforced by national regulatory institutions.

The crucial role of state capacity at the national level is perhaps clearest in the preeminent globalized economic arena—finance. One of the lessons of the Asian financial crisis was how great a danger inadequately regulated domestic financial markets could pose for international investors. Korea, for example, prompted by both the desire to conform to prevailing global norms and the increasingly international orientation of its own local elites, relinquished controls over international financial flows before constructing appropriate mechanisms for regulating national financial markets, with catastrophic results. Analysts of global financial markets, such as Barry Eichengreen (1998, 8), drew the obvious conclusion from the East Asian financial crisis “as in other forms of financial regulation, it is smart to err in the direction of caution—to be absolutely sure that the necessary preconditions are in place before opening the capital account.”

Even if the national regulatory capacities on which the survival of global markets depends are successfully preserved, national capacities to offer social and environmental protections and collective goods such as health and education could still be destroyed. For private elites and, even more, for their political allies managing the apparatus of the nation-state, the supposed power of global markets is the perfect excuse. Confronted with demands for social protection, taxing the returns on capital, or preserving basic workplace rights, politicians and state officials can say, with absolute sincerity, “My hands are tied by global market liberalism.”

It is hardly surprising that contemporary global governance institutions “tie the hands” of national political actors trying to respond to demands for social protection while facilitating the ability of those same national political actors to service the needs of transnational corporate actors. Corporate elites, powerful actors in civil society as well as in markets, were effectively shaping the construction of global governance institutions while other groups, trade unions for example, were still fully occupied by battles at the national level. Yet the current relationship between global governance and civil society should not be taken as foreordained and unchangeable.

Global Governance Institutions

Immediately after World War II, it seemed that the construction of global public institutions would mean an extension of the democratic, social rights state that was being reconstructed in Europe and prevailed in an attenuated form in the United States. The United Nations “system” of international organizations with its initial emphasis on universal human rights was the most conspicuous example, but there was also a significant attempt to incorporate social rights into global economic governance as well.

The Havana Charter, approved in 1948 by 53 nations from both North and South to set up an “International Trade Organization,” captured the prevailing views toward global economic gover-
nance. Rather than simply a device for removing barriers to the flow of goods and capital, the ITO would have had a real governance role. For example, a preparatory paper by eventual Nobel laureate Jan Timbergen made the argument that access to markets should be contingent on effective social protection:

The community of countries adhering to a full-employment policy should have the right to restrict their imports from those other countries that have not followed an adequate employment policy. In order to avoid . . . deliberate nationalist trade restrictions, its supervision should be placed in the hands of an international agency, perhaps the International Trade Organization. (Quoted in Levinson 2002, 22)

While this kind of vision was never represented organizationally in the system of global economic governance, it did become embodied diffusely in the post–World War II international system that Ruggie (1982) called “embedded liberalism,” helping to create the almost 25-year-long “golden age of capitalism.”

The ITO was stillborn primarily because of opposition from the American corporate elite. The surviving institutions of global economic governance were the “Bretton Woods twins”—the World Bank (International Bank for Reconstruction and Development) and the International Monetary Fund. “The Bank” and the “The Fund” were intended in principle to provide collective goods: grants and low-cost loans for public infrastructure and development projects in the case of the Bank and assistance to counterbalance the volatility of global fluctuations in currency values in the case of the Fund. The price of U.S. (and other rich-country) support for this provision of collective goods was, however, a set of thoroughly undemocratic rules for the governance of the two organizations themselves (Evans and Finnemore 2001).

Over time, the roles of the Bank and the Fund have shifted to focus on lending and the enforcement of “conditionality” in the global South rather than reconstruction and exchange rate stability among the countries of the industrialized North. The Fund especially has come to look more and more like an apparatus for protecting the financial assets of Northern creditors and administering the enforcement of their preferred economic policies, rather than providing the countries of the South with insulation from the volatility (and occasional irrationality) of global financial markets. Consequently, the undemocratic character of their governance has become more oppressive. If the Bretton Woods twins have long appeared coercively intrusive from the point of view of the South, the World Trade Organization and multilateral agreements like the WTO and North American Free Trade Agreement are beginning to look the same way in the North. Barenberg and Evans (2002, 28) summarize the impact of NAFTA’s Chapter 11 on U.S. governance as follows:

[T]he substantive rules of the NAFTA model embody to an astonishing degree the “restorationist” program . . . to bring back the pre–New Deal economic constitution under which property holders’ common-law rights are strictly protected against regulation in the name of public welfare—a constitution designed originally to block the advent of the modern regulatory state and, today, to roll back the regulatory state.

The central issue is whether the current focus on market access and global protection of property rights will continue to dominate the agendas of global governance institutions. Even more grimly, the current weaknesses of these institutions raise the specter of a failure of global governance in which volatile global markets generate the kind of chaos and devastation that partially destroyed the global economy in the first half of the twentieth century. But is it possible that the trajectory of governance at the global level could be pushed to replicate the trajectory of governance at the level of the nation-state, as it occurred in the industrialized countries from the nineteenth to the mid–twentieth century, complementing protection of property rights with protection of social rights? In our perspective, the answer depends on the triangular relation connecting states, markets, and civil society, and most importantly on the kind of agency that civil society is able to exercise.

**Countervailing Tendencies**

Given the forcefulness of the current movement back to a nineteenth-century priority on expanding markets and protecting property rights, it would be puzzling if there were no evidence of a Polanyian “double movement” today. While global social movements do not yet have the power and momentum that enabled social movements in nineteenth and twentieth centuries to reshape the character of the state at the national level, they are persistent and proliferating. Likewise, just as the early-nineteenth-century nation-state contained the germ of a more democratic construction of economic policy, so the early-twenty-first-century
institutions of global economic governance contain possibilities for democratic control.

The original elements of post–World War II global governance, however beleaguered they may be, have not evaporated. Hampered by lack of power and resources, the various organizations that comprise the UN system nonetheless continue to serve as organizational focal points for normative change and the organization of transnational civil society. Whether it is facilitating the enthusiasm for environmental change in Rio in 1992, or helping to generate a “normative cascade” (Finnemore and Sikkink 1998) around issues of women’s rights through a series of global women’s conferences, the UN system continues to serve as a catalyst for normative change.

Even with respect to the core organizations of global economic governance, the picture is not quite as bleak as it at first appears. Despite the undemocratic character of the Bank, the Fund, and (in practice) the WTO, they may still be a significant improvement over the traditional “anarchy” of the interstate system, especially as the United States, unconstrained by rival superpowers, slips into a “might makes right” mode of global dominance. For the weak, institutionalization (even biased institutionalization) is generally an improvement over individual confrontations with the strong. For Costa Rica, being able to take its disputes to a WTO arbitration panel, however small its chances of winning, is still likely to be an improvement on having to confront the United States behind closed doors in bilateral negotiations.

This point becomes even more interesting when one examines the internal governance at the Bank, the Fund, and the WTO. The executive board, which is the Fund’s working governance body, usually makes decisions by consensus, and consensus must include the 11 (out of 24) executive directors who represent the countries of the South. So far the South has been unable to muster the political will to overcome the obviously formidable collective action problems necessary to take advantage of this structure, but the possibility remains. At the same time, the Bank has shown itself vulnerable to pressure from NGOs and social movements, shifting its positions on environmental issues and the importance of building in “participation” of those who are affected by projects (see Fox and Brown 1998; Keck and Sikkink 1998; Narayan 1994). In the WTO, the formal rules give each member state an equal vote. The fact that decisions are made in practice by “consensus” allows an informal oligarchy of rich countries (led by the United States) to shape agendas and outcomes, but the countries of the South have occasionally managed to overcome their daunting collective action problems to block the rich country oligarchy or force compromise (e.g., in the selection of the current director-general, in Seattle in 1999, and in Doha in 2001).

These possibilities for “democratization” should not be exaggerated. They would lead, at best, toward a “Westphalian democracy,” empowering the representatives of national elites, not communities or individuals. To move beyond Westphalian democracy, a broader range of actors must gain access to global governance institutions. But this is precisely what a broad segment of the multistranded, transnational “global justice movement” is trying to do (cf. Khagram, Riker, and Sikkink 2002). Creative new organizational forms like ATTAC (Association for the Taxation of Financial Transactions for the Aid of Citizens) (see Ancelovici 2002) have helped redefine the relationship between “civil society” and “globalization.” Old organizational forms like trade unions are trying to reinvent themselves as transnational alliances (Anner 2002). Groups whose interests in redefining the way the economy works grow out of the efforts to overturn “micro” level injustices find themselves embedded in transnational networks (Keck and Sikkink 1998; Thayer 2000).

The basic challenge facing the current “multilevel” system of economic governance can be simply restated. Can it succeed in delivering globally what the nation-state succeeded in delivering in the industrial North during the mid-twentieth-century “golden age of capitalism,” namely complementing property rights with a wide range of social rights, thereby combining economic growth with general improvements in welfare? Success will depend on a complementary combination of astute exploitation of the opportunities for “Westphalian” democratization already contained within existing global institutions and effective political action on the part of oppositional social movements at both global and national levels. Most of all, success will depend on multiple forms of institutional innovation: reconstructing existing global governance institutions, inventing new organizational vehicles for transnational mobilization, and finding better ways to stimulate “norm cascades.”

**Conclusion**

State and economy are not analytically separable spheres that can function autonomously from each
other. Consequently, centering debate around the question, “Which is better, more state or more market?” is a theoretically sterile approach. We gain both analytic leverage and the capacity to conceptualize effective politics and policies by reframing the discussion around the insight that institutional structures are required both to contain and to expand markets and that these structures are built through the interaction of state and civil society.

Our approach began with the insight that market economies, even the most ideologically laissez-faire market economies, remain always embedded in civil society, a concrete set of social relationships, cultural understandings, and institutional and organizational forms that shape the possibilities for economic action. Civil society is structured by state institutions, including legal rules and the organizational practices of government, but civil societies also shape state action and state structures. We then traced the triangular relationship among state, economy, and civil society in three very different contexts: the developing and transitional societies of the global South, the welfare states of the rich countries of the global North, and the multilevel relationships that constitute the contemporary global political economy. In each of these contexts, moving beyond the question of “more state or more market” has helped us to clarify the insights of recent scholarship and shed light on central policy debates.

The current literature on developing and transitional countries shows that trying to generate sustained growth on the basis of externally imposed systems of economic incentives produces disappointing results. At the same time, “more state” is no panacea. Development has always required active involvement of the state, but the states have also been deeply implicated in decay and stagnation. Success depends, not on finding some magical balance between market and state, but on constructing institutions that enable the productive interaction of state structures, market actors, and civil society. Developmental “success stories” in different regions and time periods have been built on institutional innovations that reconstruct relations between state and civil society. From Gerschenkron’s analysis of nineteenth-century European latecomers to twenty-first-century hybrids like China and Vietnam, successful innovations embed market rules in civil society and deploy the legal and organizational capacities of the state in ways that build the potential for economic and social transformation.

This perspective has implications for two key substantive debates over development strategy. First, it suggests that seeing the divide in development strategies in terms of “accumulation versus social protection” is as misguided as seeing it as “states versus markets.” A single-minded focus on what are supposedly “accumulation-oriented” policies will be self-defeating if it undermines the way in which markets are embedded in civil society or the ability of the state to supply the legal and institutional framework that both markets and civil society require. Indeed, this was the problem in dramatic neoliberal failures like Russia and Argentina. Despite being seen by the citizenry as “legitimate” in the sense of being the only “reasonable” alternative, even as they move to the brink of failure, market liberal strategies still do not work because the ability of markets to produce development is intrinsically dependent on being connected to civil society and state structures.

Second, this perspective makes it possible to reframe the “democracy and capitalist development” debate. Older views in which democracy (even defined narrowly as the selection of political elites) is suspected of “antiaccumulation” populist pandering are too jaundiced. A more indeterminate view, such as that offered by Przeworski and his collaborators (2000), fits better. To be sure, democratic politics may fail to facilitate interaction between states and civil society consistent with effective markets, and authoritarian regimes may sometimes succeed in developing systematic, economically effective, ties to civil society. Nonetheless, democratic institutions that enable civil society to connect effectively to the administrative apparatus of the state are more likely to produce development than arbitrary rule by elites with highly selective and idiosyncratic connections to the rest of society. The economic impact of political regimes must be judged by the ways in which they mold the structure of the triangular relationship among state, economy, and civil society.

When our analysis turns from developing and transitional countries to the rich, Northern welfare states at the other pole of the contemporary global political economy, the analytical lessons are surprisingly parallel. Once again, “how much state versus how much market” is not the question. Likewise, it is a mistake to frame the debate in terms of “trade-offs” between welfare provision and economic growth. The claim that the development of welfare institutions necessarily undercuts growth lacks empirical support. On the other hand, the necessity for institutional innovations to sustain both growth and welfare outcomes is as clear in rich countries as in poor ones.
Our review of the literature suggests that welfare spending must be recognized as a key input into the effective functioning of national economies, and that conflicts and debates within civil societies—including the mobilization of labor and business—play a central role in adjusting and readjusting the ways that welfare state programs are financed and organized. We also recognize that in the current period, the European welfare states are undergoing increasing strain both as a result of budgetary pressures and a mismatch between some of the historic beneficiaries of welfare spending and current social needs. But rather than imagine large-scale welfare state retrenchment and convergence on the Anglo-American model of much less generous welfare spending, we suggested a number of indicators of potential reconstruction of advanced welfare states. One direction for this reconstruction would build on the Quebecois “social economy” with public sector subsidies for the provision of “caring” services through employee cooperatives nurtured and supported within civil society.

Examining the multilevel complexities of the global political economy further vindicates our emphasis on analyzing states and economies as mutually constitutive. The past 60 years have witnessed the construction of state-like governance institutions aimed at trying to manage an increasingly integrated global economy. Here, as well, we have seen that both efforts to expand the scope of markets globally and initiatives to place limits and restraints on global market forces require the construction of global institutions. Not surprisingly, the specific forms in which supranational governance is embodied are the target of increasing mobilization within an emergent global civil society that extends from the corporate citadels of the World Economic Forum to the popular insurgencies of the World Social Forum.

Looking at the supranational level makes it clear that institutional innovations at different levels are interdependent in a variety of ways. Arguments that globalization has eclipsed the nation-state notwithstanding, national politics, and especially the politics of the world’s only remaining superpower, are a powerful impediment to institutional innovations at the global level. Just as in national societies, the exertion of raw political power can produce political stalemates that prevent institutional renovation at the global level. At the same time, the relationship between global and national political institutions is partially symbiotic. Global governance institutions depend on the complementary capacities of national governments, and a host of global organizations, public and private, have sprung up to aid the regulatory efforts of nation-states. What is worrisome, however, is that the “rules of the game” currently enforced by global governance institutions can represent a powerful constraint against institutional innovations at the national level, with a particularly powerful impact on the poor countries of the South, as in the case of what we have called “institutional monocropping.”

Interdependencies among different levels of governance imply potential for a virtuous cycle of multilevel institutional innovation as well. Changes in global governance could open up space for institutional innovations at the national level that could accelerate development in poor countries and encourage new welfare state initiatives in rich ones. Innovations at the national level that deepen democracy and economic vitality would, in turn, expand the local roots of transnational constituencies working toward further institutional renewal at the global level, allowing the cycle to repeat itself.

Virtuous circles of institutional innovation are possibilities, not predictions. Nonetheless, for the first time in human history, the basic institutional arrangements that govern global society are the subject of debates that include participants from every corner of the globe and every social status. The existence of this debate is, in itself, a source of hope that the future will hold more fruitful forms for the triangular linkage of state, economy, and civil society.

Notes

We would like to thank the editors, Antonio Barros de Castro, and Frank Dobbin for their comments on an earlier draft and Sarah Staveteig for her impeccable research assistance. The order of the authors’ names is alphabetical.

1. This essay builds on and seeks to go beyond the analysis in Fred Block, “The Roles of the State in the Economy,” that appeared in the first edition of The Handbook of Economic Sociology. Readers are directed to that discussion for a more extensive critique of conventional perspectives on the state and the economy.

2. Even in economics, some recent work on the role of the state in defining property rights has become more respectful toward the state’s economic functions. See, particularly, Barzel 2002.

3. In developing this argument, we have been influenced by the formulations of Burawoy 2003. We are also following Zukin and DiMaggio (1990) in conceptualizing embeddedness as having multiple dimensions—it is simultaneously social, legal, political, and cognitive. See also Krippner 2001 for a valuable critique of the use of the embeddedness concept.

4. Most regulatory initiatives simultaneously eliminate some market opportunities and create new ones. For exam-
ple, social insurance schemes simultaneously reduce the labor market participation by those eligible for assistance—what Esping-Andersen (1990) has termed “decommodification” of labor, but they simultaneously create marketing opportunities for those who can now sell more to those with benefit income.

5. This section draws substantially on Evans 2001.

6. The contrast between the agonies of Russia and transitional success stories in Hungary, Poland, and the Czech Republic reinforces the proposition that locally constructed hybridity produces better results than institutional monocropping (cf. Stark and Bruszt 1998).

7. The strains come from smaller cohorts entering the workforce needed to finance the retirement of larger cohorts. These strains could be offset by higher rates of immigration, but increased immigration creates other political tensions.

8. For a contrasting argument for the existence of a new epoch, see Rosanvallon 2000.

9. As the U.S. example suggests, increased discussion of social inclusion hardly means that problems of social exclusion are being effectively ameliorated.

10. Even among the different regions of the North the dynamics are different. As Fligstein and Mérand (2002) note, supranational governance and transnational markets look more like “Europeanization” than “globalization” when viewed from Europe.

11. E.g., ideas or images, whether logical structures of bits like Windows or the formula for Coca-Cola, or cultural representations like Mickey Mouse and “Air” Jordan.

REFERENCES


From Keynesianism to Neoliberalism: Shifting Paradigms in Economics

By Thomas I. Palley

April 2004


The intellectual foundations of neoliberalism

“(T)he ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slave of some defunct economist.”


For the last 25 years, economic policy and the public’s thinking have been dominated by a conservative economic philosophy known as neoliberalism. The reference to “liberalism” reflects an intellectual lineage that connects with 19th century economic liberalism associated with Manchester, England. The Manchester system was predicated upon laissez-faire economics and was closely associated with free trade and the repeal of England’s Corn Law, which restricted importation of wheat. Contemporary neoliberalism is principally associated with the Chicago School of Economics, which emphasizes the efficiency of market competition, the role of individuals in determining economic outcomes, and distortions associated with government intervention and regulation of markets.1

Two critical tenets of neoliberalism are its theory of income distribution and its theory of aggregate employment determination. With regard to income distribution, neoliberalism asserts that factors of production--labor and capital--get paid what they are worth. This is accomplished through the supply and demand process, whereby payment depends on a factor’s relative scarcity (supply) and its productivity, which affects demand. With regard to aggregate employment determination, neoliberalism asserts that free markets will not let valuable factors of production--including labor--go to waste. Instead, prices will adjust to ensure that demand is forthcoming and that all factors are employed. This assertion is at the foundation of Chicago School monetarism, which claims that economies automatically self-adjust to full employment and that the use of monetary and fiscal policy to permanently raise employment merely generates inflation.2

1 Key figures in the Chicago School are Milton Friedman, George Stigler, Ronald Coase and Gary Becker--all of whom have been awarded the Nobel Prize in economics.

2 Monetary policy is conducted by central banks, who manage interest rates to affect the level of economic activity. Fiscal policy refers to government management of spending and taxation to affect economic activity.
These two theories have been extraordinarily influential, and they contrast with the thinking that held sway in the period between 1945 and 1980. During this earlier era, the dominant theory of employment determination was Keynesianism, which maintains that the level of economic activity is determined by the level of aggregate demand. Additionally, Keynesians maintain that capitalist economies are subject to periodic weakness in the aggregate demand generation process, resulting in unemployment. Occasionally, this weakness can be severe and produce economic depressions—as exemplified by the Great Depression. In such a world, monetary and fiscal policy can stabilize the demand generation process.

With regard to income distribution, Keynesians have always been divided, and this created a fatal breach that facilitated the triumph of neoliberalism. American Keynesians (known as neo-Keynesians) tend to accept the neoliberal “paid what you are worth” theory of income distribution, while European Keynesians (widely associated with Cambridge, U.K., and known as post-Keynesians) reject it. Instead, post-Keynesians argue that income distribution depends significantly on institutional factors. Thus, not only do a factor’s relative scarcity and productivity matter, but so too does its bargaining power, which is impacted by institutional arrangements. This explains the significance of trade unions, laws governing minimum wages, employee rights at work, and systems of social protection such as unemployment insurance. Finally, public understandings of the economy also matter, since a public that views the economy through a bargaining power lens will have greater political sympathies for trade unions and institutions of social protection.

The great reversal: the decline of Keynesianism and the rise of neoliberalism

For the 25 years after World War II (1945-1970), Keynesianism constituted the dominant paradigm for understanding the determination of economic activity. This was the era in which modern tools of monetary policy (control of interest rates) and fiscal policy (control of government spending and taxes) were developed. It was also a period in which union coverage rose to historical highs and “New Deal” style institutions of social protection and regulation were expanded.

However, in the mid-1970s the Keynesian impulse went into reverse, to be replaced by neoliberalism. This reversal piggybacked on the social and economic dislocations associated with the Vietnam War era and the OPEC oil price shocks, which dominated the 1970s. However, these dislocations only provided an entry point. The ultimate spark of neoliberal dynamism is to be found in the intellectual divisions of Keynesianism and its failure to develop public understandings of the economy that could compete with the neoliberal rhetoric of “free markets.”

Throughout the period of Keynesian dominance, there remained deep conservative opposition within the United States, providing a base from which to launch a neoliberal assault. This opposition had been present during the New Deal period, as manifested in conservative resistance to the creation of the Social Security retirement

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3 Aggregate demand is the total level of demand for goods and services in an economy. Keynesians believe that firms produce on the basis of their expectations of the level of aggregate demand and that the level of aggregate demand thus determines the overall level of economic activity.
income system. And the antagonism continued after World War II, as illustrated by the conservative-sponsored Taft-Hartley Act (1947), which sowed the seeds that eventually eviscerated the rights of American workers to form unions by undermining union power and the ability to organize.

The appeal of neoliberalism was also enhanced by economic and cultural factors. At the economic level, the success of New Deal Keynesianism may have contributed to its own undoing. Rising prosperity, built upon Keynesian policies and the postwar social contract between business and labor, may have engendered beliefs that the core economic problems of income distribution and mass unemployment had finally been solved. As a result, U.S. citizens may gradually have come to view as dispensable the very policies and institutions--such as unions--that had brought about their now-presupposed prosperity.

At the cultural level, America has always celebrated radical individualism, as epitomized in the frontiersman image. This radical individualism was further promoted by the ideological conflict embedded in the Cold War, which fostered antipathy to notions of collective economic action and denial of the limitations of market capitalism. In particular, collective economic action was tarred by identification with the communist approach to economic management. The Cold War, therefore, provided fertile ground for popularizing an economic rhetoric that spoke of “natural” free markets independent of governments and in which government regulation reduces well-being.4

Yet, as important as political and cultural factors were in explaining the appeal of neoliberalism, Keynesianism also suffered from internal intellectual divisions that made for weakness. One source of division was the theory of income distribution. Keynes was a believer in the marginal product theory of income distribution, whereby workers get paid what they are worth to the company. This gives little justification for trade unions and other forms of labor market intervention, all of which can be painted as market distortions rather than corrections of market failure associated with unequal bargaining power. In effect, whereas Keynesians contributed greatly to understanding the factors of aggregate demand and its role in determining employment outcomes, they developed no matching analysis of production conditions and their interactions with and impacts on aggregate demand.5

A second Keynesian weakness was the belief that downward price and (especially) nominal wage rigidity were responsible for unemployment. This position emerged in the 1940s, a decade after the publication of Keynes’ 1936 book, “The General Theory of Employment, Interest and Money.” The argument was that lower nominal wages would lower prices, thereby increasing the real value of money holdings, which in turn would stimulate consumption spending and aggregate demand. In addition, lower prices would increase the real money supply, thereby lowering interest rates and stimulating investment spending. In this fashion, lower nominal wages and prices could solve the problem of unemployment.

This neo-Keynesian view of price and wage flexibility was adopted especially strongly by American economists. In effect, it stated that economic rigidities were responsible for unemployment and that these rigidities included such factors as trade

4 See Palley, Plenty of Nothing, pp.31-38.
5 This theme is developed in Palley, Plenty of Nothing.
unions and minimum wage laws. In a sense, the American neo-Keynesian position was implicitly a forerunner of today’s neoliberal labor market flexibility agenda. This neo-Keynesian view contrasts sharply with post-Keynesian analysis, which holds that unemployment results from demand shortages caused by weak business confidence and uncertainty about the future. In a monetary economy, spending can dry up if people decide to hold onto money, and price flexibility can make the demand problem worse on account of debt. Thus, lower prices and nominal wages increase the interest payment burden of debtors, causing them to cut back on spending and possibly to default. The post-Keynesian bottom line is that money-based contracting yields great economic efficiency by lowering transacting costs, but it also makes economic adjustment through price and nominal wage flexibility highly problematic.

The divergent theories regarding the determination of income distribution and the role of downward nominal wage rigidity in creating unemployment created deep internal divisions among Keynesians. At the policy level, this rift opened the way for neoliberals to characterize the labor market innovations of the New Deal as market distortions rather than corrections of market failure. As such, these innovations lacked an economic efficiency rationale and could only be justified for reasons of equity.

Additionally, the theoretical divisions opened the way for an attack on Keynesian full-employment monetary and fiscal policies. American neo-Keynesians supported such policies on the pragmatic grounds that prices and wages were downwardly rigid in practice; for this reason they endorsed government policy interventions. Thus, it was not the theoretical benefits of flexibility that neo-Keynesians contested but rather the empirical possibility of price and nominal wage flexibility. Intellectually, this was a bastardization of Keynes’ message, and it provided a public policy opening for neoliberal economists to argue that economic policy should abandon targeting full employment and instead make wage flexibility a reality.

Neoliberal policy in practice

As noted above, neoliberalism can be understood in terms of its theories of income distribution and employment determination. According to the former, the market ensures that factors of production are paid what they are worth, obviating the need for institutions of social protection and trade unions. Indeed, institutions of social protection can lower social well-being and cause unemployment by interfering with the market process.

Regarding the work force, neoliberals insist that price adjustment ensures an automatic tendency toward full employment. Within this framework, policy interventions to increase employment either cause inflation or raise unemployment by destabilizing the market process. This was Milton Friedman’s claim regarding the Great Depression, which he argued was caused by mistaken monetary tightening by the Federal Reserve. The relevant implication is that macroeconomic policy-makers should discard Keynesian prescriptions of activist demand management aimed at full employment. Instead, they

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6 For a formal analysis of the destabilizing possibilities of price and nominal wage reduction see Palley, *Post Keynesian Economics*, Chapter 4.
should adopt transparent rules that take the discretion out of policy decisions, thereby avoiding mistakes and letting market forces solve the problem.\textsuperscript{7}

In practice, the application of neoliberal policy in the United States has often seen a slip between the cup and the lip— that is, pragmatism has forced neoliberal policy-makers to depart from theory. Regarding income distribution, neoliberal policy has consistently sought to promote the cause of labor market deregulation. This has taken the form of allowing the real value of the minimum wage to fall, undermining unions, and generally creating a labor market climate of employment insecurity. In this, neoliberal policy has been true to its theory, which maintains that employment protections and wage rigidities are not needed. The result has been widening wage and income inequality.\textsuperscript{8} For neoliberals, this is because the market is now paying people what they are worth; for post-Keynesians, it is because the balance of power in labor markets has tilted in favor of business.

With regard to macroeconomic policy, neoliberalism has been applied inconsistently and opportunistically and has departed from its theoretical rhetoric. In the early 1980s, neoliberal policy-makers sought to apply Chicago School monetarist prescriptions that abandoned Keynesian interest-rate fine tuning in favor of money supply targeting. The result was massive layoffs in developed countries, pushing unemployment rates to their highest levels since the Great Depression, precipitating a sharp rise in global real interest rates, and inducing significant financial market volatility. This, in turn, forced an abandonment of the monetarist experiment and a return to interest-rate based policy.

Despite this return to the use of interest rate targeting and activist Keynesian stabilization, the policy goal was changed. The concept of full employment was replaced with the notion of a “natural rate of unemployment.”\textsuperscript{9} This natural rate is unobservable and is supposedly determined by the forces of demand and supply in labor markets. The adoption of natural rate rhetoric has served two purposes. First, it has provided political cover for higher average rates of unemployment, which have undermined the bargaining position of workers. Second, it has offered a rationale for keeping real interest rates at a higher level, benefiting wealthy individuals and the financial sector. Thus, even though interest rates have been adjusted countercyclically to mitigate the business cycle, they have remained higher than average. Likewise, fiscal policy has also been adjusted countercyclically to rectify the business cycle, but it too has been used to favor elites and

\textsuperscript{7} Friedman’s rules-based policy argument has been supplemented by a second-generation Chicago School political economy theory contending that politicians are motivated by self-interest and actively engage in deceiving the public and working against its interests. According to second-generation Chicago School economists, the remedy for this situation is independent policy institutions free of political control. The problem with this remedy is that removing political accountability does not remove the self-interest of those who remain in control (Palley, The Institutionalization of Deflationary Policy Bias).

\textsuperscript{8} Mishel, et al., The State of Working America; Palley, Plenty of Nothing.

\textsuperscript{9} This concept is also known as the “non-accelerating inflation rate of unemployment” and is supposed to be an unemployment rate at which inflation shows no tendency to accelerate or decelerate.
special political interests. This is most clearly evident in tax cuts targeted toward upper-income groups.

The neoliberal cooption of stabilization policy raises two issues. First, whereas stabilization policy is the correct response, neoliberal policy-makers have employed it in a suboptimal manner, as illustrated by recent U.S. tax policy. The Bush administration used the 2001 recession opportunistically to cut taxes, but these tax cuts were directed predominantly toward wealthy individuals, thereby yielding less economic bang per buck, and were structured to be permanent, though fighting recession called only for temporary tax cuts. Second, the need for recourse to stabilization policy speaks to the inadequacy of the neoliberal theoretical account of the economy. After all, according to the neoliberal model, market economies are supposed to automatically and rapidly self-adjust to full employment.

Putting the pieces together, the challenge confronting post-Keynesians is to advance the debate at two levels. First, there is a need to challenge the particulars of neoliberal stabilization policy, which has been suboptimal. Second, there is a need to challenge the underlying neoliberal conceptual framework. This twin task is difficult, since debating policy particulars risks a public perception of mere differences of degree rather than fundamental clashes in economic conception.

**The economic record under neoliberalism**

The elections of Margaret Thatcher in 1979 and Ronald Reagan in 1980 can be viewed as inaugurating the formal period of neoliberal economic policy dominance. The last quarter century has seen an expanding application of neoliberal ideas within both industrialized and developing-country economies. Compared to the 1945–80 era, this recent period has seen substantially slower economic growth and widening income inequality, both within and between countries.¹⁰

Within industrialized countries, the economic agenda has been dominated by policies associated with the “U.S. model.” These include deregulation of financial markets, privatization, weakening of institutions of social protection, weakening of labor unions and labor market protections, shrinking of government, cutting of top tax rates, opening of international goods and capital markets, and abandonment of full employment goals, all under the guise of the natural rate. International economic policy has been dominated by the “Washington Consensus,” which advocates privatization, free trade, export-led growth, financial capital mobility, deregulated labor markets, and policies of macroeconomic austerity.

The failure of the Washington Consensus to deliver faster growth in developing countries--it has actually delivered slower growth--has contributed to a backlash that has significantly discredited it. There is now widespread recognition that: international financial markets can be prone to instability, export-led growth is not sufficient for domestic development and can promote global deflation and a “race to the bottom,” democracy and institutions promoting social inclusiveness are needed for development, and labor market protections are needed to prevent exploitation. However, though much progress has been made in countering the Washington Consensus, little progress has been

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made in combating the “U.S. model.” This poses a danger, since the U.S. model is the 
source of neoliberal policy, including the Washington Consensus.

Within public debate, the United States is presented as a model economy and 
contrasted with European economies, which are labeled as sclerotic and inflexible. 
However, the facts are more complex and indicate that both models have strengths and 
weaknesses. The strengths of the U.S. neoliberal model are a lower average rate of 
unemployment, a higher employment-to-population ratio, and faster output growth (in 
part, driven by population growth caused by legal and illegal immigration). Its 
weaknesses relative to the European model are higher and worsened income inequality 
(exemplified by the explosion of CEO pay in the United States), higher poverty rates, 
lower productivity growth (until the mid-1990s), longer working hours, and wage 
stagnation for those in the bottom half of the wage distribution. Research by 
Blanchflower and Oswald into the economics of happiness shows that happiness in the 
United States has been trending down, while happiness in the United Kingdom has not 
changed. Of all the world’s markets, these two economies have pursued the neoliberal 
path most aggressively, but it has not translated into more happiness for their citizens.

The differences between U.S. and European economic outcomes can be 
understood using Figure 1.11 Macroeconomic policy determines the overall rate of 
unemployment, while microeconomic policies concerning labor market and social 
protection institutions determine patterns of income inequality. Expansionary macro 
policy lowers unemployment, while contractionary macro policy increases 
unemployment. Eroding institutions of social protection increases income inequality, 
while maintaining protections holds income inequality constant. A pure neoliberal policy 
configuration would aim at eroding protections, since these are a form of market 
distortion, and would abandon full-employment countercyclical policy as unnecessary.

In practice, policy has not been applied as pure neoliberal theory would suggest. 
The United States has pursued a path of expansionary macro policy built on large budget 
deficits, countercyclical interest rates, and the erosion of social protections. The result has 
been relatively full employment and worsening income distribution. Contrastingly, 
Europe has pursued contractionary macro policies centered on high interest rates and 
fiscal austerity while maintaining its institutions of social protection. The result has been 
high unemployment and only modest progress in alleviating income inequality.

Finally, Figure 1 can also be used to understand the policy configuration 
recommended by a post-Keynesian perspective. At the microeconomic level, there is a 
need for institutions of social and labor market protection to ensure an appropriate 
distribution of income. At the macroeconomic level, policy should have an expansionary 
tilt in order to ensure full employment. This policy configuration fits with the underlying 
Keynesian theoretical framework, which holds that income distribution is significantly 
impacted by social and institutional forces and that full employment requires 
management of the level of aggregate demand. The challenge is to ensure that institutions 
of social protection are designed such that markets retain the appropriate incentives for 
the provision of labor effort and entrepreneurship, while corporations have an adequate 
level of flexibility. Precisely calibrated, macroeconomic policy must provide adequate 
aggregate demand but not so much that it generates unacceptably high inflation.

11 The analysis here is drawn from Palley, Restoring Prosperity.
The above analysis, in terms of macro-micro policy, also yields important political lessons. Both the U.S. and European models are flawed in important ways. Yet, politically, the U.S. model—with its lower rate of unemployment—has been hard to dent, while the European model has been under pressure to weaken its institutions of labor-market and social protection. This suggests that low-unemployment concerns trump fairer income-distribution desires among electorates. Such a conclusion is supported by the research on the economics of happiness, which reports that unemployment carries a very high unhappiness cost. People are concerned with fairness, but that goal is not strong enough to be politically decisive. This prioritizing means that a successful economic model must address the problem of unemployment, and it explains why the European social model is being sabotaged by the continent’s macroeconomic policies.

Reinventing government in economic discourse

In addition to reconfiguring the macro-micro policy mix, there is also a need to reconfigure public understanding of the economic role of government. The traditional liberal explanation for government economic involvement has focused on “market failure” related to problems of monopoly, natural monopoly, public goods and externalities. The basic idea is that market failure leads to suboptimal provision (there may be too little or too much production), calling for government intervention—through regulation, taxes and subsidies, or outright government control of production—to remedy the problem.

The concept of market failure has proved extremely powerful, but it has in turn generated a neoliberal counterargument framed in terms of government failure. The claim is that, though markets may fail, having government remedy market failures may be even worse, owing to bureaucratic inefficiencies and lack of market-styled incentives.

The government failure argument has had great resonance in the United States, given the culture of radical individualism. However, the role of government in a market economy runs far deeper, and its contribution is inadequately understood. Government not only plays a critical role in remedying market failure, it also provides essential services related to education and health. In addition, government is pivotal in stabilizing the business cycle through fiscal and monetary policy. Deeper yet, government is integral to the workings of private markets through its provision of a legal system that supports the use of contracts. Absent the ability to contract, the benefits of a market economy would be enormously diminished.

Particularly poorly understood is the role of government in preventing destructive competition, in which market incentives lure agents to engage in actions that generate a suboptimal equilibrium, but the market is unable to generate counterincentives that restore a socially optimal equilibrium. This type of situation is illustrated by the bribery

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12 Monopoly may result from private actions or from the nature of technology. In both cases it precludes the benefits of competition. Public goods refer to such activities as provision of defense and street lighting. Markets underprovide public goods because private producers cannot prevent agents from freely consuming the good. Externalities refer to actions of one agent that impact the well-being of others. The costs and benefits of these impacts are not taken into account by individuals when deciding on their actions, resulting in suboptimal outcomes.
problem. Bribery is economically destructive, because it allocates business on the basis of bribe-paying rather than economic efficiency. For this reason, societies should aim to avoid bribery. However, unregulated markets tend to produce bribery. If one agent bribes while others do not, that agent thrives while others suffer. As a result, all agents have an incentive to bribe. Left to itself, the market therefore generates a “bad” equilibrium in which all agents pay bribes. The “good” equilibrium in which none pay bribes can only be induced and maintained by laws imposing penalties that deter bribery. This illustrates how government action may be needed to support optimally efficient outcomes. The real world is afflicted by situations generating destructive competition--examples include bribery, excessive advertising expenditures, tax competition between jurisdictions to attract business investment, and the global race to the bottom, in which countries ratchet down labor standards to attract business. Remedies for all of these situations require government intervention.

**Post-Keynesianism versus the Third Way: similarities and differences**

In closing, it is worth comparing the above post-Keynesian construction with the Third Way approach of U.K. Prime Minister Tony Blair. The Third Way is an alternative attempt to topple neoliberal domination of public policy. It seeks to articulate a humane path between the first way of laissez-faire capitalism and the second way of centrally planned state economies. In this, it has some resonance with the mixed economy approach of the 1960s, which argued for a combination of privately owned and nationalized industries.

However, though the Third Way seeks to humanize the market, it is fundamentally different from a post-Keynesian perspective, because it basically accepts the major theoretical tenets of neoliberalism regarding income distribution and the stability of capitalist economies. Viewed in this light, the Third Way represents an updating of the earlier market failure approach, and it also aims to counter the neoliberal government failure argument. Thus, the Third Way emphasizes how market failure can result from imperfect information. This imperfect information argument is a variation of market failure that has gained theoretical recognition over the last 20 years. Rather than prescribing that government take over production through nationalized industries and risk government failure, the Third Way emphasizes taxation and regulation as the preferred means of changing private sector behavior. Similarly, regarding provision of essential services such as health and education—which markets underprovide—the Third Way is comfortable having government contract with the private sector for their procurement.

Although these Third Way innovations are in principle consistent with the post-Keynesian approach, unlike the Third Way, post-Keynesianism rejects both the neoliberal approach to income distribution and its claims of an automatic tendency to full employment. Post-Keynesians contend that labor is not automatically paid what it is worth by an anonymous neutral market process. Rather, the pattern of income distribution is impacted by labor market institutions, and institutional interventions are needed, because markets have a tendency to favor capital over labor. Furthermore, capitalist economies are subject to fluctuations in aggregate demand, which give rise to

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13 Arestis and Sawyer (2001) provide a survey of the economics of the Third Way, as applied around the world by governments that have adhered to this path.
unnecessary unemployment. Downward price and wage flexibility cannot resolve this problem; in fact, they often aggravate it. This calls for monetary and fiscal policy interventions to correct the problem of deficient demand, and institutions that prevent generalized declines in prices and nominal wages are highly desirable to avoid debt deflations. These analytical differences fundamentally differentiate post-Keynesianism from the Third Way, and they explain the policy disagreements that delineate old from new Laborites in the United Kingdom and old from new Democrats in the United States.

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THE NEW POLITICS OF THE WELFARE STATE

By PAUL PIERSON*

THE much-discussed crisis of the welfare state is now two decades old. The tremendous twentieth-century expansion of social programs has been a remarkable feature of advanced industrial societies. In all these countries the welfare state is a core institution, accounting for between one-fifth and one-third of GNP. Ever since the postwar economic boom ended in the early 1970s, however, social programs have faced mounting political challenges. Questions of expansion have long since given way to an acknowledgment of the limits to welfare state growth and the prospect for extended austerity. Despite this fundamental change, however, we still know stunningly little about the politics of social policy retrenchment. In contrast to our vast knowledge of the dynamics of welfare state expansion—arguably the most well-tilled subfield of comparative public policy—welfare state retrenchment remains largely uncharted terrain.¹ Theoretically informed discussion has been limited to very abstract commentaries or the rather reflexive, often implicit application of propositions derived from the study of social policy expansion.

This puzzling state of affairs results in part from the very success of earlier scholarship. The quality of historical research on the welfare state has encouraged a simple process of borrowing already developed models for the examination of a new environment. I would argue, however, that there are compelling reasons to reject such a straightforward extrapolation, that the new politics of the welfare state is instead quite different from the old. Welfare state expansion involved the enactment of popular policies in a relatively undeveloped interest-group environment. By contrast, welfare state retrenchment generally requires elected

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officials to pursue unpopular policies that must withstand the scrutiny of both voters and well-entrenched networks of interest groups. It is therefore not surprising that variables crucial to understanding the former process are of limited use for analyzing the latter one.

This essay seeks to lay the foundations for an analysis of welfare state retrenchment. I emphasize the critical constraints on reform resulting from the role of supportive interest groups and, ultimately, voters. The growth of the welfare state itself transforms the politics of social policy. As a result, the welfare state has proved to be far more resilient than other key components of national political economies and far more durable than existing theories of the welfare state would lead one to expect. The argument is presented in four stages. Section I highlights the characteristic qualities of retrenchment politics. Section II discusses in more detail the principal theories of welfare state expansion and suggests why the distinctiveness of retrenchment makes a straightforward application of these arguments to the contemporary welfare state problematic. Section III explores the dynamics of retrenchment in four cases: Great Britain, the United States, Germany, and Sweden. Section IV builds on this theoretical and empirical analysis to offer some basic propositions about retrenchment politics.

I. Why the Politics of Retrenchment Is Different

This essay's central claim is that because retrenchment is a distinctive process, it is unlikely to follow the same rules of development that operated during the long phase of welfare state expansion. There are two fundamental reasons for this. First, the political goals of policymakers are different; second, there have been dramatic changes in the political context. Each of these points requires elaboration.

There is a profound difference between extending benefits to large numbers of people and taking benefits away. For the past half century, expanding social benefits was generally a process of political credit claiming. Reformers needed only to overcome diffuse concern about tax rates (often sidestepped through resort to social insurance "contributions") and the frequently important pressures of entrenched interests. Not surprisingly, the expansion of social programs had until recently...
been a favored political activity, contributing greatly to both state-building projects and the popularity of reform-minded politicians.\(^4\)

A combination of economic changes, political shifts to the right, and rising costs associated with maturing welfare states has provoked growing calls for retrenchment. At the heart of efforts to turn these demands into policy have been newly ascendant conservative politicians. Conservative governments have generally advocated major social policy reforms, often receiving significant external support in their effort, especially from the business community.\(^5\) Yet the new policy agenda stands in sharp contrast to the credit-claiming initiatives pursued during the long period of welfare state expansion. The politics of retrenchment is typically treacherous, because it imposes tangible losses on concentrated groups of voters in return for diffuse and uncertain gains. Retrenchment entails a delicate effort either to transform programmatic change into an electorally attractive proposition or, at the least, to minimize the political costs involved. Advocates of retrenchment must persuade wavering supporters that the price of reform is manageable—a task that a substantial public outcry makes almost impossible.

Retrenchment is generally an exercise in blame avoidance rather than credit claiming, primarily because the costs of retrenchment are concentrated (and often immediate), while the benefits are not. That concentrated interests will be in a stronger political position than diffuse ones is a standard proposition in political science.\(^6\) As interests become more concentrated, the prospect that individuals will find it worth their while to engage in collective action improves. Furthermore, concentrated interests are more likely to be linked to organizational networks that keep them informed about how policies affect their interests. These informational networks also facilitate political action.

An additional reason that politicians rarely get credit for program cutbacks concerns the well-documented asymmetry in the way that voters react to losses and gains. Extensive experiments in social psy-


\(^5\) As recent research has suggested, it would be wrong to treat business as always and everywhere opposed to welfare state programs. For illuminating studies of the United States, see, for example, Colin Gordon, *New Deals: Business, Labor, and Politics in America, 1920–1935* (Cambridge: Cambridge University Press, 1994); and Cathie Jo Martin, "Nature or Nurture? Sources of Firm Preference for National Health Reform," *American Political Science Review* 89 (December 1995). Nonetheless, it is clear that most business organizations in all the advanced industrial democracies have favored—often vehemently—cutbacks in the welfare state over the past fifteen years.

chology have demonstrated that individuals respond differently to positive and negative risks. Individuals exhibit a negativity bias: they will take more chances—seeking conflict and accepting the possibility of even greater losses—to prevent any worsening of their current position.7 Studies of electoral behavior, at least in the United States, confirm these findings. Negative attitudes toward candidates are more strongly linked with a range of behaviors (for example, turnout, deserting the voter's normal party choice) than are positive attitudes.8

While the reasons for this negativity bias are unclear, the constraints that it imposes on elected officials are not. When added to the imbalance between concentrated and diffuse interests, the message for advocates of retrenchment is straightforward. A simple "redistributive" transfer of resources from program beneficiaries to taxpayers, engineered through cuts in social programs, is generally a losing proposition. The concentrated beneficiary groups are more likely to be cognizant of the change, are easier to mobilize, and because they are experiencing losses rather than gains are more likely to incorporate the change in their voting calculations. Retrenchment advocates thus confront a clash between their policy preferences and their electoral ambitions.

If the shift in goals from expansion to cutbacks creates new political dynamics, so does the emergence of a new context: the development of the welfare state itself. Large public social programs are now a central part of the political landscape. As Peter Flora has noted, "Including the recipients of [pensions,] unemployment benefits and social assistance—and the persons employed in education, health and the social services—in many countries today almost 1/2 of the electorate receive transfer or work income from the welfare state."9 With these massive programs have come dense interest-group networks and strong popular attachments to particular policies, which present considerable obstacles to reform. To take one prominent example, by the late 1980s the American Association of Retired People (AARP) had a membership of twenty-eight million and a staff of thirteen hundred (including a legislative

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The maturation of the welfare state fundamentally transforms the nature of interest-group politics. In short, the emergence of powerful groups surrounding social programs may make the welfare state less dependent on the political parties, social movements, and labor organizations that expanded social programs in the first place. Nor is the context altered simply because welfare states create their own constituencies. The structures of social programs may also have implications for the decision rules governing policy change (for example, whether national officials need the acquiescence of local ones) and for how visible cutbacks will be. "Policy feedback" from earlier rounds of welfare state development is likely to be a prominent feature of retrenchment politics.11

In short, the shift in goals and context creates a new politics. This new politics, marked by pressures to avoid blame for unpopular policies, dictates new political strategies.12 Retrenchment advocates will try to play off one group of beneficiaries against another and develop reforms that compensate politically crucial groups for lost benefits. Those favoring cutbacks will attempt to lower the visibility of reforms, either by making the effects of policies more difficult to detect or by making it hard for voters to trace responsibility for these effects back to particular policymakers.13 Wherever possible, policymakers will seek broad consensus on reform in order to spread the blame. Whether these efforts succeed may depend very much on the structure of policies already in place. As I argue in the next section, theoretical discussions of the welfare state have failed to take this point sufficiently to heart.

II. THE LIMITS OF EXISTING THEORIES

Each of the main theories of welfare state expansion—arguments about economic development, arguments about the power of the left, and arguments about institutions—has been loosely appropriated for discussions of the contemporary welfare state. In this section I make explicit the kinds of claims that an inversion of existing theories of expansion might suggest for a theory of retrenchment. While each perspective

contains insights, my main contention is that a convincing analysis of retrenchment must move beyond these formulations.

A NEW "LOGIC OF INDUSTRIALISM"?
The earliest well-developed theory of welfare state growth, associated particularly with the work of Harold Wilensky, stressed the relationship of welfare state expansion to processes of economic growth. Welfare state effort was correlated with affluence, suggesting that "strong economies produce strong welfare states." Yet while this argument explained broad social policy differences between rich and poor nations, it proved to be far less helpful in explaining differences within the club of rich democracies.

Nonetheless, versions of economic determinism have been prominent in discussions of the contemporary welfare state. The claim that a new "logic of industrialism" encourages a convergence of national social policy models is based on asserted consequences of global economic change. One possibility is that the globalization of capital markets removes crucial economic policy tools from national governments and constrains social policy options. However, as Garrett and Lange have persuasively argued, while monetary and fiscal policies may face new restrictions, there is little evidence that supply-side policies of transfers and services need be constrained, so long as tax bases remain sufficient to insure relatively low deficits. Some social policies may in fact contribute to economic growth, for example, by encouraging the formation of human capital and certain kinds of labor market flexibility.

A related argument is that heightened economic integration will result in what Europeans call "social dumping." The term refers to the possibility that firms operating where "social wages" are low may be able to undercut the prices of competitors, forcing higher-cost firms either to go out of business, or to relocate to low social wage areas, or to pressure their governments to reduce social wage costs. In extreme scenarios these actions could fuel a downward spiral in social provision, eventually producing very rudimentary, lowest-common-denominator national welfare states. The evidence for a process of social dumping

15 One could fill a small library with books and articles that make this claim. For a good recent example, see Herman Schwartz, "Small States in Big Trouble: State Reorganization in Australia, Denmark, New Zealand, and Sweden in the 1980s," World Politics 46 (July 1994).
remains limited. The social wage is only one factor in investment decisions, and firms will not invest in countries with low social wages unless other factors (for example, infrastructure, worker productivity) justify such investments.\textsuperscript{18} Neoclassical trade theory suggests that countries with high social wages should not face problems so long as overall conditions allow profitable investment.\textsuperscript{19}

A further, critical objection to the economic determinist argument has received less attention. Even if a high social wage were associated with poor economic performance, the assumption that downward adjustments in social policy would necessarily follow is unjustified. As North has recently reminded us, countries have maintained widely different levels of economic performance for very long periods of time, without marked pressures toward convergence.\textsuperscript{20} In a world where particular arrangements have been institutionalized and where local actors have adopted strategies that succeed in local terms, there is no automatic or necessary movement toward any particular definition of efficiency—market dictated or otherwise. Politicians in democratic systems generally worry first and foremost about getting elected. Helping improve the economy may make that easier, but not if it requires hugely unpopular policies, and not if the economic benefits are likely to appear at some point in the distant (that is, postelection) future.

Thus, even if social dumping arguments proved valid—a big if—much would still depend on the balance of political forces favoring and resisting a substantial restructuring of the welfare state. Tendencies toward fragility must be weighed against the considerable sources of wel-

\textsuperscript{18} Peter Lange, "The Politics of the Social Dimension," in Alberta Sbragia, ed., Euro-politics (Washington, D.C.: Brookings Institution, 1992). For evidence casting doubt on the proposition that systems of social protection have significant negative effects on economic performance, see Rebecca M. Blank, ed., Social Protection versus Economic Flexibility: Is There a Trade-off? (Chicago: University of Chicago Press, 1994). \textsuperscript{19} "Unraveling" could occur in a more subtle way, as heightened capital mobility strengthens the bargaining position of business, leading to the gradual erosion of "tightly coupled" systems of industrial relations and, perhaps, welfare states. For a good example of this kind of argument, see Wolfgang Streeck, "From Market-Making to State-Building? Reflections on the Political Economy of European Social Policy," in Stephan Leibfried and Paul Pierson, eds., European Social Policy: Between Fragmentation and Integration (Washington, D.C.: Brookings Institution, 1995). While such a scenario cannot be ruled out, the evidence for it remains quite limited. These arguments appear to be more popular among those, like Streeck, who focus on industrial relations systems. See, for example, Jonas Pontusson and Peter Swenson, "Labor Markets, Production Strategies, and Wage Bargaining Institutions: The Swedish Employer Offensive in Comparative Perspective," Comparative Political Studies (forthcoming); and Kathleen Thelen, "West European Labor in Transition: Sweden and Germany Compared," World Politics 46 (October 1993). Industrial relations systems, however, seem more fragile than welfare state structures. Welfare states, I will suggest, have considerably broader bases of support, which promote the restoration of equilibrium and inhibit the kind of unraveling that occurs in some industrial relations systems. \textsuperscript{20} Douglass C. North, Institutions, Institutional Change, and Economic Performance (Cambridge: Cambridge University Press, 1990).
fare state stability. In short, policy outcomes cannot be derived directly from economic trends. The new logic of industrialism suffers from many of the defects of the old one. Expansive claims of economic determinism pay insufficient attention to the politics of policy change. The same cannot be said about power resource and institutionalist arguments, to which I now turn.

LEFT POWER RESOURCES AND THE POLITICS OF RETRENCHMENT

The power resources perspective, which attributes cross-national variations in social provision largely to differences in the distribution of political resources among classes, has been the leading approach in comparative politics to explaining patterns of welfare state expansion. Class-based struggle over social provision occurs because social programs affect the bargaining position of workers and employers. Many social programs limit the economic vulnerability of wage earners and increase worker solidarity. According to power resource theorists, strong unions and left parties contribute to the growth of these programs. The power resources approach has had considerable success in accounting for cross-national variations in social provision during the three decades following World War II. Furthermore, the replacement of crude social expenditure data with more fine-grained distinctions among patterns of social provision has greatly improved the model’s explanatory power.

A straightforward application of power resource arguments to retrenchment would suggest that welfare states are in deep trouble. The power of organized labor and left parties has shrunk considerably in many advanced industrial societies. As I will argue in Section III, however, there is very little evidence that this decline has had a fundamental impact on welfare states. Cutbacks in social programs have been far more moderate than the sharp drop in labor strength in many countries might lead one to expect, and there appears to be little correlation between declines in left power resources and the magnitude of retrenchment.

The shift in both context and goals that characterizes the new politics of the welfare state helps to explain why this is so. Analysis of the contemporary welfare state’s supporters must include not only orga-


22 Esping-Andersen (fn. 1); Huber, Ragin, and Stephens (fn. 1).
nized labor and left parties but also the more varied constituencies of individual programs. Interest groups linked to particular social policies are now prominent political actors. The rise of these interest groups is one of the clearest examples of how policy feedback from previous political choices can influence contemporary political struggles. Groups of program beneficiaries did not build the welfare state, but the welfare state contributed mightily to the development of these groups. By the time a politics of austerity began to emerge in the mid-1970s, most welfare state programs were connected to extensive networks of social support. Most prominent were the recipients of the various benefits—pensioners, the disabled, health care consumers. The providers of public services also had a major stake in sustaining expenditure and were usually well organized. Finally, there was a range of public-interest organizations seeking to protect those too weak to mobilize on their own. Indeed, even when groups of recipients are not particularly well organized, politicians may have reason to be attentive to their concerns. Cutbacks, if recognized, are likely to incense voters, and political competitors stand ready to exploit such opportunities. The possibility of exacting punishment at the polls means that the potentially mobilized influence policymakers even in the absence of ongoing organized activity.

Thus, there are good reasons to believe that the centrality of left party and union confederation strength to welfare state outcomes has declined. The diminished relevance of power resource arguments reflects the fact that welfare states are now mature and that retrenchment is not simply the mirror image of welfare state expansion. In a context where public social provision is just emerging, the existence of very broad organizations pushing an expansionist policy agenda may be crucial. However, the unpopularity of program cutbacks and the emergence of new bases of support will give politicians pause even where unions and left parties are weak. Equally important, maturing social programs develop new bases of organized support that have substantial autonomy from the labor movement. This shifting base of support may have consequences for the dynamics of policy development, but the weakening of organized labor need not translate automatically into a commensurate weakening of the welfare state.

23 In this respect, organized labor (public employee unions) continues to be of significance, although not in the way posited by power resource theorists. Union interests are now linked primarily to the employment-generating effects of specific public programs rather than to the broad consequences of generous public provision for the bargaining position of workers.

24 On this point, see Arnold (fn. 13).
NEW INSTITUTIONALISM AND WELFARE STATE POLITICS

Patterns of governance matter. The "new institutionalist" resurgence in political science reflects a renewed appreciation of how relatively stable, routinized arrangements structure political behavior. The political institutions of different countries vary along crucial dimensions, such as the rules of electoral competition, the relationship between legislature and executive, the role of the courts, and the place of subnational governments in politics. Institutions establish the rules of the game for political struggles— influencing group identities, policy preferences, and coalitional choices, and enhancing the bargaining power of some groups while devaluing that of others. Institutions also affect government capacities—their administrative and financial resources for fashioning policy interventions.

In the field of comparative social policy, the claim that political institutions must be considered consequential structures has been developed primarily in the work of Theda Skocpol and her collaborators. These researchers have raised significant questions about the dynamics of welfare state development, pointing out, for example, that the power resources approach has had little success in accounting for pre–World War II social policy developments. The new institutionalist research agenda, however, has centered on explaining "American exceptionalism"—the belated and halfhearted development of social welfare policies in the United States. Just as a focus on Sweden was central to the development of the power resources model, concentration on the United States has underscored the importance of political institutions.

Institutionalists make two broad claims about welfare state development. First, strong states are likely to produce strong welfare states, with state strength defined in terms of governmental administrative capacities and institutional cohesion. Extensive administrative and financial resources make it easier to build expansive social policies. Where political authority is fragmented, entrenched minorities will often block social legislation. Federalism, separation of powers, strong bicameral-
ism or reliance on referenda all may restrict welfare state development. Although much of the work on institutions and welfare states has been based on comparative historical case studies, this claim about formal institutional veto points has recently received support in an important quantitative study as well.29

The second central institutional argument concerns policy legacies, or feedback—the consequences of previously introduced welfare state programs. Arguments about policy feedback are essentially arguments about the consequences of big government. As policy decisions have had increasingly pervasive effects on economic and social life, their impact on political processes has expanded. Given that the welfare state is at the very heart of big government, it should come as no surprise that studies of welfare state development have generated some of the most persuasive arguments about policy feedback.

The possible consequences of preexisting policy structures for welfare state politics are quite diverse.30 Welfare state structures affect the size and orientation of various societal groups as well as patterns of interest–group formation. Programs may provide the basis for processes of social learning that affect prospects for future program expansion, whether negatively or positively. Policies can create long-term commitments—such as the pay-as-you-go intergenerational contracts common to public pension systems—that lock in particular paths of policy development.31

How easily can these arguments be applied to the distinctive politics of retrenchment? Again, there is no reason to assume that claims for earlier periods can simply be turned on their heads. For example, there is little reason to expect that bureaucratic capacities will be particularly important in an age of retrenchment. Can we administer it? may be an important question in a discussion of new or greatly expanded public initiatives, but for advocates of retrenchment the primary goal is to dismantle existing programs. Closing offices, curtailing services, and cutting benefits do not require formidable administrative capacity.

Arguments about the consequences of governmental cohesion also need to be reappraised in this new context.32 At first glance, one might

29 Huber, Ragin, and Stephens (fn. 1).
30 Pierson (fn. 11).
31 For examples of each of these arguments, see, respectively, Esping-Andersen (fn. 11); Skocpol (fn. 26); and Paul Pierson, "Policy Feedbacks and Political Change: Contrasting Reagan and Thatcher's Pension-Reform Initiatives," *Studies in American Political Development* 6 (Fall 1992).
expect that systems with fewer institutional veto points would be in a stronger position to pursue an agenda of radical retrenchment. Because retrenchment is generally unpopular, however, there are compelling reasons to question this expectation. While cohesive systems concentrate authority, they also concentrate accountability. The former tendency facilitates retrenchment, but the latter impedes it. Where authority is centralized, the public knows that the government of the day can prevent groups from suffering cutbacks. Strong governments, anticipating the high political cost of retrenchment, may forgo the opportunities provided by concentrated power. Thus, the theoretical basis for believing that government cohesion facilitates retrenchment is weak. We are left with the empirical question of whether concentration of power effects outweighs concentration of accountability effects.33

The tremendous scope of modern welfare states suggests that institutionalist arguments about policy feedback may be even more relevant to the politics of retrenchment. There are, however, two quite different ways to apply policy feedback arguments to retrenchment. First, one could develop nuanced arguments that emphasize the distinctive characteristics of individual programs and their implications for successful retrenchment. Alternatively, one could present arguments about the overarching structures of particular welfare state regimes, suggesting that they are likely to promote a particular kind of politics.

The first approach has promise but is difficult to carry out in practice. Previous policies help shape the distribution of political resources. Preexisting policy designs may influence interest-group networks, the extent of long-term commitments, the rules governing programmatic reform, and the availability of techniques to reduce the visibility of cutbacks. These kinds of arguments have been used in qualitative case studies of both welfare state expansion and retrenchment.34 Because they often apply to idiosyncratic characteristics of individual programs, however, it is hard to use them to generate general propositions about variations across countries.

The alternative of developing broad arguments about how welfare state regimes affect contemporary politics is more easily applied to cross-national comparisons. Esping-Andersen has developed propositions that link welfare state structures to cross-national variation in oc-

33 What seems more likely is that the structure of formal institutions will influence the strategies of retrenchment advocates. I return to this point in the conclusion.

34 On expansion, see Heclo (fn. 27); and Skocpol (fn. 26). On retrenchment, see Pierson (fn. 12).
cupational structures and, in turn, to contemporary political cleavages. He suggests, for example, that social democratic welfare states like Sweden will face growing clashes between public and private sector workers, while conservative welfare states like Germany will produce a divide between labor market "insiders" and "outsiders." Such an approach offers the tantalizing promise of linking the evident significance of large welfare state structures to clear propositions about political change. Unfortunately, the argument does not work. As I will document in the next section, the hypothesized political cleavages emerge in only muted forms and have failed to generate a sustained backlash against the welfare state. The flaw in these broad arguments about welfare state regimes is that they greatly underestimate the difficulty of assembling and sustaining proretrenchment coalitions.

New institutionalist arguments have contributed greatly to our understanding of welfare state politics. Moreover, unlike arguments about the role of organized labor, there is no reason to think that the importance of institutional structures and the legacies of previous policy choices has declined. These arguments cannot simply be transferred from one context to another, however; they must be recast to apply to the specific settings and strategic problems that are characteristic of retrenchment politics.

FROM THEORIES OF EXPANSION TO THEORIES OF RETRENCHMENT

It is commonly maintained that our knowledge of welfare state expansion provides us with considerable insight into the new politics of the welfare state. Although this view is rarely stated explicitly, it undoubtedly explains why political scientists, who are usually preoccupied with understanding contemporary or rather recent events, have become so interested in historical studies of social policy. The presumed similarity of expansion and retrenchment is evident in some of the most important work on comparative social policy. In their sophisticated quantitative investigation of welfare state effort from 1956 to 1988, for example, Huber, Ragin, and Stephens acknowledge that their use of a pooled cross-sectional time-series model assumes "that causal processes are uniform through time." Esping-Andersen claims that "[t]he risks of

welfare-state backlash depend ... on the class character of welfare states. ... [T]he class coalitions in which the three welfare-state regime-types were founded, explain not only their past evolution but also their future prospects." More generally, he maintains that "a theory that seeks to explain welfare-state growth should also be able to understand its retrenchment or decline."

I see no reason to believe that this is true. Retrenchment is not simply the mirror image of welfare state expansion. Why should we assume that theories designed to explain outcomes in a particular context and involving the pursuit of particular goals will still apply once the political environment and the goals of key actors have undergone radical change? The question of whether theories of welfare state expansion offer insights into the retrenchment process is still open, but this preliminary discussion suggests that major modifications are probably required. In the following section, I draw on evidence from Great Britain, the United States, Germany, and Sweden to demonstrate the distinctiveness of retrenchment politics. Of declining importance are some formerly critical factors, such as the role of organized labor. Others, such as the design of political institutions, are of continuing significance but in new ways. Yet a crucial emerging factor is the mature welfare state itself, and its broad and deep reservoirs of public support.

III. RETRENCHMENT POLITICS IN FOUR COUNTRIES

To what extent have welfare states undergone retrenchment? What countries and programs have been most vulnerable to retrenchment initiatives and why? In this section I address these questions by reviewing the evolution of welfare states in four affluent democracies since the late 1970s. The evidence supports a number of claims. (1) There is little evidence for broad propositions about the centrality of strong states or left power resources to retrenchment outcomes. (2) The unpopularity of retrenchment makes major cutbacks unlikely except under conditions of budgetary crisis, and radical restructuring is unlikely even then. (3) For the same reason, governments generally seek to negotiate consensus packages rather than to impose reforms unilaterally, which further diminishes the potential for radical reform. And (4) far from creating a self-reinforcing dynamic, cutbacks tend to replenish support for the welfare state.

36 Huber, Ragin, and Stephens (fn. 1), 733; Esping-Andersen (fn. 1), 33, 32. Of course, Esping-Andersen has also emphasized that the growth of the welfare state affects welfare state politics.
Measuring retrenchment is a difficult task. Quantitative indicators are likely to be inadequate for several reasons. First, pure spending levels are rarely the most politically important or theoretically interesting aspects of welfare states. As Esping-Andersen put it in his analysis of welfare state expansion, "It is difficult to imagine that anyone struggled for spending per se." In particular, rising unemployment may sustain high spending even as social rights and benefits are significantly curtailed. Second, spending estimates will fail to capture the impact of reforms that are designed to introduce retrenchment only indirectly or over the long term. Analysis must focus on qualitative and quantitative changes in programs and on prospective, long-term changes, as well as on immediate cutbacks. My investigation therefore relies on a combination of quantitative data on expenditures and qualitative analysis of welfare state reforms. Rather than emphasizing cuts in spending per se, the focus is on reforms that indicate structural shifts in the welfare state. These would include (1) significant increases in reliance on means-tested benefits; (2) major transfers of responsibility to the private sector; and (3) dramatic changes in benefit and eligibility rules that signal a qualitative reform of a particular program. The selection of countries to investigate was based on the desire to achieve significant variation on what the welfare state expansion literature suggests are the most plausible independent variables. The cases vary widely in the structure of political institutions, the extent of shifts in the distribution of power resources, the design of preexisting welfare states, and the severity of budgetary crisis.

Beginning with the quantitative evidence, aggregate measures provide little evidence that any of the four welfare states have undergone dramatic cutbacks. From 1974 through 1990 the expenditure patterns across the four cases are quite similar, despite widely different starting

37 Esping-Andersen (fn. 1), 21.
38 A recent draft paper by Stephens, Huber, and Ray presents the first sophisticated statistical analysis of retrenchment, utilizing newly assembled data that allow investigation of fairly detailed programmatic changes over a large number of countries. There are important limitations: much of the programmatic data end in 1986 or 1987; many programs are not covered; and the still-small sample allows the statistical testing of only a few broad hypotheses (essentially, the impact of partisanship) about the politics of program change. The results reported strongly support most of the analysis presented here, although they view Thatcher as more successful than I do. John D. Stephens, Evelyne Huber, and Leonard Ray, "The Welfare State in Hard Times" (Paper presented at the conference on the "Politics and Political Economy of Contemporary Capitalism," University of North Carolina, Chapel Hill, September 1994).
39 Establishing what constitutes "radical" reform is no easy task. For instance, it is impossible to say definitively when a series of quantitative cutbacks amounts to a qualitative shift in the nature of programs. Roughly though, that point is reached when because of policy reform a program can no longer play its traditional role (e.g., when pension benefits designed to provide a rough continuation of the retiree's earlier standard of living are clearly unable to do so).
points. As Tables 1 and 2 show, social security spending and total government outlays as a percentage of GDP are relatively flat over most of the relevant period. The exception is the recent surge in Swedish expenditures, which will be discussed below. There is a slight upward trend overall, with fluctuations related to the business cycle. Table 3, which tracks public employment, reveals a similar pattern (although the expansion of Swedish public employment from an already high base stands out). For none of the countries does the evidence reveal a sharp curtailment of the public sector.

Table 4 offers more disaggregated indicators of shifts in social wel-

| Table 1 | SOCIAL SECURITY TRANSFERS AS % OF GDP (1974–90) |
|-------------------------|-------------------------|-------------------------|-------------------------|-------------------------|
| Britain | Germany | Sweden | United States |
| 1974  | 9.8 | 14.6 | 14.3 | 9.5 |
| 1980  | 11.7 | 16.6 | 17.6 | 10.9 |
| 1982  | 14.0 | 17.7 | 18.3 | 11.9 |
| 1984  | 14.0 | 16.5 | 17.6 | 11.0 |
| 1986  | 14.1 | 15.9 | 18.4 | 11.0 |
| 1988  | 12.3 | 16.1 | 19.5 | 10.6 |
| 1990  | 12.2 | 15.3 | 19.7 | 10.8a |


a 1989.

| Table 2 | GOVERNMENT OUTLAYS AS % OF NOMINAL GDP (1978–94) |
|-------------------------|-------------------------|-------------------------|-------------------------|-------------------------|
| Britain | Germany | Sweden | United States |
| 1978  | 41.4 | 47.3 | 58.6 | 30.0 |
| 1980  | 43.0 | 47.9 | 60.1 | 31.8 |
| 1982  | 44.6 | 48.9 | 64.8 | 33.9 |
| 1984  | 45.2 | 47.4 | 62.0 | 32.6 |
| 1986  | 42.5 | 46.4 | 61.6 | 33.7 |
| 1988  | 38.0 | 46.3 | 58.1 | 32.5 |
| 1990  | 39.9 | 45.1 | 59.1 | 33.3 |
| 1992  | 43.2 | 49.0 | 67.3 | 35.1 |
| 1994a | 44.8 | 51.4 | 70.9 | 33.9 |

**SOURCE:** OECD, *Economic Outlook* (December 1993), table A23.

a Projection.
Table 3

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<th>Year</th>
<th>Britain</th>
<th>Germany</th>
<th>Sweden</th>
<th>United States</th>
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<td>19.6</td>
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<td>1980</td>
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<td>1982</td>
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<td>1986</td>
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fear spending among the four countries; spending patterns are reported for what the OECD terms “merit goods” (primarily housing, education, and health care) as well as for various income transfers. The figures suggest a bit more divergence among the cases, with the United States and Germany emerging as somewhat more successful in curbing spending. A very few program areas—notably British housing and German pensions—experienced significant reductions. Nonetheless, similarities across countries remain more striking than differences. None of the cases show major rises or declines in overall effort, and there are few indications of dramatic change in any of the subcategories of expenditure.

The data suggest a surprisingly high level of continuity and stability. These figures must be treated with caution, however, since major changes in the spending for particular programs could be occurring within these broad categories. Policy reforms could have imposed lagged cutbacks that do not show up in spending figures. Furthermore, many other features of programs, not just spending levels, are of significance. To investigate these issues and to get a better sense of the processes that generated these aggregate outcomes, we turn to a more detailed investigation of the four cases.

Great Britain

By the mid-1970s Britain had developed a midsize welfare state with a mix of fairly modest income transfer programs and relatively extensive

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40 This broad conclusion is echoed for a much larger number of cases in Stephens, Huber, and Ray (fn. 38).
Table 4
GOVERNMENT OUTLAYS BY FUNCTION AS % OF TREND GDPA* (1979–90)

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<td>−0.2</td>
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<td>3.7</td>
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<td>2.7</td>
<td>3.5</td>
<td>+0.8</td>
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* Numbers may not sum to total due to rounding.

b Defense and other public services.

c For the U.S., social security related to health spending is included under "additional transfers" below.
and interventionist policies in health care and housing. The past fifteen years of Conservative rule represent a powerful test of a number of claims about retrenchment. There are few if any cases within the OECD of such a radical swing to the right in the distribution of power resources. A balanced two-party system gave way to Conservative hegemony, as reflected in four consecutive electoral victories. A fairly strong labor movement suffered repeated defeats in the face of high unemployment and changes in industrial relations law; union density declined from over 55 percent in 1979 to 35 percent in 1993. Furthermore, Britain's Westminster political system concentrates political authority. If a strong state with few internal veto points is the key to reforming the contemporary welfare state, the British Conservatives were in an unusually favorable position. In short, a simple inversion of welfare state expansion arguments would suggest that Britain should have been fertile ground for social policy cutbacks. The evidence does not support such a conclusion. While there are individual instances of significant retrenchment, notably in housing and pensions policy, these are the exception rather than the rule. The British welfare state, if battered, remains intact. As Table 4 indicates, social expenditure (merit goods plus transfers) as a share of GDP remains almost unchanged after more than a decade of Conservative governance.

It is worth starting with the two cases of retrenchment success, because these experiences are instructive. One of the triumphs of the Thatcher government was the privatization of public council housing. The sale of roughly 1.5 million homes to tenants laid the foundation for a major expansion of home ownership and sharp cutbacks in subsidies for those who remained in the public sector. Housing reform was a uniquely popular case of retrenchment—in many respects, the exception that proves the rule. The liquidation of extensive public sector assets created a rare opportunity for credit claiming rather than blame avoidance, offering considerable benefits for both home purchasers and taxpayers. Public sector tenants, who under other circumstances would have fought the government, became disinterested or divided.

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43 Pierson (fn. 12), chaps. 3–6.

The government's pension reforms were also relatively successful. A less generous indexation rule for the basic pension produced gradual but considerable budgetary savings. The government also introduced significant cutbacks in the State Earnings-Related Pension Scheme (SERPS), while introducing a private personal pension alternative. The government's initial proposal—to abolish SERPS with a very limited phase-in period—met with overwhelming opposition, even from usual supporters like the Confederation of British Industry (CBI). Forced into an embarrassing retreat, the government introduced more modest but nonetheless substantial changes in SERPS, which will gradually expand private pensions while reducing public sector benefits. These changes, though criticized, failed to generate the kind of outcry that often led the government to back off from other reforms. Offering the carrot of personal pensions diminished the pain of the cuts in public pensions (although the required tax incentives also diminished the government's budgetary savings). More important, the government's use of incremental and seemingly technical reforms limited the emergence of opposition.

Careful political planning in the context of programs that were either weakly institutionalized (SERPS) or offered rare opportunities for credit claiming (council housing) protected the Thatcher government. These cases were exceptions, however. On the whole, the British Conservatives found the welfare state to be a political minefield, as popular support for social spending remained strong. In fact, British public opinion regarding social policy reveals the same pattern found elsewhere: a modest decline of support for the welfare state preceded the arrival of the Thatcher government but rebounded at the first hint of serious retrenchment. Public opinion in Britain has run strongly, and increasingly, in favor of maintaining or even expanding social provision.

Thus while the government was clearly hostile to much of the welfare state and had the political authority to implement dramatic changes if it chose to do so, the fear of being held accountable for unpopular initiatives held it in check. Preserving the National Health Service, for example, became far and away the Labour Party's best issue in the 1980s. Initial exploration of various options for privatization provoked public outrage. The Thatcher government repeatedly backed off

from plans for fundamental restructuring of the system. By the end of the decade the government's repeated promise had become "the NHS is safe with us."

While the government achieved some nontrivial incremental cutbacks in various programs, radical retrenchment efforts failed, often at considerable political cost. The universal Child Benefit, frequently rumored to be in jeopardy, survived (although at a somewhat reduced level), due in part to well-organized lobbying efforts. A massive and highly publicized social security review promising to offer a "new Beveridge" ended up making modest adjustments to programs for low-income groups. Sickness Pay, touted as an instance of successful privatization, remains a thinly disguised public sector benefit. Furthermore, attempts to foster retrenchment arguably caused Thatcher's ultimate downfall. The tremendously unpopular poll tax—designed to cripple the social spending of local governments by cutting their financial legs out from under them—was a major source of the downward spiral in the polls that forced Thatcher's resignation. Her successor, John Major, followed a more moderate course. While attempting to consolidate Thatcher's least unpopular reforms, he launched few initiatives of his own and retreated on unpopular issues like cutbacks in Child Benefit.

Parts of the Conservative record demonstrate that major retrenchment is not impossible. Where a government can obscure the consequences of reform—or better yet, turn reform into a source of tangible benefits—the welfare state may be vulnerable. Had the entire British welfare state resembled council housing, the Conservative agenda would have succeeded. Yet the government's record reveals more cases of incremental adjustments or failed attempts to restructure programs. Overall social expenditure remains almost unchanged; housing and pensions aside, the government paid a significant price for the cutbacks it was able to impose. This outcome stands in sharp contrast to the Thatcher government's remarkably successful efforts in other policy areas, such as its overhaul of Britain's industrial relations system and its privatization of publicly owned industries.

THE UNITED STATES

Many have seen the United States as another likely candidate for a dismantling of the welfare state. Like Britain, the United States experienced a significant rightward shift in power resources during the 1980s. Republicans captured the presidency in 1980 (as well as the Senate until 1986). Union power—never that extensive to begin with—continued a seemingly inexorable decline. The American welfare state was already fairly modest in scope, suggesting to some observers that public support for maintaining it would be weak. Unlike Thatcher, however, retrenchment advocates in the United States operated in a context of severely fragmented political authority. The combination of weak parties, separation of powers, and federalism created an institutional environment that was in many respects the polar opposite of that in Britain.

Yet at least through 1994 the American story reads like the British one, minus most of Thatcher's sporadic successes. Reagan's first year was the exception. Riding the antitax wave that had helped to elect him, Reagan was able to cobble together a loose coalition of southern Democrats and Republicans in his first year to pass some cuts in social programs, especially those affecting the poor. A decade-long expansion of low-income housing programs was rapidly reversed. Significant cuts were introduced in the main program for the poor, AFDC, and in Unemployment Insurance. The Reagan administration successfully exploited the fact that responsibility for these two programs was shared with fiscally strapped state governments. Both fared poorly in the 1980s, although many of the cutbacks occurred at the state level.50

This first-year record has shaped many appraisals of the Reagan revolution.51 As in other countries, however, popular support for retrenchment dissipated rapidly. The Reagan assault petered out in 1982, when further budget cuts were overwhelmingly rejected. Reagan's single major reform initiative, the New Federalism proposal, would have transferred responsibility for AFDC and food stamps to the states (in return for the federal government's assumption of complete control over

50 In the case of AFDC, which is not indexed, this happened largely because state governments failed to index benefits to inflation. Given this structural feature of the program, "nondecisions" allowed quiet retrenchment. This trend predated Reagan's arrival in office. Indeed, cuts in real benefits were greater during Carter's presidency (when inflation was high) than under Reagan.

Medicaid). The proposal was so unpopular, however, that it could not find even a single congressional sponsor and died without ever being introduced.\textsuperscript{52} By Reagan's second term incremental expansions of various social programs for the poor were back on the agenda, and Congress passed modest increases in food stamps and Medicaid and a dramatic expansion of the earned income tax credit for poor working families.\textsuperscript{53}

Middle-class programs also weathered the storm. Trust fund difficulties forced significant reforms of Social Security, and there was a series of efforts to trim Medicare's exploding costs (mostly through cuts in provider compensation). In all these efforts, however, Republicans fearful of the electoral consequences of retrenchment refused to move forward in the absence of bipartisan agreement. The need for consensus in turn assured that reforms would be acceptable to program defenders within the Democratic Party. This was most clearly evident in the 1983 Social Security amendments, where the reliance on a bipartisan, quasicorporatist commission assured that radical reforms would be rejected.\textsuperscript{54} It was also true, however, of the series of broad budget packages that sought cutbacks in the Medicare system.\textsuperscript{55}

Although it is generally argued that the residual nature of the welfare state in the United States creates a narrow political base, the initial backlash against the welfare state was short-lived. Declining support for social programs preceded Reagan's election. From 1982 onward—that is, immediately following the first round of budget cuts—polls revealed growing support for the welfare state.\textsuperscript{56} As is true elsewhere, support for means-tested programs was far lower than that for middle-class programs, but the same public opinion pattern of modest declines in support followed by rapid recovery is evident for both targeted and universal programs. Reagan became much more hesitant as popular enthusiasm for retrenchment faded. In any event, the fragmented nature


\textsuperscript{55} Joseph White and Aaron Wildavsky, \textit{The Deficit and the Public Interest} (Berkeley: University of California Press, 1989).

\textsuperscript{56} Fay Lomax Cook and Edith J. Barret, \textit{Support for the American Welfare State} (New York: Columbia University Press, 1992); Robert Y. Shapiro and John T. Young, "Public Opinion and the Welfare State: The United States in Comparative Perspective," \textit{Political Science Quarterly} 104 (Spring 1989). In line with my general argument, Shapiro and Young's research indicates similar patterns in other countries.
of American political institutions assured that plans for further cutbacks met a hostile reception in Congress.

To be sure, with both the emergence of a large structural budget deficit during the 1980s and resistance to tax increases, little room was left for social policy expansion. The American welfare state moved into a zero-sum era, in which gains for some programs often came at the expense of others. This atmosphere continued when the Democrats returned to the White House in 1992, although social spending for the poor was a prime beneficiary of the 1993 budget agreement. From the late 1980s through 1994 the situation was one of reallocation within an essentially stagnant budget.57

The 1994 elections, which ended forty years of Democratic predominance in Congress, precipitated the most vigorous challenge yet to the American welfare state. Republicans had learned important lessons from past defeats. Social Security was taken off the table. The issue was carefully framed as a matter of controlling the deficit and bringing government “closer to the people.” Efforts at institutional change (the line-item veto and balanced-budget amendment) preceded (though with limited success) attacks on social programs. To diminish visibility, most of the major cuts were scheduled for the year 2000 and beyond. If fully implemented, the Republican budget proposals introduced in 1995 would represent a fundamental reform of American social policy. It will, however, be several years before the outcome of this latest battle is clear. Republican cutbacks are only now being formulated, and it will take some time for their impact to register with the electorate. While the current political environment poses a major test of the resilience of the welfare state, both American precedent and the experience elsewhere cast doubt on the proposition that Republicans will discover a deep reservoir of public tolerance for sharp cuts in social programs.

GERMANY

Germany, like Sweden, has a very extensive welfare state, though the German system is geared toward transfer payments rather than public services, and toward redistribution over the life cycle rather than across income groups. As in Britain and the United States, there has been a considerable swing to the right in elections during the period of austerity. A right-of-center coalition has been in office since 1982. In recent

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57 On recent spending trends, see House Ways and Means Committee, Background Material on Programs within the Jurisdiction of the Committee on Ways and Means (Washington, D.C.: GPO, March 1994).
years, however, the Social Democrats, with their majority in the Bundesrat, have gained considerable influence. And although Germany's powerful unions have been under pressure, compared with unions in other countries their organizational strength has held up quite well. Thus, Germany represents a case of moderately diminished left power resources and relatively fragmented political authority.

The German welfare state is based, not on maximizing employment, but on providing subsidies to the "outsiders," who are encouraged to leave the labor market to those who are highly productive. Esping-Andersen has speculated that the result is likely to be an "insider-outsider" conflict in which the employed (along with employers) increasingly balk at the cost of subsidizing a large and growing "surplus population." Indeed, within the recent wave of commentary about the contribution of high wages and extensive social protection to Europe's economic problems, Germany's huge wage costs (including steeply rising payroll taxes) have received particular attention. Adding to the stress has been the cost of unification, as the West German welfare state was extended to cover the far less productive East Germany.

The fiscal pressures facing Germany are evident and are unlikely to go away. Demographic shifts will increase costs even if expenses related to unification begin to subside. There is, however, little sign that these pressures will translate into a sharp insider/outsider conflict. This line of potential cleavage is based largely on age, with by far the largest and most expensive group of outsiders consisting of former insiders: pensioners and early retirees. There are formidable barriers to the development of political cleavages along generational lines. Where costs associated with aging are the main source of budgetary pressure, insiders will have to recognize that in the future they too will be outsiders. This is likely to temper any tendency toward a polarization between "them" and "us." Far from revealing a sharp new political cleavage, the reform of pensions in the late 1980s fits the general cross-national pattern for re-

58 Thelen (fn. 19).
60 Combined employer and employee social insurance contributions were 26.5% of gross income in 1970, 32.4% in 1980, and are forecast to hit 39.2% in 1994. Financial Times, July 2, 1993, p. 13.
62 Esping-Andersen (fn. 35, 1992) rightly suggests that the development of private pension schemes could encourage such a polarization, since it would allow current workers to sever the link between their own retirement situation and that of the preceding generation. Yet the enormous institutional and political barriers to any radical change in a mature, pay-as-you-go pension system make a major development along these lines highly unlikely. See Pierson (fn. 31).
trenchment in popular social programs. With projections indicating enormous long-term deficits as a result of demographic trends, the need for pension reform was widely recognized. While some critics pressed for a rethinking of the entire scheme, the Kohl government instead searched for consensus among experts and the social partners, and eagerly sought support from the opposition Social Democrats. Union and business representatives submitted joint statements on pension reform. All parties except the Greens supported the Pension Reform Act passed in November 1989. The resulting plan incorporated familiar pruning techniques: slightly lower replacement rates, an increase in the retirement age, and increased contributions. Combined with earlier cutbacks, these reforms have generated substantial budgetary savings. The basic structure of Germany's generous pension system remained unaltered, however. In the case of health care reform as well, corporatist accommodation of entrenched interests and a search for cross-party consensus has been the rule.

The one indication of a distinctly conservative cast to retrenchment initiatives prior to 1989 came in the pattern of benefit cuts. Most affected were welfare and unemployment insurance benefits that could be considered a hindrance to labor market flexibility. While these benefits were relatively well protected under the SPD-led coalition of the late 1970s, they experienced disproportionate reductions after 1982. Still, the differences were limited and did not overturn the basic reality that social welfare policy operated within a relatively consensual framework. As Offe has argued, moderate cutbacks were carefully designed by a "de facto bipartisan coalition" and orchestrated to prevent a political outcry.

The strains of the postunification period raised the possibility of more dramatic reform. Germany's worsening fiscal situation, combined with concern about industrial competitiveness, generated growing crit-

67 Offe (fn. 66), 140.
icism of the welfare state. Yet the response to unification emphasized continuity: East Germans were brought into the West German social policy regime on extremely generous terms. In response to budgetary pressures since then, a series of cuts have been introduced in major social programs, and more cuts are probably on the way. Again, however, the pattern has been to trim benefit levels rather than challenge the basic structure of programs.

The recent ambitious expansion of long-term care covering in-home and nursing-home services is clear grounds for skepticism about the prospects for radical retrenchment or a generational backlash against the German welfare state. The system will relieve the sickness funds and local social assistance budgets of responsibility for long-term care expenditures. While the scheme partly amounts to fiscal relief for strapped Länder (state) governments, it involves significant new benefits as well. Its introduction at a time of budgetary stress and widespread discussion of high social wage costs indicates the continuing political attractiveness of social programs, as well as the electoral clout of the elderly.

There is a possibility that groups more easily defined as problem cases, such as the long-term unemployed (especially disaffected youth, immigrants, or East Germans) could become the targets for political attacks. Concern about mounting unemployment rates and labor market inflexibilities point in the same direction. The Kohl government’s recent proposals for cuts in social expenditures do indeed concentrate on unemployment and welfare benefits. Sharp cuts, however, will provoke a strong challenge from the SPD and unions, since the conditions of the unemployed have significant implications for workers. Furthermore, the force of demographic demands is such that even these politically difficult reforms would have only a limited effect on the long-term budgetary situation. The recent history of retrenchment suggests that most governments are likely to be skittish about pursuing

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69 Jens Alber, “The Debate over Long-Term Care Insurance in Germany” (Contribution to an OECD seminar on the Care of the Elderly, Paris, OECD, 1994); Ulrike Götting, Karin Haug, and Karl Hinrichs, “The Long Road to Long-Term Care Insurance in Germany: A Case Study in Welfare State Expansion” (Paper presented at the World Congress of Sociology, Bielefeld, July 1994).
70 Tyll Necker, president of the Association of German Industry (BDI), described the original proposal (which did not include the reduction of one paid holiday as an offset) as an official declaration of war against German industry. Alber (fn. 69), 17.
71 By 2040 pensions are expected to account for 61% of German social expenditure, compared with 40% in Britain and 44% in Sweden. OECD, Aging Populations: The Social Policy Implications (Paris: OECD, 1988).
big social policy battles unless they promise to yield substantial budgetary gains.

Demographic and budgetary pressures assure that an atmosphere of austerity will continue to surround the German welfare state. Indeed, the German government has been quite successful in holding the line on spending. Yet, as Offe aptly puts it, it has been a period of "smooth consolidation." A fundamental rethinking of social policy seems a remote possibility. The structure of political institutions—both constitutional rules and corporatist policy networks—puts a premium on consensus. The SPD's significant gains in the October 1994 elections, where Kohl's coalition government retained only a razor-thin majority, are unlikely to invigorate a governing coalition that has never shown much appetite for radical initiatives.

**SWEDEN**

Sweden combines a tremendously successful social democratic party, powerful unions, and one of the world's most extensive and redistributive welfare states. With the breakdown of centralized collective bargaining, union power has weakened in the past decade, and the political hegemony of the SAP has given way to periodic fluctuations between SAP governance and coalitions of the bourgeois parties. Sweden's system of extensive service provision and high public sector employment promotes a cleavage between workers in the public and private sectors. Esping-Andersen has tried to link the prospects for retrenchment to policy feedback from the structure of Sweden's welfare state, positing that Sweden's system of extensive service provision and high public sector employment promotes a cleavage between workers in the public and private sectors.

72 A bourgeois coalition government was in power from 1976 to 1982 and, following the SAP's worst showing in decades in the "earthquake" election of 1991, from 1991 to 1994.
private sectors. In the 1980s both private sector unions and employers criticized public employees. This occurred in part because of the way Sweden’s centralized industrial relations system created linkages between public and private sector pay, and in part simply because of the high tax costs of massive public sector employment expansion. 

It might be expected that the events of the past few years would exacerbate this tension. The Swedish economy came under extraordinary pressure after 1990. The fall in output and the rise in unemployment seem to have had relatively little to do with the welfare state itself. Yet if the welfare state did not cause the economic crisis, it is clearly implicated in Sweden’s current predicament. Unemployment, including those participating in government-financed active labor market schemes, rose from 3 percent in 1989 to over 12 percent in 1993. Designed to operate at full employment, the Swedish welfare state cannot tolerate burdens of this magnitude. Sweden’s generous and expensive social benefits led to immediate fiscal trouble when rising unemployment produced falling revenues and higher outlays. In only four years Sweden went from having the largest surplus in the OECD to operating the largest deficit. Government outlays reached the extraordinary level of 73 percent of GDP in 1993, and the deficit stood at over 14 percent of GDP. Given existing levels of taxation, the adjustment burden was bound to fall heavily on the expenditure side.

The emergence of a true fiscal crisis after 1990 required extensive reforms. Furthermore, between 1991 and 1994 Sweden was governed by a bourgeois coalition—and one whose center of gravity was considerably to the right of the one that governed between 1976 and 1982. Conditions thus might have seemed uniquely favorable to a complete overhaul of social policy. What is striking is that even under these extraordinary circumstances there was no sign that the welfare state would be radically restructured. Instead, considerable care was taken to operate within the structure of existing programs. Prominent ex-

73 Esping Andersen (fn. 1); Esping-Andersen (fn. 35, 1992); see also Peter Swenson, “Labor and the Limits of the Welfare State,” Comparative Politics 23 (July 1991).
74 Schwartz (fn. 15); Pontusson and Swenson (fn. 19).
76 OECD (fn. 75), 36.
77 Ibid.
amples include an expansion of waiting days for unemployment and sickness benefits, a lowering of replacement rates for unemployment benefits (from 90 percent to 80 percent), a freeze on adjustments in child allowances, and a raise in the retirement age, from sixty-five to sixty-six.

Ironically, the breakdown of other components of the Swedish economic model also diffused some of the pressure on the divide between public and private sector workers. The end of centralized bargaining has made it easier for private sector workers to decouple pay settlements from the public sector.\(^7^9\) Higher unemployment made the option of cutting the public sector workforce less attractive and shifted attention to transfer programs, where the provision of generous benefits has always depended on keeping the cohort of recipients small. Both the crisis package accepted by the unions and the SAP in late 1992 and the government's 1993 budget were geared toward cuts in transfer programs (sick pay, unemployment insurance, pensions).\(^8^0\) Thus, while economic problems created added pressure for the welfare state, they did so in a way that encouraged a more dispersed and incremental politics of austerity, rather than a polarization between public and private sector workers.

The government showed little inclination to use the opening for radical restructuring of the welfare state. Coping with the pain of administering austerity weakened the bourgeois coalition's enthusiasm for drastic measures. In any event, only the Conservatives within the governing coalition expressed serious doubts about Sweden's universalist welfare state. Polling data from 1992 indicated overwhelming support for social spending, including increases since 1986 for the major programs.\(^8^1\) The coalition carefully followed the principal rules of blame avoidance. It sought SAP and union support for crisis packages of reform, purchasing political cover at the price of forgoing opportunities for radical change.\(^8^2\) A similar approach was taken to pension reform, paralleling the process followed in Germany and the United States. The pension reform introduced in June 1994, based on extensive consultations among the major parties and representative of labor and cap-

\(^7^9\) Pontusson and Swenson (fn. 19).
\(^8^0\) Evelyne Huber and John Stephens, "The Swedish Welfare State at the Crossroads," Current Sweden, no. 394 (January 1993), 1–7; OECD (fn. 75).
\(^8^1\) Bo Rothstein, "The Crisis of the Swedish Social Democrats and the Future of the Universal Welfare State," Governance 6 (October 1993). Rothstein himself argues that weakening middle-class attachment to the welfare state may have contributed to the SAP's 1991 election defeat, but his article provides no real evidence for this claim and the polling data he presents suggest otherwise.
\(^8^2\) Huber and Stephens (fn. 80).
ital, seeks to get Sweden's public pension system on a stable, long-term footing without challenging its basic principles.83

Far from using its electoral breakthrough and the onset of a budgetary crisis as a golden opportunity to remake the welfare state, Sweden's bourgeois coalition chose a cautious course. Throughout, the coalition studiously avoided initiatives that might lend credence to the accusation that it sought to dismantle the welfare state. The October 1994 elections vindicated the coalition's concerns, but in a way that revealed the unpopularity of even modest assaults on social programs. In the face of Sweden's economic difficulties, the SAP triumphed, posting one of its highest vote totals ever. Moreover, the victory was achieved on a platform that stressed the SAP's intention to reduce the deficit largely through tax increases rather than budget cuts.

IV. THE NEW POLITICS OF THE WELFARE STATE

Economic, political, and social pressures have fostered an image of welfare states under siege. Yet if one turns from abstract discussions of social transformation to an examination of actual policy, it becomes difficult to sustain the proposition that these strains have generated fundamental shifts. This review of four cases does indeed suggest a distinctly new environment, but not one that has provoked anything like a dismantling of the welfare state. Nor is it possible to attribute this to case selection, since the choice of two prototypical cases of neoconservatism (Britain and the United States) and two cases of severe budgetary shocks (Germany and Sweden) gave ample room for various scenarios of radical retrenchment. Even in Thatcher's Britain, where an ideologically committed Conservative Party has controlled one of Europe's most centralized political systems for over a decade, reform has been incremental rather than revolutionary, leaving the British welfare state largely intact. In most other countries the evidence of continuity is even more apparent.84


84 Schwartz (fn. 15) argues that there has been major change in the four small states he studies: Sweden, Denmark, Australia, and New Zealand. His study focuses on the internal organization of public service provision, rather than on the level and quality of services actually provided, and it does not even discuss the transfer payments that account for the majority of welfare-state spending. Even on its own narrow terms, however, Schwartz's study provides remarkably little evidence that the changes he catalogs add up to radical reform rather than the continuous tinkering common in all modern public sectors. The evidence looks credible only for New Zealand, a tiny country on the periphery of the world economy, which clearly faced severe adjustment problems in light of its long (and unusual) tradition of protectionism. It seems far more reasonable to treat this case as an outlier than to view it as the pacesetter in a global march toward radical reform of the welfare state. See Stephens, Huber, and Ray (fn. 38).
To be sure, there has been change. Many programs have experienced a tightening of eligibility rules or reductions in benefits. On occasion, individual programs (such as public housing in Britain) have undergone more radical reform. In countries where budgetary pressures have been greatest, cuts have been more severe. Over the span of two decades, however, some changes in social policy are inevitable; even in the boom years of the 1960s specific social programs sometimes fared poorly. What is striking is how hard it is to find radical changes in advanced welfare states. Retrenchment has been pursued cautiously: whenever possible, governments have sought all-party consensus for significant reforms and have chosen to trim existing structures rather than experiment with new programs or pursue privatization.

This finding is striking, given that so many observers have seen the post-1973 period as one of fundamental change in modern political economies. A harsher economic climate has certainly generated demands for spending restraint. Additional pressures have stemmed from the maturation of social programs and adverse demographic trends. Yet compared with the aspirations of many reformers and with the extent of change in fields such as industrial relations policy, macroeconomic policy, or the privatization of public industries, what stands out is the relative stability of the welfare state.

I have suggested that to understand what has been happening requires looking beyond the considerable pressures on the welfare state to consider enduring sources of support. There are powerful political forces that stabilize welfare states and channel change in the direction of incremental modifications of existing policies. The first major protection for social programs stems from the generally conservative characteristics of democratic political institutions. The welfare state now represents the status quo, with all the political advantages that this status confers. Nondecisions generally favor the welfare state. Major policy change usually requires the acquiescence of numerous actors. Where power is shared among different institutions (for example, Germany, the United States), radical reform will be difficult.

As the British and Swedish cases show, radical change is not easy even in a situation of concentrated political power. A second and crucial source of the welfare state's political strength comes from the high electoral costs generally associated with retrenchment initiatives. Despite scholarly speculation about declining popular support for the welfare state, polls show little evidence of such a shift, and actual political struggles over social spending reveal even less. On the contrary, even halting efforts to dismantle the welfare state have usually exacted a high
politics of social benefits are relatively concentrated and are generally well organized. They are also more likely to punish politicians for cutbacks than taxpayers are to reward them for lower costs. Nowhere is there evidence to support the scenario of a self-reinforcing dynamic, with cutbacks leading to middle-class disenchantment and exit, laying the foundation for more retrenchment. Instead, the recurrent pattern in public-opinion polls has been a mild swing against the welfare state in the wake of poor economic performance and budgetary stress, followed by a resurgence of support at the first whiff of significant cuts.

Nor does the welfare state's political position seem to have been seriously eroded—at least in the medium term—by the decline of its key traditional constituency, organized labor. Only for those benefits where unions are the sole organized constituency, such as unemployment insurance, has labor's declining power presented immediate problems, and even here the impact can be exaggerated. The growth of social spending has reconfigured the terrain of welfare state politics. Maturing social programs produce new organized interests, the consumers and providers of social services, that are usually well placed to defend the welfare state.

The networks associated with mature welfare state programs constitute a barrier to radical change in another sense as well. As recent research on path dependence has demonstrated, once initiated, certain courses of development are hard to reverse. Organizations and individuals adapt to particular arrangements, making commitments that may render the costs of change (even to some potentially more efficient alternative) far higher than the costs of continuity. Existing commitments lock in policymakers. Old-age pension systems provide a good example. Most countries operate pensions on a pay-as-you-go basis: current workers pay "contributions" that finance the previous genera-

85 Indeed, a cross-national comparison of unemployment programs provides further support for this analysis. The OECD has measured replacement rates for UI (benefits as a percentage of previous income) over time in twenty countries, with data through 1991. This data thus permit, for one program, a recent quantitative appraisal of program generosity rather than simply spending levels. In the majority of cases (twelve out of twenty), replacement rates were higher in 1991 than the average rate for either the 1970s or the 1980s, while most of the other cases experienced very marginal declines. Organization for Economic Cooperation and Development, The OECD Jobs Study: Facts, Analysis, Strategies (Paris: OECD, 1994), chart 16, p. 24.

tion's retirement. Once in place, such systems may face incremental cutbacks, but they are notoriously resistant to radical reform.87 Shifting to private, occupationally based arrangements would place an untenable burden on current workers, requiring them to finance the previous generation's retirement while simultaneously saving for their own.

Over time, all institutions undergo change. This is especially so for very large ones, which cannot be isolated from broad social developments. The welfare state is no exception. But there is little sign that the last two decades have been a transformative period for systems of social provision. As I have argued, expectations for greater change have rested in part on the implicit application of models from the period of welfare state expansion, which can be read to suggest that economic change, the decline in union power, or the presence of a strong state creates the preconditions for radical retrenchment. I find little evidence for these claims.

This preliminary investigation still leaves us some distance from a coherent comparative theory of retrenchment politics. It does, however, suggest some of the building blocks for such a theory. The pressures of a shifting global economy, which have long been at the center of discussions of the contemporary welfare state, continue to deserve major (if more nuanced) attention. What needs more consideration is what happens when these considerable pressures collide with popular, deeply institutionalized public policies. I have emphasized that politicians are likely to pursue strategies that will not damage their chances for reelection. The centrality of electoral considerations, combined with the general unpopularity of welfare state cutbacks, suggests some plausible hypotheses about the political preconditions for significant reform. These hypotheses are only tentative and would need to be subjected to sustained comparative scrutiny. Each, however, is compatible with the analysis of retrenchment outlined here and with the evidence presented.

First, radical retrenchment may be facilitated when there is significant electoral slack, that is, when governments believe that they are in a strong enough position to absorb the electoral consequences of unpopular decisions.88 Thus, one reason for Thatcher's relative (though still limited) success may have been the division among her opponents

87 Thus in Germany, Sweden, and the United States the maturity of existing schemes limited policymakers to very gradual and incremental reforms of earnings-related pension systems. More dramatic reform was possible in Britain because the unfunded earnings-related scheme was far from maturity, having been passed only in 1975. Pierson (fn. 31).

88 For an example of this argument, see Garrett (fn. 41).
within a first-past-the-post electoral system. This may have given her more room to pursue unpopular policies that would have been beyond the reach of a government in a precarious electoral position. However, calculating electoral slack ex ante is a tricky business, and most governments are likely to proceed cautiously. As I have indicated, even the Thatcher government generally retreated when confronted with widespread opposition.

Second, moments of budgetary crisis may open opportunities for reform. Advocates of retrenchment will try to exploit such moments to present reforms as an effort to save the welfare state rather than destroy it. Framing the issue in this manner may allow governments to avoid widespread blame for program cutbacks. Making the claim of crisis credible, however, generally requires collaboration with the political opposition. In turn, the need for consensus makes it difficult to utilize crises to promote radical restructuring. Thus, while the appearance of fiscal stress encourages downward adjustments in social programs, it is far less clear that it provides a platform for a radical overhaul of social policy.

Third, the success of retrenchment advocates will vary with the chances for lowering the visibility of reforms. Those seeking retrenchment will try to avoid political outcries by diminishing the visibility of their cutbacks or by trying to hide their own responsibility for unpopular outcomes. Success in these efforts, I have argued, depends partly on the design of political institutions. Whether political authority is concentrated or not helps to structure the choices available to retrenchment advocates. Where authority is concentrated (as in Britain and Sweden), governments will be hard-pressed to avoid blame for unpopular decisions, but they will have a greater capacity to develop and implement strategies that obscure cutbacks. Governments in more fragmented systems must fashion strategies that minimize the need to force multiple policy changes through institutional veto points. However, they may find it easier to duck accountability for unpopular policies. Federalism, for example, opened up considerable possibilities for Reagan to shift the blame for cuts in some programs, a tactic that is central to the current efforts of congressional Republicans.

Finally, the prospects for changing institutions (the rules of the game) may be of great significance. If retrenchment advocates can restructure the ways in which trade-offs between taxes, spending, and deficits are presented, evaluated, and decided, they may be able to shift the balance of political power. So far, these institutional shifts have been rare, but several instances may be of growing relevance. In Europe
the increasing policy significance of the EC may alter the terrain for struggles over the welfare state. If reforms can be presented as legally required or economically imperative because of the single market or moves toward monetary union, national governments may be freed from some blame for welfare-state cutbacks. In the United States the new Republican majority in Congress deferred efforts to cut programs until after a strong (but only modestly successful) push to change the rules of the game. The intent of the rule changes was to increase the salience of taxes and create a more favorable climate for attacking social spending.

If this analysis suggests some plausible sources of cross-national variation, it also highlights the need to disaggregate welfare states and consider variations across programs. Indeed, in the four cases considered outcomes often differed more across programs (for example, the contrast between council housing and the NHS in Britain) than across countries. It is commonly argued that the crucial distinction across programs will be between universal programs and those that target the poor, and that the latter will be especially vulnerable. Yet the current investigation does not support this assertion. Rather, variations in outcomes across programs in the four countries do not generally track the universal/targeted divide. Among the likely reasons that targeted programs have generally not proved more vulnerable: cuts in these programs tend to yield only minimal budgetary savings, and conservative governments interested in radical reform object the most to the universal programs that require high tax rates and compete with plausible private alternatives. Instead, the current investigation suggests that a promising area of research concerns the features of programs that allow governments either to obscure the impact of retrenchment on voters or to diminish their own accountability for unpopular reforms. Programs that are poorly indexed, for example, make it easier to pursue a low-visibility strategy of allowing inflation to gradually erode the value of benefits.

All of these hypotheses build on the core argument of this essay: that frontal assaults on the welfare state carry tremendous electoral risks.

89 For an argument about how EC institutions may allow blame-avoiding behavior on the part of member state governments, see Andrew Moravcsik, "Why the EC Strengthens the State" (Manuscript, 1994).

90 Robert Kuttner has called this "the most fundamental principle in the political economy of social spending," Kuttner, "Reaganism, Liberalism, and the Democrats," in Sidney Blumenthal and Thomas Byrne Edsall, eds., The Reagan Legacy (New York: Pantheon, 1988), 113. For a critique, see Pierson (fn. 12), 6, 170.

91 See Pierson (fn. 12), 17–26, 169–75.
The contemporary politics of the welfare state is the politics of blame avoidance. Governments confronting the electoral imperatives of modern democracy will undertake retrenchment only when they discover ways to minimize the political costs involved. But as I emphasize, such techniques are hard to come by. While this analysis suggests some of the possible keys to variation in policy outcomes, the most significant finding concerns not variation but commonality. Everywhere, retrenchment is a difficult undertaking. The welfare state remains the most resilient aspect of the postwar political economy.

Understanding why this is so requires that old arguments be rethought and recast to address the exigencies of a new setting. At a time when historical institutionalism has become fashionable, this conclusion has broad implications for the study of comparative politics. The strong calls to incorporate historical analysis into the study of contemporary politics are compelling. Yet we must remain cognizant of the hazards of drawing on history in the wrong way. There are significant dangers in using historical analogies to study contemporary social politics, since the goals of social policy reformers and the context in which they operate have undergone profound change. Instead, historically grounded analysis should emphasize that social policy change is a process that unfolds over time. My focus on the impact of inherited social policy structures draws on this precise point. The growth of the welfare state has transformed the politics of social policy. A historical perspective should stress that today’s policymakers operate in an environment fundamentally shaped by policies inherited from the past, rather than suggesting that current politics will echo the conflicts of a previous era.

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1982). Thus, the origins of the Keynesian full-employment commitment and the social democratic welfare-state edifice have been traced to the capacity of (variably) strong working-class movements to forge a political alliance with farmer organizations; additionally, it is arguable that sustained social democracy has come to depend on the formation of a new-working-class–white-collar coalition.

The class-coalitional approach has additional virtues. Two nations, such as Austria and Sweden, may score similarly on working-class mobilization variables, and yet produce highly unequal policy results. This can be explained by differences in the history of coalition formation in two countries: the breakthrough of Swedish social democratic hegemony stems from its capacity to forge the famous ‘red–green’ alliance with the farmers; the comparative disadvantage of the Austrian socialists rests in the ‘ghetto’ status assigned to them by virtue of the rural classes being captured by a conservative coalition (Esping-Andersen and Korpi, 1984).

In summary, we have to think in terms of social relations, not just social categories. Whereas structural functionalist explanations identify convergent welfare-state outcomes, and class-mobilization paradigms see large, but linearly distributed, differences, an interactive model such as the coalition approach directs attention to distinct welfare-state regimes.

What is the Welfare State?

Every theoretical paradigm must somehow define the welfare state. How do we know when and if a welfare state responds functionally to the needs of industrialism, or to capitalist reproduction and legitimacy? And how do we identify a welfare state that corresponds to the demands that a mobilized working class might have? We cannot test contending arguments unless we have a commonly shared conception of the phenomenon to be explained.

A remarkable attribute of the entire literature is its lack of much genuine interest in the welfare state as such. Welfare-state studies have been motivated by theoretical concerns with other phenomena, such as power, industrialization, or capitalist contradictions; the welfare state itself has generally received scant conceptual attention. If welfare states differ, how do they differ? And when, indeed, is a state a welfare state? This turns attention straight back to the original question: what is the welfare state?

A common textbook definition is that it involves state responsibility
for securing some basic modicum of welfare for its citizens. Such a definition skirts the issue of whether social policies are emancipatory or not; whether they help system legitimation or not; whether they contradict or aid the market process; and what, indeed, is meant by ‘basic’? Would it not be more appropriate to require of a welfare state that it satisfies more than our basic or minimal welfare needs?

The first generation of comparative studies started with this type of conceptualization. They assumed, without much reflection, that the level of social expenditure adequately reflects a state's commitment to welfare. The theoretical intent was not really to arrive at an understanding of the welfare state, but rather to test the validity of contending theoretical models in political economy. By scoring nations with respect to urbanization, level of economic growth, and the proportion of aged in the demographic structure, it was believed that the essential features of industrial modernization were properly considered. Alternatively, power-oriented theories compared nations on left-party strength or working-class power mobilization.

The findings of the first-generation comparativists are difficult to evaluate, since there is no convincing case for any particular theory. The shortage of nations for comparisons statistically restricts the number of variables that can be tested simultaneously. Thus, when Cutright (1965) or Wilensky (1975) find that economic level, with its demographic and bureaucratic correlates, explains most welfare-state variations in 'rich countries', relevant measures of working-class mobilization or economic openness are not included. Their conclusions in favor of a 'logic of industrialism' view are therefore in doubt. And, when Hewitt (1977), Stephens (1979), Korpi (1983), Myles (1984a), and Esping-Andersen (1985b) find strong evidence in favor of a working-class mobilization thesis, or when Schmidt (1982; 1983) finds support for a neo-corporatist, and Cameron (1978) for an economic openness argument, it is without fully testing against plausible alternative explanations. 7

Most of these studies claim to explain the welfare state. Yet their focus on spending may be misleading. Expenditures are epiphenomenal to the theoretical substance of welfare states. Moreover, the linear scoring approach (more or less power, democracy, or spending) contradicts the sociological notion that power, democracy, or welfare are relational and structured phenomena. By scoring welfare states on spending, we assume that all spending counts equally. But some welfare states, the Austrian one, for example, spend a large share on benefits to privileged civil servants. This is normally not what we would consider a commitment to social citizenship and solidarity. Others spend disproportionately on means-tested social assistance. Few contemporary
analysts would agree that a reformed poor-relief tradition qualifies as a welfare-state commitment. Some nations spend enormous sums on fiscal welfare in the form of tax privileges to private insurance plans that mainly benefit the middle classes. But these tax expenditures do not show up on expenditure accounts. In Britain, total social expenditure has grown during the Thatcher period, yet this is almost exclusively a function of very high unemployment. Low expenditure on some programs may signify a welfare state more seriously committed to full employment.

Therborn (1983) is right when he holds that we must begin with a conception of state structure. What are the criteria with which we should judge whether, and when, a state is a welfare state? There are three approaches to this question. Therborn's proposal is to begin with the historical transformation of state activities. Minimally, in a genuine welfare state the majority of its daily routine activities must be devoted to servicing the welfare needs of households. This criterion has far-reaching consequences. If we simply measure routine activity in terms of spending and personnel, the result is that no state can be regarded as a real welfare state until the 1970s, and some that we normally label as welfare states will not qualify because the majority of their routine activities concern defence, law and order, administration, and the like (Therborn, 1983). Social scientists have been too quick to accept nations' self-proclaimed welfare-state status. They have also been too quick to conclude that if the standard social programs have been introduced, the welfare state has been born.

The second conceptual approach derives from Richard Titmuss's (1958) classical distinction between residual and institutional welfare states. In the former, the state assumes responsibility only when the family or the market fails; it seeks to limit its commitments to marginal and deserving social groups. The latter model addresses the entire population, is universalistic, and embodies an institutionalized commitment to welfare. It will, in principle, extend welfare commitments to all areas of distribution vital for societal welfare.

The Titmuss approach has fertilized a variety of new developments in comparative welfare-state research (Myles, 1984a; Korpi, 1980; Esping-Andersen and Korpi, 1984; 1986; Esping-Andersen, 1985b; 1987b). It is an approach that forces researchers to move from the black box of expenditures to the content of welfare states: targeted versus universalistic programs, the conditions of eligibility, the quality of benefits and services, and, perhaps most importantly, the extent to which employment and working life are encompassed in the state's extension of citizen rights. The shift to welfare-state typologies makes simple linear
welfare-state rankings difficult to sustain. Conceptually, we are comparing categorically different types of states.

The third approach is to theoretically select the criteria on which to judge types of welfare states. This can be done by measuring actual welfare states against some abstract model and then scoring programs, or entire welfare states, accordingly (Day 1978; Myles, 1984a). But this is ahistorical, and does not necessarily capture the ideals or designs that historical actors sought to realize in the struggles over the welfare state. If our aim is to test causal theories that involve actors, we should begin with the demands that were actually promoted by those actors that we deem critical in the history of welfare-state development. It is difficult to imagine that anyone struggled for spending *per se*.

**A Re-Specification of the Welfare State**

Few can disagree with T. H. Marshall's (1950) proposition that social citizenship constitutes the core idea of a welfare state. But the concept must be fleshed out. Above all, it must involve the granting of social rights. If social rights are given the legal and practical status of property rights, if they are inviolable, and if they are granted on the basis of citizenship rather than performance, they will entail a de-commodification of the status of individuals *vis-à-vis* the market. But the concept of social citizenship also involves social stratification: one's status as a citizen will compete with, or even replace, one's class position.

The welfare state cannot be understood just in terms of the rights it grants. We must also take into account how state activities are interlocked with the market's and the family's role in social provision. These are the three main principles that need to be fleshed out prior to any theoretical specification of the welfare state.

**Rights and de-commodification**

In pre-capitalist societies, few workers were properly commodities in the sense that their survival was contingent upon the sale of their labor power. It is as markets become universal and hegemonic that the welfare of individuals comes to depend entirely on the cash nexus. Stripping society of the institutional layers that guaranteed social reproduction outside the labor contract meant that people were commodified. In turn, the introduction of modern social rights implies a loosening of the pure commodity status. De-commodification occurs
when a service is rendered as a matter of right, and when a person can maintain a livelihood without reliance on the market.

The mere presence of social assistance or insurance may not necessarily bring about significant de-commodification if they do not substantially emancipate individuals from market dependence. Means-tested poor relief will possibly offer a safety net of last resort. But if benefits are low and associated with social stigma, the relief system will compel all but the most desperate to participate in the market. This was precisely the intent of the nineteenth-century poor laws in most countries. Similarly, most of the early social-insurance programs were deliberately designed to maximize labor-market performance (Ogus, 1979).

There is no doubt that de-commodification has been a hugely contested issue in welfare state development. For labor, it has always been a priority. When workers are completely market-dependent, they are difficult to mobilize for solidaristic action. Since their resources mirror market inequalities, divisions emerge between the ‘ins’ and the ‘outs’, making labor-movement formation difficult. De-commodification strengthens the worker and weakens the absolute authority of the employer. It is for exactly this reason that employers have always opposed de-commodification.

De-commodified rights are differentially developed in contemporary welfare states. In social-assistance dominated welfare states, rights are not so much attached to work performance as to demonstrable need. Needs-tests and typically meager benefits, however, serve to curtail the de-commodifying effect. Thus, in nations where this model is dominant (mainly in the Anglo-Saxon countries), the result is actually to strengthen the market since all but those who fail in the market will be encouraged to contract private-sector welfare.

A second dominant model espouses compulsory state social insurance with fairly strong entitlements. But again, this may not automatically secure substantial de-commodification, since this hinges very much on the fabric of eligibility and benefit rules. Germany was the pioneer of social insurance, but over most of the century can hardly be said to have brought about much in the way of de-commodification through its social programs. Benefits have depended almost entirely on contributions, and thus on work and employment. In other words, it is not the mere presence of a social right, but the corresponding rules and preconditions, which dictate the extent to which welfare programs offer genuine alternatives to market dependence.

The third dominant model of welfare, namely the Beveridge-type citizens’ benefit, may, at first glance, appear the most de-commodifying.
It offers a basic, equal benefit to all, irrespective of prior earnings, contributions, or performance. It may indeed be a more solidaristic system, but not necessarily de-commodifying, since only rarely have such schemes been able to offer benefits of such a standard that they provide recipients with a genuine option to working.

De-commodifying welfare states are, in practice, of very recent date. A minimal definition must entail that citizens can freely, and without potential loss of job, income, or general welfare, opt out of work when they themselves consider it necessary. With this definition in mind, we would, for example, require of a sickness insurance that individuals be guaranteed benefits equal to normal earnings, and the right to absence with minimal proof of medical impairment and for the duration that the individual deems necessary. These conditions, it is worth noting, are those usually enjoyed by academics, civil servants, and higher-echelon white-collar employees. Similar requirements would be made of pensions, maternity leave, parental leave, educational leave, and unemployment insurance.

Some nations have moved towards this level of de-commodification, but only recently, and, in many cases, with significant exemptions. In almost all nations, benefits were upgraded to nearly equal normal wages in the late 1960s and early 1970s. But in some countries, for example, prompt medical certification in case of illness is still required; in others, entitlements depend on long waiting periods of up to two weeks; and in still others, the duration of entitlements is very short. As we shall see in chapter 2, the Scandinavian welfare states tend to be the most de-commodifying; the Anglo-Saxon the least.

The Welfare State as a System of Stratification

Despite the emphasis given to it in both classical political economy and in T. H. Marshall's pioneering work, the relationship between citizenship and social class has been neglected both theoretically and empirically. Generally speaking, the issue has either been assumed away (it has been taken for granted that the welfare state creates a more egalitarian society), or it has been approached narrowly in terms of income distribution or in terms of whether education promotes upward social mobility. A more basic question, it seems, is what kind of stratification system is promoted by social policy. The welfare state is not just a mechanism that intervenes in, and possibly corrects, the structure of inequality; it is, in its own right, a system of stratification. It is an active force in the ordering of social relations.
Comparatively and historically, we can easily identify alternative systems of stratification embedded in welfare states. The poor-relief tradition, and its contemporary means-tested social-assistance offshoot, was conspicuously designed for purposes of stratification. By punishing and stigmatizing recipients, it promotes social dualisms and has therefore been a chief target of labor-movement attacks.

The social-insurance model promoted by conservative reformers such as Bismarck and von Taffe, was also explicitly a form of class politics. It sought, in fact, to achieve two simultaneous results in terms of stratification. The first was to consolidate divisions among wage-earners by legislating distinct programs for different class and status groups, each with its own conspicuously unique set of rights and privileges which was designed to accentuate the individual’s appropriate station in life. The second objective was to tie the loyalties of the individual directly to the monarchy or the central state authority. This was Bismarck’s motive when he promoted a direct state supplement to the pension benefit. This state-corporatist model was pursued mainly in nations such as Germany, Austria, Italy, and France, and often resulted in a labyrinth of status-specific insurance funds.

Of special importance in this corporatist tradition was the establishment of particularly privileged welfare provisions for the civil service (Beamten). In part, this was a means of rewarding loyalty to the state, and in part it was a way of demarcating this group’s uniquely exalted social status. The corporatist status-differentiated model springs mainly from the old guild tradition. The neo-absolutist autocrats, such as Bismarck, saw in this tradition a means to combat the rising labor movements.

The labor movements were as hostile to the corporatist model as they were to poor relief – in both cases for obvious reasons. Yet the alternatives first espoused by labor were no less problematic from the point of view of uniting the workers as one solidaristic class. Almost invariably, the model that labor first pursued was that of self-organized friendly societies or equivalent union- or party-sponsored fraternal welfare plans. This is not surprising. Workers were obviously suspicious of reforms sponsored by a hostile state, and saw their own organizations not only as bases of class mobilization, but also as embryos of an alternative world of solidarity and justice; as a microcosm of the socialist haven to come. Nonetheless, these micro-socialist societies often became problematic class ghettos that divided rather than united workers. Membership was typically restricted to the strongest strata of the working class, and the weakest – who most needed protection – were
most likely excluded. In brief, the fraternal society model frustrated the goal of working-class mobilization.

The socialist 'ghetto approach' was an additional obstacle when socialist parties found themselves forming governments and having to pass the social reforms they had so long demanded. For political reasons of coalition-building and broader solidarity, their welfare model had to be recast as welfare for 'the people'. Hence, the socialists came to espouse the principle of universalism; borrowing from the liberals, their program was, typically, designed along the lines of the democratic flat-rate, general revenue-financed Beveridge model.

As an alternative to means-tested assistance and corporatist social insurance, the universalistic system promotes equality of status. All citizens are endowed with similar rights, irrespective of class or market position. In this sense, the system is meant to cultivate cross-class solidarity, a solidarity of the nation. But the solidarity of flat-rate universalism presumes a historically peculiar class structure, one in which the vast majority of the population are the 'little people' for whom a modest, albeit egalitarian, benefit may be considered adequate. Where this no longer obtains, as occurs with growing working-class prosperity and the rise of the new middle classes, flat-rate universalism inadvertently promotes dualism because the better-off turn to private insurance and to fringe-benefit bargaining to supplement modest equality with what they have decided are accustomed standards of welfare. Where this process unfolds (as in Canada or Great Britain), the result is that the wonderfully egalitarian spirit of universalism turns into a dualism similar to that of the social-assistance state: the poor rely on the state, and the remainder on the market.

It is not only the universalist but, in fact, all historical welfare-state models which have faced the dilemma of changes in class structure. But the response to prosperity and middle-class growth has been varied, and so, therefore, has been the outcome in terms of stratification. The corporatist insurance tradition was, in a sense, best equipped to manage new and loftier welfare-state expectations since the existing system could technically be upgraded quite easily to distribute more adequate benefits. Adenauer's 1957 pension-reform in Germany was a pioneer in this respect. Its avowed purpose was to restore status differences that had been eroded because of the old insurance system's incapacity to provide benefits tailored to expectations. This it did simply by moving from contribution- to earnings-graduated benefits without altering the framework of status-distinctiveness.

In nations with either a social-assistance or a universalistic Beveridge-
type system, the option was whether to allow the market or the state to furnish adequacy and satisfy middle-class aspirations. Two alternative models emerged from this political choice. The one typical of Great Britain and most of the Anglo-Saxon world was to preserve an essentially modest universalism in the state, and allow the market to reign for the growing social strata demanding superior welfare. Due to the political power of such groups, the dualism that emerges is not merely one between state and market, but also between forms of welfare-state transfers: in these nations, one of the fastest growing components of public expenditure is tax subsidies for so-called 'private' welfare plans. And the typical political effect is the erosion of middle-class support for what is less and less a universalistic public-sector transfer system.

Yet another alternative has been to seek a synthesis of universalism and adequacy outside of the market. This road has been followed in countries where, by mandating or legislation, the state incorporates the new middle classes within a luxurious second-tier, universally inclusive, earnings-related insurance scheme on top of the flat-rate egalitarian one. Notable examples are Sweden and Norway. By guaranteeing benefits tailored to expectations, this solution reintroduces benefit inequalities, but effectively blocks off the market. It thus succeeds in retaining universalism and also, therefore, the degree of political consensus required to preserve broad and solidaristic support for the high taxes that such a welfare-state model demands.

Welfare-State Regimes

As we survey international variations in social rights and welfare-state stratification, we will find qualitatively different arrangements between state, market, and the family. The welfare-state variations we find are therefore not linearly distributed, but clustered by regime-types.

In one cluster we find the 'liberal' welfare state, in which means-tested assistance, modest universal transfers, or modest social-insurance plans predominate. Benefits cater mainly to a clientele of low-income, usually working-class, state dependents. In this model, the progress of social reform has been severely circumscribed by traditional, liberal work-ethic norms: it is one where the limits of welfare equal the marginal propensity to opt for welfare instead of work. Entitlement rules are therefore strict and often associated with stigma; benefits are typically modest. In turn, the state encourages the market, either
passively – by guaranteeing only a minimum – or actively – by subsidizing private welfare schemes.

The consequence is that this type of regime minimizes de-commodification-effects, effectively contains the realm of social rights, and erects an order of stratification that is a blend of a relative equality of poverty among state-welfare recipients, market-differentiated welfare among the majorities, and a class-political dualism between the two. The archetypical examples of this model are the United States, Canada and Australia.

A second regime-type clusters nations such as Austria, France, Germany, and Italy. Here, the historical corporatist-statist legacy was upgraded to cater to the new ‘post-industrial’ class structure. In these conservative and strongly ‘corporatist’ welfare states, the liberal obsession with market efficiency and commodification was never preeminent and, as such, the granting of social rights was hardly ever a seriously contested issue. What predominated was the preservation of status differentials; rights, therefore, were attached to class and status. This corporatism was subsumed under a state edifice perfectly ready to displace the market as a provider of welfare; hence, private insurance and occupational fringe benefits play a truly marginal role. On the other hand, the state’s emphasis on upholding status differences means that its redistributive impact is negligible.

But the corporatist regimes are also typically shaped by the Church, and hence strongly committed to the preservation of traditional family- hood. Social insurance typically excludes non-working wives, and family benefits encourage motherhood. Day care, and similar family services, are conspicuously underdeveloped; the principle of ‘subsidiarity’ serves to emphasize that the state will only interfere when the family’s capacity to service its members is exhausted.

The third, and clearly smallest, regime-cluster is composed of those countries in which the principles of universalism and de-commodification of social rights were extended also to the new middle classes. We may call it the ‘social democratic’ regime-type since, in these nations, social democracy was clearly the dominant force behind social reform. Rather than tolerate a dualism between state and market, between working class and middle class, the social democrats pursued a welfare state that would promote an equality of the highest standards, not an equality of minimal needs as was pursued elsewhere. This implied, first, that services and benefits be upgraded to levels commensurate with even the most discriminating tastes of the new middle classes; and, second, that equality be furnished by guaranteeing workers full participation in the quality of rights enjoyed by the better-off.
This formula translates into a mix of highly de-commodifying and universalistic programs that, nonetheless, are tailored to differentiated expectations. Thus, manual workers come to enjoy rights identical to those of salaried white-collar employees or civil servants; all strata are incorporated under one universal insurance system, yet benefits are graduated according to accustomed earnings. This model crowds out the market, and consequently constructs an essentially universal solidarity in favor of the welfare state. All benefit; all are dependent; and all will presumably feel obliged to pay.

The social democratic regime's policy of emancipation addresses both the market and the traditional family. In contrast to the corporatist-subsidiarity model, the principle is not to wait until the family's capacity to aid is exhausted, but to preemptively socialize the costs of familyhood. The ideal is not to maximize dependence on the family, but capacities for individual independence. In this sense, the model is a peculiar fusion of liberalism and socialism. The result is a welfare state that grants transfers directly to children, and takes direct responsibility of caring for children, the aged, and the helpless. It is, accordingly, committed to a heavy social-service burden, not only to service family needs but also to allow women to choose work rather than the household.

Perhaps the most salient characteristic of the social democratic regime is its fusion of welfare and work. It is at once genuinely committed to a full-employment guarantee, and entirely dependent on its attainment. On the one side, the right to work has equal status to the right of income protection. On the other side, the enormous costs of maintaining a solidaristic, universalistic, and de-commodifying welfare system means that it must minimize social problems and maximize revenue income. This is obviously best done with most people working, and the fewest possible living off of social transfers.

Neither of the two alternative regime-types espouse full employment as an integral part of their welfare-state commitment. In the conservative tradition, of course, women are discouraged from working; in the liberal ideal, concerns of gender matter less than the sanctity of the market.

In the chapters to follow, we show that welfare states cluster, but we must recognize that there is no single pure case. The Scandinavian countries may be predominantly social democratic, but they are not free of crucial liberal elements. Neither are the liberal regimes pure types. The American social-security system is redistributive, compulsory, and far from actuarial. At least in its early formulation, the New Deal was as social democratic as was contemporary Scandinavian social democracy.
And European conservative regimes have incorporated both liberal and social democratic impulses. Over the decades, they have become less corporativist and less authoritarian.

Notwithstanding the lack of purity, if our essential criteria for defining welfare states have to do with the quality of social rights, social stratification, and the relationship between state, market, and family, the world is obviously composed of distinct regime-clusters. Comparing welfare states on scales of more or less or, indeed, of better or worse, will yield highly misleading results.

The Causes of Welfare-State Regimes

If welfare states cluster into three distinct regime-types, we face a substantially more complex task of identifying the causes of welfare-state differences. What is the explanatory power of industrialization, economic growth, capitalism, or working-class political power in accounting for regime-types? A first superficial answer would be: very little. The nations we study are all more or less similar with regard to all but the variable of working-class mobilization. And we find very powerful labor movements and parties in each of the three clusters.

A theory of welfare-state developments must clearly reconsider its causal assumptions if it wishes to explain clusters. The hope of finding one single powerful causal force must be abandoned; the task is to identify salient interaction-effects. Based on the preceding arguments, three factors in particular should be of importance: the nature of class mobilization (especially of the working class); class-political coalition structures; and the historical legacy of regime institutionalization.

As we have noted, there is absolutely no compelling reason to believe that workers will automatically and naturally forge a socialist class identity; nor is it plausible that their mobilization will look especially Swedish. The actual historical formation of working-class collectivities will diverge, and so also will their aims, ideology, and political capacities. Fundamental differences appear both in trade-unionism and party development. Unions may be sectional or in pursuit of more universal objectives; they may be denominational or secular; and they may be ideological or devoted to business-unionism. Whichever they are, it will decisively affect the articulation of political demands, class cohesion, and the scope for labor-party action. It is clear that a working-class mobilization thesis must pay attention to union structure.

The structure of trade-unionism may or may not be reflected in labor-party formation. But under what conditions are we likely to
expect certain welfare-state outcomes from specific party configura-
tions? There are many factors that conspire to make it virtually
impossible to assume that any labor, or left-wing, party will ever be
capable, single-handedly, of structuring a welfare state. Denomination-
al or other divisions aside, it will be only under extraordinary historical
circumstances that a labor party alone will command a parliamentary
majority long enough to impose its will. We have noted that the
traditional working class has hardly ever constituted an electoral
majority. It follows that a theory of class mobilization must look beyond
the major leftist parties. It is a historical fact that welfare-state construc-
tion has depended on political coalition-building. The structure of class
coalitions is much more decisive than are the power resources of any
single class.

The emergence of alternative class coalitions is, in part, determined
by class formation. In the earlier phases of industrialization, the rural
classes usually constituted the largest single group in the electorate. If
social democrats wanted political majorities, it was here that they were
forced to look for allies. One of history’s many paradoxes is that the
rural classes were decisive for the future of socialism. Where the rural
economy was dominated by small, capital-intensive family farmers, the
potential for an alliance was greater than where it rested on large pools
of cheap labor. And where farmers were politically articulate and
well-organized (as in Scandinavia), the capacity to negotiate political
deals was vastly superior.

The role of the farmers in coalition formation and hence in welfare-
state development is clear. In the Nordic countries, the necessary
conditions obtained for a broad red–green alliance for a full-
employment welfare state in return for farm-price subsidies. This was
especially true in Norway and Sweden, where farming was highly
precarious and dependent on state aid. In the United States, the New
Deal was premised on a similar coalition (forged by the Democratic
Party), but with the important difference that the labor-intensive South
blocked a truly universalistic social security system and opposed further
welfare-state developments. In contrast, the rural economy of continen-
tal Europe was very inhospitable to red–green coalitions. Often, as in
Germany and Italy, much of agriculture was labor-intensive; hence the
unions and left-wing parties were seen as a threat. In addition, the
conservative forces on the continent had succeeded in incorporating
farmers into ‘reactionary’ alliances, helping to consolidate the political
isolation of labor.

Political dominance was, until after World War II, largely a question
of rural class politics. The construction of welfare states in this period
was, therefore, dictated by whichever force captured the farmers. The absence of a red-green alliance does not necessarily imply that no welfare-state reforms were possible. On the contrary, it implies which political force came to dominate their design. Great Britain is an exception to this general rule, because the political significance of the rural classes eroded before the turn of the century. In this way, Britain's coalition-logic showed at an early date the dilemma that faced most other nations later; namely, that the rising white-collar strata constitute the linchpin for political majorities. The consolidation of welfare states after World War II came to depend fundamentally on the political alliances of the new middle classes. For social democracy, the challenge was to synthesize working-class and white-collar demands without sacrificing the commitment to solidarity.

Since the new middle classes have, historically, enjoyed a relatively privileged position in the market, they have also been quite successful in meeting their welfare demands outside the state, or, as civil servants, by privileged state welfare. Their employment security has traditionally been such that full employment has been a peripheral concern. Finally, any program for drastic income-equalization is likely to be met with great hostility among a middle-class clientele. On these grounds, it would appear that the rise of the new middle classes would abort the social democratic project and strengthen a liberal welfare-state formula.

The political leanings of the new middle classes have, indeed, been decisive for welfare-state consolidation. Their role in shaping the three welfare-state regimes described earlier is clear. The Scandinavian model relied almost entirely on social democracy's capacity to incorporate them into a new kind of welfare state: one that provided benefits tailored to the tastes and expectations of the middle classes, but nonetheless retained universalism of rights. Indeed, by expanding social services and public employment, the welfare state participated directly in manufacturing a middle class instrumentally devoted to social democracy.

In contrast, the Anglo-Saxon nations retained the residual welfare-state model precisely because the new middle classes were not wooed from the market to the state. In class terms, the consequence is dualism. The welfare state caters essentially to the working class and the poor. Private insurance and occupational fringe benefits cater to the middle classes. Given the electoral importance of the latter, it is quite logical that further extensions of welfare-state activities are resisted.

The third, continental European, welfare-state regime has also been patterned by the new middle classes, but in a different way. The cause is historical. Developed by conservative political forces, these regimes
institutionalized a middle-class loyalty to the preservation of both occupationally segregated social-insurance programs and, ultimately, to the political forces that brought them into being. Adenauer's great pension-reform in 1957 was explicitly designed to resurrect middle-class loyalties.

Conclusion

We have here presented an alternative to a simple class-mobilization theory of welfare-state development. It is motivated by the analytical necessity of shifting from a linear to an interactive approach with regard to both welfare states and their causes. If we wish to study welfare states, we must begin with a set of criteria that define their role in society. This role is certainly not to spend or tax; nor is it necessarily that of creating equality. We have presented a framework for comparing welfare states that takes into consideration the principles for which the historical actors have willingly united and struggled. When we focus on the principles embedded in welfare states, we discover distinct regime-clusters, not merely variations of 'more' or 'less' around a common denominator.

The historical forces behind the regime differences are interactive. They involve, first, the pattern of working-class political formation and, second, political coalition-building in the transition from a rural economy to a middle-class society. The question of political coalition-formation is decisive. Third, past reforms have contributed decisively to the institutionalization of class preferences and political behavior. In the corporatist regimes, hierarchical status-distinctive social insurance cemented middle-class loyalty to a peculiar type of welfare state. In liberal regimes, the middle classes became institutionally wedded to the market. And in Scandinavia, the fortunes of social democracy over the past decades were closely tied to the establishment of a middle-class welfare state that benefits both its traditional working-class clientele and the new white-collar strata. The Scandinavian social democrats were able to achieve this in part because the private welfare market was relatively undeveloped and in part because they were capable of building a welfare state with features of sufficient luxury to satisfy the wants of a more discriminating public. This also explains the extraordinarily high cost of Scandinavian welfare states.

But a theory that seeks to explain welfare-state growth should also be able to understand its retrenchment or decline. It is generally believed that welfare-state backlash movements, tax revolts, and roll-backs are
Ours is a framework that should be of interest to economists, scholars of business, and political scientists alike. We turn now to an elucidation of its basic elements.

1.2 The Basic Elements of the Approach

This varieties of capitalism approach to the political economy is actor-centered, which is to say we see the political economy as a terrain populated by multiple actors, each of whom seeks to advance his interests in a rational way in strategic interaction with others (Scharpf 1997a). The relevant actors may be individuals, firms, producer groups, or governments. However, this is a firm-centered political economy that regards companies as the crucial actors in a capitalist economy. They are the key agents of adjustment in the face of technological change or international competition whose activities aggregate into overall levels of economic performance.

1.2.1 A Relational View of the Firm

Our conception of the firm is relational. Following recent work in economics, we see firms as actors seeking to develop and exploit core competencies or dynamic capabilities understood as capacities for developing, producing, and distributing goods and services profitably (Teece and Pisano 1998). We take the view that critical to these is the quality of the relationships the firm is able to establish, both internally, with its own employees, and externally, with a range of other actors that include suppliers, clients, collaborators, stakeholders, trade unions, business associations, and governments. As the work on transactions costs and principal–agent relationships in the economics of organization has underlined, these are problematic relationships (Milgrom and Roberts 1992). Even where hierarchies can be used to secure the cooperation of actors, firms encounter problems of moral hazard, adverse selection, and shirking. In many cases, effective operation even within a hierarchical environment may entail the formation of implicit contracts among the actors; and many of a firm’s relationships with outside actors involve incomplete contracting (cf. Williamson 1985). In short, because its capabilities are ultimately relational, a firm encounters many coordination problems. Its success depends substantially on its ability to coordinate effectively with a wide range of actors.

For the purposes of this inquiry, we focus on five spheres in which firms must develop relationships to resolve coordination problems central
to their core competencies. The first is the sphere of industrial relations where the problem facing companies is how to coordinate bargaining over wages and working conditions with their labor force, the organizations that represent labor, and other employers. At stake here are wage and productivity levels that condition the success of the firm and rates of unemployment or inflation in the economy as a whole. In the sphere of vocational training and education, firms face the problem of securing a workforce with suitable skills, while workers face the problem of deciding how much to invest in what skills. On the outcomes of this coordination problem turn not only the fortunes of individual companies and workers but the skill levels and competitiveness of the overall economy.

Issues of coordination also arise in the sphere of corporate governance, to which firms turn for access to finance and in which investors seek assurances of returns on their investments. The solutions devised to these problems affect both the availability of finance for particular types of projects and the terms on which firms can secure funds. The fourth sphere in which coordination problems crucial to the core competencies of an enterprise appear is the broad one of inter-firm relations, a term we use to cover the relationships a company forms with other enterprises, and notably its suppliers or clients, with a view to securing a stable demand for its products, appropriate supplies of inputs, and access to technology. These are endeavors that may entail standard-setting, technology transfer, and collaborative research and development. Here, coordination problems stem from the sharing of proprietary information and the risk of exploitation in joint ventures. On the development of appropriate relationships in this sphere, however, depend the capacities of firms to remain competitive and technological progress in the economy as a whole.

Finally, firms face a set of coordination problems vis-à-vis their own employees. Their central problem is to ensure that employees have the requisite competencies and cooperate well with others to advance the objectives of the firm. In this context, familiar problems of adverse selection and moral hazard arise, and issues of information-sharing become important (see Milgrom and Roberts 1992). Workers develop reservoirs of specialized information about the firm’s operations that can be of value to management, but they also have the capacity to withhold information or effort. The relationships firms develop to resolve these problems condition their own competencies and the character of an economy’s production regimes.
1.2.2 Liberal Market Economies and Coordinated Market Economies

From this perspective, it follows that national political economies can be compared by reference to the way in which firms resolve the coordination problems they face in these five spheres. The core distinction we draw is between two types of political economies, liberal market economies and coordinated market economies, which constitute ideal types at the poles of a spectrum along which many nations can be arrayed.\(^6\)

In *liberal market economies*, firms coordinate their activities primarily via hierarchies and competitive market arrangements. These forms of coordination are well described by a classic literature (Williamson 1985). Market relationships are characterized by the arm’s-length exchange of goods or services in a context of competition and formal contracting. In response to the price signals generated by such markets, the actors adjust their willingness to supply and demand goods or services, often on the basis of the marginal calculations stressed by neoclassical economics.\(^7\) In many respects, market institutions provide a highly effective means for coordinating the endeavors of economic actors.

In *coordinated market economies*, firms depend more heavily on non-market relationships to coordinate their endeavors with other actors and to construct their core competencies. These non-market modes of coordination generally entail more extensive relational or incomplete contracting, network monitoring based on the exchange of private information inside networks, and more reliance on collaborative, as opposed to competitive, relationships to build the competencies of the firm. In contrast to liberal market economies (LMEs), where the equilibrium outcomes of firm behavior are usually given by demand and supply conditions in competitive markets, the equilibria on which firms coordinate in coordinated market economies (CMEs) are more often the result of strategic interaction among firms and other actors.

Market relations and hierarchies are important to firms in all capitalist economies, of course, and, even in liberal market economies, firms enter

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\(^6\) In other works by the contributors to this volume, ‘organized market economy’ is sometimes used as a term synonymous with ‘coordinated market economy’. Although all of the economies we discuss are ‘coordinated’ in the general sense of the term, by markets if not by other institutions, the term reflects the prominence of strategic interaction and hence of coordination in the game-theoretic sense in CMEs.

\(^7\) Although we do not emphasize it here, this is not meant to deny the observation of Granovetter (1985) and others that market relations are usually underpinned by personal relationships of familiarity and trust.
into some relationships that are not fully mediated by market forces. But this typology is based on the contention that the incidence of different types of firm relationships varies systematically across nations. In some nations, for instance, firms rely primarily on formal contracts and highly competitive markets to organize relationships with their employees and suppliers of finance, while, in others, firms coordinate these endeavors differently. In any national economy, firms will gravitate toward the mode of coordination for which there is institutional support.

1.2.3 The Role of Institutions and Organizations

Institutions, organizations, and culture enter this analysis because of the support they provide for the relationships firms develop to resolve coordination problems. Following North (1990: 3), we define institutions as a set of rules, formal or informal, that actors generally follow, whether for normative, cognitive, or material reasons, and organizations as durable entities with formally recognized members, whose rules also contribute to the institutions of the political economy.

From this perspective, markets are institutions that support relationships of particular types, marked by arm’s-length relations and high levels of competition. Their concomitant is a legal system that supports formal contracting and encourages relatively complete contracts, as the chapters by Teubner and Casper indicate. All capitalist economies also contain the hierarchies that firms construct to resolve the problems that cannot be addressed by markets (Williamson 1985). In liberal market economies, these are the principal institutions on which firms rely to coordinate their endeavors.

Although markets and hierarchies are also important elements of coordinated market economies, firms in this type of economy draw on a further set of organizations and institutions for support in coordinating their endeavors. What types of organizations and institutions support the distinctive strategies of economic actors in such economies? Because the latter rely more heavily on forms of coordination secured through

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8 This point applies with particular force to market relationships in which one or more of the participants has substantially more market power than the others, as in cases of oligopoly, oligopsony, and the relations found in some supplier chains. We are not arguing that all markets in LMEs are perfectly competitive.

9 Note that, from time to time, we refer loosely to the ‘institutions’ or ‘organization’ of the political economy to refer to both the organizations and institutions found within it.
strategic interaction to resolve the problems they face, the relevant institutions will be those that allow them to coordinate on equilibrium strategies that offer higher returns to all concerned. In general, these will be institutions that reduce the uncertainty actors have about the behavior of others and allow them to make credible commitments to each other. A standard literature suggests that these are institutions providing capacities for (i) the exchange of information among the actors, (ii) the monitoring of behavior, and (iii) the sanctioning of defection from cooperative endeavor (see Ostrom 1990). Typically, these institutions include powerful business or employer associations, strong trade unions, extensive networks of cross-shareholding, and legal or regulatory systems designed to facilitate information-sharing and collaboration. Where these are present, firms can coordinate on strategies to which they would not have been led by market relations alone.

The problem of operating collaborative vocational training schemes provides a classic example. Here, the willingness of firms to participate depends on the security of their beliefs that workers will learn useful skills and that firms not investing in training will not poach extensively from those who do, while the participation of workers depends on assurances that training will lead to remunerative employment. As Culpepper’s chapter in this volume indicates, it is easier for actors to secure these assurances where there are institutions providing reliable flows of information about appropriate skill levels, the incidence of training, and the employment prospects of apprentices (Finegold and Soskice 1988; Culpepper and Finegold 1999).

Similarly, the terms on which finance is provided to firms will depend on the monitoring capacities present in the economy. Where potential investors have little access to inside information about the progress of the firms they fund, access to capital is likely to depend on highly public criteria about the assets of a firm of the sort commonly found on balance sheets. Where investors are linked to the firms they fund through networks that allow for the development of reputations based on extensive access to information about the internal operations of the firm, however, investors will be more willing to supply capital to firms on terms that do not depend entirely on their balance sheets. The presence of institutions providing network reputational monitoring can have substantial effects on the terms on which firms can secure finance.

In short, this approach to comparative capitalism emphasizes the presence of institutions providing capacities for the exchange of information, monitoring, and the sanctioning of defections relevant to cooperative
behavior among firms and other actors; and it is for the presence of such institutions that we look when comparing nations.

In addition, examination of coordinated market economies leads us to emphasize the importance of another kind of institution that is not normally on the list of those crucial to the formation of credible commitments, namely institutions that provide actors potentially able to cooperate with one another with a capacity for deliberation. By this, we simply mean institutions that encourage the relevant actors to engage in collective discussion and to reach agreements with each other. Deliberative institutions are important for several reasons.

Deliberative proceedings in which the participants engage in extensive sharing of information about their interests and beliefs can improve the confidence of each in the strategies likely to be taken by the others. Many game-theoretic analyses assume a level of common knowledge that is relatively thin, barely stretching past a shared language and familiarity with the relevant payoffs. When multiple equilibria are available, however, coordination on one (especially one that exchanges higher payoffs for higher risks) can be greatly facilitated by the presence of a thicker common knowledge, one that extends beyond the basic situation to a knowledge of the other players sufficiently intimate to provide confidence that each will coordinate on a specific equilibrium (Eichengreen 1997). Deliberation can substantially thicken the common knowledge of the group.

As Scharpf (1987: ch. 4) has pointed out, although many think only of a ‘prisoner’s dilemma’ game when they consider problems of cooperation, in the political economy many such problems take quite different forms, including ‘battle of the sexes’ games in which joint gains are available from more than one strategy but are distributed differently depending on the equilibrium chosen. Distributive dilemmas of this sort are endemic to political economies, and agreement on the distribution of the relevant gains is often the prerequisite to effective cooperation (Knight 1992). In some cases, such as those of collaborative research and development, the problem is not simply to distribute the gains but also the risks attendant on the enterprise. Deliberation provides the actors with an opportunity to establish the risks and gains attendant on cooperation and to resolve the distributive issues associated with them. In some cases, the actors may simply be negotiating from positions of

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10 One political economist who has consistently drawn attention to the importance of deliberation is Sabel (1992, 1994) and the issue is now the subject of a growing game-theoretic literature (see Elster 1998).
relative power, but extensive deliberation over time may build up specific conceptions of distributive justice that can be used to facilitate agreement in subsequent exchanges.

Finally, deliberative institutions can enhance the capacity of actors in the political economy for strategic action when faced with new or unfamiliar challenges. This is far from irrelevant since economies are frequently subject to exogenous shocks that force the actors within them to respond to situations to which they are unaccustomed. The history of wage negotiations in Europe is replete with examples. In such instances, developments may outrun common knowledge, and deliberation can be instrumental to devising an effective and coordinated response, allowing the actors to develop a common diagnosis of the situation and an agreed response.

In short, deliberative institutions can provide the actors in a political economy with strategic capacities they would not otherwise enjoy; and we think cross-national comparison should be attentive to the presence of facilities for deliberation as well as institutions that provide for the exchange of information in other forms, monitoring, and the enforcement of agreements.

1.2.4 The Role of Culture, Informal Rules, and History

Our approach departs from previous works on comparative capitalism in another respect. Many analyses take the view that the relevant outcomes in economic performance or policy follow more or less directly from differences in the formal organization of the political economy. Particular types of wage settlements or rates of inflation and unemployment are often said to follow, for instance, from the organizational structure of the union movement. Because we believe such outcomes are the products of efforts to coordinate in contexts of strategic interaction, however, we reject the contention that they follow from the presence of a particular set of institutions alone, at least if the latter are defined entirely in terms of formal rules or organizations.

As we have noted, the presence of a set of formal institutions is often a necessary precondition for attaining the relevant equilibrium in contexts of coordination. But formal institutions are rarely sufficient to guarantee that equilibrium. In multi-player games with multiple iterations of the sort that characterize most of the cases in which we are

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11 Here we depart from some of our own previous formulations as well (cf. Hall 1986; Soskice 1990b).
interested, it is well known that there exist multiple equilibria, any one of which could be chosen by the actors even in the presence of institutions conducive to the formation of credible commitments (Fudenberg and Maskin 1986). Something else is needed to lead the actors to coordinate on a specific equilibrium and, notably, on equilibria offering high returns in a non-cooperative context.\footnote{Culpepper documents this problem and explores some solutions to it in this volume and Culpepper (1998).} In many instances, what leads the actors to a specific equilibrium is a set of shared understandings about what other actors are likely to do, often rooted in a sense of what it is appropriate to do in such circumstances (March and Olsen 1989).

Accordingly, taking a step beyond many accounts, we emphasize the importance of informal rules and understandings to securing the equilibria in the many strategic interactions of the political economy. These shared understandings are important elements of the ‘common knowledge’ that lead participants to coordinate on one outcome, rather than another, when both are feasible in the presence of a specific set of formal institutions. By considering them a component of the institutions making up the political economy, we expand the concept of institutions beyond the purely formal connotations given to it in some analyses.

This is an entry point in the analysis for history and culture. Many actors learn to follow a set of informal rules by virtue of experience with a familiar set of actors and the shared understandings that accumulate from this experience constitute something like a common culture. This concept of culture as a set of shared understandings or available ‘strategies for action’ developed from experience of operating in a particular environment is analogous to those developed in the ‘cognitive turn’ taken by sociology (Swidler 1986; DiMaggio and Powell 1991). Our view of the role that culture can play in the strategic interactions of the political economy is similar to the one Kreps (1990) accords it in organizations faced with problems of incomplete contracting.

The implication is that the institutions of a nation’s political economy are inextricably bound up with its history in two respects. On the one hand, they are created by actions, statutory or otherwise, that establish formal institutions and their operating procedures. On the other, repeated historical experience builds up a set of common expectations that allows the actors to coordinate effectively with each other. Among other things, this implies that the institutions central to the operation of the political economy should not be seen as entities that are created at one point in time and can then be assumed to operate effectively afterwards.
To remain viable, the shared understandings associated with them must be reaffirmed periodically by appropriate historical experience. As Thelen emphasizes in this volume, the operative force of many institutions cannot be taken for granted but must be reinforced by the active endeavors of the participants.

1.2.5 Institutional Infrastructure and Corporate Strategy

This varieties of capitalism approach draws its basic conceptions of how institutions operate from the new economics of organization. We apply a set of concepts commonly used to explain behavior at the micro level of the economy to problems of understanding the macroeconomy (Milgrom and Roberts 1992). One of the advantages is an analysis with robust and consistent postulates about what kind of institutions matter and how they affect behavior. Another is the capacity of the approach to integrate analysis of firm behavior with analysis of the political economy as a whole.

However, there are at least two respects in which our account deviates from mainstream views in the new economics of organization. First, although we make use of the influential dichotomy between ‘markets’ and ‘hierarchies’ that Williamson (1975) has impressed on the field, we do not think this exhausts the relevant variation. Markets and hierarchies are features of LMEs and CMEs but we stress the systematic variation found in the character of corporate structure (or hierarchies) across different types of economies and the presence of coordination problems even within hierarchical settings (Milgrom and Roberts 1992). Even more important, we do not see these two institutional forms as the only ones firms can employ to resolve the challenges they confront. In coordinated market economies in particular, many firms develop relationships with other firms, outside actors, and their employees that are not well described as either market-based or hierarchical relations but better seen as efforts to secure cooperative outcomes among the actors using a range of institutional devices that underpin credible commitments. Variation in the incidence and character of this ‘third’ type of relationship is central to the distinctions we draw between various types of political economies.13

Second, it is conventional in much of the new economics of organization to assume that the core institutional structures of the economy,

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13 Williamson (1985) himself acknowledges the presence of institutionalized relationships extending beyond markets or hierarchies, albeit without characterizing them precisely as we do here.
whether markets, hierarchies, or networks, are erected by firms seeking the most efficient institutions for performing certain tasks. The postulate is that (institutional) structure follows (firm) strategy (cf. Chandler 1974; Williamson 1975, 1985; Chandler and Daems 1980). In a restricted sense, this is certainly true: firms can choose whether to contract out an endeavor or perform it in-house, for instance, and they enjoy some control over their own corporate form.

However, we think it unrealistic to regard the overarching institutional structures of the political economy, and especially those coordinating the endeavors of many actors (such as markets, institutional networks, and the organizations supporting collaborative endeavor), as constructs created or controlled by a particular firm. Because they are collective institutions, a single firm cannot create them; and, because they have multifarious effects, it may be difficult for a group of firms to agree on them. Instead, as Calvert (1995) observes, the construction of coordinating institutions should be seen as a second-order coordination problem of considerable magnitude. Even when firms can agree, the project may entail regulatory action by the government and the formation of coalitions among political parties and labor organizations motivated by considerations going well beyond efficiency (Swenson 1991, 1997).

As a result, the firms located within any political economy face a set of coordinating institutions whose character is not fully under their control. These institutions offer firms a particular set of opportunities; and companies can be expected to gravitate toward strategies that take advantage of these opportunities. In short, there are important respects in which strategy follows structure. For this reason, our approach predicts systematic differences in corporate strategy across nations, and differences that parallel the overarching institutional structures of the political economy. This is one of the most important implications of the analysis.

Let us stress that we refer here to broad differences. Of course, there will be additional variation in corporate strategies inside all economies in keeping with differences in the resource endowments and market settings of individual firms. The capabilities of management also matter, since firms are actors with considerable autonomy. Our point is that (institutional) structure conditions (corporate) strategy, not that it fully determines it. We also agree that differences in corporate strategy can be conditioned by the institutional support available to firms at the regional or sectoral levels (Campbell et al. 1991; Hollingsworth et al. 1994; Herrigel

\[14\] At the sectoral or regional level, of course, large firms may be able to exercise substantial influence over the development of these institutions, as Hancké shows in this volume (see also Hancké forthcoming).
1996). Many of the works making this point are congruent with our own in that they stress the importance of the institutional environment to firm strategy, even though there has been fruitful disagreement about which features of that environment matter most (cf. Streeck 1992b).

However, we emphasize variations in corporate strategy evident at the national level. We think this justified by the fact that so many of the institutional factors conditioning the behavior of firms remain nation-specific. There are good reasons why that should be the case. Some of the relevant institutions were deeply conditioned by nationally specific processes of development, as are most trade unions and employers’ associations. In others, the relevant institutions depend heavily on statutes or regulations promulgated by national states, as do many institutions in the financial arena and labor market, not to mention the sphere of contract law.

In sum, we contend that differences in the institutional framework of the political economy generate systematic differences in corporate strategy across LMEs and CMEs. There is already some evidence for this. For instance, the data that Knetter (1989) has gathered are especially interesting. He finds that the firms of Britain, a typical LME, and those of Germany, a CME, respond very differently to a similar shock, in this case an appreciation of the exchange rate that renders the nation’s goods more expensive in foreign markets. British firms tend to pass the price increase along to customers in order to maintain their profitability, while German firms maintain their prices and accept lower returns in order to preserve market share.

Our approach predicts differences of precisely this sort. We would argue that British firms must sustain their profitability because the structure of financial markets in a liberal market economy links the firm’s access to capital and ability to resist takeover to its current profitability; and they can sustain the loss of market share because fluid labor markets allow them to lay off workers readily. By contrast, German firms can sustain a decline in returns because the financial system of a coordinated market economy provides firms with access to capital independent of current profitability; and they attempt to retain market share because the labor institutions in such an economy militate in favor of long-term employment strategies and render layoffs difficult.

It is possible to apply the general analytical framework of this volume to variations at the regional or sectoral level, as the chapter by Hancké does in some respects. From the perspective of this volume, institutional variation at the regional or sectoral level provides an additional layer of support for particular types of coordination and one that enhances a nation’s capacity to support a range of corporate strategies and production regimes.
These are only some of the ways in which the institutional arrangements of a nation's political economy tend to push its firms toward particular kinds of corporate strategies. We explore more of these below with special emphasis on innovation.

To put the point in the most general terms, however, firms and other actors in coordinated market economies should be more willing to invest in specific and co-specific assets (i.e., assets that cannot readily be turned to another purpose and assets whose returns depend heavily on the active cooperation of others), while those in liberal market economies should invest more extensively in switchable assets (i.e., assets whose value can be realized if diverted to other purposes). This follows from the fact that CMEs provide more institutional support for the strategic interactions required to realize the value of co-specific assets, whether in the form of industry-specific training, collaborative research and development, or the like, while the more fluid markets of LMEs provide economic actors with greater opportunities to move their resources around in search of higher returns, encouraging them to acquire switchable assets, such as general skills or multi-purpose technologies.\footnote{For examples in one sphere, see the essay by Estevez-Abe, Iversen, and Soskice in this volume.}

\section*{1.2.6 Institutional Complementarities}

The presence of institutional complementarities reinforces the differences between liberal and coordinated market economies. The concept of 'complementary goods' is a familiar one: two goods, such as bread and butter, are described as complementary if an increase in the price of one depresses demand for the other. However, complementarities may also exist among the operations of a firm: marketing arrangements that offer customized products, for instance, may offer higher returns when coupled to the use of flexible machine tools on the shop floor (Jaikumar 1986; Milgrom and Roberts 1990, 1995).

Following Aoki (1994), we extend this line of reasoning to the institutions of the political economy. Here, two institutions can be said to be complementary if the presence (or efficiency) of one increases the returns from (or efficiency of) the other.\footnote{Conversely, two institutions can be said to be 'substitutable' if the absence or inefficiency of one increases the returns to using the other. Note that we refer to total returns, leaving aside the question of to whom they accrue, which is a matter of property rights, and we define efficiency as the net returns to the use of an institution given its costs.} The returns from a stock market trading
in corporate securities, for instance, may be increased by regulations mandating a fuller exchange of information about companies.

Of particular interest are complementarities between institutions located in different spheres of the political economy. Aoki (1994) has argued that long-term employment is more feasible where the financial system provides capital on terms that are not sensitive to current profitability. Conversely, fluid labor markets may be more effective at sustaining employment in the presence of financial markets that transfer resources readily among endeavors thereby maintaining a demand for labor (cf. Caballero and Hamour 1998; Fehn 1998). Casper explores complementarities between national systems of contract law and modes of inter-firm collaboration, and we identify others in the sections that follow.

This point about institutional complementarities has special relevance for the study of comparative capitalism. It suggests that nations with a particular type of coordination in one sphere of the economy should tend to develop complementary practices in other spheres as well.\(^\text{18}\) Several logics may be operative here. In some cases, the institutions sustaining coordination in one sphere can be used to support analogous forms of coordination in others. Where dense networks of business associations support collaborative systems of vocational training, for instance, those same networks may be used to operate collective standard-setting. Similarly, firms may pressure governments to foster the development of institutions complementary to those already present in the economy in order to secure the efficiency gains they provide.

If this is correct, institutional practices of various types should not be distributed randomly across nations. Instead, we should see some clustering along the dimensions that divide liberal from coordinated market economies, as nations converge on complementary practices across different spheres. Fig. 1.1 presents some support for these propositions. It locates OECD nations on two axes that provide indicators for the character of institutions in the spheres of corporate finance and labor markets respectively. A highly developed stock market indicates greater reliance on market modes of coordination in the financial

\(^{18}\) Of course, there are limits to the institutional isomorphism that can be expected across spheres of the economy. Although efficiency considerations may press in this direction, the presence of functional equivalents for particular arrangements will limit the institutional homology even across similar types of political economies, and the importance to institutional development of historical processes driven by considerations other than efficiency will limit the number of complementarities found in any economy.
sphere, and high levels of employment protection tend to reflect higher levels of non-market coordination in the sphere of industrial relations.\footnote{The employment protection index developed by Estevez-Abe, Iversen, and Soskice in their chapter for this volume is a composite measure of the relative stringency of legislation or collective agreements dealing with hiring and firing, the level of restraint embedded in collective dismissal rules, and the extent of firm-level employment protection. Stock market capitalization is the market value of listed domestic companies as a percentage of GDP.} Although there is some variation within each group, a pronounced clustering is evident. Nations with liberal market economies tend to rely on markets to coordinate endeavors in both the financial and industrial relations systems, while those with coordinated market economies have institutions in both spheres that reflect higher levels of non-market coordination.

Among the large OECD nations, six can be classified as liberal market economies (the USA, Britain, Australia, Canada, New Zealand, Ireland) and another ten as coordinated market economies (Germany, Japan, Switzerland, the Netherlands, Belgium, Sweden, Norway, Denmark, ...
### Table 1.1 The economic performance of liberal and coordinated market economies

#### Liberal market economies

<table>
<thead>
<tr>
<th></th>
<th>Growth rate of GDP</th>
<th>GDP per capita</th>
<th>Unemployment rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>5.2 2.8 3.3</td>
<td>7932 16701</td>
<td>1.9 6.2 8.5</td>
</tr>
<tr>
<td>Canada</td>
<td>5.3 3.0 2.3</td>
<td>9160 18835</td>
<td>5.1 8.4 9.5</td>
</tr>
<tr>
<td>Ireland</td>
<td>4.4 3.9 6.5</td>
<td>4751 12830</td>
<td>5.0 9.1 14.1</td>
</tr>
<tr>
<td>New Zealand</td>
<td>4.0 1.8 1.7</td>
<td>7378 14172</td>
<td>0.2 2.2 6.9</td>
</tr>
<tr>
<td>UK</td>
<td>3.1 1.3 2.4</td>
<td>7359 15942</td>
<td>2.0 6.7 8.7</td>
</tr>
<tr>
<td>United States</td>
<td>4.0 2.2 2.9</td>
<td>11055 22862</td>
<td>4.9 7.5 6.0</td>
</tr>
<tr>
<td>LME average</td>
<td>4.3 2.5 3.2</td>
<td>7939 16890</td>
<td>3.2 6.7 8.9</td>
</tr>
</tbody>
</table>

#### Coordinated market economies

<table>
<thead>
<tr>
<th></th>
<th>Growth rate of GDP</th>
<th>GDP per capita</th>
<th>Unemployment rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria$^a$</td>
<td>4.9 2.3 2.5</td>
<td>7852 17414</td>
<td>1.6 2.2 5.3</td>
</tr>
<tr>
<td>Belgium</td>
<td>4.9 2.0 2.2</td>
<td>8007 17576</td>
<td>2.2 8.2 11.3</td>
</tr>
<tr>
<td>Denmark</td>
<td>4.4 1.8 2.2</td>
<td>8354 18618</td>
<td>1.4 7.1 9.3</td>
</tr>
<tr>
<td>Finland</td>
<td>5.0 2.7 2.2</td>
<td>7219 15619</td>
<td>2.0 4.8 9.4</td>
</tr>
<tr>
<td>Iceland</td>
<td>5.7 4.1 2.7</td>
<td>8319 18285</td>
<td>0.6 0.6 2.5</td>
</tr>
<tr>
<td>Germany</td>
<td>4.3 1.8 2.2</td>
<td>7542 16933</td>
<td>0.8 4.6 8.5</td>
</tr>
<tr>
<td>Japan</td>
<td>9.7 3.3 2.6</td>
<td>7437 18475</td>
<td>1.3 2.1 2.8</td>
</tr>
<tr>
<td>Netherlands$^b$</td>
<td>4.9 1.9 2.8</td>
<td>7872 16579</td>
<td>1.5 5.6 6.8</td>
</tr>
<tr>
<td>Norway</td>
<td>4.3 4.0 2.9</td>
<td>8181 19325</td>
<td>1.6 2.1 4.3</td>
</tr>
<tr>
<td>Sweden</td>
<td>4.2 1.8 1.5</td>
<td>8450 16710</td>
<td>1.9 2.3 4.8</td>
</tr>
<tr>
<td>Switzerland</td>
<td>4.4 5.8 1.3</td>
<td>10680 21398</td>
<td>0.1 0.4 2.5</td>
</tr>
<tr>
<td>CME average</td>
<td>5.1 2.4 2.3</td>
<td>8174 17902</td>
<td>1.3 3.6 6.1</td>
</tr>
</tbody>
</table>

Notes: Growth rate of GDP: average annual growth in GDP, averaged for the time-periods indicated. GDP per capita: per capita GDP at purchasing power parity, averaged for the time-periods indicated. Unemployment rate: annual unemployment rate.

$^a$ Unemployment series begins in 1964.

$^b$ Unemployment series begins in 1969.

Finland, and Austria) leaving six in more ambiguous positions (France, Italy, Spain, Portugal, Greece, and Turkey). However, the latter show some signs of institutional clustering as well, indicating that they may constitute another type of capitalism, sometimes described as ‘Mediterranean’, marked by a large agrarian sector and recent histories of extensive state intervention that have left them with specific kinds of capacities for non-market coordination in the sphere of corporate finance but more liberal arrangements in the sphere of labor relations (see Rhodes 1997).

Although each type of capitalism has its partisans, we are not arguing here that one is superior to another. Despite some variation over specific periods, both liberal and coordinated market economies seem capable of providing satisfactory levels of long-run economic performance, as the major indicators of national well-being displayed in Table 1.1 indicate. Where there is systematic variation between these types of political economies, it is on other dimensions of performance. We argue below that the two types of economies have quite different capacities for innovation. In addition, they tend to distribute income and employment differently. As Fig. 1.2 indicates, in liberal market economies, the adult population tends to be engaged more extensively in paid employment and levels of income inequality are high. In coordinated market economies, working hours tend to be shorter for more of the population and incomes more equal. With regard to the distribution of well-being, of course, these differences are important.

To make this analytical framework more concrete, we now look more closely at coordination in the principal spheres of firm endeavor in coordinated and liberal market economies, drawing on the cases of Germany and the United States for examples and emphasizing the institutional complementarities present in each political economy.

1.3 Coordinated Market Economies: The German Case

As we have noted, we regard capitalist economies as systems in which companies and individuals invest, not only in machines and material

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20 Luxembourg and Iceland have been omitted from this list because of their small size and Mexico because it is still a developing nation.

21 The Gini Index used in Fig. 1.2 is a standard measure for income inequality, measured here as post-tax, post-transfer income, reported in the Luxembourg Income Study for the mid- to late 1980s. Full-time equivalent employment is reported as a percentage of potential employment and measured as the total number of hours worked per year divided by full-time equivalent hours per person (37.5 hours at 50 weeks) times the working-age population. It is reported for the latest available of 1993 or 1994.
Fig. 1.2 Distributional outcomes across political economies

Note: Full-time equivalent employment is defined as the total number of hours worked per year divided by full-time equivalent hours per year per person times working age population. GINI refers to the gini coefficient measuring post-tax, post-transfer income inequality.

Sources: For full-time equivalent unemployment: OECD (1996a). For GINI index: Spain, Japan, New Zealand are from Deininger and Squire (1996); the remaining countries are from OECD (1996a).

technologies, but in competencies based on relations with others that entail coordination problems. In coordinated market economies, firms resolve many of these problems through strategic interaction. The resulting equilibria depend, in part, on the presence of supportive institutions. Here, we use the case of Germany to illustrate how non-market coordination is achieved in each of the principal spheres of firm endeavor. Of course, the institutions used to secure coordination in other CMEs may differ to some extent from those of Germany.

(i) The financial system or market for corporate governance in coordinated market economies typically provides companies with access to finance that is not entirely dependent on publicly available financial data or current returns. Access to this kind of ‘patient capital’ makes it possible for firms to retain a skilled workforce through economic downturns and to invest in projects generating returns only in the long run. The core problem here is that, if finance is not to be dependent on balance-sheet criteria, investors must have other ways of monitoring the performance
of companies in order to ensure the value of their investments. In general, that means they must have access to what would normally be considered 'private' or 'inside' information about the operation of the company.

This problem is generally resolved in CMEs by the presence of dense networks linking the managers and technical personnel inside a company to their counterparts in other firms on terms that provide for the sharing of reliable information about the progress of the firm. Reliability is secured in a number of ways. Firms may share information with third parties in a position to monitor the firm and sanction it for misleading them, such as business associations whose officials have an intimate knowledge of the industry. Reputation is also a key factor: where membership in a network is of continuing value, the participants will be deterred from providing false information lest their reputation in the network and access to it suffer. CMEs usually have extensive systems for what might be termed 'network reputational monitoring' (Vitols et al. 1997).

In Germany, information about the reputation and operation of a company is available to investors by virtue of (a) the close relationships that companies cultivate with major suppliers and clients, (b) the knowledge secured from extensive networks of cross-shareholding, and (c) joint membership in active industry associations that gather information about companies in the course of coordinating standard-setting, technology transfer, and vocational training. Other companies are not only represented on the supervisory boards of firms but typically engaged closely with them in joint research, product development, and the like. In short, firms sit inside dense business networks from which potential funders can gain a considerable amount of inside information about the track record and projects of a firm.\(^\text{22}\)

The overall structure of the market for corporate governance is equally important. Since firms often fund their activities from retained earnings, they are not always sensitive to the terms on which external finance is supplied. But they can be forced to focus on profitability and shareholder value if faced with the prospect of hostile takeover by others claiming to be able to extract more value from the company. Thus, the corporate strategies found in many CMEs also depend on tax provisions, securities regulations, and networks of cross-shareholding that

\(^{22}\) In previous decades, the German banks were also important contributors to such networks by virtue of their control over large numbers of shares in industrial firms (Hall 1986: ch. 9). In recent years, the role of the large commercial banks has declined, as they divest themselves of many holdings (Griffin 2000).
discourage hostile mergers and acquisitions, which were very rare until recently, for instance, in Germany.

(ii) The internal structure of the firm reinforces these systems of network monitoring in many CMEs. Unlike their counterparts in LMEs, for instance, top managers in Germany rarely have a capacity for unilateral action. Instead, they must secure agreement for major decisions from supervisory boards, which include employee representatives as well as major shareholders, and from other managers with entrenched positions as well as major suppliers and customers. This structural bias toward consensus decision-making encourages the sharing of information and the development of reputations for providing reliable information, thereby facilitating network monitoring.

In the perspective we present, the incentives facing individuals, whether managers or workers, are as important as those facing firms. In CMEs, managerial incentives tend to reinforce the operation of business networks. Long-term employment contracts and the premium that firm-structure places on a manager’s ability to secure consensus for his projects lead managers to focus heavily on the maintenance of their reputations, while the smaller weight given to stock-option schemes in managerial compensation in CMEs relative to LMEs inclines them to focus less on profitability than their counterparts in LMEs. The incentives for managers are broadly aligned with those of firms.

(iii) Many firms in coordinated market economies employ production strategies that rely on a highly skilled labor force given substantial work autonomy and encouraged to share the information it acquires in order to generate continuous improvements in product lines and production processes (Sorge and Warner 1986; Dore 1986). However, companies that adopt such strategies are vulnerable to ‘hold up’ by their employees and the ‘poaching’ of skilled workers by other firms, while employees who share the information they gain at work with management are open to exploitation.23 Thus, CMEs need industrial relations institutions capable of resolving such problems.

The German industrial relations system addresses these problems by setting wages through industry-level bargains between trade unions and employer associations that generally follow a leading settlement, normally reached in engineering where the union is powerful enough to

23 ‘Hold up’ is Williamson’s (1985) term for the withdrawal of active cooperation to back up demands.
Introduction

assure the labor movement that it has received a good deal. Although union density is only moderately high, encompassing employers' associations bind their members to these agreements. By equalizing wages at equivalent skill levels across an industry, this system makes it difficult for firms to poach workers and assures the latter that they are receiving the highest feasible rates of pay in return for the deep commitments they are making to firms. By coordinating bargaining across the economy, these arrangements also limit the inflationary effects of wage settlements (Streeck 1994; Hall and Franzese 1998).

The complement to these institutions at the company level is a system of works councils composed of elected employee representatives endowed with considerable authority over layoffs and working conditions. By providing employees with security against arbitrary layoffs or changes to their working conditions, these works councils encourage employees to invest in company-specific skills and extra effort. Their effectiveness is underpinned by the capacity of either side to appeal a disputed decision to the trade unions and employers' associations, who act as external guarantors that the councils function as intended (Thelen 1991).

(iv) Because coordinated market economies typically make extensive use of labor with high industry-specific or firm-specific skills, they depend on education and training systems capable of providing workers with such skills.24 As Culpepper notes in his chapter, the coordination problems here are acute, as workers must be assured that an apprenticeship will result in lucrative employment, while firms investing in training need to know that their workers will acquire usable skills and will not be poached by companies that do not make equivalent investments in training. CMEs resolve these problems in a variety of ways.

Germany relies on industry-wide employer associations and trade unions to supervise a publicly subsidized training system. By pressuring major firms to take on apprentices and monitoring their participation in such schemes, these associations limit free-riding on the training efforts of others; and, by negotiating industry-wide skill categories and training protocols with the firms in each sector, they ensure both that the training fits the firms' needs and that there will be an external demand for any graduates not employed by the firms at which they apprenticed. Because German employer associations are encompassing organizations

24 Compared to general skills that can be used in many settings, industry-specific skills normally have value only when used within a single industry and firm-specific skills only in employment within that firm.
that provide many benefits to their members and to which most firms in a sector belong, they are well placed to supply the monitoring and suasion that the operation of such a system demands as well as the deliberative forums in which skill categories, training quotas, and protocols can be negotiated. Workers emerge from their training with both company-specific skills and the skills to secure employment elsewhere.

(v) Since many firms in coordinated market economies make extensive use of long-term labor contracts, they cannot rely as heavily on the movement of scientific or engineering personnel across companies, to effect technology transfer, as liberal market economies do. Instead, they tend to cultivate *inter-company relations* of the sort that facilitate the diffusion of technology across the economy. In Germany, these relationships are supported by a number of institutions. Business associations promote the diffusion of new technologies by working with public officials to determine where firm competencies can be improved and orchestrating publicly subsidized programs to do so. The access to private information about the sector that these associations enjoy helps them ensure that the design of the programs is effective for these purposes. A considerable amount of research is also financed jointly by companies, often in collaboration with quasi-public research institutes. The common technical standards fostered by industry associations help to diffuse new technologies, and they contribute to a common knowledge-base that facilitates collaboration among personnel from multiple firms, as do the industry-specific skills fostered by German training schemes (Lütz 1993; Soskice 1997b; Ziegler 1997).

Casper's chapter in this volume shows that Germany has also developed a system of contract law complementary to the presence of strong industry associations that encourages relational contracting among companies and promotes this sort of technology transfer. Because of the many contingencies that can arise in close inter-firm relationships involving joint research or product development, tightly written, formal contracts are often inadequate to sustain such relationships. However, the German courts permit unusually open-ended clauses in inter-firm contracts on the explicit condition that these be grounded in the prevailing standards of the relevant industry association. Thus, the presence of strong industry associations capable of promulgating standards and resolving disputes among firms is the precondition for a system of contract law that encourages relational contracting (cf. Casper 1997; Teubner in this volume).

In these respects, German institutions support forms of relational contracting and technology transfer that are more difficult to achieve in
liberal market economies. One of the effects is to encourage corporate strategies that focus on product differentiation and niche production, rather than direct product competition with other firms in the industry, since close inter-firm collaboration is harder to sustain in the presence of the intense product competition that tends to characterize LMEs. The chapter by Estevez-Abe, Iversen, and Soskice examines the linkages between these product market strategies, skill systems, and social-policy regimes.

The complementarities present in the German political economy should be apparent from this account. Many firms pursue production strategies that depend on workers with specific skills and high levels of corporate commitment that are secured by offering them long employment tenures, industry-based wages, and protective works councils. But these practices are feasible only because a corporate governance system replete with mechanisms for network monitoring provides firms with access to capital on terms that are relatively independent of fluctuations in profitability. Effective vocational training schemes, supported by an industrial-relations system that discourages poaching, provide high levels of industry-specific skills. In turn, this encourages collective standard-setting and inter-firm collaboration of the sort that promotes technology transfer. The arrows in Fig. 1.3 summarize some of these complementarities. Since many of these institutional practices enhance the effectiveness with which others operate, the economic returns to the system as a whole are greater than its component parts alone would generate.

1.4 Liberal Market Economies: The American Case

Liberal market economies can secure levels of overall economic performance as high as those of coordinated market economies, but they do so quite differently. In LMEs, firms rely more heavily on market relations to resolve the coordination problems that firms in CMEs address more often via forms of non-market coordination that entail collaboration and strategic interaction. In each of the major spheres of firm endeavor, competitive markets are more robust and there is less institutional support for non-market forms of coordination.

(i) Several features of the financial systems or markets for corporate governance of liberal market economies encourage firms to be attentive to current earnings and the price of their shares on equity markets. Regulatory regimes are tolerant of mergers and acquisitions, including the hostile
takeovers that become a prospect when the market valuation of a firm declines. The terms on which large firms can secure finance are heavily dependent on their valuation in equity markets, where dispersed investors depend on publicly available information to value the company. This applies to both bonds, share issues, and bank lending.\textsuperscript{25} Compensation systems that reward top management for increases in net earnings

\textsuperscript{25} Firms in LMEs tend to rely on bond and equity markets for external finance more heavily than those in CMEs. However, bank lending in such economies also privileges publicly accessible, balance-sheet criteria, since banks find it difficult to monitor the less-
or share price are common in such economies. Liberal market economies usually lack the close-knit corporate networks capable of providing investors with inside information about the progress of companies that allows them to supply finance less dependent on quarterly balance sheets and publicly available information. The relevant contrast is with CMEs, where firms need not be as attentive to share price or current profitability in order to ensure access to finance or deter hostile takeovers.

Of course, there are some qualifications to these generalizations. Companies with readily assessable assets associated with forward income streams, such as pharmaceutical firms with a ‘pipeline’ of drugs, consumer-goods companies with strong reputations for successful product development, and firms well positioned in high-growth markets, need not be as concerned about current profitability. New firms in high-technology fields can often secure funds from venture-capital companies that develop the resources and technical expertise to monitor their performance directly and trade ownership stakes in these firms for the high risks they take.\footnote{Note that we avoid a distinction often drawn between countries in which firms can raise ‘long-term’ capital versus those in which only ‘short-term’ capital is available because this distinction is rarely meaningful. Many companies in LMEs with established market reputations can raise capital for projects promising revenues only in the medium to long term, and firms often finance the bulk of their activities from retained earnings. Of more relevance are the rules governing hostile takeovers, whose prospect can induce firms to pay more attention to corporate earnings and the price of their shares.}\footnote{Partly for this reason, the market valuation of firms in LMEs often depends more heavily on the reputation of its CEO than it does in CMEs.} On the whole, however, the markets for corporate governance in LMEs encourage firms to focus on the publicly assessable dimensions of their performance that affect share price, such as current profitability.

(ii) In the \textit{industrial relations arena}, firms in liberal market economies generally rely heavily on the market relationship between individual worker and employer to organize relations with their labor force. Top management normally has unilateral control over the firm, including substantial freedom to hire and fire.\footnote{Partly for this reason, the market valuation of firms in LMEs often depends more heavily on the reputation of its CEO than it does in CMEs.} Firms are under no obligation to establish representative bodies for employees such as works councils; and trade unions are generally less powerful than in CMEs, although they may have significant strength in some sectors. Because trade unions
and employer associations in LMEs are less cohesive and encompassing, economy-wide wage coordination is generally difficult to secure. Therefore, these economies depend more heavily on macroeconomic policy and market competition to control wages and inflation (see Franzese in this volume; Hall and Franzese 1998).

The presence of highly fluid labor markets influences the strategies pursued by both firms and individuals in liberal market economies. These markets make it relatively easy for firms to release or hire labor in order to take advantage of new opportunities but less attractive for them to pursue production strategies based on promises of long-term employment. They encourage individuals to invest in general skills, transferable across firms, rather than company-specific skills and in career trajectories that include a substantial amount of movement among firms.

(iii) The education and training systems of liberal market economies are generally complementary to these highly fluid labor markets. Vocational training is normally provided by institutions offering formal education that focuses on general skills because companies are loath to invest in apprenticeship schemes imparting industry-specific skills where they have no guarantees that other firms will not simply poach their apprentices without investing in training themselves. From the perspective of workers facing short job tenures and fluid labor markets, career success also depends on acquiring the general skills that can be used in many different firms; and most educational programs from secondary through university levels, even in business and engineering, stress ‘certification’ in general skills rather than the acquisition of more specialized competencies.

High levels of general education, however, lower the cost of additional training. Therefore, the companies in these economies do a substantial amount of in-house training, although rarely in the form of the intensive apprenticeships used to develop company-specific or industry-specific skills in CMEs. More often, they provide further training in the marketable skills that employees have incentives to learn. The result is a labor force well equipped with general skills, especially suited to job growth in the service sector where such skills assume importance, but one that leaves some firms short of employees with highly specialized or company-specific skills.

(iv) Inter-company relations in liberal market economies are based, for the most part, on standard market relationships and enforceable formal contracts. In the United States, these relations are also mediated by
rigorous antitrust regulations designed to prevent companies from colluding to control prices or markets and doctrines of contract laws that rely heavily on the strict interpretation of written contracts, nicely summarized by MacNeil's dictum: 'sharp in by clear agreement, sharp out by clear performance' (Williamson 1985). Therefore, companies wishing to engage in relational contracts with other firms get little assistance from the American legal system, as Casper observes.

In some fields of endeavor, such as after-sales service, companies can engage successfully in incomplete contracting by building up reputations on which other parties rely. But extensive reputation-building is more difficult in economies lacking the dense business networks or associations that circulate reputations for reliability or sharp practice quickly and widely. Because the market for corporate governance renders firms sensitive to fluctuations in current profitability, it is also more difficult for them to make credible commitments to relational contracts that extend over substantial periods of time.

How then does technology transfer take place in liberal market economies? In large measure, it is secured through the movement of scientists and engineers from one company to another (or from research institutions to the private sector) that fluid labor markets facilitate. These scientific personnel bring their technical knowledge with them. LMEs also rely heavily on the licensing or sale of innovations to effect technology transfer, techniques that are most feasible in sectors of the economy where effective patenting is possible, such as biotechnology, micro-electronics, and semiconductors. In the United States, the character of standard-setting reinforces the importance of licensing. Since few sectors have business associations capable of securing consensus on new standards, collective standard-setting is rarely feasible. Instead, standards are often set by market races, whose winners then profit by licensing their technology to many users (see also Tate in this volume). The prominence of this practice helps to explain the presence of venture-capital firms in liberal market economies: one success at standard-setting can pay for many failed investments (Borrus and Zysman 1997).

In LMEs, research consortia and inter-firm collaboration, therefore, play less important roles in the process of technology transfer than in CMEs where the institutional environment is more conducive to them. Until the National Cooperative Research Act of 1984, American firms engaging in close collaboration with other firms actually ran the risk of being sued for triple damages under antitrust law; and it is still estimated that barely 1 to 7 per cent of the funds spent on research and development in the American private sector are devoted to collaborative research.
It should be apparent that there are many institutional complementarities across the sub-spheres of a liberal market economy (see Fig. 1.4). Labor market arrangements that allow companies to cut costs in a downturn by shedding labor are complementary to financial markets that render a firm’s access to funds dependent on current profitability. Educational arrangements that privilege general, rather than firm-specific, skills are complementary to highly fluid labor markets; and the latter render forms of technology transfer that rely on labor mobility more feasible. In

Fig. 1.4 Complementarities across subsystems in the American liberal market economy
the context of a legal system that militates against relational contracting, licensing agreements are also more effective than inter-firm collaboration on research and development for effecting technology transfer.

Special note should be taken of the complementarities between the internal structure of firms and their external institutional environment in liberal and coordinated market economies. In LMEs, corporate structures that concentrate authority in top management make it easier for firms to release labor when facing pressure from financial markets and to impose a new strategy on the firm to take advantage of the shifting market opportunities that often present themselves in economies characterized by highly mobile assets. By contrast, in CMEs, where access to finance and technology often depends on a firm’s attractiveness as a collaborator and hence on its reputation, corporate structures that impose more consensual forms of decision-making allow firms to develop reputations that are not entirely dependent on those of its top management. By reducing the capacity of top management to act arbitrarily, these structures also enhance the firm’s capacity to enter credibly into relational contracts with employees and others in economies where a firm’s access to many kinds of assets, ranging from technology to skills, may depend on its capacity for relational contracting. Lehrer’s chapter explores some of these linkages between corporate structure and the external environment in more detail.

1.5 Comparing Coordination

Although many of the developed nations can be classified as liberal or coordinated market economies, the point of this analysis is not simply to identify these two types but to outline an approach that can be used to compare many kinds of economies. In particular, we are suggesting that it can be fruitful to consider how firms coordinate their endeavors and to analyze the institutions of the political economy from a perspective that asks what kind of support they provide for different kinds of coordination, even when the political economies at hand do not correspond to the ideal types we have just outlined.

It is important to note that, even within these two types, significant variations can be found. Broadly speaking, liberal market economies are distinguishable from coordinated market economies by the extent to which firms rely on market mechanisms to coordinate their endeavors as opposed to forms of strategic interaction supported by non-market institutions. Because market institutions are better known, we will not explore the differences among liberal market economies here. But a few
words about variation in coordinated market economies may be appropriate, if only to show that variation in the institutional structures underpinning strategic coordination can have significant effects on corporate strategy and economic outcomes.

One important axis of difference among CMEs runs between those that rely primarily on *industry-based coordination*, as do many of the northern European nations, and those with institutional structures that foster *group-based coordination* of the sort found in Japan and South Korea. As we have seen, in Germany, coordination depends on business associations and trade unions that are organized primarily along sectoral lines, giving rise to vocational training schemes that cultivate industry-specific skills, a system of wage coordination that negotiates wages by sector, and corporate collaboration that is often industry-specific. By contrast, the business networks of most importance in Japan are built on *keiretsu*, families of companies with dense interconnections cutting across sectors, the most important of which is nowadays the *vertical keiretsu* with one major company at its center.

These differences in the character of business networks have major implications. In Germany, companies within the same sector often cooperate in the sensitive areas of training and technology transfer. But the structure of the Japanese economy encourages sharp competition between companies in the same industry. Cooperation on sensitive matters is more likely to take place within the *keiretsu*, i.e. among firms operating in different sectors but within one ‘family’ of companies. The sectoral cooperation that takes place usually concerns less sensitive matters, including recession cartels, licensing requirements, and entry barriers as well as the annual wage round (Soskice 1990a). Partly for this reason, the attempts of MITI to develop cooperative research projects within sectors have had very limited success; serious research and development remains the preserve of the laboratories of the major companies.

This pattern of *keiretsu*-led coordination also has significant implications for patterns of skill acquisition and technology transfer. Serious training, technology transfer and a good deal of standard-setting take place primarily within the vertical *keiretsu*. Workers are encouraged to acquire firm- or group-specific skills, and notably strong relational skills appropriate for use within the family of companies within which they have been trained. In order to persuade workers to invest in skills of this specificity, the large firms have customarily offered many of them lifetime employment. And, in order to sustain such commitments, many Japanese firms have cultivated the capacity to move rapidly into new
products and product areas in response to changes in world markets and technologies. This kind of corporate strategy takes advantage of the high levels of workforce cooperation that lifetime employment encourages. To reinforce it, Japanese firms have also developed company unions providing the workforce with a voice in the affairs of the firm.

Japanese firms tend to lack the capacities for radical innovation that American firms enjoy by virtue of fluid market settings or for sector-centered technology transfer of the sort found in Germany. Instead, the group-based organization of the Japanese political economy has encouraged firms there to develop distinctive corporate strategies that take advantage of the capacities for cross-sector technology transfer and rapid organizational redeployment provided by the *keiretsu* system. These translate into comparative institutional advantages in the large-scale production of consumer goods, machinery, and electronics that exploit existing technologies and capacities for organizational change. Although Japan is clearly a coordinated market economy, the institutional structures that support group-based coordination have been conducive to corporate strategies and comparative advantages somewhat different from those in economies with industry-based systems of coordination.

The varieties of capitalism approach can also be useful for understanding political economies that do not correspond to the ideal type of a liberal or coordinated market economy. From our perspective, each economy displays specific capacities for coordination that will condition what its firms and government do.

France is a case in point, and the chapters in this volume by Lehrer, Culpepper, and Hancké explore some of the implications of this approach for it. Collaboration across French companies is based on career patterns that led many of the managers of leading firms through a few elite schools and the public service before taking up their positions in the private sector. Lehrer observes that the top managers of many French firms, therefore, have close ties to the state and weak ties to the rest of the enterprise. As a result, he argues, they are less likely to pursue the corporate strategies found in Britain or Germany and more likely to look to the state for assistance than their counterparts in other nations. Using the case of vocational training, however, Culpepper shows that there are clear limits to what states can do in the absence of strong business associations capable of monitoring their members. Hancké examines how large French firms are adapting to these limits, suggesting that many are taking industrial reorganization upon themselves, sometimes devising new networks to coordinate their activities.
In sum, although the contrast between coordinated and liberal market economies is important, we are not suggesting that all economies conform to these two types. Our object is to advance comparative analysis of the political economy more generally by drawing attention to the ways in which firms coordinate their endeavors, elucidating the connections between firm strategies and the institutional support available for them, and linking these factors to patterns of policy and performance. These are matters relevant to any kind of political economy.

1.6 Comparative Institutional Advantage

We turn now to some of the issues to which this perspective can be applied, beginning with a question central to international economics, namely, how to construe comparative economic advantage. The theory of comparative economic advantage is important because it implies that freer trade will not impoverish nations by driving their production abroad but enrich them by allowing each to specialize in the goods it produces most efficiently and exchange them for even more goods from other nations. It can be used to explain both the expansion of world trade and the patterns of product specialization found across nations. The most influential version of the theory focuses on the relative endowment of basic factors (such as land, labor, and capital) found in a nation and suggests that trade will lead a nation to specialize in the production of goods that use its most abundant factors most intensively (Stolper and Samuelson 1941).

However, recent developments have dealt a serious blow to this account of comparative economic advantage. The most important of these include the expansion of intra-industry trade and increases in the international mobility of capital. If the theory is correct, nations should not import and export high volumes of goods from the same sector; and there is a real possibility that international movements of capital will even out national factor endowments. As a result, some economists have become skeptical about whether comparative advantages really exist, and many have begun to seek other explanations for the expansion of trade and the geographic distribution of production.

Some explain the growth of trade, and intra-industry trade in particular, as the result of efforts to concentrate production in order to secure returns to scale (Helpmann 1984). Others explain the concentration of particular kinds of production in some nations as the result of firms' efforts to secure the positive externalities generated by a group of firms.
The State, Internationalization, and Capitalist Diversity in Eastern Europe

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Contributions to the debate on varieties of capitalism in Eastern Europe are made in three ways. First, the four types of capitalist regimes that differ in particular institutional configurations and performances are empirically identified: the state-crafted neoliberalism of the Baltic States, the more directly world-market driven neoliberalism of the CIS countries, the embedded neoliberalism of the Visegrad countries, and neo-corporatism in Slovenia. Second, the diversity of capitalist regimes are explained as a result of the complex interplay of external factors – specifically world commodity and financial markets, international institutions and foreign direct investment – and different state capacities to implement reform choices. Third, a caution is given against an uncritical application of the dominant approach of comparative political economy, varieties of capitalism, since it is ill suited to study the emergence of institutions, their international embeddedness, and the semi-peripheral character of East European capitalisms.

KEY WORDS

1 Introduction

A surprising diversity of capitalisms has emerged from the transformation of East European societies. Researchers identified a deep dividing line between the socio-economic regimes of many countries of the Commonwealth of Independent States (CIS) and their counterparts in Central-Eastern Europe (CEE). Whereas the former are characterized by the persistence of non-market relations, and political domination of the economy, the latter seem to be closer to the Western type of liberal market economies. Within these two groups, further major distinctions have emerged. Some states in the first group seem to have abandoned the transformation towards a democratic market economy altogether, while countries within the second group exhibit more success in their effort to achieve full-scale Westernization.

In order to characterize and explain this diversity, recent scholarship has increasingly built on the insights of the currently most influential approach in comparative political economy, the ‘Varieties of Capitalism’ (VoC) framework as developed by Hall and Soskice (2001). This framework has generated powerful insights in the diversity of advanced capitalist economies. In our view, however, it is much less well suited to understand capitalism’s varieties in Eastern Europe. First, the VoC was designed to analyse a very limited number of cases, namely the world of the Organization for European Cooperation and Development.
Assuming that the models of capitalism characterizing the rich and powerful of this world can be transplanted wholesale to a region where capitalism is much less developed is the contemporary equivalent of assuming that by studying the life at the king’s court we can gain meaningful insight into the life of the peasant, or the vagabond. Staying with the two models of capitalism discovered by the VoC approach is to underestimate the true diversity of capitalism, especially once outside the OECD world. Second, whereas the VoC approach takes institutional configurations for granted, and analyses their impact on firm behaviour and on different national strategies to meet the challenges of the global economy, capitalist institutions in CEE have emerged only recently, and their consolidation cannot yet be taken for granted. Third, the emergence of capitalist institutions in CEE have been much more thoroughly shaped by international and transnational influences than is the case in the advanced economies.

Our study therefore seeks to contribute to the development of a more suitable framework for analyzing the diversity of capitalisms in CEE, to empirically substantiate major differences between these new capitalisms, and to offer some reflections as to how this variation materialized. In section 2, we critically review the growing literature on post-communist varieties of capitalism. We also outline the elements of our own framework, particularly emphasizing the inter- and transnational context of the region’s transformation, as well as the state, the key agent of change. Sections 3 to 6, demonstrate the divergences based on a number indicators of institutional configuration and performance: state capacity, market reforms, political stability, social inclusion, democratization, industrial transformation, and macroeconomic stability. Our sample is based on the most internationalized cases: the eight new CEE EU members, and three highly internationalized CIS countries. Based on the empirical evidence, section 7 identifies four major types of capitalism in Eastern Europe, and offers an interpretation of their logic of emergence. In section 8 we conclude.

2 East European Varieties of Capitalism: State of the Art and Criticism

The diversity of post-socialist political economies became a major issue for East Europeanists in the late 1990s. Before that discussions had been dominated by the essential problem of the road towards capitalism ‘without adjectives’. As Sachs asserted,

\[ \text{The main debate in economic reform should therefore be about the means of transition not the ends. Eastern Europe will still argue over the ends: for example, whether to aim for Swedish-style social democracy or Thatcherite liberalism. But that can wait. Sweden and Britain alike have nearly complete private ownership, private financial markets and active labour markets. Eastern Europe today has none of these institutions; for it, the alternative models of Western Europe are almost identical (1990: 19).} \]

As if to corroborate the above sequence, 15 years after the breakdown of state-socialism and after sustained attempts at market reform, the East European societies indeed seem to have settled on divergent models of capitalism, and ‘transitology’ has moved on to comparison.

2.1 Capitalist Diversity in Eastern Europe

As to the diversity, the first major finding of the literature is a dividing line between two types of post-socialist capitalism. As King summarizes, there exists ‘a patrimonial variety...
capitalist diversity in eastern europe

Dependent on raw material exports which produces “involution” and a liberal variety that is dependent on capital imports and manufactured exports, and that leads to some development’ (2002: 28). While King derives his conclusion from the analysis of only two cases, the existence of these distinct types is confirmed by wider research. Based on a number of indicators capturing the extent of liberalization, privatization, type of integration in the global economy, redistribution and inequality, Lane (2005) finds that one group of East European countries has developed features that resemble the attributes of the continental European type of market societies. This group encompasses all East European newcomers and applicants to the EU. Recognizing these countries’ overall successful rapprochement to continental European economic standards, Lane identifies deviations too: stronger state involvement in the economy, lower level of capital accumulation, and much higher degree of exposure to the global economy. Nevertheless, Lane claims that these countries ‘tutored by the conditionality requirements of the EU and the IMF . . . have developed not only the economic preconditions of capitalism but also the political and societal: an appropriate type of government, a civil society and an emerging bourgeois class structure’ (Lane 2005:245).

In contrast, in many of the CIS countries a different type of capitalism has emerged, which is much less successful, significantly more unequal, with questionable democratic credentials even in the best cases.1 Focusing on the tensions between capitalism and democracy, Bruszt (2002) comes to a similar result: in the new member states of the EU, the ‘co-evolution’ of capitalism and democracy can be observed, whereas the development of a second group of countries is better described as ‘co-decomposition’ of capitalism and democracy.2

A second major contribution of the literature on capitalist diversity in Eastern Europe lies in its growing interest in international and transnational influences. Whereas earlier comparative research on the region mainly focused on the transformative role of national political institutions and choices, more recent studies have started to investigate the consequences of Eastern Europe’s thorough exposure to the global and the European political economy (Bohle et al. this volume). Their key assumption is that the EU locked the CEE countries in more promising development paths, while transnational corporations (TNC) contributed to their dependent modernization. In contrast, the predominantly raw material exporting CIS countries achieved far less favourable positions in the international division of labour, with EU membership far out of reach, left to the less benign influence of volatile resource markets and the IMF.

Even if we consider these ideas as useful starting points to explore capitalist diversity in Eastern Europe, we see two major weaknesses. First, for most authors there remains the unanswered question: why different countries embarked upon divergent trajectories leading to diverse market societies. The failure to explore systematically the factors and dynamics of East European capitalisms is particularly characteristic of those studies which try to describe similarities and differences across a large number of cases. Second, while there is an increasing recognition that the internationalization and transnationalization of East European capitalisms matter, little attention is paid to their varied impact. For instance, King sees a single liberal variety dependent on capital import (2002). Similarly, Vliegenthart and Noelke (2006) only append a third type of ‘dependent’ East European capitalism to the earlier types identified: Western liberal-market and coordinated-market economies.

In challenging generalizations of this kind, our earlier work has uncovered significant differences in the East European impact of foreign direct investment (FDI) and TNC, which are mediated by the sectoral composition of the national economy (Greskovits 2004, Bohle and Greskovits 2006; 2007). Likewise, we view the influence of the EU as much less
uniformly top-down than suggested by some students of East European VoC and many authors in the ‘Europeanization’ literature (Schimmelfennig & Sedelmeier 2005). Even if the pressure the EU exerts on newcomers is stronger and more encompassing than its influence in old member states, for us ‘Europeanization’ ultimately depends on what East European actors and institutions make of the requirements posed to them (Bohle et al., and Lindstrom & Piroška, this issue). Indeed, comparative analyses of the Estonian and Slovene models of capitalism point to the fact that EU membership is compatible with significant divergence in institutional settings (Buchen 2006, Feldmann 2006).

2.2 ‘Varieties of Capitalism’ Travels East?

The interest in institutional configurations is also a cornerstone of the VoC approach. Hall, Soskice and their collaborators have developed a powerful account of how different institutional configurations have shaped firm behaviour and national strategies to meet the challenges of the global economy. They distinguish two models of capitalism. The liberal market economy (LME) characterized by the prevalence of market relations in the spheres of corporate governance, industrial relations, and inter-firm contacts. The market-generated flexibility is particularly suited to promote strategies of radical innovation. LMEs thus compete successfully in high-tech, high-risk sectors. In contrast, coordinated market economies (CME) rely much more on consensual and cooperative relations among enterprises, between enterprises and their respective banks, as well as between social partners. Although CMEs are less well prepared to promote radical innovation, they compete successfully in sectors where incremental innovation is crucial. Without doubt, the VoC approach has influenced many recent studies on capitalist diversity in Eastern Europe due to its straightforward logic and parsimony. However, we find the direct adoption of this framework problematic for three reasons.

First, as often pointed out, the VoC approach does not account for the emergence of institutions, a crucial issue in Eastern Europe. Rather, VoC authors usually assume the prior existence and hence explanatory power of established and consolidated institutions for firm behaviour and adaptation to the challenges of the global economy. In our view, this assumption fails to hold in post-socialist regimes. Their current institutions have emerged only recently, have been built on and with the ruins of communism, and their consolidation cannot yet be taken for granted. Arguably, their impact on firm behaviour should thus be weaker than assumed in the VoC literature. Indeed, state actors and firms have been influential in shaping institutions. An analysis of East European varieties of capitalism, therefore, has to devote much more attention to the agency of political and economic actors. This also implies that any meaningful conceptualization of institutional configurations must include propositions about the dynamic impact of the state as well as the political system.

Second, most of the post-socialist institutions have not yet been in place before these economies became exposed to global pressures. Rather, their emergence and consolidation have been much more thoroughly shaped by international and transnational influences than in the Western cases. Therefore, transnational and international agents and factors of institution building have to be taken more seriously than in the VoC literature. An adequate approach to the varieties of capitalism has to be able to map and carefully assess the concrete form of international and transnational embeddedness of national institutions, and the contradictory pressures stemming from this condition.
Third, the VoC approach has been designed to analyse advanced capitalist economies. However, as Lane argues:

In post-communist economies, as well as other developing countries, many components of capitalism are compromised by alien features – non-market economic relationships, the absence of a complementary ideology, and classes of entrepreneurs and capitalists. They are ‘transiting’, as it were, to capitalism. Analysis then must grasp not only the type of capitalism, but the extent to which capitalism has been constructed’ (2005: 231).

The limits of simply applying the VoC framework to the post-socialist realm is most clearly demonstrated by Knell and Srholec (2006). Their finding that the most liberal economies of the East are Estonia, Russia, and Armenia, makes us wonder how this can be reconciled with the fact that the two latter countries, as we shall demonstrate below, barely have a fully institutionalized market economy to begin with. Of the three countries, it is only Estonia which would on some substantive grounds qualify as a LME (Buchen 2006, Feldmann 2006). However, even in the Estonian case, liberal-market institutions are hardly able to shape firm behaviour in a way predicted by the VoC approach. Whereas the advanced LMEs have developed comparative advantages in radically innovative industries, the most liberal East European countries, as we will show, appear to have specialized in low-tech/low-skill sectors. Thus, the less-advanced or semi-peripheral character of many post-socialist societies has to be taken seriously when conceptualizing their differences.

3 Internationalization, Transnationalization and Market-building States

In line with the above criticism of existing literature, we begin the presentation of our own concept of capitalist diversity in Eastern Europe with some evidence on its essential context, internationalization and transnationalization, and on its initiator and change agent, the state. We focus on state capacities and uses of state power because in the absence of powerful social actors, it fell largely to state reformers to set the direction of change, and state capacities decided upon success or failure of the new rules and regulations and essential institutions.

3.1 Internationalization and Transnationalization

The pattern of internationalization of the different country groups confirms the picture of a divide between the CEE and the CIS countries. The former were quickly integrated into the global and European economy. They trade mainly with countries of the EU. The value of their foreign trade approximates or exceeds their GDP. Via substantial FDI inflows, their assets have been incorporated into global and European systems of production, commerce, and finance. In the early 2000s, foreign control is the norm in all major export industries, and many services and utilities. The banking sector is one strategic area where foreign penetration has reached record levels, almost unprecedented in other parts of Europe and the world. This exposure to external influences has been further exacerbated by entry to the IMF, the World Bank, OECD, WTO, and, after lengthy preparation, the EU. In sum, CEE’s internationalization and transnationalization has occurred via multiple heavily institutionalized channels, and can thus be termed ‘thorough’.

In contrast, none of the CIS-3, i.e. Azerbaijan, Kazakhstan and Russia, has yet achieved WTO membership, with EU and OECD membership currently beyond their
reach. While they are more open to global trade and investment than many other CIS countries, their global integration significantly differs from the CEE pattern. All three countries have been more cautious in liberalizing trade and FDI inflows. They maintained to a large extent national ownership of their banking system, though this did not help Russia to avoid the consequences of the devastating financial meltdown of 1998 that also affected many neighbours and trading partners. In their exports, all three countries have been heavily dependent on the global markets of energy and other natural resources. The same industries attracted the bulk of FDI both in Azerbaijan and Kazakhstan. Thus, in contrast to the multi-channel global integration of CEE, the CIS pattern seems under-institutionalized and ‘shallow’ as it essentially occurs through a handful of world markets.

3.2 Transformative State Capacity

The question then, is whether the post-socialist states are little more than the playthings of powerful international and transnational forces? Could they retain or develop a capability to assist ‘the economy to transform itself and to respond to changes in the global economic environment’ considered to be the key to economic development and power (Gilpin 1987: 77)? The literature on less advanced countries in other parts of the world proposed important ideas on the impact of varied channels of global integration on domestic state capacity (Shafer 1994). First, that the type of capital inflows is an important factor of domestic state capacity. The impact of capital inflows regulated exclusively by international market forces . . . such as oil revenues, labor remittances, and portfolio investments’ radically differs from the impact of foreign investment, and international borrowing . . . that favor a large state role in negotiating, administering and allocating resources’ (Chaudry 1997: 25).

Second, according to Chaudry initial institutional endowment matters too:

[C]ountries still forging central institutions can potentially evolve almost solely in response to capital inflows, generating bureaucracies that are the direct products of the international economy . . . In contrast, where strong institutions are in place, as in the East Asian cases . . . international capital is more likely to be used to promote economic goals’ (27–28).

It follows that the thoroughly institutionalized CEE path of international integration should be more conducive to building state capacity than the shallow CIS trajectory that was exposed to the volatility of global commodities and financial markets. Similarly, post-socialist states, faced with the less demanding task of (re)building national institutions should be more capable than where essential institutions had to be built ‘from scratch’.

Stylized facts of state capacity confirm these expectations, since they highlight a radical divergence between CEE and CIS states. According to World Bank quality of governance indicators, the former are among the more capable states of the world (Kaufman et al. 2006, see Figure 1). Fair degrees of government effectiveness and regulatory quality set them apart from the CIS countries, which perform much worse on these dimensions. As far as the trends of state capacity are concerned, from 1996 to 2004 the Baltic countries, which started the transformation at lower initial levels of state capacity, managed to catch up with the rest of CEE. In contrast, state capacity in the CIS has not converged towards CEE standards at all. Rather, by 2004 the CIS states are as weak and incapable as in 1996.

One particular aspect of state (in)capacity, the rule of law and control of corruption, can be captured by the World Bank quality of governance data. These indicators tell the
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same story of a deep divide between CEE and the CIS in terms of state–society relationships. This forces analysts to ask questions about the actual significance of formal institutions in the latter group of countries, characterized by a high incidence of informal or even illegal activity, markets that are often substituted by barter or violence, and states, which are often unable to enforce existing rules and regulations. While we are aware of the salience and power of informal and illegal agents in shaping capitalism in the CIS and even in CEE, in this paper, we cannot analyze this aspect in greater detail, and shall only compare international and transnational influences and their interplay with domestic state agents.

The striking divergence in state capacity is crucial for our understanding of post-socialist capitalism’s diversity in all other important respects. Most importantly, while the above data allows us to trace the variation within CEE at least partly to the varied uses of state power to pursue different transformation agendas, we cannot explain the divergence between the CEE and CIS capitalisms in the same terms, since the latter’s state capacity has been barely sufficient to make a comparable impact. Consequently, in the latter cases, the influence of other types of factors and agents must be our primary focus.

The next question we then need to ask is: state capacity to do what? As often argued, the agenda of post-socialist transformative states has been overloaded by all of the major economic, political, and social challenges that development can pose. They had to build markets, preserve political stability, maintain social cohesion, democratize the political system, transform industry, and secure a stable macro-economic environment. Furthermore, advances on these conflicting dimensions often had to be made simultaneously, and within short time scales. How successfully could state actors pursue and coordinate multiple transformations?

3.3 Building Markets

By the early 2000s, all of the CEE regimes achieved high levels of liberalization, privatization, and market-oriented institution building (Figure 2). However, there is systematic variation in the radicalism of the reform paths that led to this outcome. Assessing
radicalism by the rate at which market reforms have been introduced and new institutions built, and using the annual advance on the transition index of the European Bank for Reconstruction and Development (EBRD) as a proxy to measure it, leads us to conclude that, within CEE, the Baltic States have been more market-radical than the Visegrád states and Slovenia. First, due to their long experimentation with reform-socialism, Hungary, Poland, and Slovenia already had relatively marketized economies in 1989, while the Baltic States had to start ‘from scratch’. Second, since state-socialism persisted until 1991 in the Baltic countries, their reforms began later than those of other CEE states.

Finally, the CIS, which started late and had the weakest legacy of marketization, continue to lag behind CEE. Nonetheless, even the CIS members adopted a degree of economic freedom and openness, and, in 2004, they are significantly closer to a market economy than back in the early 1990s.

However, this observation poses a puzzling supplementary question: how to explain the CIS’ advance in market liberalism without a capable state? Our contention is that the CIS’ relative success is restricted to administratively rather simple measures, while they advanced much more slowly in the more sophisticated and politically difficult institutional reform areas. Nelson offers a convincing explanation of why and exactly how lacking state capacity can hamper advances with complex reforms:

‘Despite the intense political controversies regarding first-phase stabilization and liberalization measures, many are administratively simple, in the sense that they can be decided and put into effect by a small circle of senior economic officials. Measures that usually come later – such as financial sector reforms, privatization or rationalization of large state enterprises, liberalization of labor markets, and restructuring of social services and social security – are much more complex. They require sweeping institutional and legal changes and involve the legislature, the courts, and multiple central and local government agencies . . . Moreover, while many of the initial costs of stabilization are temporary and spread over much of the population, sectoral and institutional reforms usually impose permanent losses focused on specific interests. They, therefore, prompt tenacious resistance’ (1994: 14).

Thus, to the extent that the CIS countries have established a market economy at all, their relative statelessness has left it heavily under-institutionalized compared with the standards of CEE market societies. Simultaneously, the political resistance provoked by
complex reforms points to another kind of public good states have to provide to keep development on track, and this is political stability.

4 Political Stability Through Social Inclusion Versus Political Exclusion

According to the World Bank quality of governance data, the ranking of East European capitalisms in terms of political stability is straightforward: Slovenia has been by far the most stable over the whole period 1996–2004, usually followed by the Visegrád states. Interestingly, in the 1990s, the Baltic States still ranked third but by the early 2000s they appear to be more politically stable than the Visegrád countries. In striking contrast, CIS polities have remained unstable over the whole period (Figure 3).

To grasp this pattern, it is helpful to explore the distinct ways the East European capitalist regimes tried to secure political stability. One issue that received ample attention in the academic and policy discussion of the politics of post-socialist transformation was the need for social safety nets to help losers to survive hard times, and for institutions of labour inclusion to make workers feel to be active participants in the dramatic changes affecting their livelihood. East European reformers used state power with different vigour and capacity to offer greater or lesser degrees of social inclusion.

4.1 A Map of Social Inclusion

Rather than displaying a fundamental divide between the CIS on the one hand and the eight CEE states on the other, evidence on social inclusion performance attests to the essential similarity of the CIS and the Baltic States setting them apart from the Visegrád states and Slovenia. Thus, in terms of inequality there is no significant difference between the former two country groups, while Estonia seems to stand out as the most inequitable country (Table 1).

Both in light of their meagre economic performance over the 1990s, and in comparison with other countries at similar levels of development and resource-export dependency, the

![Diagram showing political stability over time for different regions](Source: Authors’ own calculation based on Kaufman et al. (2006).)

Fig. 3. Political stability.
distribution of income in the CIS can even be considered as surprisingly ‘equal’. Indeed, Lane (2005), with reference to Gini coefficients around 50 rather than 30, still finds the CIS countries to be far the most unequal in Eastern Europe. Even taking Lane’s data into account, our observation that both the Baltic States and the CIS are significantly more unequal than the Visegrád states and Slovenia still holds true.

How about the pattern of state capacity to protect society? Since we could not find comparable data on social spending for the CIS, we chose two proxies: public expenditure on health, and general government expenditure’s share in GDP. Overall, Slovenia and the Visegrád states seem to command much larger welfare states then the Baltic group. The CIS states have the weakest welfare-capacity in both respects, while Russia’s figures come close to those of the Baltic States. It is important to note, however, that in both Russia and the Baltic States it was only in the aftermath of the Russian financial crisis that general government expenditure began to drastically lose its share within GDP (EBRD Transition Reports various). Thus, especially in Russia, the currently meagre welfare state might more accurately be a reflection of the devastating impact of global financial market shock than any conscious and ideologically grounded choice of socially exclusive policies.

All in all, the CIS’ meagre performance in political stability then, might be closely linked with these states’ incapacity for social inclusion. Conversely, the political stability of

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1 Eurostat for EU countries, UNDP Human Development Report 2006 for CIS. 2 UNPD Human Development Report 2006. 3 Transmonee Database, UNICEF 2006. 4 EBRD Transition Report 2005. 5 The higher average is for Poland and Hungary only, thus taking into account that the data for Czech Republic and Slovakia stem from a much earlier period in their transition.
the more inclusive Slovene and Visegrad polities is unsurprising. However, if the lack of social solidarity indeed has the potential to destabilize democracy, then the remarkable stability of Baltic polities is truly puzzling, and points to a mismatch between protective state efforts and political balance. We find the solution in the fact that the Baltic States could rely on a powerful substitute for social solidarity, namely national and ethnic identity politics, and thus mobilize permanent political support for a socially exclusive transformation path – albeit at the heavy expense of democratic quality.

4.2 Identity Politics and Democratization

As Anderson wrote, ‘regardless of the actual inequality and exploitation that may prevail in each the nation is always conceived as a deep horizontal comradeship. Ultimately it is this fraternity that makes it possible, over the past two centuries, for so many millions of people not so much to kill, as willingly to die for such limited imaginings’ (1991: 7, emphasis added). Since communism in its quest for ideological monopoly oppressed people as nations and believers, many East Europeans might have felt true satisfaction over their regained freedom to ‘imagine’ and actually craft such communities. This, however, means that related emotionally powerful attachments could have a profound and varied impact on how the East European polities cope with other polarizing issues, such as economic discontent and conflict. For example, in Slovenia, belonging to the newly independent nation enhanced and consolidated the sense of socially inclusive politics. In most of the Visegrad countries, identity politics did not have much influence until relatively recently. However, in Estonia and Latvia (but not in Lithuania) exclusionary identity politics has had a profound impact, and undermined social solidarity from the very beginning. Because of the primary importance attributed to national sovereignty and security, the Russian speaking populations had been disenfranchised before neoliberal restructuring pushed many of their members to the margins of society. While democratic opposition of the radical transformation has thus been muffled, the rest of society has lent permanent support to a drastic break with the past that buttressed a mutually reinforcing relationship between economic neoliberalism, identity politics, and limited democracy.

Estonia’s and Latvia’s political stability thus was achieved at the expense of the quality of their democracy. While this fact has largely escaped mainstream measurement of democratic consolidation in Eastern Europe, which has focused on the competitiveness of elections and limitations on executive power, a recent study that reconceptualizes the measurement of democracy by including participation as a key component ranks the quality of Estonian and Latvian democracy below or close to the Russian score in 2003 (Moon et al, 2006).

Put simply then, over the first decade and a half of transformation there have been two main kinds of political economy configurations in which East European states could pursue marketization and restructuring in relatively stable political contexts. This has been made possible either by illiberal identity politics and limits on democratic opposition, as in the Baltic States, or by mitigating the deleterious social impact of neoliberal reforms by welfare protection, as in the Visegrad states and Slovenia. However, in the CIS, where neither social welfare policies nor exclusionary imagined communities have been consistently used to stabilize politics, authoritarian practices and features continued (as in Azerbaijan and Kazakhstan) or revived (as in Russia), to buttress claims for authority with grave implications for
political stability. In a more dynamic view, the above trade-off also implies that once ‘embedding’ neoliberalism into protective arrangements becomes untenable, democratic politics is likely to lose balance – witness the most recent destabilization in all Visegrád polities. We cannot exclude the potential for restoration of these countries’ political balance via larger doses of illiberal identity politics, and sacrifices in democratic quality.

5 Industrial Transformation

So far, we have mainly focused on the domestic factors of regime variation, and paid little attention to international and transnational aspects. We now turn to these. The impact of a crucially important international factor, namely the EU, which certainly had a formative role in the divergence of the CEE regimes from the CIS capitalisms, is discussed more in detail by Bohle et al. and Lindstrom & Piroska elsewhere in this issue. Here, we focus on key transnational actors, TNC, which, similar to the EU, have not been enmeshed in domestic politics, but have had other means to intervene in, and leave their mark on, the emergence of regime diversity.

Our argument is that the type of FDI a country attracts has a strong impact on the capacity of the respective states to restructure the economy and transform industry. Taking a look at the performance in respect to industrial transformation, it is obvious that the Baltic States have been much less successful in upgrading their industrial profile than the rest of CEE. The bulk of their exports originate from resource- or unskilled labour-intensive industries, and thus exhibit a profile reminiscent of many less-advanced countries. The three CIS countries perform even worse. They underwent a dramatic process of deindustrialization and either never developed or almost entirely lost their skill-base of industrial upgrading and a more complex pattern of development. Consequently, their share of manufactured exports in total merchandise exports has become so low that currently they barely qualify as industrialized nations. The overwhelming majority of their export earnings originates from resources, thus from products characteristic for the least advanced countries in the world. In contrast, the Visegrád states and Slovenia mainly export the same products as many advanced countries, which rely heavily on complex capital, technology, and human skills (Figure 4).

Finally, the divergence in industrial transformation appears to be consistent with varied patterns of state institutions aimed at fostering the transformation of inherited socialist industries into new foreign controlled and invested operations. The Visegrád states mitigated the impact of market shock on their industrial legacy and at the same time attracted foreign capital through protective regulation and tariffs, export zones, foreign trade and investment agencies, investment support funds, tax exemption regimes, and public development banks. In contrast, industrial policies have not been pursued with similar vigour in the Baltic States, whereas in the CIS their aim was to conserve rather than restructure a selected few state-socialist industries.

The pattern in Figure 4 raises the question of how this variation came about. We see an important element of the answer in the type of FDI the respective countries attracted. Specifically, the variation in industrial export performance is closely linked to FDI inflow in complex manufacturing sectors. In the early 2000s, on a per capita basis, FDI stock in the complex industries of the Visegrád countries exceeded the relevant Baltic data by a multiplier of 10 (Bohle & Greskovits 2007). With the partial exception of Slovenia, no
country managed to upgrade its industrial base without relying heavily on external investments. How can we then explain why the Visegrád countries were so much more successful in attracting FDI in their complex manufacturing sector than the rest of Eastern Europe?

The mainstream claims that FDI is endogenous to the advance of market reforms, therefore the meagre achievements of the Baltic States in attracting complex-industry FDI, and the resulting low-skill exports should present a conundrum. Why have these states proved so ineffective in importing the main drivers of industrial upgrading if they have been so capable of creating many of its alleged formative conditions: radically reformed stable economies, low taxes, political stability, and national security? Why have complex-industry TNC consistently preferred Visegrád locations to the Baltic as well as the CIS area? Our answer is that TNC location choices responded to the incentives stemming from a dynamic interplay between inherited and restructured industry profiles, inherited and newly-built market institutions, and special subsidy packages.

To account for TNC motivation to invest, we adapt Vernoni’s product–cycle theory (1971). We contend that export-oriented, complex FDI would most likely flow first to those former socialist economies whose initial supply structures (that we proxy by the export structures of the late-1980s–early 90s) had been relatively complex, i.e. intensive in technologically sophisticated physical capital and human skills. As a consequence, the Visegrád countries, which already specialized in the automobile, machinery or electronics industries in late-socialism could rightly expect larger inflows of industry-specific FDI than the CIS states, where this sector was virtually absent (as in Azerbaijan and Kazakhstan) or by the end of state socialism was significantly weakened (as in Russia), as shown in Figure 5.

In this respect, the Baltic States, which by the last decade of state socialism increasingly exchanged technology and skill-intensive goods for natural resources from other parts of the Soviet empire, had not been particularly disadvantaged. Given that on the basis of their supply structures initially all CEE countries seem to have had similar attractions as new locations for transnational complex–export production, product-cycle theory alone cannot account for the diverging path taken by the Baltic and Visegrád states. How then did investors choose among them?

For an answer, we have to consider that even similar supply structures might fail to raise investors’ interest if institutional and policy barriers hamper access to the local factors
of production. It follows then that countries which by the time investors were ready and able to cross the former Cold War borders, advanced furthest in removing entry barriers and rebuilding their institutions and policy regimes were better able to attract FDI. We argued above that, in the first half of the 1990s, the Visegrád states had an advantage over the Baltic States, which could start their quest for institutional convergence with the West only with a delay and from scratch. In the first phase of the transformation then, in the context of rather similar supply structures, institutional advantages tilted the balance of investors’ preferences in favour of the Visegrád countries. Complex FDI inflows had been endogenous to the initial levels of marketization. In turn, initially the CIS lacked both industrial structural and institutional similarities with the home countries of TNCs, which thus had double reasons to avoid them entirely, and invested, if it was possible, only in their natural resource-based activities.

However, the interplay of structural and institutional factors seems to have fully reversed, and the endogeneity of complex FDI to marketization levels failed to materialize after the mid-1990s (Table 2). The Baltic States gradually worked off their institutional disadvantage and, by 2003, arrived at a relatively high degree of institutional similarity with their regional rivals and the West. However, their institutional catching-up does not seem to have been appreciated by transnational complex-industry investors. What seems to explain the Baltic States’ inability to attract FDI in complex industries after the mid-1990s is that their radical institutional convergence has been achieved at the expense of increasing divergence in supply structure terms. Rapid liberalization without support and time for restructuring has led to deindustrialization, wiping out the most complex industries (Tiits 2006: 23). From the late 1990s on, in the context of increasing institutional similarity, TNCs continued to prefer the same Visegrád area locations mainly because of their enhanced structural similarity with the West, whereas the Baltic countries might have lost out for the increasing divergence of their supply profile. In the CIS economies, the combination of an under-institutionalized precarious market economy with increasingly dissimilar structures of supply continued to deter complex manufacturing investors.

Initial investor preferences, motivated by a combination of structural and institutional factors, seem to have launched both virtuous and vicious circles of foreign-led capital accumulation. Driving forces included the contrasting trends of industry upgrading versus...
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<td><strong>Patterns of FDI inflow in the manufacturing sector</strong></td>
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deindustrialization; the tendency that many more TNCs ‘followed the leaders’, their rivals and buyers, to the initially preferred Visegrád locations; the concomitant clustering of the complex industries in the same area; and lastly the generous subsidy packages offered by the Visegrád states to TNCs.

6 Macroeconomic Stability and Growth

Finally, macroeconomic stability, manifested in low inflation rates, small budget deficits, and controlled state household debt, has become increasingly important to protect national economies against harmful fluctuations in short-term capital flows and exchange rates. To what degree are East European states capable of providing a stable macroeconomic environment? Interestingly, on this dimension, their clustering displays a similar pattern to the one that we recognized earlier when assessing social inclusion (Table 3). In the early 2000s, in several respects, macroeconomic stability in the CIS states seems more closely matching the performance of the Baltic States and Slovenia, whereas the Visegrád countries find it much harder to keep their budgets balanced and their government debt controlled.

How to come to terms with this peculiar clustering? After all, during the 1990s the CEE and the CIS states still populated the opposite clusters of success and failure, notwithstanding their shared interest in stability that had been driven by their wish to restore macroeconomic balance against the background of deep recession, galloping inflation, and threatening financial crises. Furthermore, roughly since the year 2000, new ‘sticks and carrots’ began to impact upon the CEE countries: pressures to adopt the EU’s ‘stability culture’ (Dyson 2006) as a condition for membership in the Eurozone. Once more, we find an answer

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Source: EBRD Transition Report
in the combined effect of different forms of international integration and pressures, and the different capacities of state actors to pursue their own economic policy agendas. The CIS, and especially Russia’s path towards macroeconomic stability was essentially shaped by two international factors: the financial crisis of 1998 and its consequences, and the reversal of the oil prices. While the financial crisis had immediate devastating effects on the Russian economy, and on its neighbours who depended on Russian markets, it was after the crisis that Russia experienced substantial economic growth for the first time since the collapse of the Soviet Union (Montes and Popov 1999). Several factors can explain this, including depreciation of the rouble in the aftermath of the financial crisis, and the fact that the banking sector started to lend to the real economy for the first time.

However, a major factor in the rapid recovery of the Russian economy was the hike in oil prices. The combined effects of growth in the aftermath of the financial crisis and oil price hike helped Russia and other CIS countries to achieve impressive results in macroeconomic stability (EBRD Transition Report 2005). This suggests that the stability of the CIS countries has more to do with the current phase of the energy cycle than with their state capacity and institutional settings. Windfall gains spare such weak states the administrative and political challenge of creating a sustainable financial base for development by taxing their own citizens.

The financial crisis also hit the Baltic States, and even reinforced their quest for macroeconomic stability. In contrast to the CIS, however, macroeconomic stability had been a priority of the Baltic governments from early in the transformation process, and they developed a unique institutional setting that helped pursue this goal. Establishing their own currencies was one of the most important means and symbols of the newly acquired sovereign statehood. In order to acquire credibility in global and European markets, the Baltic States chose to operate by far the smallest fiscal states of the region, relying on the most restrictive monetary institutions, currency boards, and most consciously utilizing their ERM-2 entry as an international pillar of their policies to lock in macroeconomic stability (Feldmann 2006).

Prioritizing macroeconomic stability over any other economic and social policy consideration distinguished the Baltic States from the rest of the new EU members. So far most Visegrad states (except the Slovak Republic recently) have been less successful in controlling their fiscal deficits or other macroeconomic fundamentals. Confronted with demands for social protection, and active industrial policies favouring TNCs, governments in the Visegrad countries were neither willing nor able to pursue tight macroeconomic policies at the expense of these demands (Greskovits 2006, Zubek 2006). Only Slovenia managed to meet all three demands simultaneously where neocorporatist institutions such as legally enforced negotiated management–labour relations, and extended collective agreements have so far delivered the social compromises required for a balanced and inclusive agenda.

7 Paths Towards East European Capitalist Diversity: State-crafted Versus Directly Market-driven, and Embedded Versus Pure Neoliberal Regimes

The evidence presented so far allows us to distinguish between four types of capitalist regimes that emerged in Eastern Europe as a result of their transformation and integration into the world economy. The Baltic States are distinguished by radically liberalized markets, a thoroughly reformed market-supporting institutional framework, and the least generous welfare states among the new EU members. They integrated into the global economy mainly
through labour-intensive traditional industries controlled by highly mobile TNCs, and through resource-based exports and the related services. Similar to their meagre welfare states, their industrial policies are minimalist, with low flat taxes rather than targeted protectionist measures at their core. In Estonia and Latvia, exclusionary democratic institutions conspire with restrictive monetary and fiscal institutions to keep their regimes stable in political and macroeconomic terms.

From a more advantageous starting position, the Visegrád countries have equally successfully transformed into capitalist economies. Their socio-economic regimes differ from the Baltic States in three major respects: first, they have offered more protection to society to compensate for some of the social costs of transformation; second, this enabled them to preserve to date a far more inclusive democracy and third, whereas the Baltic States’ economic priority has been macroeconomic stability, the Visegrád countries are primarily driven by the cause of industry upgrading. With institutions and policies geared towards attracting FDI having high priority, TNCs have become the driving forces of restructuring. The relative success of the Visegrád countries’ foreign-led development path is reflected in their export structure, which closely resembles that of the advanced Western countries.

Among the new EU members, Slovenia stands out for its simultaneous successful pursuit of social cohesion, industrial upgrading, macroeconomic stability, and democratic inclusion. Slovenia is exceptional among all East European countries in that it could pursue its transformation largely based on national institutions and actors, and indeed transformed into a Western type of capitalism: Its neo-corporatist regime is typical of many small West European states.

Finally, by the early 2000s, the CIS countries appear to have introduced rather liberal market economies too. Their regime performances and institutions seem to fall closest to the Baltic States as both groups of countries have very limited welfare states, failed to upgrade their industries, but performed well in terms of macroeconomic stability. In addition, countries in both regions have democratic regimes with serious quality problems. There are though significant differences as well. Recent developments in the quality of democracy seem to diverge, with the Baltic States improving and the CIS deteriorating. Deindustrialization has been much more severe in the CIS, and their integration into world trade is overwhelmingly based on raw material exports and industrial goods imports. The major difference, finally, setting the CIS apart from all other eight EU new members, is their comparatively weak states, which make these countries much more exposed to the direct influence of international forces and factors.

How did such variation come about? Our framework stresses the interplay between transformative state power with specific agendas – or its absence – on the one hand, and the concrete form of the inter- and transnational embeddedness of the respective political economies on the other. Thus the following regime paths can be identified.

The CIS countries experienced the collapse of their major state institutions and capacities together with the fall of state socialism. As is well documented in the Russian case, the first phase of transformation was characterized by the dissolution of central state authority (Bunce 1999). Newly independent states, increasingly independent regions, and powerful societal actors picked up the pieces left behind by the collapse of the empire, and used them to accumulate fragmented, special-interest, or personal, rather than common wealth (Hellman 1998). In this context, there was no state capacity to speak of to transform the economy in any comprehensive and coherent way. The disastrous reform performance of the first period of transformation was as much reflecting the non-existence of central state
authority, as the influence of the International Financial Institutions (IFIs). While the Russian reformers radically liberalized their economy in line with the policy prescriptions of the IMF, and the ideological beliefs of the Washington Consensus, they largely failed in building up market-supporting institutions. The social and economic consequences have been devastating. Industrial production and GDP plummeted, social inequality ballooned, the economy informalized at high speed, the new owners of the Russian economy have extracted billions of dollars from the country, and the country is increasingly indebted externally. The untenable path towards ‘involution’ (Burawoy 1996) exploded with the financial crisis 1998.

International developments, rather than state capacity, also seem at the origin of the socio-economic recovery of the CIS states after the crisis, with unprecedented increases in oil prices allowing them to restore growth, macroeconomic stability, and repayment of international debt. It is an open question, how far the sustained period of high oil prices has indeed given them the resources to build more stable institutions and a stronger state. Evidence from the literature on petrol states suggests that when state (re)building coincides with massive inflows of petrol revenue, the new institutions are likely to be direct products of the international economy and, therefore, highly vulnerable to future bust periods (Chaudry 1997, Karl 1997). Therefore, we see that the paths, institutional outcomes, and performances of the CIS regimes as largely driven by the forces of international markets and IFIs. At the same time, powerful domestic social groups dependent on these same markets have pressed CIS state actors to pursue adjustment in line with their own particularistic interests.

In contrast to the CIS, all the CEE regimes can be viewed as essentially ‘state crafted’. All eight CEE either inherited functioning states and institutions from the socialist system, or were able to build these up within a short time. Therefore, whatever similarities between the Baltic and CIS regimes might exist, they also differ in three key aspects. First, the neoliberal Baltic regime was largely the result of conscious reform choices. Their fast reforms stemmed from the wish to implement a most radical break with their past, and to dismantle the former strongholds of power of old of state and party bureaucrats (Bunce 1999). Radical reforms also had an anti-imperial aspect to them. Getting rid of the nomenklatura, their institutions, and their inherited industries essentially meant forcing ethnic Russian to the side-lines. Second and closely linked, the Baltic countries chose to marginalise inherited social forces and invited new groups to buttress their new states. Initial reforms were to a large extent designed and led by émigrés. The Latvian and Estonian approaches to privatisation were much less conducive to insider wealth accumulation than the methods chosen by the CIS. Mostly ethnic Russian employees were marginalized by deindustrialization and their voices muffled by disenfranchisement. In strategic sectors, the Baltic States welcomed foreign investors. Third, the Baltic regime is supported by adequate institutions, which are likely to be more resistant to international market forces than those in the CIS. Macroeconomic stability, which had the highest priority in the economic institutional setting is more a result of restrictive monetary institutions, than purely of windfall gains from resource exports.

The inter- and transnational influences the Baltic States are exposed to partly reinforce, and partly mildly correct their initial choices. Both the breakdown of the Soviet economy and later the financial crisis of 1998 hit the Baltic States harder than other CEE countries. Yet, these international crises reinforced the initial choices of elites to weaken ties with the former Soviet Union, and justified the stress on macroeconomic stability. To be sure,
economic ties with Russia have never been entirely severed. Ironically, in recent years, the Baltic States have gained from the same windfall profits as the CIS, both as transit routes for Russian oil, gas, and other resources, and as exporters of manufacturing goods to the growing Russian market. The spectacular growth rates the Baltic States have experienced over the last years probably results – at least partly – from their increased trade with Russia. Once again, international factors – in this case powerful neoliberal political and policy networks – confirm the domestic choices made by the Baltic States, since they interpret their high growth rates as signs of the victory of radical neoliberalism.

International developments have reinforced domestic choices in yet another way. The Baltic integration into the low end of the international division of labour makes transnational capital investing in the region primarily interested in flexible labour markets, low wages, and minimal public intervention into employment practices and work conditions. TNC preferences dovetail with the Baltic priorities of a neoliberal regime and minimal (welfare) state. The EU, on the other hand, has served throughout the accession process as a mild corrector of the Baltic States’ overzealous economic liberalism. Trade barriers had to be raised again, and improving the standards of social and democratic inclusion has become an issue in the accession negotiations. Overall, however, EU priorities in the region are in line with the Baltic reform priorities, and EU accession therefore could mostly serve as a factor locking in earlier institutional choices.

Similar to the Baltic States, the Slovene path towards capitalism was based on conscious choices of reformers, and a state capable of implementing them. Nonetheless, the choices have been very different. The transformation of Slovenia was built on a consensus among all major forces of society – employers, employees, experts, major political parties – that had been institutionalized in neo-corporatist bodies. While Slovenia accepted the general framework of macroeconomic stability, it was also clear for the reformers that this ‘alone would not facilitate a successful transition to a capitalist economy’ (Lindstrom 2005: 23). Trade liberalisation and privatisation was carried out gradually, and the Slovene reform elites relied heavily on domestic forces, including labour, in the privatisation process. Slovenia opened its economy only very reluctantly and gradually to foreign ownership and control, especially in strategic sectors, e.g. banking.

This gradual and home grown transformation strategy could be built on the best legacies of CEE. Not only has Slovenia been the richest CEE country, it also inherited the most liberal, politically and socially most differentiated socio-economic system as a result of Yugoslavia’s reform communism. Firms had been relatively independent from the state, able to develop dense commercial and production links to Western markets well before the transition. Trade unions, rather than being transmission belts – as had been the case in most other countries of the region – also gained a measure of independence in the 1980s (Stanojevic 2003). All these factors made a transition strategy based on broad incorporation of all domestic social forces more feasible.

As in the Baltic States, Slovenia’s international embeddedness by and large reinforced its choices. Slovenia only accepted – and could afford to do so – limited FDI in its strategic export sectors, thus controlling its dependence on TNC. The markets it mainly operates in – medium to high skill manufacturing goods – are not as prone to short term fluctuations as the markets for labour-intensive goods and raw materials. Overall, the reform path chosen by Slovenian actors was also compatible with EU requirements. In some instances, where the EU pushed towards a different direction, Slovenia refused to comply without ever putting at risk the perspective of EU membership (Lindstrom and Piroska this volume).
Finally, the Visegrád countries’ regime path – even if it reflected a measure of conscious choice – proved to be less straightforward, more contested, and contradictory than either the Baltic or the Slovene trajectories. Two elements set the Visegrád transformation strategy apart from the Slovene. First, their welfare states originated in political elite-driven ‘reforms from above’ rather than in institutionalized neocorporatist negotiations between social partners. Second, instead of domestic capitalists, foreign owners have come to dominate these economies. Rather than being purely strategic choices, both differences also reflect the concessions reformers had to make in light of the unexpected difficult challenges of transformation. The legacies of the Visegrád area had been less favourable than those of Slovenia. Accordingly, reformers were well aware of the social hardship coming with the collapse and market reforms. They could however not fall back upon identity politics and disenfranchise large parts of the affected population to stifle protest as the Baltic States did. At the same time, they shied away from offering institutionalized voice to unions and the losers of reforms, as they feared that these groups would block the road towards reforms (Balcerowicz 1995). Instead, they decided to offer ad hoc compensation in the form of relatively generous targeted social protection packages in order to overcome opposition (Vanhuysse 2006).

International constraints acted more strongly and in a different way upon the Visegrád countries than in the Slovene or Baltic cases. Initially, Hungary took the lead in supporting foreign take-overs across the whole economy. The origin of this privatization strategy was the huge external debt Hungary had accumulated by the late 1980s. Because of this debt service Hungary was highly dependent on hard currency cash receipts available only from export and privatization. Poland, the other ex-socialist country with huge foreign debts at the onset of transformation, was somewhat less constrained in reform choices (Greskovits & Bohle 2001). Poland’s creditors were national governments rather than – as in the Hungarian case – private banks. Moreover, at the beginning of the transition, Poland successfully managed to negotiate a partial debt relief. Thus, Poland’s initial transition choices to some extent resembled those of Czechoslovakia (and later the Czech and Slovak Republics). As its two southern neighbours, Poland initially hoped for maintaining significant domestic ownership in the economy. However, these attempts at ‘national capitalism’ failed, and since the second half of the 1990s, all four Visegrád countries increasingly have built their institutions and economic strategies around the priority of attracting FDI (Bohle 2002; Drahokoupil 2007; Shields this volume).

The concessions reformers had to make to the (perceived) threats of the losers of transformation on the one hand, and to foreign investors on the other, partly explain the more instable nature of the Visegrád regimes compared with the rest of CEE. On the one hand, as we argued above, under the conditions of inclusive democracy, political stability can only be achieved by ‘embedding’ neoliberalism in protective welfare regimes. Similarly, industrial upgrading in Eastern Europe – with the sole exception of Slovenia – could only be achieved by luring foreign investors with generous incentives. On the other hand, embedding members of society and key actors of economy resulted in a whole set of new problems. First, it put pressures on public budgets, which sooner or later destabilized the economy. Second, embedding society and industry can lead to mutually contradictory and overly costly fiscal spending goals. Faced with budget constraints, the Visegrád states seem increasingly compelled to reduce welfare expenditure within their budgets. More fundamentally, the resources Visegrád countries spend for welfare might just not be enough to offer sufficient protection for society (Shields in this volume). Finally, in this context, the EU
functions as an additional constraint on the Visegrád countries, pushing them towards compliance with the Maastricht criteria that might ultimately result in disembedded societies. Currently, Visegrád country domestic politics and policies seem to conspire with EU pressures to produce potentially less stable and less democratic regimes.

8 Conclusion

By the early years of the new Millennium, varied types of market societies replaced the former state socialist political economies all over Eastern Europe. In our study, we set out to map and explain their diversity. Our first contribution to the existing literature on East European capitalisms is an empirically grounded distinction among four types of capitalist regimes that differ in particular institutional configurations and performances. Specifically, we identified two subtypes of a regime that seem to share, at first glance, many characteristics of a neoliberal regime in accordance with the dominant ideology of the Washington Consensus. Both the CIS and the Baltic States approximate that ideal of small fiscal and welfare states, and perform well in terms of macroeconomic stability.

In contrast, though in different ways, both Slovenia and the Visegrád countries have embedded their neoliberalisms (for this term see Ruggie 1982, and van Apeldoorn 2002). Slovenia achieved this through neo-corporatist institutions and a generous welfare state, whereas the Visegrád countries did so through ad hoc compensation, that is, relatively generous targeted social protection packages to losers and opponents of neoliberal reforms. More than any other East European country, the Visegrád states also developed measures and institutions to attract and ‘settle’ a multitude of complex-industry TNC.

These regimes do not only differ in their current institutional configurations and performances, but also in the pathways that led to these differences. Our second contribution is our proposed framework of the logic of emerging regime diversity. Since most institutions that currently characterize Eastern European capitalisms evolved in the course of transformation, our key task was to identify the agents and factors shaping that process. We argued that the crucial explanatory variables of regime paths have been twofold. On the one hand, transformative state power, and its uses to pursue market reforms, political stability, social inclusion, democratization, industrial transformation, and macroeconomic stability – or the absence of state capacity to accomplish these tasks – mattered. On the other hand, the concrete form of the inter- and transnational embeddedness of the respective political economies has been important too.

Hence our distinction between the essentially state-crafted CEE neoliberalisms and the more directly world market-driven CIS variants, indicates the dramatically different extent to which these states have exercised control over their own institutions and performances. In this interpretation, the Baltic and CIS neoliberal regimes, which at a first glance look as two variants of a similar species, turn out to be qualitatively different. CIS neoliberalism is largely due to repeated state weakening, and as such highly vulnerable to periods of bust and boom in international resource markets. In contrast, the institutionally consolidated Baltic neoliberalism largely stems from conscious choices made by reformers. International factors reinforced – rather than directly produced – these choices. In the same way, Slovene neocorporatism was mostly the product of a conscious social and political choice, which got reinforced through inter- and transnational influences. Finally, the embedded neoliberal regimes of the Visegrád countries, rather than merely resulting from a conscious strategy,
strongly reflect concessions and compromises by which elites responded to the unexpected challenges of transformation. Rather than pure altruism and solidarity, it had been the fear of massive protest against neoliberal reforms that led reformers towards welfare measures. Similarly, except in Hungary, they only became generous towards foreign investors after their initial strategy of creating a dominantly national type of capitalism failed.

We see our third contribution in that our analysis also offers some propositions concerning the potential for stability and the particular vulnerabilities of each regime type. If we are correct, and the CIS regime is linked to state weakness and reflects rather unmitigated world market influence, then we should indeed be cautious about its future. Today, it is an open question how far the recent sustained period of high oil prices has given these countries the necessary resources to build more stable institutions and stronger states.

The state-crafted neoliberal regimes of the Baltic States seem to be much more stable. They have been able to build coherent and adequate institutions consolidating the early choices. At the same time, society is not likely to be able to question neoliberalism, provided that democratic rights are only gradually extended to those who do not share in the ‘horizontal comradeship’ of nationhood (Anderson 1991). The Slovene regime seems to be equally stable, but for the opposite reasons. While no less coherent and adequate institutions were built here to support initial choices, these included the whole society in the broadest sense. In stark contrast to the Baltic States, where political stability comes at the expense of exclusion from democracy, in Slovenia it results from negotiated social compromises.

Finally, the Visegrád states share uncertain futures. Their regimes combine mutually contradictory aims and features—embedding society, luring investors, and restoring macro-economic stability, which require fine-tuned and complex balancing acts. Balancing has become more difficult especially in light of Eurozone accession. Recent developments indicate that the Visegrád countries might have to sacrifice their welfare schemes in order to comply with the Maastricht criteria. The price could be increasing political instability and illiberal politics.

Finally, we hope that our contribution has raised doubts concerning the uncritical and mechanical adaptation of the models, methods, and predictions of the VoC approach to the East European countries. Indeed, we believe such transfer might produce more problems than valuable knowledge. Where institutions are in the making rather than consolidated, the direct application of an approach conceptualizing the impact of consolidated institutions on firm behaviour seems ill-suited. Where transnational and international influences shape the emergence of institutions, it is the varied impact of these factors that has to be systematically studied. Where capitalisms are semi-peripheral rather than advanced, similar institutions might produce very different outcomes. It is only in advanced capitalist countries that liberal institutions seem to be conducive to patterns of radical innovation. In the less developed part of the world, neoliberalism is likelier to spell the fast decline of the most innovative industries, as these will be the first victims of the global competition with their advanced country rivals.

9 Acknowledgements

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Notes

1 Lane distinguishes a third group of countries, which failed to make the breakthrough towards democratic capitalism altogether, such as Uzbekistan, Belarus, and Turkmenistan.

2 Bruszt also defines a third group (including Bulgaria and Romania), where institutional change in the economy and democracy permanently exhibit tensions, although neither democracy nor market reforms have been completely abandoned.

3 CEE in our sample includes Slovenia, the Baltic states Estonia, Latvia, and Lithuania, and the Visegrád states, the Czech and Slovak Republics, Hungary, and Poland. The CIS in our sample is represented by Azerbaijan, Kazakhstan, and Russia.

4 At the time of writing however, the obstacles to Russia’s entry to the WTO are close to being lifted.

5 In 2003, oil, gas, and other natural resources accounted for about 94, 74, and 60% of the Azerbaijani, Kazakh, and Russian exports, respectively (authors’ calculation based on UN Tradecom Database).

6 Observers have been well aware of the phenomenon of the radical expansion of private and market forces in the context of relative ‘statelessness’ in the CIS, as well as of the initially mainly domestic actors, who deprived these states of the capability to engage in full-scale reforms:

‘Bearing in mind the later starting date for economic reforms in the CIS, it appears that many former Soviet Republics initially made rapid progress . . . After this initial spurt, however, the majority of CIS countries did not make further progress and have fallen behind as a result. This evidence suggests that constraints on the reform process resulting, for instance, from difficult initial conditions may become more binding as reforms become more complex. It is also consistent with the view that in many CIS countries the winners of partial liberalization and privatization efforts have often been able to block further progress in reform and to preserve for themselves the advantages created by a partially liberalized economy’ (EBRD Transition Report 2000: 30, also Hellman 1998).

7 Inequality in the CIS dwarfs in comparison with Venezuela or Mexico, where the Gini-coefficients are around 50%, and the ratios of income received by the richest versus poorest 10% of population 60 and 45, respectively. Indeed, in terms of income distribution, the three CIS countries perform better than the USA (Human Development Report 2005).

8 We cover these arguments and processes in greater detail in Bohle and Greskovits 2007.

9 The third major Eastern debtor state was the former Yugoslavia. As Slovenia did not take over responsibility for these debts, she was not constrained in her reform choices.

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Author query

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ENLARGING THE VARIETIES OF CAPITALISM
The Emergence of Dependent Market Economies in East Central Europe

By ANDREAS NÖLKE and ARJAN VLIEGENTHART*

INTRODUCTION

DURING the last few years, comparative typologies of capitalisms (comparative capitalism)¹ have become canonical among students of the political economy of Western societies.² This research field has been pioneered by scholars such as Andrew Shonfield³ and popularized by Michael Albert,⁴ and the landmark volume compiled by Peter Hall and David Soskice⁵ has both built upon and inspired many related studies. The idea that the basic institutions of capitalism differ from one country to another and that these differences are not accidental but linked to strong institutional complementarities, has led to a very sophisticated, holistic, and easily understandable picture of the institutional complexity of advanced capitalism. Many empirical studies depart from the juxtaposition of liberal market economies (LMEs), typically represented by the U.S., and coordinated market economies (CMEs), typically represented by Germany.

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¹ Jackson and Deeg 2006.
³ Shonfield 1965.
⁴ Albert 1991.
⁵ Hall and Soskice 2001a.

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Given that the original varieties of capitalism (VOC) research program was developed for analysis of the U.S., Japan, and Western Europe, scholars may wonder whether the approach is as useful for analysis of countries outside of this traditional core of the world economy. As cases for an extension of the VOC framework, we have chosen the countries of East Central Europe (ECE), namely the Czech Republic, Hungary, Poland, and the Slovak Republic. In these countries the period of “transition” has come to an end and it is time to reflect on their position in the wider context of global political economy. They are different from the countries further to the east, such as Russia and the Ukraine, that have experienced a specific type of economic and political transformation and occupy a different position in the capitalist world economy. From a comparative political economy perspective, the Czech Republic, Hungary, Poland, and Slovakia are increasingly considered as four cases of the same basic variety—sharing very similar socioeconomic institutions while being distinct from, for example, the Baltic states, the Commonwealth of Independent States (CIS), Romania, or Slovenia.\footnote{Whitley 1999, chp. 8; Bruszt 2002; McMenamin 2004, 269; Lane 2005, 245; Cernat 2006; Mykhnenko 2007; Bohle and Greskovits 2007a, 2007b; Hancék, Rhodes, and Thatcher 2007b; King 2007; Drahokoupil 2009.}

The VOC research program is currently quite popular within comparative political economy and it is no surprise that quite a few scholars have already started to apply the VOC approach to the economies of East Central Europe. After all, it was the collapse of real-existing socialism that paved the way for the ongoing explosion of research on inner-capitalist diversity. This is not to say that prior to 1989 the question of what defines modern capitalism was neglected, but a large part of comparative research focused on the differences between capitalism and socialism.\footnote{Feldmann 2006, 830.} It is therefore not without irony that the VOC approach has now entered the former socialist area with much force. The outcomes of these applications, however, are puzzling because they have led to somewhat contradicting conclusions. While some studies claim a convergence of East Central Europe on the CME type,\footnote{McMenamin 2004; Lane 2005.} others observe a convergence on the LME type,\footnote{Cernat 2002; Crowley 2005.} and a third group argues the rise of a bastard or hybrid variety of capitalism that combines features of both types.\footnote{Pald 1997; Neumann and Egan 1999; Iankova 2002; King and Sznajder 2006; Mykhnenko 2007.}

These outcomes are not only confusing, but also challenge the basic assumption of the VOC approach that strong institutional comple-
mentarities exist between the central elements of a successful variety of capitalism. It is exactly this core hypothesis—that the character of institutions within a successful economy are mutually reinforcing, balanced, and complementing—that is at the heart of the VOC theory. As seen from the traditional VOC perspective, bastard or hybrid varieties of capitalism that combine features of both models should lead to suboptimal outcomes if compared to a coherent variety. We argue that these different and contradictory inferences are partly explained by a somewhat premature, mechanistic preference for quantitative approaches.

Many studies simply take the basic characterization of the two dominant models of political economy (CME and LME) as a given and apply their dominant categories to the economies of ECE. But given the fact that statistical correlations as such do not necessarily imply causal interrelationships between the institutional elements involved, this may lead to producing methodological artifacts. Alternatively, studies that focus on only one institution may also lead to problematic conclusions because a narrow focus does not allow for an identification of the quintessential interdependencies between different institutions within one capitalist model.

We depart from a somewhat more complex reading of the VOC approach and focus on the most crucial institutional complementarities within these models. Based on this reading, we conclude that the emerging ECE capitalism does not fit well with the established varieties since fitting in would entail an exclusion of the central characteristic of the region, its external dependency. From our perspective, the identification of individual institutional parallels between ECE capitalism and either the CME or the LME model is misleading. We suggest that ECE signifies the emergence of a third basic variety—a dependent market economy (DME) type of capitalism. DMEs have comparative advantages in the assembly and production of relatively complex and durable consumer goods. These comparative advantages are based on institutional complementarities between skilled, but cheap, labor; the transfer of technological innovations within transnational enterprises; and the provision of capital via foreign direct investment (FDI). Given these complementarities, the superior performance of a DME, for instance,
ENLARGING THE VARIETIES OF CAPITALISM

compared with the rather incoherent “cocktail capitalism”\(^\text{17}\) of Romania, becomes understandable.

Characterizing ECE countries as DMES not only clarifies the confusion noted above, but also helps to eliminate some pitfalls of the VOC approach that have been noted in the literature.\(^\text{18}\) First, it broadens the original Hall and Soskice framework’s narrow focus on the U.S. and Western Europe. Second, it overcomes the overly strict dualism of this framework. Third, it incorporates transnational influences—in particular the role of transnational companies (TNC)—in an approach that traditionally tends to consider socioeconomic systems as closed containers and contributes to an emerging literature on the interaction between “national capitalisms and global production networks.”\(^\text{19}\) However, not all typical shortcomings of the VOC approach can be addressed at the same time. The most important omission in this article concerns the domestic class struggles and transnational politics that have historically led to the emergence and transformation of specific economic institutions.\(^\text{20}\) Since we cannot give a complete picture of the emergence of ECE capitalism in these pages, our broad account needs to be complemented by more historically detailed and country-specific articles on the domestic political origins of these institutions, including the role of the state, domestic bourgeoisies, and unions, and their interplay with multinational corporations.\(^\text{21}\)

Still, when compared with the existing literature, our extension of the varieties-of-capitalism approach leads to different policy conclusions. Against transitionology studies from mainstream economics,\(^\text{22}\) our extension of the VOC approach argues that there are different models for economic success and that it would be futile to expect or to hope that the ECE economies converge on the liberal model. Against more orthodox Marxist analyses,\(^\text{23}\) our approach highlights the existence of a rather coherent segment within ECE economies that can successfully compete in world markets for the time being, as long as inconsistent institutional frameworks are avoided. Thus, we see some potential for taking the VOC approach as a basis for the development of economic strategies for emerging market countries. After all, the concerns of the

\(^{17}\) Cernat 2006.


\(^{19}\) Lane 2008.

\(^{20}\) See Streeck and Yamamura 2001; Thelen 2004; Crouch 2005; on ECE see Jacoby 2006; Drahokoupil 2008.

\(^{21}\) Drahokoupil 2009.

\(^{22}\) E.g., Balcerowicz 1993, 1995; Frydman et al. 1993.

\(^{23}\) E.g., Nesvetailova 2004; Raviv 2008.
contemporary VOC debate and important strands of development theory are strikingly similar. But our analysis highlights some challenges for the long-term future of these DMEs: their comparative advantages are constantly being threatened by countries located further to the east and will continue to remain limited to segments of their economies, thereby leading to increasing social and political tensions.

To support our argument, we briefly introduce the two basic models put forward by the established VOC literature. Next we apply these models to the ECE countries thereby demonstrating that they do not fit either model, that they are not simply bastard combinations of the two basic models, and that they form a distinct third model we call dependent market economy. We also provide an analysis of the institutional complementarities within DMEs, based on the analytical categories of the VOC approach, which explains the comparative advantages that these countries currently enjoy. Our conclusion focuses on future perspectives for the sustainability of the DME variety of capitalism and for research. In addition, given that the main purpose of this article is conceptual development, we outline some options for a more systematic empirical test of our argument.

**Dependent Market Economies as a Third Variety of Capitalism**

The most widely used and comprehensive comparative typology of capitalism is still the varieties-of-capitalism model developed by Hall and Soskice. Although there are a number of comparative capitalism alternatives that propose a much larger number of types of capitalism, most authors still prefer to depart from the juxtaposition of CMEs and LMEs. Besides offering a rather balanced and comprehensive framework, one of the most important advantages of this typology is its parsimony; while the two basic models clearly are unable to give full justice to the intricacies of, for example, British, French, or Italian capitalism, they still grasp the most important differences between the basic ideal types of “Anglo-Saxon” and “Rhenish” economies. Moreover, not even the scholars that highlight the particular features of state-enhanced capitalism in France or Italy would claim that these socioeconomic systems entail a third type of coordination mechanism—a necessary

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25 Hall and Soskice 2001b.
26 E.g., Hollingsworth and Boyer 1997; Whitley 1999; Coates 2000; Amable 2003; Schmidt 2003.
precondition for a third basic variety of capitalism (see below); instead these economies are mostly described as “in between” or “mimicking” features of CMES and LMES.\(^{28}\)

The main theoretical task of the CME/LME juxtaposition is to explain the marked differences in the comparative advantages of advanced capitalist economies. These advantages are most easily demonstrated by focusing on the different types of innovation processes that are central to the two production systems.\(^{29}\) CMES such as Germany or Austria are assumed to have a premium on incremental innovation, whereas LMES such as the U.S. and the U.K., in contrast, are supposed to focus on radical innovation. Of course, these patterns of specialization do not comprise the whole of the economy. Basic services, for example, are produced throughout all economies, but are hardly covered by any of the VOC models.\(^{30}\) Furthermore, it is problematic to equate a whole industry with a certain specialization pattern in innovation given that there are more- and less-innovative activities within the same industry and that these can vary over time.\(^{31}\) Correspondingly, the VOC models are meant as broad ideal types.

The basic hypothesis of the varieties-of-capitalism approach is that the inherent institutional complementarities of the two different types of market economies can explain these broadly conceived innovation patterns. Each element of the two basic types has strong institutional complementarities with other elements of the same model and differs clearly from its functional equivalent in the other model. Usually, five interdependent elements can be highlighted:\(^{32}\) the financial system (the primary means to raise investments); corporate governance (the internal structure of the firm); the pattern of industrial relations; the education and training system; and the preferred mode for the transfer of innovations within the economy. More generally, the two models differ with respect to the basic mechanisms available for the solution of coordination problems within national economies. In liberal market economies, the most important forms of coordination are competitive market arrangements and formal contracts. In coordinated market economies, nonmarket forms of coordination, such as interfirm networks and national or sectoral associations, play a crucial role.\(^{33}\)
Given the importance of a parsimonious scheme for the success of the Hall and Soskice model, new varieties should not be added without hesitation. In order to qualify as a distinct variety of capitalism, three conditions have to be met: (1) the existence of an alternative overall economic coordination mechanism closely related to (2) a relatively stable set of institutions based on marked institutional complementarities, that leads to (3) a set of specific comparative advantages (in relationship to CME and LME) and a superior economic performance over comparable, but less pure, socioeconomic systems. We address each of these conditions in turn to demonstrate that we can identify a third basic variety of capitalism that is emerging in ECE, although it is perhaps still too early to judge the long-term stability of this variety and its ability to provide an equal alternative to CMEs and LMEs.

The common denominator of the third variety is the fundamental dependence of the ECE economies on investment decisions by transnational corporations. Though we accept that the CME and the LME models are embedded in the global economy, we will demonstrate that the DMEs are—in both quantitative as well as qualitative terms—more deeply dependent on foreign capital than any of the core CMEs and LMEs. We baptized the third variety “dependent market economy” because it is similar to the label “liberal dependent post-communist capitalism” coined by Lawrence King; it was inspired by earlier works on dependent development in Latin America.

The point of departure for our argument is a recent literature on the relationship between transnational corporations and capitalist variety. The main conclusion derived from this literature is that TNCs tend to look for a combination of low labor costs and the acquisition of “tacit knowledge embedded in local industrial districts.” As we demonstrate below, it is a combination of relatively low labor costs and a skilled population with substantial knowledge of a medium level of technology that constitutes the comparative advantage of the DME model. Similar to previous studies on the origin of economic institutions, we highlight the crucial importance of an extraordinary crisis for the emergence of new socioeconomic institutions—in this case, the collapse of communism. TNCs always strive to create an institutional setup conducive to their needs. The political situation in ECE was uniquely well

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34 We owe this point to two anonymous reviewers.
35 King 2007, 309.
36 Evans 1979.
38 Morgan and Whitley 2003, 610.
suited for a full-blown institutional design geared towards the preferences of these corporations, given the absence in the region after 1989 of strong domestic bourgeoisies that could resist such a development.\textsuperscript{40} The ideology of the leading political class fostered the development of an economic system that catered to the interests of TNCs as this class adhered to economic policies that spurred economic restructuring and economic growth through foreign investments.\textsuperscript{41} Correspondingly, we identify the hierarchy within transnational corporations as the central coordination mechanism in DME\textsubscript{s},\textsuperscript{42} in contrast to competitive markets and formal contracts as the central coordination mechanism in LME\textsubscript{s}, or interfirm networks and associations having that role in CME\textsubscript{s} (see Table 1). The notion of hierarchy not only complements markets and networks as the classical coordination mechanisms of modern societies,\textsuperscript{43} but it is also closely linked to the complementarities between the most important socioeconomic institutions within the DME variety. Following earlier works in the VOC tradition,\textsuperscript{44} we take corporate governance (specifically the hierarchical control by TNC headquarters) as our focal point and demonstrate its complementarities with the other four major institutions identified within the VOC framework.

First and most obvious are the complementarities between corporate governance and the primary means for rising investment within DMEs. Given the extremely huge volumes of FDI, TNCs prefer to hierarchically control local subsidiaries from their headquarters as an alternative mode of finance and governance rather than to accept financing by international capital markets and outsider control by dispersed shareholders (LME), or to accept financing by domestic bank lending as well as retained earnings and insider control by networks of concentrated shareholders (CME).

Second is the close relationship between the corporate governance institutions—the primary means of raising investments—and the system of industrial relations. On one side, TNCs need low labor costs for the DME model to work well and therefore will not accept costly institutions such as comprehensive collective agreements or cumbersome procedures for layoffs. Given the heavy competition for FDI, TNCs are in an excellent position to bargain on these issues. On the other side, the integration of corporate decision making into transnational commodity

\textsuperscript{40} Eyal, Selényi, and Townsley 1998.
\textsuperscript{41} Drahokoupil 2008; Vliegenthart and Overbeek 2007.
\textsuperscript{42} For a remarkably similar concept see the notion of Hierarchical Market Economy (HME) as coined by Schneider 2008.
\textsuperscript{43} Thompson, et al. 1991.
\textsuperscript{44} E.g., Hall and Gingrich 2004; Höpner 2005.
chains leads to TNC interest in keeping workers in the distinct subsidiaries fairly satisfied. Widespread labor unrest would not only hinder the functioning of the distinct subsidiary, but might also have an effect on other parts of the commodity chain. We assume that the position of the subsidiaries is not so rooted within the national societies as to require a general arrangement with regard to labor issues. As a result, rather selective company-level agreements should dominate; ones that allow for catering to the needs of TNCs and create stable relationships between management and labor within the individual firm.

Third, we expect to observe an intrinsic interconnection between the education system, the system of corporate governance, the primary means for investment, and the innovation system. Given that FDI into this variety of capitalism pays off with rather low labor costs as well as with considerable tax breaks, TNCs will not be in favor of a generous public education system or of their own substantial investment into their labor force. In addition, they do not see the need to invest heavily into innovation-relevant skills, given that they prefer to transfer innovations into the region from abroad (see below). Furthermore, the strongly individualized system of company-level industrial relations in the DME as well as a system of corporate governance strongly geared toward the corporate hierarchies of individual TNCs would hardly allow for the introduction of a CME-style system of vocational training institutions, given that effective training institutions require national (or at least sectoral) coordination within interfirm networks and associations.

Fourth, TNCs prefer to keep the most innovation-heavy activities at their headquarters or to acquire them via takeovers (LMEs) or joint ventures with other companies in their country and sector (CMEs). Dependent market economies are expected to be used as assembly platforms based on innovations that are made at TNC headquarters and transferred within TNC hierarchies. This again entails complementarities between the DME institutions. Investment financing by FDI and hierarchical control by TNC headquarters allow for the transfer of innovations to DMEs without the risk of the intellectual-property-rights problems associated with joint ventures, for example. Moreover, given the limited amount of innovative activity, there is no need for an LME-type system of general-skill education combined with massive research and development (R and D) expenditures, or for a CME-type system of comprehensive vocational training. The same applies for industrial relations; TNCs do not need highly flexible labor markets to acquire
innovations (as in LMEs) or long-term investment into skill acquisition based on inflexible labor contracts (as in CMEs). DMEs work particularly well with a medium level of labor-market flexibility; TNCs retain the ability to adjust employment levels to demand in order to avoid too much labor-market fluidity for their skilled staff and avert a breakdown of their assembly platforms.

Taken together, the complementarities outlined above should give rise to a specific type of comparative advantage that is not based on radical innovation (LMES) or incremental innovation (CMEs), but rather on an assembly platform for semistandardized industrial goods. While the highly innovative parts of the business cycle remain at TNC headquarters, fully developed technologies are transferred to the TNC’s subsidiaries in the DMEs and remain under the control of the corporate hierarchy. At the same time, based on extremely favorable conditions for FDI (for example, tax breaks financed by low public expenditures), moderate labor costs, and a fairly skilled workforce, the region can successfully compete in the global market for this kind of investment.

East Central Europe: The DME Model in Practice

Our modification of the VOC conceptual framework identifies as the central coordination mechanism within these economies a number of institutional complementarities that are centered on the multinational enterprise core principle of intrafirm hierarchy. In this section we take a closer look at the five institutional components introduced by Hall and Soskice and further develop our idea that a third variety of capitalism is emerging in ECE. We demonstrate the complementarities between these institutions, as well as their mutual reliance on the hierarchical coordination within transnational enterprises, by using empirical data from the ECE region. However, with regard to the specialization pattern in CME and LME as discussed above, our construction of the DME model covers only the dominant industries within the region and cannot represent East Central European economies as a whole.

Primary Means of Raising Investments

In our view, the decisive impact of foreign capital in the restructuring of the former socialist economies symbolizes the primary characteristic of the emerging DME variety. The dependency on foreign capital is best illustrated by a look at the way in which investments are financed.

See also King 2007.
In the case of ECE, the primary source of investment is foreign direct investment (see Table 2), not the stock market (as in LMEs) or domestic credit (as in CMEs). FDI is concentrated in complex industries and ECE countries clearly have more of these than other transition economies such as the Baltic states and the CIS.  

Although FDI does play a role in the CME and LME models, the degree of external dependency is much more extreme in ECE. This is best demonstrated by an examination of the relationship between inward and outward FDI stock (see Table 3). While the relationship is fairly balanced in both CMEs and LMEs, DMEs are heavy importers of capital.
Another indicator of the importance of foreign capital to ECE countries is the measure, by sector, of their exports. In industries in which the ECE states have clear comparative advantages, such as automobiles, manufacturing, and electronics, foreign ownership clearly dominates (see Table 4). In the banking sector, which affects the distribution of capital within an economy (particularly for small- and medium-scaled enterprises), foreign ownership is also omnipresent.

Taken together, these data about the origin of the primary means for raising investments demonstrate the external dependency of the ECE economies. Foreign direct investment is by far the most important source of capital. Domestic bank lending, the second most important source of finance, is also clearly dominated by transnational companies. When compared with ownership relationships in Western Europe, the heavy penetration of the ECE banking sector by FDI is obvious. At the end of 2004 the market shares of foreign branches and subsidiaries in the Euro area amounted to a mere 15.5 percent; the figure was well over 70 percent in ECE economies.  

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47 Rugraff 2006.
48 Raviv 2008, 168–70; see also King 2007, 310.
TNCs as well as mid and small domestic companies, these companies also depend on foreign financing.\textsuperscript{49} We can thus safely conclude that the most fundamental financing decisions are not made in the region itself, but in Western Europe and the U.S.

**Corporate Governance**

The relationship between management and owners constitutes the central part of any corporate governance system. In most of the literature on corporate governance, ECE countries are considered to be hybrids of CMEs and LMEs.\textsuperscript{50} We argue, however, that this assessment is superficially based on an analogy that looks only at formal governance structures such as two-tier boards. We suggest linking corporate governance to the specific ownership pattern of the region. Many larger corporations have been taken over by foreign investors. Especially in Hungary, but also in the other ECE states, privatization has led to a host of foreign takeovers of formerly state-owned corporations.

As a result, with regard to the institutional setup and its dependency on foreign investments, the East Central European DME model is different from the CME and LME models. Foreign ownership leads to important changes in the internal corporate-governance structure within ECE enterprises; major corporate decisions are not negotiated between managers and shareholders, but rather between managers of the ECE

\begin{table}
\centering
\caption{Ratio Inward FDI Stock/Outward FDI Stock}
\begin{tabular}{ll}
\hline
Country & 2006 \\
\hline
\textbf{DME} \\
Czech Republic & 15.3 \\
Hungary & 6.4 \\
Poland & 9.7 \\
Slovak Republic & 23.6 \\
\hline
\textbf{LME} \\
U.K. & 0.8 \\
\hline
\textbf{CME} \\
Austria & 1.0 \\
Germany & 0.5 \\
\hline
\end{tabular}
\end{table}

\textsuperscript{49} We owe this point to an anonymous reviewer.

\textsuperscript{50} Iankova 2002; Neumann and Ëgan 1999, 175; Palda 1997, 93.
ENLARGING THE VARIETIES OF CAPITALISM

Table 4
SHARE OF FOREIGN OWNERSHIP IN THREE STRATEGIC SECTORS

<table>
<thead>
<tr>
<th>Country</th>
<th>Automotive</th>
<th>Manufacturing</th>
<th>Electronics</th>
<th>Banking</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Republic</td>
<td>93.1</td>
<td>52.6</td>
<td>74.8</td>
<td>85.8</td>
</tr>
<tr>
<td>Hungary</td>
<td>93.2</td>
<td>60.3</td>
<td>92.2</td>
<td>90.7</td>
</tr>
<tr>
<td>Poland</td>
<td>90.8</td>
<td>45.2</td>
<td>70.3</td>
<td>70.9</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>97.3</td>
<td>68.5</td>
<td>79.0</td>
<td>95.6</td>
</tr>
</tbody>
</table>

Source: Data for 2004, based on OECD.stat database, measured as a percentage of turnover; banking data for 2002 based on Mérő and Valentiny 2003.

subsidiary and Western headquarters. TNCs “have fully integrated the CEE [Central and East European] subsidiaries into their company networks.”51 As a result, corporate managers of ECE subsidiaries are responsible to internal supervisors in other countries. “Foreign companies… have applied tight budgets… exercised close control on managerial decisions and relied heavily on their appointees to the board of directors.”52 In general, we perceive a strong institutional complementarity between an ownership structure that is dominated by foreign direct investments and a corporate governance structure that demonstrates close supervision of local managers by Western-based headquarters. This contrasts both the LME model, in which there is an active market of corporate control based on financial markets to supervise management, and the CME model, where managers primarily have to deal with holders of large blocks of stock and domestic banks that provide funding as preferred partners (so-called Hausbanken).

To some extent these observations are also valid for subsidiaries in Western Europe and the U.S., but in East Central European countries the process is more marked. Corporate governance in ECE is more transnationalized than in the core of the world economy. TNCs play a decisive role in total growth as domestically owned small- and medium-scale enterprises (SMEs) are often dependent on foreign partners in supplier-driven and buyer-driven supply chains.53 As a result, corporate strategies adopted in foreign headquarters have a decisive impact on the whole economy of the region, which reflects the dependent position of the ECE countries discussed earlier. Thus, these investments have an ambivalent character, as indicated by the case of a German paper multinational: “This firm integrates the Polish economy with the Western

51 Radosevic 2003, 33.
52 Czaban and Henderson 2003, 182; see also Holman 2002, 414.
53 Radosevic 2003, 33.
European ones, while simultaneously making it dependent on the decision of a firm with operations in many countries, making investment decisions with its global empire, not Poland’s development, in mind.  

Finally, the corporate-governance regulatory framework first introduced in the early 1990s has been highly influenced by the process of EU enlargement. In this process, the EU has laid out the kind of corporate-governance reforms needed in order to acquire EU membership. As a result, corporate-governance practices as well as corporate-governance regulations are not pure endogenous products, but have been strongly influenced by transnational agents.

**Industrial Relations**

Regarding labor relations, ECE economies do not resemble either the market-based Anglo-Saxon or highly cooperative Rhineland models, but constitute a variety in their own right. Again, a study that looks only at quantitative data and formal institutions might classify the region as a hybrid. In general terms, East Central European collective bargaining coverage rates are higher than in the Anglo-Saxon world, but lower than in the Rhineland states (see Table 5).

Indeed, unlike the Anglo-Saxon model, ECE countries do not have a culture of hiring and firing, nor do they have a corporatist structure in which organized labor is incorporated into a complex system of bargaining procedures and enjoys real power in the struggle over wages and collective agreements on the sector level. The position of labor in DMEs is substantially weaker than in CMEs, given the heavy competition for foreign direct investment and the lingering threat of companies being relocated further east. Correspondingly, transnational companies will not accept factors such as high wages, high union density, comprehensive collective agreements, powerful worker representation or cumbersome procedures for layoffs. Given that the incorporation of DMEs as assembly platforms in complex global commodity chains makes strikes very costly, as soon as TNCs invest heavily within the region they become interested in keeping workers fairly satisfied. At the same time, these TNCs cannot easily replace their skilled labor and they cannot avoid worker defection by simply paying higher wages, doing so would cause them to lose the cost advantage of that workforce. Thus, they avoid the rather fluid relationship with workers that can be observed in LMEs, and generally strive for an appeasement of workers.

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54 King and Szajder 2006, 781.
55 Vliegenthart 2009.
in terms of work conditions. A typical phenomenon is the existence of company-level agreements, which make up 80 percent of all collective bargains in ECE, in contrast to Western Europe where most agreements are made at the sectoral or even national level.57

In this respect, ECE states can be characterized as countries with incomplete social pacts,58 a characterization that is also represented in public social spending. ECE welfare arrangements are not as comprehensive as those of CME states, but the ECE governments spend more on welfare than do their counterparts in LME states (see Table 5). In ECE industrial relations and social spending systems are not built on broad-based social struggles, but rather are instituted to selectively appease transnational corporate employees. The issue of worker representation on supervisory boards poses another example of the incomplete system of employee involvement within ECE industrial relations; such representation is officially part of the institutional setup in countries, but in practice only half-heartedly implemented.59

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58 Bohle and Greskovits 2006; Meardi 2007.
If the system of industrial relations is linked with the primary means to raise investments and the system of corporate governance, given the dominant interest of Western owners to keep labor costs low and to safeguard the smooth working of tightly integrated commodity chains, strong institutional complementarities can again be identified. While this preference is well served by company-level collective agreements, sectoral or even national agreements are hardly viable because coordination between the owners of local businesses—situated in a number of various Western capitals—is difficult to generate. In contrast, sectoral- or national-level agreements are fairly typical for CME countries where the existence of a strong domestic bourgeoisie heavily reduces the corresponding transaction costs. At the same time, the increasing scarcity of skilled labor in ECE countries (examined in the next section) would make an LME system—with its high reliance on fluid labor markets and individual contracts—very costly if disruptions of complex commodity chains are to be prevented.

**Education and Training Systems**

When turning to education and training systems, ECE can again be distinguished from the countries that manifest the LME or CME varieties of capitalism. The 1990s saw substantial cutbacks in government spending on education and a decentralization of the responsibility for education. Between 1995 and 2000, government spending on education was reduced “from 5.5 percent to 5.2 percent in Poland, from 5.4 percent to 4.9 percent in Hungary, and in the Czech Republic from 4.9 percent to 4.4 percent” of the GDP. At the same time the basics of the socialist educational system, with its focus on vocational training, survived but its orientation radically changed. As K. Roberts points out, one of the key elements of the postsocialist education system is that vocational training is structured to meet the labor demands of TNCs. Spending on and structuring the vocational system then, in turn, shape the rest of the educational system.

In this respect, it is important to stress that employers usually “are unwilling to bear the additional costs of on-the-job training of inexperienced young workers.” It seems that most employers do not find it rewarding to invest heavily in their own workforce. The DME model

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60 Commandor and Kollo 2008.
61 Barrow 1998.
64 Nesperova 2002, 12.
65 Bohle and Greskovits 2006, 15.
differs from the CME model in the sense that in it, public vocational training, largely outside of corporations, dominates the system; not much vocational training occurs at the workplace. At the same time, the withdrawal of governmental involvement no longer allows for a strong public education system that counterbalances limited vocational training with a high quality general-skills education along Anglo-Saxon lines. ECE governments find it difficult to invest heavily in public education—a major precondition for a comprehensive general-skills education—given the fiscal constraints that go hand in hand with the intense competition for FDI, frequently including massive tax-reduction packages.

All in all, the postsocialist educational system fits neatly with our interpretation that the economies of ECE countries belong to a third variety of capitalism and that this third variety is primarily characterized by its external dependency. Whereas demanding tasks such as research and development are executed in the CMEs and LMEs of the core regions of Western Europe, the DMEs of East Central Europe are used as assembly platforms for semistandardized goods. For these purposes, existing vocational skills are largely adequate; major investment to upgrade required skills would endanger ECE’s cost advantages and would be difficult to organize, given the firm-centered system of industrial relations within DMEs. In addition, given the specific corporate-governance and finance systems of DMEs, it hardly comes as a surprise that there are few activities that counter the slowly eroding comparative advantage of these economies—which probably goes hand in hand with low levels of spending on education and training. Whereas nationally owned businesses would be concerned about these long-term developments and might coordinate for reverse action, Western headquarters do not care much about these tendencies, given their potential to relocate production in the long term if local skill levels deteriorate too much.

**Innovation Systems**

Similarly, for tasks such as assembly platforms for semistandardized goods, major investments in R and D are not necessary and too costly. Decisions regarding research and development are not dominated by concerns about the long-term innovation potential of local economies, but rather by their current profitability within a transnational company. The tendency not to invest into the valorization of the production process is reflected in the total spending on research and development,

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which falls way below the figures of Western Europe and the U.S. (see Table 6).

The level of spending on research and development is not the only thing that sets dependent market economies (negatively) apart from the other varieties; the organization of the innovation system within them differs considerably from those within LMEs (where innovations are transferred via the market) and CMEs (where innovations are spread by diverse means of business cooperation). In the case of DMEs, most R and D is done outside the region and then imported into the production process through transnational networks that bind together the different places of production. Foreign corporations often import new technologies into the region and do their R and D and design elsewhere in the world because they consider ECE economies as a place for production and not for research.67 The consequence for local companies within DMEs has been nicely summarized by Ottó Sinkó, president of Videoton, a leading Hungarian company: “Downsize radically, stop developing new products, and focus on labor-intensive manufacturing to serve a hungry crop of multinational investors.”68 Modern technology is transferred to ECE economies under the strict control of TNC headquarters, something enabled by the externally dominated corporate-governance patterns described above. Correspondingly, more than 70 percent of R and D expenditure in Hungary is provided for by foreign-controlled firms.69 As a further consequence, there has been an increasing shift from joint ventures to majority foreign ownership—the latter accounting for 40 percent of FDI in Poland in 1993, 45 percent in 1995, 50 percent in 1998,70 and even 100 percent ownership in the technologically most demanding activities71—thereby indicating a strong complementarity between innovation systems and the control over the means of investment. Still, technology transfer should not be underestimated, since it has allowed for the modernization of ECE production facilities and thus supported the region’s current competitive advantage within global capitalism. ECE economies have been able to attain a relative degree of economic success72 without massive investment in their own education systems due to a disproportionate amount of foreign direct investment.

67 For an excellent account of these tendencies in the clothing industry see Pickles et al. 2006.
69 King 2007, 312.
70 King and Szajjer 2006, 778.
71 Greskovits 2005, 120.
72 King 2007, 314.
Although we do not go into the details of different types of innovation (product, process, etc.) in this article, the assessment can be broadly supported by an analysis of patent data, as utilized by Hall and Soskice in their analysis of CME and LME innovation patterns. ECE performs relatively poorly with regard to the number of patents when compared to CMEs and LMEs (see Table 7), even when the shortcomings of this broad indicator are taken into account. Moreover, the gap with regard to investments within the enlarged European Union seems to be growing. For all countries in the region, R and D intensity declined between 1990 and 2000. This might also explain the fact that the number of patents in the region has actually decreased during the last ten years.

The absence of large numbers of (high-tech) patents does not mean that there is no innovation activity undertaken in DMES. Innovation in ECE “has so far been predominantly imitative and not creative. Technological activities in firms are skewed towards downstream non-analytical and non-R and D activities like testing and standards.”

73 Hall and Soskice 2001b, 41–44.
75 OECD 2002, 16.
76 Högsetius 2003, 22.
reflected in the number of high-tech patents that are registered in the region (see Table 8). There is a big gap between ECE economies and both LMEs and CMEs.

Again, this is not to say that there is no innovation whatsoever in ECE or that the region produces outdated products. On the contrary, the comparative advantage of the region rests upon its ability to quickly adapt to new trends in the production of qualitative durable consumer goods. Yet most of the new trends come from outside the region; the existing innovation in ECE is rather limited in scale and is conducted by a number of small companies that are active suppliers and final producers for the major transnational companies. Whereas the TNCs deliver the technology to subsidiaries, the subsidiaries in return are widely connected, partly through ownership ties, to their national suppliers. This leads to a rather stable relationship between these firms.\textsuperscript{77} The transnational corporations are on the top of the institutional hierarchy, the national suppliers are highly dependent on the TNCs for the continuation of their work,\textsuperscript{78} and the practices brought into the region by the TNCs are subsequently introduced by domestically owned corporations.

\textsuperscript{77} Czaban and Henderson 2003, 185.
\textsuperscript{78} Pavlinek 2004.

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Table 7

<table>
<thead>
<tr>
<th>Country</th>
<th>1990</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>DME</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Czech Republic</td>
<td>0.71</td>
<td>0.60</td>
</tr>
<tr>
<td>Hungary</td>
<td>2.69</td>
<td>1.62</td>
</tr>
<tr>
<td>Poland</td>
<td>0.14</td>
<td>0.16</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>n.a.</td>
<td>0.02</td>
</tr>
<tr>
<td>LME</td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.K.</td>
<td>25.26</td>
<td>16.78</td>
</tr>
<tr>
<td>U.S.</td>
<td>44.57</td>
<td>n.a.</td>
</tr>
<tr>
<td>CME</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Austria</td>
<td>22.52</td>
<td>26.61</td>
</tr>
<tr>
<td>Germany (including ex-GDR from 1991)</td>
<td>51.74</td>
<td>53.79</td>
</tr>
</tbody>
</table>

Source: Eurostat, patent statistics.

*Triadic patents are patents acknowledged by U.S., EU, and Japanese patent organizations.
This fits the general picture that foreign direct investment is not only important in regards to ownership issues, but also to the region’s whole institutional setup.

### Comparative Advantages and Economic Performance

Although the limited large-scale innovation capacity of DMEs may be worrisome in the long run, for the time being, the specialization of ECE has allowed for substantial growth in the region. This is reflected by the comparative advantages of the ECE states that are situated in the assembly and production of relatively complex and durable consumer goods. Poland, for example, has undergone a remarkable shift with regard to its export structure, moving from agricultural products and industrial materials to consumer goods such as vehicles and vehicle parts. ECE countries are now increasingly specialized in labor-intensive export industries, such as medium-quality cars, machinery, electronics, and electrical products. As Table 4 demonstrates, these sectors are predominantly foreign owned. They can be considered complex when it comes to the worker skills involved, but the intensity in physical capital varies

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**Table 8**

<table>
<thead>
<tr>
<th>Country</th>
<th>1990</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>CME</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Czech Republic</td>
<td>0.097</td>
<td>0.178</td>
</tr>
<tr>
<td>Hungary</td>
<td>0.193</td>
<td>1.139</td>
</tr>
<tr>
<td>Poland</td>
<td>0.013</td>
<td>0.039</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td><strong>LME</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.K.</td>
<td>7.156</td>
<td>11.305</td>
</tr>
<tr>
<td>U.S.</td>
<td>34.493</td>
<td>n.a.</td>
</tr>
<tr>
<td><strong>DME</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Germany (including ex-GDR from 1991)</td>
<td>7.093</td>
<td>15.75</td>
</tr>
<tr>
<td>Austria</td>
<td>1.814</td>
<td>8.292</td>
</tr>
</tbody>
</table>

Source: Eurostat, patent statistics.

USPTO patents are patents that are registered at the U.S. patent organization.

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79 King and Sznajder 2006, 779.
from heavy (i.e., cars) to light (i.e., electrical products and electronics). The comparative advantage of the region in component manufacturing and assembly for diverse industrial goods primarily stems from the availability of cheap, but skilled labor. In this respect, ECE has become what John Pickles et al. call “a global assembly platform”—a region where technical products are put together before they are exported (mostly) to more advanced economies. After the collapse of state socialism and the subsequent deindustrialization, the region specialized in the reexport of high-tech consumer goods. For this particular type of activity, no major research and development in the region is necessary.

In order to assess the overall economic performance of the emerging DME model, it must be compared with countries in a similar position, i.e., postsocialist European states. Measured in terms of GDP per capita development, the four major ECE states—the Czech Republic, Hungary, Poland, and Slovakia—are among the best performing countries (see Table 9). A rare exception in the cluster of postsocialist states is Slovenia, which emulates the CME model and also has a high GDP per capita.

While the ECE states have outperformed former CIS states such as Russia and Ukraine in terms of GDP per capita development, their superior economic performance (particularly that of Slovakia) becomes most obvious when compared with Bulgaria or Romania. The DME model of Slovakia has been much more successful than the rather incoherent “cocktail capitalism” of Romania. This superior performance is also exemplified by the export share of complex, human-capital intensive industries; from 1996 to 2005 it rose in Slovakia from 41 percent to 51 percent while it decreased in Bulgaria from 31 percent to 23. Slovakia also reports rapid development in high-tech exports from 2003 on. In contrast, the Bulgarian export structure has been relatively stable for the last five years, with some increase in heavy basic exports. Although

80 Greskovits 2005.
81 Czaban and Henderson 2003, 182.
82 Pickles et al. 2006.
83 In line with other comparative evaluations of the economic performance of specific varieties of capitalism such as Hall and Gingrich (2004) as well as Kenworthy (2006), we are using data on GDP growth. The utilization of patent data by Hall and Soskice (2001a and b) has been severely criticized (Taylor 2004). Moreover, it would be misleading to use patent data as performance indicators for DMEs since they, by definition, rely less on this type of innovation activity than on CMEs and LMEs. Still, we agree with Kenworthy (2006, 86) that aggregate analyses, e.g., based on GDP data, have limited merits in testing causal hypotheses on economic performance.
84 Feldmann 2006.
85 Cernat 2004.
ENLARGING THE VARIETIES OF CAPITALISM

Table 9
GROSS NATIONAL INCOME PER CAPITAL PURCHASING POWER PARITY

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>East Central Europe</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Czech Republic</td>
<td>12,820</td>
<td>15,640</td>
<td>22,020</td>
</tr>
<tr>
<td>Hungary</td>
<td>12,830</td>
<td>12,830</td>
<td>17,210</td>
</tr>
<tr>
<td>Poland</td>
<td>7,330</td>
<td>10,880</td>
<td>15,330</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>8,380</td>
<td>11,900</td>
<td>19,340</td>
</tr>
<tr>
<td><strong>Baltics</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estonia</td>
<td>6,320</td>
<td>10,160</td>
<td>19,810</td>
</tr>
<tr>
<td>Latvia</td>
<td>5,080</td>
<td>8,550</td>
<td>16,890</td>
</tr>
<tr>
<td>Lithuania</td>
<td>6,040</td>
<td>9,050</td>
<td>17,180</td>
</tr>
<tr>
<td><strong>South East Europe</strong></td>
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<td>6,690</td>
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<td>5,860</td>
<td>6,620</td>
<td>10,980</td>
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<td>26,640</td>
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<tr>
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<td>3,160</td>
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<td>6,810</td>
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Source: World Development Index, Quick Query

*All figures represent U.S. dollars.

the current differences between ECE and the Baltics in terms of GDP development are far less obvious, the long-term prospects for sustainable economic development are brighter for the ECE states, given that they have specialized in complex exports and not in exporting worked primary goods such as wood manufacturing. The Baltics might still be caught in a “postsocialist developmental trap” that hinders structural economic development.86

Conclusion and Research Perspectives

We have identified an economic model in East Central Europe that is stable and fairly successful—particularly when compared with most other transition economies. For the time being, this model leads to comparative advantages of parts of ECE economies in sectors such as

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86 Greskovits 2005.
automobiles and consumer electronics. The comparative advantages of the economies can be explained by looking at the complementarities between the different institutions within these capitalist systems. Taken together, these institutions form a rather coherent, stable whole. At the same time it becomes clear that these institutional complementarities do not fit the coordinated market economy or the liberal market economy models and it does not make sense to describe ECE as epitomizing a mixture of CME and LME elements. The latter not only ignores the fundamental argument of the VOC approach (institutional complementarities), but also leads to the identification of superficial similarities that do not cover the basic functions of ECE capitalism. Instead, we have constructed a third variety, based on the original categories supplied by the VOC approach. We have baptized this variety the “dependent market economy” since its overriding feature is the fundamental dependence on investment decisions by TNCs. Thus, the hierarchy between TNC headquarters and local subsidiaries replaces markets (LME) and associations (CME) as a typical coordination mechanism within these economies. Subsequently, we have identified a number of complementarities between these corporate governance features and the other major institutions of DMEs.

This perspective opens a range of avenues for further research including the need to combine it with a more political account of the emergence of these institutions. Conceptualizing the economies of ECE as dependent market economies raises the question as to whether these findings may also be applied to other semiperipheral regions within the contemporary world economy, such as parts of Latin America or South East Asia. This comparison would lead to a more systematic empirical test of our argument and would clarify the role of the timing of integration into the capitalist world economy in the evolution of DMEs. Arguably, this timing has heavily contributed to the extraordinarily dependent character of the ECE economies (when compared to other regions of the semiperiphery), given the weakness of domestic bourgeoisies after the demise of communism. Therefore the ECE region is perfectly suited as an empirical illustration of the development of a DME ideal type, as are Germany and the U.S., respectively, in cases of CME and LME. However, the specific heritage of the recent transition from communism makes it difficult to test ECE’s economic performance against less pure cases of DME in other world regions; according to VOC logic, DME performance should be superior.

A second comparative perspective instigated by our theoretical development concerns the ongoing graduation of former semiperipheral
economies, such as Ireland, into the core of the world economy. These countries have experienced sustained economic growth in the context of a prominent role for foreign TNCs. Will this graduation be possible for ECE as well? Given the extraordinarily high degree of external dependency in DMEs, our findings indicate a somewhat skeptical perspective. On the one side, the extreme situation in ECE leads to particular risks, as indicated by the case of Poland (and made more obvious by the recent subprime crisis):

While some of the smaller European economies are probably similarly dependent, it seems possible that Poland may have a greater reliance on TNCs for technology transfer... It also seems that even more of the "commanding heights" of the Central Eastern European economies—banking, telecom, utilities, and high-tech manufacturing—are foreign owned... Polish growth has become extremely dependent on imported industrial goods, foreign markets, and the investment decisions of foreign-owned firms and banks. It is therefore extremely sensitive to exchange-rate fluctuations and changes in external demand.

Western owners of eastern production sites may well have a certain interest in the short- and medium-term viability of their investments in DMEs, but they have less incentive than domestic bourgeoisies to invest in the long-term sustainability of these economies. Instead, Western owners might relocate their production sites further to the east, driven by the competitive pressures of financial capitalism. At the same time, the current comparative advantages of ECE may gradually be eroded, given the decreasing value of the skill heritage acquired during communism and the absence of substantial investment into R and D and education that have been so crucial for the Irish case. Correspondingly, the movement of DMEs towards CME or LME status does not look likely and the stability of DMEs might even be slowly undermined in the very long run.

A third comparative perspective, however, stemming from the institutional features of many economies of the former Soviet Union states—in particular their high degree of rent-seeking activities—could lead to the conclusion that there may still be limitations to the eastward relocation drive. These economies are marked by the prominent role of informal patronage networks and the overriding role of control over the access to raw goods—their most important economic assets. It is difficult to imagine that they could offer the same institutional

87 See also Böröcz 2004, 6–9.
88 King and Sznajder 2006, 790.
89 Keating 2006.
complementarities that support the competitive position of the ECE economies, in spite of their considerable economic growth. In the logic of our argument one may therefore assume the existence of at least a fourth basic variety of capitalism—based on “clans”—as a fourth basic mode of social coordination90 and dominating the global periphery of Central Asia91 and sub-Saharan Africa.

Of course, not all economies have to be institutionally coherent. One might be tempted to use the variety of capitalism approach as the basis for a theory of underdevelopment, explaining it by the absence of sufficient institutional complementarities. This theory would suggest seeking equilibrium in domestic systems and strongly advise against benchmarking “best” institutions across countries.92 In particular, the transfer of individual institutions from one variety to another has rarely proven successful, as numerous attempts to export the German system of apprenticeships have demonstrated. Moreover, studies exploring the origin of vocational training institutions indicate that the institutionalization of a stable system of firm-based training relies on very specific class settlements.93 Correspondingly, the usefulness of the VOC theory for the design of development strategies might be somewhat limited, given the considerable difficulties of creating these complex institutions and linkages by policy design.

In any case, the policy conclusions from our investigation are quite ambivalent. The most immediate implication from our assessment would be for the ECE economies to substantially invest in education, training, and research in order to stabilize their current comparative advantages against the relocation of production and to attract new investments. But doubt may still be raised as to whether stabilization of the current position in the world economy is really desirable, given that few countries would explicitly choose an export-oriented development path with a medium level of technology under the domination of foreign capital.94 Moreover, only part of the society benefits from the success of the externally dominated industries. While the DME model has proven to be fairly coherent and successful for certain sectors, it clearly fails to lift the standard of living of the whole population. Instead, we observe a growing dualism within these societies with rising income disparities between those who participate in the export-oriented industries and

90 Ouchi 1980.
91 “Patrimonial postcommunist capitalism,” see King 2007, 309.
92 Höpner 2005, 334.
93 Thelen 2004.
94 We owe this point to an anonymous reviewer.
those who are excluded or who have to bear the costs incurred by the generous incentives offered by governments to attract FDI. Most recently, this uneven development has led to increasing political and social tensions in East Central Europe, accompanied by the rise of populism. While massive FDI has undoubtedly contributed to the modernization of East Central European industries, its broader societal implications may be more ambivalent.

REFERENCES


The Rise and Fall of the Washington Consensus as a Paradigm for Developing Countries

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United Nations Conference on Trade and Development, Geneva, Switzerland

Summary. — The introduction of the Washington Consensus involved not simply a swing from state-led to market-oriented policies, but also a shift in the ways in which development problems were framed and in the types of explanation through which policies were justified. Key changes were the partial globalization of development policy analysis, and a shift from historicism to ahistorical performance assessment. The main challenge to this approach is a latent Southern Consensus, which is apparent in the convergence between East Asian developmentalism and Latin American neostructuralism. The demise of the Washington Consensus is inevitable because its methodology and ideology are in contradiction. © 2000 Elsevier Science Ltd. All rights reserved.

Key words — development theory, development policies, World Bank/IMF policies

1. INTRODUCTION

Developing countries is an international practice. The essence of this practice is the mobilization and allocation of resources, and the design of institutions, to transform national economies and societies, in an orderly way, from a state and status of being less developed to one of being more developed. The agencies engaged in this practice include national governments of less-developed countries, which have adopted “development” as a purpose to which State power is put, and governments of richer countries, which disburse official development aid to support and influence this process; a variety of non-governmental organizations concerned to animate and channel popular concerns; and international intergovernmental organizations, such as the organs of the United Nations and the World Bank, many of which have been expressly set up to resolve various development problems. Often it is the last group who have acted as the avant-garde of development practice. It is because of their activities, as well as the widespread tendency of governments to copy successful practice elsewhere, that it is appropriate to describe developing countries as an international practice. But it is by no means global in scope. Indeed the practice of developing countries is only done in a particular set of countries—those which in the 1950s and 1960s were generally called “underdeveloped” or “less developed” countries, but which now generally identify themselves, and are identified by others, as “developing countries.”

This paper discusses trends in the body of knowledge which guides and justifies the practice of development. It examines, in particular, the ideas propagated by international development agencies, and focuses on the shift in thinking which occurred in the 1980s with the introduction and widespread adoption of an approach to the practice of developing countries known as the “Washington Consensus.” In broad terms, this approach recommends that governments should reform their policies and, in particular: (a) pursue macroeconomic stability by controlling inflation and reducing fiscal deficits; (b) open their economies to the rest of the world through trade and capital account liberalization; and (c) liberalize

* This paper is an extended version of comments made at the Berlin-Brandenburgische Akademie der Wissenschaften Conference on “Paradigms of Social Change” held in Berlin on September 3–5, 1998. I would like to thank John Toye, Gabrielle Köhler, Richard Kozul-Wright and two anonymous referees for critical comments on an earlier draft. The arguments and interpretations are those of the author. The views expressed do not necessarily reflect those of UNCTAD. Final revision accepted: 17 October 1999.
domestic product and factor markets through privatization and deregulation. Propagated through the stabilization and structural adjustment policies of the International Monetary Fund (IMF) and World Bank, this has been the dominant approach to development from the early 1980s to the present. The paper examines the introduction of the Washington Consensus as a paradigm shift, and assesses the configuration of development thinking in the 1990s and pressures for a further paradigm shift, particularly in the light of the East Asian financial crisis and recent attempts to construct a “post-Washington Consensus.”

The paradigmatic nature of the Washington Consensus is most clearly evident in the work of John Williamson (1990,1993,1997), who coined the name and also set out a specific formulation of the approach at the end of the 1980s. This formulation was founded on an attempt to summarize, with particular reference to policy reform in Latin America, “the conventional wisdom of the day among the economically influential bits of Washington, meaning US government and the international financial institutions” (Williamson, 1993, p. 1329). Williamson never explicitly identifies the Washington Consensus as a paradigm. But the way he describes the approach conforms in many respects with Thomas Kuhn’s notion of one. Thus, he argued that the Washington Consensus is a “universal convergence,” and that it constitutes “the common core of wisdom embraced by all serious economists” (Williamson, 1993, p. 1334). He codified the approach as a set of 10 axiomatic generalizations which, given certain values, are generally shared by scholars and practitioners concerned with economic growth in developing countries; and he listed remaining analytical problems on which normal economic science needs to focus. Finally, he dismissed those who challenged the consensus view as “cranks” (p. 1330). As he put it,

[The superior economic performance of countries that establish and maintain outward-oriented market economies subject to macro-economic discipline is essentially a positive question. The proof may not be quite as conclusive as the proof that the Earth is not flat, but it is sufficiently well established as to give sensible people better things to do with their time than to challenge its veracity (p. 1330).

The structure of the revolution in thinking which occurred with the introduction of Washington Consensus policies is usually seen as a shift from state-led dirigisme to market-oriented policies. Such a switch undoubtedly occurred. But it is not a sufficient description of the nature of the change as a paradigm shift. As Kuhn shows, when paradigms change, there are usually significant changes in the “methods, problem-field, and standards of solution” which are accepted by a community of practitioners (Kuhn, 1970, p. 103). As a consequence, “the proponents of competing paradigms practice their trades in different worlds...[they] see different things when they look from the same point in the same direction” (p. 150). In examining the introduction of the Washington Consensus as a paradigm shift, what matters is not simply the substantive differences with earlier approaches, but also the nature of the change in the disciplinary matrix and worldview.

Here it will be argued that together with the swing to market-oriented policies, there was a deeper shift in the way development problems were framed and in the types of explanation through which development policies were justified. This involved changes in the spatial and temporal frame of reference of development policy analysis. In brief, these changes were: the partial globalization of development policy analysis; and a shift from historicism to ahistorical performance assessment.

2. THE PARTIAL GLOBALIZATION OF DEVELOPMENT POLICY ANALYSIS

Specifying development policy problems involves both explanations of development trends and normative judgements about how the world should be. For each of these activities, an important decision which must be made is deciding the policy frame, i.e. what elements should be included when viewing a problem and what elements excluded. The framing of policy issues has various parts but one which critically affects the practice of developing countries is whether policy problems are seen within a global or national frame of reference. Explanations and normative judgements can each be elaborated within a national or global frame of reference, and so the thinking which underpins the practice of developing countries can be wholly national, wholly global, or some combination of both (Figure 1). The full globalization of development policy analysis will be understood here to mean a shift from a
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<th>Explanatory Framework</th>
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<td>Global</td>
<td>Global Norms/ National Explanations</td>
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There were, of course, major controversies both over the meaning of development and the means of achieving it. In the 1950s and 1960s there were debates about development strategy (for example, balanced or unbalanced growth), the nature of dualistic development processes, and the role of human capital. Moreover, in the 1970s the earlier focus on economic growth with structural change was strongly challenged by those who pointed to the need to focus on social objectives, notably income distribution, poverty, employment and basic needs satisfaction. But these disputes actually served to reinforce the normative and explanatory frames of development policy analysis as being national. Whatever objectives were taken to be central, national objectives were the focal concern. Moreover the development strategy debates essentially examined the articulation and sequencing of internal (national) ingredients which could facilitate or accelerate the national development process.

An important countercurrent to mainstream development policy analysis before the 1980s came from structuralist and dependency theories elaborated in Latin America (see Kay, 1989). Like the dominant approach the normative concern of these theories was national, and indeed strongly informed by nationalist concerns. But their analytical perspective was global in scope and this underpinned their critiques of mainstream thinking. Both structuralist and dependency theorists emphasized the importance of center-periphery relations as determining or conditioning the national development process. But some strands within dependency theory,

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Figure 1. Four main combinations of explanatory and normative framework in development policy analysis.
instead of indicating how national development was affected by the articulation between internal and external factors, simply put forward an antithesis to the mainstream approach, arguing that external factors were the only ones that mattered, and then deduced that by delinking from the world economy, an “authentic” development process, solely founded on internal factors, could be made to occur.

In the late 1970s and early 1980s, the growth rate of most developing countries, with the notable exception of some countries in East Asia, collapsed. The economic crises which beset most developing countries lent weight to arguments that mainstream development practice had failed. But at the same time the East Asian success neutralized those versions of dependency theory which argued that development would always be blocked on the periphery, and also Latin American structuralism, which allegedly was wedded to inward-oriented import-substitution policies in contrast to East Asia’s alleged outward-orientation. In this situation, arguments which emphasized the positive role of free markets in development attracted greater attention. These ideas had always been an element within development policy analysis, represented, for example, by early critiques of protectionism, such as G. Haberler and H. Myint, Milton Friedman’s support of free enterprise, and P.T. Bauer’s dissection of mainstream thinking (Bauer, 1971). The uptake of these ideas was not strong however until the late 1970s and early 1980s, when a new approach to developing countries, which was later labeled the Washington Consensus, emerged as the main alternative to national developmentalism.

The frame of reference for this new approach was, like the Latin American countercurrents of the pre-1980s, partially global and partially national. But rather than combining normative economic nationalism with a methodological internationalism, the Washington Consensus was its mirror image. It combined normative economic internationalism with a methodologically nationalist form of explanation which attributed what was happening within countries mainly to national factors and policies (Figure 2).

In this new approach, the key norms which played the decisive role in defining development practice were the norms of a liberal international economic order (LIEO). In most general terms, these norms involve a commitment to free markets, private property and individual incentives, and a circumscribed role for government. But they can be specified in different ways, according to different interpretations of the precise content of the LIEO. For example, in the early 1980s, laissez-faire liberalism was strongly advocated. This entailed liberalization of both external and domestic economic relations. But at the start of the 1990s, this extreme market fundamentalism was softened with the emergence of the so-called market-friendly approach to development (see, notably, World Bank, 1991). This

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<td>Competing Mainstream Dev. Paradigms Pre-1982 e.g. Balanced v.Unbalanced Growth</td>
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<td>Dominant Development Paradigm Post-1982: Washington Consensus</td>
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<td>Main Counter-currents Pre-1982 Latin American Structuralism and Dependency Theory</td>
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Figure 2. The configuration of development policy analysis: 1950–1990.
continued strongly to advocate liberalization of external trade and capital movements. But, the scope of domestic economic liberalization was limited, in particular, by recognizing more fully the legitimacy of state intervention in cases of market failure.

These norms were propagated through two types of persuasive argument: first, arguments about the intrinsic ethical superiority of economic liberalism; and second, theoretical and empirical analyses which demonstrate that conformity to the norms of a LIEO (variably defined) would lead to better outcomes, not simply for the world community as a whole, but also for individual nation-states within it. The latter, which have served as the principal form of argument supporting the new approach, have mainly been articulated on a terrain in which promoting the national interest has been narrowly equated with promoting economic growth and increasing personal economic welfare. Important developmentalist concerns such as constructing national unity and realizing national sovereignty are thus excluded. On this narrowed ground, attention and publicity has been given to analyses which show that national policies which are in conflict with the norms of LIEO, including many elements at the heart of earlier development practice, such as protection of infant industries, managed interest rates and selective credit, have been harmful to national interests, and thus constituted domestic mismanagement and “irrationalities.”

At the same time, the policies of the East Asian newly industrializing economies which had actually achieved rapid and sustained growth have been described in ways which suggest that they conformed to the requisite liberal norms. For both conflicting and conforming policies, their impact on the efficiency of resource allocation has been identified as the main mechanism by which domestic policies affect economic growth.

While the normative frame of reference of the new approach was global in scope, the explanatory arguments which sought to prove the instrumental superiority of the LIEO were characterized by methodological nationalism. That is to say, in explaining economic trends within countries, they partitioned influences into external and internal factors and attributed most of what was happening to internal (national) factors and, in particular, to domestic policy. In making the case for trade liberalization and export promotion, for example, conditions of global demand are generally ignored and, through the “small country” assumption, it is typically assumed that foreign markets are always available, and at prices largely independent of a country’s exports. Empirically, the most common approach to prove the dynamic benefits of outward-orientation has been cross-country regression analyses which establish the statistical relationships between indicators of national economic change and a series of national variables, which include, in particular, indicators of national policy. The essence of this methodology is areal correlation between dependent and independent variables, to identify the extent to which variation in the former between a given set of national territories matches variation in the latter between the same territories. This can be done at a certain point in time or for periods of time (e.g. by using growth rates over 20 years). In either case, specific histories are filtered out and it is assumed that relationships which pertained in the past will continue into the future. Economic trends are necessarily attributed to the behavior of the national factors.

In the 1990s, changes in the nature of the external environment are increasingly being used to explain why liberalization, coupled with the right macroeconomic fundamentals, “works.” Thus it is argued that in an increasingly globalized world economy, in which there is the globalization of production systems, increasing reliance on trade and increased availability of external financial flows, countries which do not follow Washington Consensus policies will be especially penalized, as they will be cut off and thus excluded from the intensifying (and implicitly beneficial) global field of flows. Concomitantly, those countries which do follow the right policies will be rewarded, as they can capture foreign direct investment which brings technology and market access, and they can also supplement national savings with international capital flows, thus reaping the benefits of the new external environment. In this way, the case for liberalization is rooted in the rhetoric of the globalization. But the analysis remains methodologically nationalist as it retains the distinction between external and internal (national) factors, and still attributes country trends largely to domestic policy (see, for example, IMF, 1997; World Bank, 1997). Globalization is something which is happening to the external economic environment of countries; it is outside them.
3. THE SHIFT FROM HISTORICISM TO AHISTORICAL PERFORMANCE ASSESSMENT

The curious combination of global liberalism and methodological nationalism which underpins the way in which development is seen in the new paradigm has been buttressed by a second key shift which occurred in development policy analysis at the end of the 1970s. This can be characterized as a shift from historicism to ahistorical performance assessment.

Theorizing on development strategy from the 1950s to the 1970s was historicist in the general sense that it was founded on an attempt to understand rhythms, patterns and laws of development. This understanding was based on historical analysis of long-term sequences of economic and social change, which had occurred in the past in already-industrialized countries and which were expected to re-occur, particularly if the right policy interventions were made, in “less developed” countries. Such theorizing most typically understood development as a societal and economy-wide transition from a “traditional” (rural, backward, agricultural) society to a “modern” (urban, advanced, industrial) society. This process was seen as a sequence of stages of growth, a process of modernization, or recurrent patterns of structural transformation. All countries were expected to go through such patterns of development, and development agencies sought to ensure or accelerate the arrival of a better future for whole societies through interventions in these long-term processes of historical transformation.

With the shift to ahistorical performance assessment, the focal object of enquiry has been to describe and explain national “performances” of various types. Not surprisingly but now taken-for-granted, the key word in the discourse propagated by international development agencies since the start of the 1980s has been “performance.” Attention has been particularly paid to economic performance, but also agricultural performance, industrial performance, trade performance, financial performance, fiscal performance, poverty performance, human development performance and so on. Using these various standards, countries have been partitioned into good and bad performers, and ranked according to their performance in various new leagues of nations. Moreover comparative performances have been explained by reference to national factors and national policy.

It is according to these performance standards that past development policies have been criticized because they do not “work” and narratives have been constructed about the effectiveness of the Washington Consensus. A succession of countries which have undertaken policy reform in the requisite way and achieved good short-term growth results have also been identified as, and dubbed, “success stories.” These stories have acted as exemplars for the new paradigm, providing not only practical rules-of-thumb guidance on how policy reform should be undertaken, but also proof of the validity of the Washington Consensus.

The transition from historicism to ahistorical performance assessment started in the 1970s, and was initially animated by those who sought to refine the definition of development by adding social aspects. Efforts to measure poverty based on the quality of life and satisfaction of basic needs were particularly important in this regard. Michael Lipton’s book Why Poor People Stay Poor was a key text in propagating a performance-oriented approach. The uptake of the notion of urban bias, a concept which was forged within debates about how to achieve redistribution with growth but which became central to the neoliberal paradigm, can be attributed to its performance-based definition, and the vitriolic debates of the late 1970s, particularly with Byres, can be interpreted as an attempt to sustain a historicist view (see, for example, Byres, 1979). In the 1980s, these initial moves toward performance assessment were overtaken by, and later incorporated in, the discourse and practice of structural adjustment. Adjustment involved improving the performance of national economies by increasing the efficiency of resource allocation. The central criterion used to measure performance was current or recent GDP growth rate, and macroeconomic stability, indicated by fiscal and external payments balance and low inflation. The dynamics of long-term transformations of economies and societies slipped from view and attention was placed on short-term growth and re-establishing financial balances.

The shift to ahistorical performance assessment can be interpreted as a form of the post-modernization of development policy analysis. It reflects, in particular, the questioning of grand narratives of historical transformation which was central to the appeal of the post-
modern ethos in the 1980s. Before the shift, development agencies acted as handmaidens of “progress,” “modernization,” “industrialisation,” or the emancipation of people from oppression, exploitation, disease and drudgery. After it most agencies re-oriented their work to monitor and seek to improve “performance,” often through local problem-solving and local social engineering designed to make economic and social institutions “work” better. Adjustment also entailed the abandonment of grand long-term government-directed designs for whole societies and a shift to decentralized decision-making, laissez-faire and local social engineering. But ironically, this shift away from holism could not be achieved without a holistic approach. Everything has been made subject to the rules and discipline of the market. The vision of the liberation of people and peoples, which animated development practice in the 1950s and 1960s, has thus been replaced by the vision of the liberalization of economies. The goal of structural transformation has been replaced with the goal of spatial integration.

4. THE CONFIGURATION OF DEVELOPMENT POLICY ANALYSIS IN THE 1990S

The collapse of communism in Eastern Europe and the Soviet Union has served as confirmation of arguments which predicted the impossibility of central planning and reinforced the apparent superiority of a market-oriented development approach. Since the late 1980s however there have developed two important challenges to the Washington Consensus. The first is the UNDP’s sustainable human development (SHD) approach. This approach takes up some of the themes of the UNICEF critique of the dominant approach, Adjustment with a Human Face, originally published in 1987, and has been elaborated through the annual Human Development Report, which first appeared in 1990 (UNDP, Various years). The second is a latent “Southern Consensus,” which is founded on analyses made from the perspective of countries undertaking late industrialization and seeking to catch up with richer countries in the global economy. This Southern Consensus does not exist as a political reality. Nor has it, as yet, been articulated analytically. Its existence is apparent however in the convergence between the policy conclusions of Latin American neostructuralism, initially set out by ECLAC in 1990, and the deeper understanding of East Asian development models, which is described in ESCAP (1990), but has been most thoroughly reconstructed by UNCTAD in its annual Trade and Development Report (particularly 1994, part 2, chapter 1; 1996, part two; 1997, part 2, chapters V and VI; and 1998, part 1, chapter 3).

These two challenges to the Washington Consensus have shaped development thinking and practice in different ways. Indeed development policy analysis is now characterized by a double dialectic. The clash between the Washington Consensus and the sustainable human development approach acts to reinforce and conserve the key elements of the current paradigm, and in particular its ahistorical approach and its combination of normative internationalism with methodological nationalism, whilst the clash between the Washington Consensus and ideas within the two strands of the Southern Consensus serves to undermine these elements and creates tensions and pressures for a further paradigm shift.

The key feature of the sustainable human development approach which distinguishes it from the Washington Consensus, is that it espouses a different set of values. Whereas the Washington Consensus focuses on the promotion of GDP growth, and has been implemented through a top-down, donor-conditionality-driven and outside-expert-led, approach, the sustainable human development approach argues that the ultimate test of development practice is that it should improve the nature of people’s lives, and advocates that it should be founded on participation and a more equal partnership between developing countries and aid donors.

This “people-centered” approach, which explicitly identifies itself as an alternative paradigm (see, for example, ul Haq, 1995, Part I), has been quite influential. An important strand of development research in the early 1990s has sought to refute its challenge by showing that Washington Consensus policies in fact serve to reduce poverty, increase employment and can, in themselves, deliver growth with equity, and that therefore social concerns are already adequately addressed by the mainstream approach. But the SHD alternative has promoted the introduction of poverty reduction as a key goal of development practice and increasing attention to possible LIEO-compatible relaxation of Washington Consensus poli-
cies in order better to achieve poverty objectives (see World Bank, 1990).

These changes have certainly made the Washington Consensus more humane. But at the same time, the SHD approach has had the effect of conserving key features of the worldview of the dominant paradigm. Although its different values have emphasized different indicators and weighting systems, particularly to capture levels of human development and poverty, these measures have reinforced a focus on short-term performance assessment. The substitution of multidimensional indicators of poverty for simple income poverty, for example, has added greater reality to the description of deprivation and more leverage for moral outrage, but at the cost of crippling effective analysis of the dynamics of change. Significantly also, the analytical basis of the SHD approach, which is itself somewhat loose, is methodologically nationalist. A central focus is the mismatch between economic growth performance and social performance and the ways in which domestic policy can rectify this mismatch to deliver more social achievements for any given level of GDP per capita. Even the apparent difference in values between the SHD approach and the Washington Consensus is less clear-cut than it appears. This applies whether human development is specified rigorously, as in Amartya Sen’s capability approach which underpins the human development index, or through a vaguer focus on decentralization and participation. Sen’s capability concept emphasizes freedom of choice which is quite consonant with the liberal perspective. Moreover the project of making economic and social institutions work better through decentralization and the use of local knowledge, indigenous management practices and the participation, not of the masses, but of “local people” and “small communities,” can be, and has easily been, fused into a kind of neoliberal populism.

Whereas the SHD approach has made a moral critique of the Washington Consensus, the two strands of the Southern Consensus, Latin American neostucturalism and East Asian developmentalism, remain focused on economic growth as the central objective. They offer however a different economic analysis of how growth occurs in late industrializing countries and on this basis propose a different policy orientation to the dominant paradigm.

From the Southern perspective, national economic growth involves a process of catch-up, in which national enterprises build up production capabilities and international competitiveness in a range of activities undertaken in more advanced countries. The structure of the economy changes as the relative importance of agriculture and natural resource exploitation declines while that of manufacturing activities increases, and as production progresses from less to more skill-, technology-, and capital-intensive activities. At the macro-level, growth, structural change and productive upgrading is driven by a rapid pace of capital accumulation, which depends on increased domestic savings, investment, and exports, linked together in a virtuous circle of cumulative causation (ECLAC, 1990, pp. 48–49; ESCAP, 1990, pp. 13–14, 115, 151; UNCTAD, 1996, pp. 108–112). At the microlevel, this process is founded on imitation, adaptation and learning of internationally available technologies in order to reduce costs, improve quality, and introduce goods and services not existing in the country, and the diffusion of best practices from more advanced to less advanced enterprises within the country, including from foreign-owned to locally-owned firms (ESCAP, 1990, pp. 92–95; ECLAC, 1990, pp. 64–71).

An important feature of the Southern Consensus is that it rejects the idea that growth with late industrialization can be animated using a general blueprint. Policy measures have to be adapted to initial conditions and the external environment, and change over time as an economy matures (ECLAC, 1990, pp. 97–102; UNCTAD, 1996, pp. 133–134; ESCAP, 1990, pp. 21–23, 140–141). It is possible however, to identify some general policy orientations which apply in all circumstances.

First, the process of growth and structural change is best achieved through the “strategic integration” of the national economy into the international economy rather than either delinking from the rest of the world or rapid across-the-board opening up of the economy to imports and external capital. This means that the timing, speed and sequencing of opening, in relation to different types of international flows, should be decided on the basis of how they support the national interest in terms of promoting economic growth and structural change (Singh, 1994). Multilateral norms are not disregarded (ECLAC, 1996, p. 86; UNCTAD, 1996, pp. 156–157). As far as possible, however, import liberalization should
be gradual—to enable national enterprises to build up production capabilities and thus face external competition—and selective. Tariffs should also be complemented by special measures to promote exports (ECLAC, 1990, pp. 103–107; ECLAC, 1995, chapter VI; and for East Asian policies, UNCTAD, 1994, pp. 58–59). Capital account liberalization should also be gradual and should be managed, in coordination with domestic financial development, to ensure that capital flows are, as much as possible, additional to, rather than a substitute for, domestic resources, that they support increased investment rather than consumption, and that they do not undermine macroeconomic stability (ECLAC, 1995, pp. 285–291; UNCTAD, 1998, pp. 75–76, 101–106). Inward FDI should support the build-up of domestic production capabilities and exports, and this is not automatic but requires specific domestic policies (ESCAP, 1990, p. 132; ECLAC, 1990, p. 45; UNCTAD, 1996, pp. 131–133).

Secondly, growth and structural change is best promoted through a combination of a macroeconomic policy and what Latin American neostructuralists describe as a “productive development policy.” The macroeconomic policy is growth-oriented. It seeks to reduce inflation and fiscal deficits, but also aims to ensure full utilization of production capacity and encourage the pace of capital formation (ECLAC, 1996, chapter V; ESCAP, 1990, pp. 17–19). The productive development policy involves a range of measures, coordinated with the trade policy, which are designed to improve the supply capabilities of the economy as a whole and also specific sectors within it, and to help private enterprise identify and acquire competitive advantages. These measures are founded on a dynamic interpretation of the principle of comparative advantage. In this forward-looking approach, the opportunities of current relative cost advantages are exploited to the full, but efforts are made at the same time to promote investment and learning in economic activities where comparative advantage can realistically be expected to lie in the immediate future as the economy develops and as other late industrializing countries catch up (ESCAP, 1990, pp. 148–149; OECF, 1991; UNCTAD, 1996, pp. 112–123; ECLAC, 1995, pp. 132–135, 159).

Elements of a productive development policy include: technology policy, financial policy, human resource development, physical infrastructure development, and industrial organization and competition policy (UNCTAD, 1994, pp. 57–69; ECLAC, 1990, pp. 107–148, ECLAC, 1995, pp. 161–190; ESCAP, 1990, chapter V, pp. 149–150). These elements can form part of, but they should not be simply equated with, a selective industrial policy. They are directed at improving productivity and competitiveness in agriculture and natural-resource based activities as well as manufacturing (ESCAP, 1990, pp. 22, 70–75; ECLAC, 1990, pp. 126–137). They entail a mix of sectorally-neutral as well as selective policies. Moreover their main goal is to accelerate the rate of capital accumulation and learning throughout the economy.

Third, the successful implementation of these development policies requires government-business cooperation within the framework of a pragmatic developmental State. The policies are implemented, as far as possible, through private initiative rather than public ownership, and through the market mechanism rather than administrative controls. But government plays a key role both in animating the “animal spirits” of the private sector and harnessing the aggressive pursuit of profits, which are the motor of the system, to the realization of the national interest. This requires the enhancement of state capacities rather than state minimalism. Policy should be formulated by a capable and pragmatic economic bureaucracy which, through various formal and informal ties with business, develops a common vision of development objectives and targets, and a common understanding of how these can best be achieved (ECLAC, 1990, pp. 94–96; Evans, 1998). But government must ensure that any support or protection for the private sector is conditional on investment, export or productivity targets, and also temporary. Policies should also focus on overcoming specific problems which impede the achievement of national development objectives, notably, missing markets and the lack of an entrepreneurial base, imperfections in technology and capital markets, risks of exporting, and dynamic complementarities between sectors which render competitiveness systemic rather than just dependent on firm-level capabilities (UNCTAD, 1994, pp. 50, 69; ECLAC, 1995, pp. 152–157; ECLAC, 1996, Box VI.1; JDB/JERI, 1993, pp. 53–56).

Fourth, distributional dimensions of the growth process are managed in order to ensure the legitimacy of the overall growth process.
This is primarily achieved through a production-oriented approach rather than redistributive transfers. That is to say, the main bases for a more equitable and inclusive growth process are wide asset ownership and the expansion of productive employment. Important policies in this regard are: agrarian reform and rural development policies; high rates of re-investment of profits and the establishment of profit-related payment systems; support for small and medium enterprises, particularly through financial policies; and broad-based human resource development (Campos & Root, 1996; ECLAC, 1992, pp. 15–27; UNCTAD, 1997, pp. 183–189).

Finally, regional integration and cooperation policies are identified as an important element of strategic integration (ECLAC, 1990, chapter VI; ECLAC, 1994, pp. 9–19; ESCAP, 1990, pp. 24–25; UNCTAD, 1996, Part II, chapter 1, especially pp. 75–79, 92–94). Such policies should support the goal of increased international competitiveness, for example, by promoting regional production chains, and also nurture the development of regional markets in order to reduce demand-side constraints on growth.

These substantive features of the Southern Consensus arise because Latin American neoliberalism and East Asian developmentalism are rooted in a totally different worldview to the Washington Consensus (Figure 3). This does not reject performance standards as a guide to policy, but actions are founded on historical analysis, particularly of long-term processes of late industrialization in the periphery of the world economy. A global analytical perspective is adopted and this has a realist rather than idealist view of the way in which market economies work. This recognizes vulnerabilities associated with integration into the international economy and also external constraints due to restrictions in access to advanced country markets, falling terms of trade for primary commodities and simple manufactures, cartelization in global markets, difficulties in gaining access to technology, and instabilities of the international financial system. Finally, the approach is normatively rooted in a distinctive form of economic nationalism. This is not ideologically committed to self-sufficiency or public ownership, nor hostile to foreign ownership and of itself. It does not seek the appearance of catching up, through either imitating consumption standards, or setting up showcase industries. It respects multilateral rules and arrangements, engaging in their design, negotiation and interpretation. But its aim is to build international competitiveness as part of a long-term national economic project founded on the development of national capabilities.

Of the two strands of the Southern Consensus, the challenge from the East Asian development models has proved to be most powerful because these models have, in terms of their performance and according to the criterion of economic growth, “worked” spectacularly well. Since the early 1990s, the major fault line in development policy analysis has been the discrepancy between the policies which have been pursued in rapidly growing and industrializing East Asian economies and the policies advocated by the Washington Consensus.
Kuhn argues that the questioning of a paradigm begins when anomalies arise between paradigmatic expectations and actual events, and shows that numerous ad hoc modifications typically are made to maintain an old paradigm before the accumulation of anomalies requires, and the availability of a superior alternative paradigm enables, a paradigm shift. With increasing awareness of the discrepancy between Washington Consensus recommendations and East Asian development practices, such a process has occurred with the Washington Consensus. The discrepancy has been a key factor which has impelled the shift in the Washington Consensus from laissez-faire liberalization to the market-friendly approach. But more fundamental change has, at the same time, been slowed by semantic ambiguities, particularly centred on the key words “outward-oriented” and “openness” (see Gore, 1996a), and also further work to re-describe the East Asian experience as being compatible with the norms of the market-friendly LIEO. The World Bank’s East Asian Miracle study—which was prompted by disagreements between the Japanese government and the World Bank on specific development policy mechanisms and which Wade (1996) has explicitly dubbed an exercise in the “art of paradigm maintenance”—is a particularly significant example of the latter (World Bank, 1993).

These re-descriptions have, like earlier characterizations, now been shown to have inconsistencies and ambiguities (Amsden, 1994; Rodrik, 1994). But the debate has taken yet another turn with the financial crisis in East Asia, and the apparent fall of the newly industrializing economies which hitherto had been claimed on all sides as “legitimating angels.”

5. THE COMING PARADIGM SHIFT

The financial crisis in East Asia is significant for the future directions in development thinking and practice. Economic growth has fallen dramatically in developing countries and, just as there was during the crisis of the early 1980s, there is now increasing reason to call into question the effectiveness of dominant policies. Commentators of every persuasion have been quick to argue that events confirm their analysis. Some of those who support the Washington Consensus have reversed their earlier description of East Asian policies as market-friendly, and identified domestic mismanagement, in the guise of crony capitalism and excessive government intervention, as responsible for the crisis. On the other side, it is argued that the crisis is mainly due to speculative financial flows and contagion. But domestic policy, particularly fast financial liberalization, is also said to have played a role. The abandonment of government coordination of capacity expansion has led to overinvestment, and the lack of government supervision of the scale of the foreign debts of domestic companies has precipitated overexposure to external debt. Finally, the IMF bailout packages are said to have exacerbated the problem. At best they are seen as a misdiagnosis; at worst, an attempt to use the crisis further to impose in a deeper way LIEO norms on domestic economic activity.

Although these debates are still playing themselves out, it is becoming increasingly unconvincing to attribute the crisis solely to domestic mismanagement (see, for example, Chang, Palmer & Whittaker, 1998), or analytically to separate external and internal factors. Moreover the Washington Consensus has cracked in the practical sense that real differences of opinion have emerged in Washington, between the IMF and the World Bank, on the causes of the crisis and how best to handle it. One important opinion-leader, Paul Krugman (1995), has already written the obituary of the Washington Consensus. After the Mexican crisis of 1994, he argued that the major mechanism through which its policies have worked is a speculative bubble in emerging markets in which policy reforms attracted private capital flows, and the attraction of the flows stimulated policy reforms, and that this bubble had now burst. In effect, he exposed market-friendly policies as actually being markets-friendly—financial markets, that is. Similarly, Joseph Stiglitz (1998a,b) has argued that there is a need for a “post-Washington Consensus,” a new paradigm. This should seek to achieve broader objectives—embracing a focus on the living standards of people and the promotion of equitable, sustainable and democratic development. It should use a wider range of instruments to build markets as well as to correct market failure, and to foster competition as well as liberalization and privatization. It should also adopt limited forms of regulation, if necessary controlling short-term international capital flows. Finally change should not be imposed from outside but requires owner-
ship, participation, partnership and consensus-building.

It may be too early yet to announce the fall of the Washington Consensus. Stiglitz’s proposed new paradigm contains some important shifts on values, continuing the incorporation of the goals and implementation style advocated by SHD, and, perhaps more significantly, it argues for a return to the notion of a development strategy, based on a long-term perspective, respecting historical specificities and with a more holistic approach centred on the transformation of societies. Development should no longer be a monopoly of economists. But the proposed post-Washington Consensus consensus can also be interpreted as simply a change to preserve the old order by making it more effective as well as more humane. In elaborating the new paradigm, Stiglitz (1998b, p. 34) explicitly states that a key task is to lessen the momentum of an expected swing of the pendulum of opinion against openness. The proposal retains a strong commitment to the fundamental principles of a LIEO founded on open trade regimes, competitive markets and open societies. But, by de-linking trade and financial liberalization and then analytically separating short-term from long-term international capital flows, it reduces the risk that in the aftermath of the financial crisis the liberalization of external economic transactions will be called into question as a whole. Through this analytical splitting, what previously was propagated as a total package can now be taken to be a more flexible menu of options, and any possible backlash against liberalization can be more easily contained.

Whether or not Stiglitz’s courageous intervention is a rupture with the past or the preservation of the old regime, more profound change is inevitable. This is because the forced marriage of global liberalism and methodological nationalism, the latter providing the empirical justification for the internalization in domestic policy of the prescribed international norms of the former, is inherently unsustainable. The only circumstances under which methodological nationalism is a completely coherent approach to explanation is if national economies are completely isolated and closed from outside influences. The more that the norms of a LIEO are adhered to, the more that national economies become open to outside influences, the less tenable methodological nationalism becomes as a form of explanation. The dominant paradigm is thus unstable. Its ideology and methodology are in contradiction.

The coming paradigm shift will be driven by the main “workable” alternative, East Asian models, politically strengthened through their convergence with Latin America neostructuralism, and extended to Africa and the least developed countries. But while this approach can offer a more effective way of developing countries than the Washington Consensus, it does not, as it stands, provide an ideal alternative paradigm. This is not because the current financial crisis has somehow nullified the development transformation which has occurred in East Asia—though the crisis demands closer consideration of the issue of “development strategy in the age of global money,” 17 Rather it is because it remains a moot point whether it is possible to achieve similar results to those achieved by East Asian countries in their high-growth period, given the widespread, simultaneous adoption of past East Asia-type policies. Moreover, though exaggerated, some new global rules, particularly concerning technological borrowing and adaptation, may inhibit the replication of some of these policies.

In the future, the full globalization of development policy analysis seems inevitable (Figure 3). This will entail the explanation of national development trends in a global context, and also the elaboration of alternative normative principles for the international regimes which constrain and enable national policy choices. Signs that such a spatial frame shift is now occurring are evident in diverse and unconnected analytical arenas. These include: attempts to link international trade theory to labor market performance (Wood, 1994); the development of the new economic geography (Ottavino & Puga, 1998) and sociological analysis of global production chains (Gereffi, 1995); work on global environmental commons; and the emergence of social exclusion as a concept of deprivation (Gore, 1996b). The spatial frame shift is likely to be linked to the re-introduction of a historical perspective, which is already becoming evident, for example, in analyses of the history of globalization of economic activity (Bairoch, 1993; Bairoch & Kozul-Wright, 1998; Brenner, 1998). But with the rejection of grand narratives, bringing history back in should not presage a return to the old teleological historicism, but rather identify alternative situations and possible development paths, and thereby inform a
pragmatic commitment to progressive change in favor of present as well as future generations. The values which will glue together the new way of seeing the world are, like the methods of global analysis, as yet unclear. The most likely prospect is that we shall be blown into the future facing backward, embracing a form of embedded communitarian liberalism, which seeks to reconcile the achievement of national, regional and global objectives, and to marry universal values with a respect for diversity. But this is still waiting to be born.

NOTES

1. That is, a constellation of beliefs, values, techniques and group commitments shared by members of a given community, founded in particular on a set of shared axioms, models and exemplars (see Kuhn, 1970). The term “paradigm” is used in this sense throughout this paper.

2. For an extended discussion of the importance of frames in policy analysis, see Schön and Rein (1994). The notion of the frame is also pivotal in Amartya Sen’s work on development evaluation, though he uses the term “informational basis” of evaluative judgements rather than “frame.”

3. For deeper discussion of these debates, and the role of international development agencies in them, see Arndt (1987), chapters 3 and 4.

4. This was a complex historical process. As Kuhn (1970) explains, the timing of paradigm shifts is influenced not simply by scientific and policy debate, but also broader political and ideological configurations. These broader changes, which include the election of conservative political leaders in the United Kingdom, United States and Germany in the late 1970s and early 1980s, will not be dealt with here. For a subtle account, which locates changes in development thinking and practice within a broader counter-revolution against Keynesian economic policies, see Toye (1993).

5. For these two lines of argument, see various World Development Reports, particularly World Bank (1983, 1986, 1987). The last, as well as criticizing deviant policies, is an exemplar of the mobilization of East Asian experience to support key principles of a LIEO.

6. For an extended discussion of methodological nationalism, see Gore (1996a).

7. The term “global liberalism” is used here as shorthand for various types of LIEO, which may or may not allow a circumscribed role for national government intervention in market processes.

8. The term “historicism” is used here in the most general sense given by Popper (1960, p. 3). It does not imply that planning which aims at arresting, accelerating or controlling development processes is impossible, though some historians would adopt this stronger position (Popper, 1960, pp. 44–45).

9. Exemplars are Rostow (1960) and Chenery and Syrquin (1975).

10. Lyotard (1984) sees the main criterion which is used to legitimate knowledge after the questioning of the grand narratives as “performativity,” which is understood as assessment of the performance of systems in terms of the best input/output relations (p. 46).

11. Various academic books and articles are associated with these policy reports. Key elements of Latin American neostucturalism, which developed as a response to the weaknesses of both neoliberalism and import-substitution industrialization, are set out in Bitar (1988), Ffrench-Davies (1988), Sunkel and Zuleta (1990), Fajnzylber (1990) and Sunkel (1993), and are surveyed in Kay (1998). A Japanese view of the contrast between East Asian developmentalism and the Washington Consensus is set out in OECD (1990), whilst Okudo (1993) and JDB/JERI (1993) discuss the Japanese approach, focusing on two important policy mechanisms which diverge from the tenets of the dominant approach—two-step loans and policy-based lending. UNCTAD’s reconstruction of East Asian developmentalism, which was elaborated independently of Latin American neostucturalism, draws on analyses of the Japanese development experience, particularly Akamatsu (1961, 1962) and Shinohara (1982), and key elements are set out in Akyüz and Gore (1996) and Akyüz (1998).

12. For an outline of this approach see, inter alia, Sen (1993), and an analysis of the limits of its moral individualism is made in Gore (1997).

13. For examples of a loose approach to poverty analysis based on the concept of sustainable human development, see UNDP (1995a,b); but Banuri et al. (1994) attempt to give a more rigorous specification of
the concept through the notion of social capital. An interesting recent development has been to link sustainable human development to the promotion of human rights discourse, which some see as an alternative global ethics to neoliberalism. The increasing incorporation of the voice of nongovernmental organizations (NGOs) into or alongside UN social deliberations is also affecting the SHD approach. A good discussion of some of the notions which animate these discussions is Ndeyveen Piertser (1998).


15. There are some divergences between the East Asian and Latin American approaches. The latter gives more prominence to environment and democracy, is less committed to aggressive sectoral targeting (ECLAC, 1996, pp. 70–71; Ocampo, 1999), and has a more refined policy analysis of the process of financial integration than East Asian developmentalism (ECLAC, 1995, Part 3). But their similarities, and common disagreements with the Washington Consensus, are more striking.

16. For an interesting alternative interpretation of this fault line, see Yanagihara (1997) who contrasts an ingredients approach and a framework approach and seeks ways of synthesizing them.

17. To paraphrase Yanagihara and Sambomatsu (1996).

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Welfare regimes in Central and Eastern Europe: Incorporating post-communist countries in a welfare regime typology
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Abstract
This article uses hierarchical cluster analysis to empirically assess if the post-communist welfare states of Central and Eastern Europe can be classified according to any of Esping-Andersen’s well-known welfare types, or if they form a distinct group of their own. It shows that at the start of the twenty-first century, there are clear differences in the governmental programmes and the social situation between traditional Western welfare states and post-communist welfare states. The article argues that the welfare states in post-communist countries might be subdivided into three groups: (1) a group of former-USSR countries, including Russia and Belarus; (2) a group of rather successful Cen-

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Central and Eastern European countries including Poland and the Czech Republic, and (3) a group of developing welfare states, consisting of Romania, Moldova and Georgia.

1 Introduction

Ever since its appearance in 1990, Esping-Andersen’s typology of welfare regimes (Esping-Andersen 1990) has been the subject of both extensive praise and extensive criticisms. For instance, in his critical assessment of ‘the welfare modelling business’, Abrahamson cites Peter Baldwin (1996: 29), who states that “typologizing (...) is the lowest form of intellectual endeavour, parallel to the works of bean-counters and bookkeepers” (Abrahamson 1999; Baldwin 1996). Moreover, in addition to the critics on the scholarly activity of creating typologies as such, also a wide variety of competing typologies, refinements and additions of Esping-Andersen’s types have been proposed. Finally, attempts have been made to extend the application of the typology beyond its original, European roots.

This article examines to what extent the post-communist countries of Central and Eastern Europe fit into Esping-Andersen’s typology. In 1993, Deacon suggested a “probably temporary” classification of most of these countries as an additional type, that of a ‘post-communist conservative corporatist’ welfare regime. This expression then captured “the ideological and practical commitment to socialist values, the maintenance in power of some of the old guard, and the social deal struck with major labour interests” (Deacon 1993). In 1996, Esping-Andersen rejected the idea of a ‘new’ wel-
fare model in Central and Eastern Europe, suggesting that the differences between these countries and his proposed three welfare types were only of a transitional nature (Esping-Andersen 1996). However, if both Deacon and Esping-Andersen were correct in their assessment of the transitional phase of the post-communist welfare states in the 1990s, we might expect the differences between the Western and Eastern-European welfare states to have vanished after 15 years of transition in 2005. On the other hand, if these differences still exist, this might lead to the abandonment of the idea of a transitional stage. In that case, it is likely that half a century of communist rule has created institutional legacies that lead these states to following a path that deviates markedly from existing welfare states.

Ideally, an assessment of the evolution of the Eastern-European welfare states would require a comparison of the current state of the welfare state and in the early-post-transition stage. However, there are no reliable statistical data that would enable such an analysis. Therefore, this article uses hierarchical cluster analysis to empirically assess if the post-communist welfare states of Central and Eastern Europe can be slotted into any of Esping-Andersen’s well-known welfare types, or if they form a distinct group of their own. The relevance of this exercise goes beyond the mere classifying that Baldwin (1996) so despises. The empirical assessment of the post-communist countries’ development is a helpful tool in the explanation of welfare state development, especially considering the relation between institutional path-dependency theories on the one hand and theories of policy diffusion on the other. From a path-dependency perspective, we might expect the communist legacies to be strong enough to impose a distinct path of development.
on at least some of the post-communist countries (Pierson 2004). On the contrary, from a policy diffusion perspective we would expect the transfer of ideas, knowledge and other resources to guide these countries’ developments in the direction of one of the well-known welfare regimes. This development is likely to be reinforced by the work of international donor organizations like the IMF and the World Bank and, even more prominently, by (prospective) membership in the European Union of some of the countries of the Central and Eastern European region. The Europeanization of social policies that is now getting shaped by the open method of coordination, stresses even more the importance of processes of mutual learning, thereby increasing the probability of development towards one of Esping-Andersen’s welfare regimes.

This article starts with a short and general introduction of Esping-Andersen’s typology of welfare regimes, its critics and its proposed modifications. Next, other attempts to classify the post-communist welfare states of Central and Eastern Europe are discussed. The empirical core of this article builds upon Saint-Arnaud and Bernard’s (2003) validation of Esping-Andersen’s welfare typology. By replicating their method of hierarchical cluster analysis but replacing their data with data that are available for other countries than the traditional OECD countries, I will show that the post-communist welfare states differ significantly from the types that are distinguished by Esping-Andersen. By outlining the distinct features of the post-communist type and its differences with the other European types, it is possible to achieve a measure of discrimination between the types of welfare regime under review. The final section of this article reflects on the lessons that can be drawn from this approach for the explanation of welfare state development.
2 Classifying welfare states: The Esping-Andersen typology and its critics

Without doubt, Esping-Andersen’s ‘The Three Worlds of Welfare Capitalism’ has been one of the most influential books in late-twentieth and early-twenty-first century welfare state research. Although Esping-Andersen certainly was not the first to develop a typology of welfare states (Abrahamson 1999), his tripolar typology has served as a focussing point for both further development and intense criticism. Even the fiercest critics of the welfare typology approach cannot ignore his seminal work (see Kasza 2002). This section starts by briefly introducing Esping-Andersen’s three types of welfare regimes. Next it deals with the modifications and additions that have been proposed. Finally, it deals with the more fundamental critiques that reject the attempts to classify welfare regimes. This section relies upon the elaborate overviews of Abrahamson (1999) and Arts and Gelissen (2002).

The central argument of Esping-Andersen is that welfare states cluster around three distinct welfare regimes. The concept of welfare state regimes denotes:

... the institutional arrangements, rules and understandings that guide and shape concurrent social policy decisions, expenditure developments, problem definitions, and even the respond-and-demand structure of citizens and welfare consumers. The existence of policy regimes reflects the circumstance that short term policies, reforms, debates, and decision-making take place within frameworks of historical institutionalization that differ qualita-
Esping-Andersen distinguishes the three regimes by the degree of decommodification and the kind of stratification they produce in society. Decommodification “occurs when a service is rendered as a matter of right, and when a person can maintain a livelihood without reliance on the market” (Esping-Andersen, 1990: 21-22). Stratification refers to the intensity of redistribution and the level of universality of solidarity that is imposed by the welfare state. Based upon these two dimensions, Esping-Andersen distinguished between liberal, conservative-corporatist and social-democratic welfare states. Liberal welfare states are characterized by means-tested assistance, modest universal transfers, or modest social insurance plans. Benefits cater mainly to a clientele of low-income, usually working-class, state dependants. There is little redistribution of incomes in this type. The conservative-corporatist type is characterized by a moderate level of decommodification. The direct influence of the state is restricted to the provision of income maintenance benefits related to occupational status. Labour market participation by married woman traditionally is discouraged, and the principle of subsidiarity implies that the state will only interfere when the family’s capacity to service its members is exhausted. In the social-democratic type, the level of decommodification is high. The generous universal and highly redistributive benefits do not depend on any individual contributions (Arts and Gelissen 2002; Esping-Andersen 1990).

The publication of ‘The Three Worlds of Welfare Capitalism’ triggered a wide variety of reactions. Some of them proposed alternative typologies with different labels, based on different dimensions. Others suggested the
addition of welfare types like a ‘Southern’ or ‘Mediterranean’ type (Bonoli 1997; Ferrera 1996), an ‘East Asian’ or ‘Confucian’ type (Jones 1993; Kwon 1997), and a ‘radical’ or ‘Antipodean’ type to distinguish Australia and New Zealand from other liberal regimes (Castles 1998; Castles and Mitchell 1991). And finally there were authors who radically rejected the idea of a general welfare typology (Kasza 2002). In the remainder of this section I will briefly deal with each of these three categories of reactions.

Although there is a wide variety of different labels under which welfare states might be classified - each based upon different indicators - it is surprising to observe how persistent the clustering of countries is. For instance, Leibfried identifies four social policy or poverty regimes, based on different policy models: modern, institutional, residual and rudimentary. He distinguishes between the Scandinavian welfare states, the ‘Bismarck’ countries, the Anglo-Saxon countries and the Latin Rim countries (Arts and Gelissen 2002; Leibfried 1992). However, with the exclusion of the countries that he classifies in the Latin Rim type, the classification of the other types converges completely on Esping-Andersen’s typology (Arts and Gelissen 2002). According to Leibfried the distinct features of the Latin Rim countries (Spain, Portugal, Italy, Greece and France) are the lack of an articulated social minimum and a right to welfare. Based on four other dimensions of social security systems - the rules of access, the conditions under which benefits are granted, the regulations to finance social protection and the organization and management of social security administration - Ferrera (1996) comes to virtually the same classification, including a fourth, Southern-European type.

Bonoli (1997) is critical of Esping-Andersen’s decommodification approach.
As an alternative, he bases his classification on the extensiveness of the welfare state (indicated by social expenditures as a proportion of GDP) and the way the welfare state is financed (indicated by the percentage of social expenditures financed through contributions). Focusing on European countries only, he labels the resulting types the British, Continental European, Nordic and Southern countries. Again, the first three types more or less confirm Esping-Andersen’s typology, the differences between this typology and Esping-Andersen’s original classification stemming from the addition of the Southern type (Arts and Gelissen 2002; Bonoli 1997).

Castles and Mitchell (1993) point out that Australia, specifically, does not fit in well with any of Esping-Andersen’s types. Based on the level of welfare expenditure, average benefit equality, and income and profit taxes as a percentage of GDP, they propose an alternative, four-way classification of welfare states: Liberal, Conservative, Non-Right Hegemony and Radical. Again, with the exception of the Radical category that encompasses Australia, New Zealand and the UK, this classification very much resembles Esping-Andersen’s original typology (Arts and Gelissen 2002; Castles and Mitchell 1991). The same holds true for Korpi and Palme’s classification, which is based on the institutional characteristics of welfare states. They distinguish between targeted, voluntarily state subsidized, corporatist, basic security and encompassing models of welfare states. This distinction is based on the basis of entitlements, the principles applied to determine benefit levels, and the governance of social insurance programmes (Arts and Gelissen 2002; Korpi and Palme 1998). While they do not find the voluntarily state subsidized model in their selection of 18 countries, the classification of countries
in the other models basically once again follows Esping-Andersen’s classification with the exception of Australia, which is the only country in the class of ‘targeted’ welfare states.

Some authors argue that Esping-Andersen does not sufficiently take into account the gender inequality dimension in his attempts to classify welfare states. For instance Siaroff therefore proposes a more gender-sensitive typology that is based on the work and welfare choices of men and women across countries. He distinguishes between a Protestant social-democratic, a Protestant liberal, an Advanced Christian-democratic and a Late female mobilization type of welfare regime. The first three types show a strong overlap with the original typology, while the last category resembles the group of countries that other authors have labelled the ‘Southern’ or ‘Mediterranean’ type (Arts and Gelissen 2002; Siaroff 1994).

3 Incorporating other countries in the Esping-Andersen typology

Several authors have tried to apply the welfare regime typology to transitional or development countries, specifically in East Asia and Eastern Europe. Considering the importance of the attempts to classify the welfare states of Eastern Europe for this article, I will deal with this issue extensively in the next section. Here I will briefly discuss the characteristics of the East-Asian countries. According to Jones (1993: 214), it is clear that the East-Asian welfare states do not fit into any of Esping-Andersen’s categories, although the conservative type comes closest: “They are not liberal: there is far too
much social direction and too little sense of individual rights (...). Manifestly they are not social democratic either. Nor, given the absence of sufficient status-preserving statutory social benefits to accommodate the aspirations of the employed ‘middle classes’ for instance, are they to be accounted conservative corporatist; though this category comes closest to the mark”. Both Kwon (1997) and Jones (1993) advance the claim for a separate, East Asian or Confucian welfare system (Gough 2000). This type is characterized by “Conservative corporatism without (Western-style) worker participation; subsidiarity without the Church; solidarity without equality; laissez-faire without libertarianism: an alternative expression for all this might be ‘household economy’ welfare states - run in the style of a would-be traditional, Confucian, extended family” (Jones 1993).

In addition to the modifications and complementary welfare types that have been discussed in the previous paragraphs, there are also authors that are critical of the attempt to identify welfare regimes itself. Kasza (2002) is one of the most outspoken critics. He argues that most countries “practice a disjointed set of welfare policies due to the following typical features of welfare policy making: (1) the cumulative nature of welfare policies, (2) the diverse histories of policies in different welfare fields, (3) the involvement of different sets of policy actors, (4) variations in the policymaking process, and (5) the influence of foreign models” (Kasza 2002). First, Kasza argues that each regime consists of a variety of welfare programmes: housing, health, pensions, unemployment benefits and so on. Today’s welfare policies are the cumulative work of different governments and different forms of governance, and they represent responses to a variety of historical circumstances. As a
result, few policies are likely to reflect any one set of practical concerns or ideologies (Kasza, 2002: 273). Next, because these policies have different histories, “the likelihood that they will somehow form a coherent ‘regime’ is low from the start and becomes increasingly less probable as a country’s policies multiply and age” (Kasza, 2002: 277). Thirdly, policy processes in the welfare area are not necessarily linked to each other. The policy arena in the health area consists or a totally different group of public, non-profit and private actors than for instance in the employment policies domain. Policies formed by diverse bodies of officials and subject to the demands of different pressure groups are likely to show different institutional characteristics and policy outcomes. Fourth, different policy domains might have different policy-making characteristics. This depends on the culture in the bureaucracies and policy arenas that deal with the field, but it also follows from different formal procedures, like the consultation of advisory boards. Finally, the diffusion and transfer of policy ideas from other countries might blur the pureness of the welfare regimes, making it unlikely that distinct, coherent regimes will emerge (Kasza, 2002: 277-280).

Esping-Andersen’s typology is a classification based upon three ideal-typical welfare states. Some countries do resemble these ideal types pretty well. The United States serves as a typical example of the liberal welfare state. This is confirmed in almost all alternative classifications, except in those that only focus on the European welfare states. Germany can be regarded as the country that most clearly resembles the conservative welfare state, and Norway and Sweden serve as basic examples for the social-democratic type. Of course, there are also countries that show mixed characteristics or only
partially resemble one of the categories. The Netherlands, Switzerland and Denmark are examples of countries that are classified in different categories by different authors, depending on the characteristics that are highlighted in the typology (Arts and Gelissen 2002). Within the conservative model, Spain, Portugal and Greece share so many characteristics that this justifies classifying them in a separate cluster. However, given the overlap of many of the characteristics of these countries with the conservative type, this remains disputable. The empirical analysis that follows later in this article merely places these countries as a distinct subtype within the conservative type. This same line of argument holds true for New Zealand and Australia. Kasza’s fundamental critique of the endeavour of classifying welfare states is convincing in some aspects. However, once we accept that Esping-Andersen’s types are ideal-types rather than real-world types, the critique loses some of its foundational ‘specialness’. Instead, Kasza powerfully explains the origins of a country’s deviations from the ideal-typical models.

The countries of East Asia form a challenge to Esping-Andersen’s original typology. They have clearly different characteristics and a distinct path of development. Although Esping-Andersen argues that these welfare states are still developing towards one or other of the main types, the evidence that they are fundamentally and enduringly different seems pretty strong. An attempt to apply the typology beyond the traditional European countries should take the unique features of the East Asian welfare states into account.

The remainder of this article focuses on the classification and development of the welfare states of post-communist Central and Eastern Europe. The following section provides an overview of other attempts to classify these
countries in terms of the Esping-Andersen typology.

4 Attempts to classify the post-communist countries

The concept of Central and Eastern European (CEE) countries wrongfully suggests a basic similarity in institutional characteristics and paths of development in these countries. In reality, the region encompasses a wide variety of countries that range from the affluent enclave of Slovenia to the impoverished, military state of Belarus, and from the new EU member states whose developments and institutional framework have been heavily influenced by the negotiations with the European Commission, to countries like Moldova and Ukraine that until recently stood under influence of the Russian Federation. Any attempt to classify the welfare states of Central and Eastern Europe should take this variety into account (Standing 1996).

If we are to take historical institutionalism and particularly path-dependency theories seriously, it is inevitable that current welfare regimes in Central and Eastern European countries should be seen to carry the marks of fifty years of communism. Therefore, I start this section with a brief outline of the characteristics of communist social policies. Next, I turn to the issue of the classification of the social policies in these countries.

According to Deacon, communist social policies were characterized by “heavily subsidised foods and rents, full employment, the relatively high wages of workers, and the provision of free or cheap health, education and cultural services” (Deacon 1993; Deacon 2000). Similarly, Fajth argues that
social security in Eastern European countries had three big ‘pillars’: old age pensions; health-related transfers and family benefits. These were supported by two other big systems: employee benefits and consumer subsidies (Fajth 1999).

The early years of transformation in most Central and Eastern European countries brought economic crises unlike anything experienced under socialism. Inflation, unemployment and poverty created an urgent need for forms of social protection (Fultz, 2002: 1). The new governments’ legitimacy to a large extent depended on their ability to provide adequate social policies in answer to these problems. The necessity of dealing with the consequences of unemployment explains the introduction of relatively elaborate unemployment, disability, sickness and early retirement schemes in the CEE countries. As the economies of the Central and Eastern European countries stabilized in the second half of the 1990s, virtually all governments set about the task of restructuring social policies. The earlier emergency measures needed to be restructured because of rising costs, and because of the necessity to adapt some features of the pre-transition scheme to the new needs of people in market economies (Fultz 2002).

A few years after the transition, Deacon (1993: 193) suggested that a divergence between countries would be the most likely outcome of the transition process of East-European welfare states. He predicted that “in a few years time we will be able to look back and characterize the social policy of these countries in terms that reflect Esping-Andersen’s threefold typology, together with a new term that will have to be coined to describe the unique post-communist conservative corporatism of parts of the one-time
USSR, Romania, Bulgaria and parts of one-time Yugoslavia” (Deacon 1993). More recently, Ferge stated that though there are formal similarities between the Bismarckian welfare system and the Eastern European welfare system, the essence of what is called the “European model” is almost totally absent in the latter because most CEE-governments have to acquire the goodwill of foreign capital and supranational agencies to manage their financial problems (Deacon 2000; Ferge 2001). However, Sengoku (2004) argues that the role of supranational agencies like the IMF and the World Bank in CEE countries is restricted only to the countries with a high level of foreign debt (Sengoku 2004).

In contrast, Rys (2001) rejects the idea of a distinctive post-communist welfare type by pointing out the high order of variety across these countries. He states that “some common trends are noted in healthcare but this does not seem to add up to a special model” (Rys 2001). However, we should keep in mind that the actual and prospective EU-membership of some of these countries might have an impact on welfare state development in these countries. Even though social policy is not a subject of direct European policy, and there is no consensus on what European social policy should look like, it might lead these countries to move in a more ‘European’ direction. This might result in convergence both between the Central and Eastern European countries, and between these countries and the other European welfare states.

From this brief assessment, we learn that opinions differ on whether or not the CEE-countries can be assimilated into the welfare-type classification that has been held out for the Western countries. In the next section, I will show that there are indeed good reasons to consider the post-communist countries as
being both mutually differentiated and collectively distinct from the Western countries’ welfare typology.

5 Clustering welfare states

Esping-Andersen’s typology of welfare states and the responses of his supporters and critics are primarily based on the qualitative study of the main public policies governing social security. This typology has proven to be robust when primarily quantitative data are used as well (Saint-Arnaud and Bernard 2003). However, most of these quantitative verifications have been based upon data that are exclusively available for OECD countries. In this article, I will replicate Saint-Arnaud and Bernard’s hierarchical cluster analysis approach, but use data that are available for a broader set of countries than exclusively the OECD countries. In this section, I will first deal with the choice of the variables that are used in this analysis. Next, I will apply hierarchical cluster analysis to analyse the position of the Central and Eastern European countries in the Esping-Andersen typology and its proposed modifications. Finally, I will highlight the distinctive features of the welfare types that have been identified in the cluster analysis.

To analyse the position of Central and Eastern European Countries in Esping-Andersen’s typology, “(...) hierarchical cluster analysis is the most appropriate method because it allows grouping countries that have similar characteristics across a set of variables, thus leading to homogenous empirical types. It is called hierarchical because it divides a set of cases (the countries) into ever more numerous and specific subsets, according to the distance mea-
sured among all pairs of cases, taking into account their position across the whole set of variables under analysis” (Saint-Arnaud and Bernard 2003).

The selection of variables is a crucial step in the performance of the cluster analysis. Saint-Arnaud and Bernard (2003) selected variables that represent three causally interrelated components of welfare regimes: social situations, public policies and political participation. Their analysis showed four different welfare regimes: a Latin regime including Spain, Italy, Greece and Portugal; a conservative regime including - amongst others - Austria, Germany and France; a Social-Democratic Regime with Finland, Sweden, Denmark and Norway, and a Liberal regime which includes the UK, Australia, New Zealand and the US. The number of clusters in any hierarchical cluster analysis potentially lies between one and the number of cases. This implies that the decision to distinguish a group of countries that show similar characteristics is not only based on statistical techniques, but also on theoretical grounds. The cluster analysis only shows that countries within a group resemble each other and that groups are differentiated by mutually resembling collections of countries. From Saint-Arnaud and Bernard’s analysis it appears that the group of Latin countries share similar characteristics and can be distinguished from the conservative countries, although the differences between these two groups are significantly smaller than between these two groups and the social democratic and liberal regimes. So the decision to treat the Latin countries as a separate cluster rather than as a subtype of the conservative regime is a theoretical decision which can be legitimised by the observed statistical similarities and dissimilarities.

The analysis in this article begins with the construction of a list of 47
selected countries, which include 18 well-known western countries and 29 Central and Eastern European and Central Asian countries. A set of variables has been selected that more or less resembles the set that Saint-Arnaud and Bernard have used. However, not all of their data are available for all countries, so some variables have been omitted and others have been replaced. As SPSS does not include countries for which the data on one or more variables are missing in the hierarchical cluster analysis, the challenge was to find the right balance between a meaningful set of variables and the inclusion of a significant number of CEE countries in the analysis. This resulted in a dataset consisting of 19 variables that more or less replicated Saint-Arnaud and Bernard’s original results for 15 western countries, and that enabled us to incorporate 15 Central and Eastern European countries in the analysis. These data refer both to the social situations and the government programmes in a country. For political participation, the ‘level of trust’ is the only variable that is available for a wide set of countries. Table 1 gives an overview of the variables that have been used in this analysis.

Table 1 Variables in the analysis

*Characteristics of governmental programmes*

- Total government expenditures (average 1998-2003; % of GDP)
- General health expenditures (average 1998-2003; % of GDP)
- Government health expenditures (average 1998-2003; % of total government expenditures)
- Public spending on education (average 1998-2003; % of GDP)
- Number of physicians per 1000 persons (average 1998-2003)
Spending on social protection (% of GDP; 2002 or latest available year)$^b$
Revenues from social contributions (% of GDP; 2002 or latest available year)$^b$
Income and corporate taxes (% of GDP; 2002 or latest available year)$^b$
Individual taxes (% of total government revenues; 2002 or latest available year)$^b$
Payments to government employees (% of GDP; 2002 or latest available year)$^b$

Social situation variables

Inequality (GINI-coefficient; 2002 or latest available year)$^a$
Female participation (% of women in total workforce; average 1998-2003)$^a$
GDP Growth (average 1998-2003)$^a$
Total fertility rate (births per woman; average 1998-2003)$^a$
Inflation (average 1998-2003)$^a$
Life expectancy (average 1998-2003)$^a$
Infant mortality (< 5 years, per 1000 births, average 1998-2003)$^a$
Unemployment (average 1998-2003)$^a$

Political participation variables

Level of trust (2000)$^c$

a) Source: World Development Indicators;
b) Source: IMF;
c) Source: World Values Survey.

In the cluster analysis, a number of technical decisions have been made that need to be explained. First, all variables have been standardized on a scale from 0 to 1, to prevent the skewed analysis that might result if some variables with a broad range of absolute values dominate the data. Second, for the measure of distance between cases, the common ‘squared Euclidean’ measure has been used. For the grouping of the cases I have adopted Ward’s method, which minimizes the variance within groups and maximizes their homogeneity. Finally, I have decided to create six clusters. As has been stated earlier, the decision on the number of clusters is based on both statistical and theoretical considerations. Creating more clusters would only lead to the isolation of individual countries in a separate cluster. For instance, in a seven-cluster solution Belarus would be regarded as a separate cluster, without any other shifts in the grouping of countries, whereas in a five-cluster solution, all Eastern-European countries except Moldova, Romania and Georgia would be placed in the same cluster.

6 Classifying Welfare States: Outcomes

As has been stated in the previous section, a six-cluster solution seems to provide the best representation of the similarities and differences between the countries that have been analysed. Figure 1 shows the dendogram that represents the outcomes of the cluster analysis.
Figure 1: Hierarchical cluster analysis
From the hierarchical cluster analysis, it becomes clear that at this moment, the Eastern European welfare states can be clearly distinguished from the traditional European welfare states. In fact, there are two dominant groups of countries. In the traditional European countries, we can observe a replication of Esping-Andersen’s welfare regimes, supplemented with the Southern-European or Latin type. More interesting are the subgroups within the group of post-communist countries. It is more or less common knowledge that the Baltic states share a lot of similarities. Therefore it does not come as a surprise that these countries are treated as a separate cluster in this analysis. More surprising is the fact that some of the other former Soviet states (Belarus, Ukraine, Russia) share a lot of the characteristics with these countries too. The Eastern-European countries can be grouped as a separate cluster, and in this cluster it is striking that at first sight there are no big differences between the EU-admitted countries and the other countries. Finally, there is a cluster consisting of Moldova, Georgia and Romania.

In order to obtain an insight into the distinctive characteristics of each of these groups, table 2 provides an overview of the average scores of each of these groups on the variables that have been used in the analysis. Based on the analysis, six different types of welfare states might be distinguished. The welfare state types are the following:

\textit{I: Conservative-corporatist type} (Austria, Belgium, France, Germany, Greece, Italy, The Netherlands and Spain) The cluster analysis clearly shows that the Southern-European countries form a distinct subtype of the conservative type. However, these differences are too small to distinguish them as a sep-
Table 2: Characteristics of six welfare state types

<table>
<thead>
<tr>
<th>Welfare state type</th>
<th>I</th>
<th>II</th>
<th>III</th>
<th>IV</th>
<th>V</th>
<th>VI</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Characteristics of governmental programmes</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Total government expenditures</td>
<td>19,80</td>
<td>24,04*</td>
<td>17,25</td>
<td>19,97</td>
<td>18,71</td>
<td>10,06**</td>
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<td>General health expenditures</td>
<td>8,74</td>
<td>8,19</td>
<td>9,62*</td>
<td>5,64</td>
<td>6,75</td>
<td>5,23**</td>
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<tr>
<td>Government health expenditures</td>
<td>12,69</td>
<td>13,12</td>
<td>16,34*</td>
<td>10,62</td>
<td>11,43</td>
<td>9,05**</td>
</tr>
<tr>
<td>Public spending on education</td>
<td>5,01</td>
<td>7,26*</td>
<td>5,68</td>
<td>5,27</td>
<td>4,32</td>
<td>3,31**</td>
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<td>Number of physicians per 1000 persons</td>
<td>3,69</td>
<td>3,17</td>
<td>2,61</td>
<td>3,67</td>
<td>2,95</td>
<td>3,14</td>
</tr>
<tr>
<td>Spending on social protection</td>
<td>0,19</td>
<td>0,22*</td>
<td>0,13</td>
<td>0,12</td>
<td>0,16</td>
<td>0,08**</td>
</tr>
<tr>
<td>Revenues from social contributions</td>
<td>0,16</td>
<td>0,10</td>
<td>0,05</td>
<td>0,10</td>
<td>0,13</td>
<td>0,07</td>
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<tr>
<td>Income and corporate taxes</td>
<td>0,12</td>
<td>0,21*</td>
<td>0,15</td>
<td>0,08</td>
<td>0,08</td>
<td>0,04**</td>
</tr>
<tr>
<td>Individual taxes</td>
<td>0,20</td>
<td>0,29*</td>
<td>0,32</td>
<td>0,14</td>
<td>0,11</td>
<td>0,09</td>
</tr>
<tr>
<td>Payments to government employees</td>
<td>0,11</td>
<td>0,15*</td>
<td>0,10</td>
<td>0,09</td>
<td>0,09</td>
<td>0,07</td>
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<tr>
<td><strong>Social situation variables</strong></td>
<td></td>
<td></td>
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<tr>
<td>Inequality</td>
<td>31,56</td>
<td>25,60**</td>
<td>37,67*</td>
<td>34,42</td>
<td>28,02</td>
<td>34,47</td>
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<tr>
<td>Female participation</td>
<td>40,59**</td>
<td>47,31</td>
<td>45,31</td>
<td>48,34</td>
<td>46,36</td>
<td>46,79</td>
</tr>
<tr>
<td>GDP Growth</td>
<td>2,31</td>
<td>2,45</td>
<td>2,95</td>
<td>5,28*</td>
<td>3,29</td>
<td>2,81</td>
</tr>
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<td>Total fertility rate</td>
<td>1,45</td>
<td>1,71</td>
<td>1,88</td>
<td>1,25</td>
<td>1,28</td>
<td>1,28</td>
</tr>
<tr>
<td>Inflation</td>
<td>2,20</td>
<td>1,96</td>
<td>2,16</td>
<td>27,28</td>
<td>6,41</td>
<td>21,00</td>
</tr>
<tr>
<td>Life expectancy</td>
<td>78,45</td>
<td>78,22</td>
<td>77,71</td>
<td>69,10*</td>
<td>73,16</td>
<td>70,09*</td>
</tr>
<tr>
<td>Infant mortality</td>
<td>4,50</td>
<td>3,78</td>
<td>6,01</td>
<td>12,17</td>
<td>11,50</td>
<td>28,67*</td>
</tr>
<tr>
<td>Unemployment</td>
<td>8,57</td>
<td>6,06</td>
<td>5,43</td>
<td>10,75</td>
<td>12,88</td>
<td>8,88</td>
</tr>
<tr>
<td><strong>Political participation variables</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Level of trust</td>
<td>32,45</td>
<td>62,33*</td>
<td>37,43</td>
<td>24,80</td>
<td>20,18</td>
<td>13,90**</td>
</tr>
</tbody>
</table>

* More than one standard deviation above total average
** More than one standard deviation below total average
arate cluster in this analysis. Table 2 clearly shows some of the well-known features of the conservative-corporatist type: low female participation, reliance upon social contributions instead of taxes, moderate income redistributions, and rather high levels of unemployment.

II: Social-Democratic type (Finland, Denmark, Norway and Sweden) This type is the familiar Scandinavian type with high taxes, high income redistributions, high female participation, a high level of material well-being as becomes clear from the low infant mortality and high life expectancy and a high level of trust among the citizens.

III: Liberal type (New Zealand, United Kingdom and United States) Again, table 2 confirms the features of the Anglo-Saxon type: low level of total government expenditures, high level of inequality and a low level of spending on social protection.

IV: Former-USSR type (Belarus, Estonia, Latvia, Lithuania, Russia and Ukraine) This first post-communist subtype is highly interesting. Concerning the total government expenditures, this type resembles the conservative-corporatist type, but the scores on all other governmental programmes variables are below the three well-known Western European types. However, the biggest differences can be observed in the social situation and the level of trust in these countries.

V: Post-communist European type (Bulgaria, Croatia, Czech Republic, Hun-
This type to some extent resembles the previous type. The most striking differences stem from a more relaxed economic development over the last few years. This is reflected in the levels of economic growth and inflation. Moreover, the level of social well-being is somewhat higher than in the former-USSR countries. This is reflected in the infant mortality and the life expectancy scores. Finally, this group of countries clearly is more egalitarian than the previous group.

VI: Developing welfare states type (Georgia, Romania and Moldova). This final type clearly represents countries that are still developing towards mature welfare states. Both the programme variables and the indicators for the social situation remain clearly behind the levels of the other groups of countries. The high-level of infant mortality and the low life expectancy illustrate the difficult social situation in which these countries are.

7 Conclusions

This article has shown that there is a clear distinction between the traditional European welfare states that formed the subject of Esping-Andersen’s famous typology, and the countries of Central and Eastern Europe. The group of post-communist countries might be subdivided into three groups. In general, the level of trust, the level of social programmes and social situation in the post-communist countries are considerably lower than in the other countries. The subgroup of Central and Eastern European post-communist countries most closely resembles the Western countries. The social situation in the
subgroup primarily consisting of former-USSR countries is worse than in the Central and Eastern European countries, but the governmental programme characteristics do not vary significantly. The third group consists of countries that are in the stage of developing into mature welfare states. The social situation, governmental programmes and level of trust in Moldova, Georgia and Romania are clearly less developed in comparison with those of all other countries in this analysis.

The question now is how to interpret these results. On the one hand, it is clear that almost half a century of communist rule has had its effect upon the development of the welfare states in the post-communist countries. The lack of historical data hinders the ability to draw conclusions on the convergence or divergence of the Western and Eastern European countries. However, it is clear that if convergence is occurring, the transitional stage takes much longer than some authors had anticipated. On the other hand, the differences between the Western countries and the post-communist countries stem primarily from differences in the social situation, not so much from differences in the governmental programmes. Whereas the three Western subtypes clearly represent different perspectives on the welfare state and governments’ role in it, the post-communist subtypes mix elements of the conservative-corporatist and, to a lesser extent the social-democratic type.

This leads to the following conclusions. The empirical analysis of post-communist and Western welfare states in this article clearly shows large differences between these welfare states. The differences between the group of post-communist countries and the traditional Western welfare states are bigger than the differences between the countries within any of those groups.
Therefore, at this moment the post-communist welfare states can not be reduced to any of Esping-Andersen’s or any other well-known types of welfare states. However, the empirical analysis does not show a distinct, specific type of post-communist welfare states. Post-communist welfare states are merely characterised by the lower levels of their governmental programmes and the social situation. What this means for their future developments, remains an open question. However, this article has shown the contribution of hierarchical cluster analysis to the analysis of post-communist welfare states’ developments. By periodically replicating this analysis, and by complementing it with qualitative analyses, we might be able one day to pinpoint the distinct features of the full-grown, post communist welfare state type.

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four? Camberra: Graduate Program in Public Policy.


The battle over flexibilization in post-communist transitions: Labor politics in Poland and the Czech Republic, 1989–2010

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Abstract
In post-communist transitions, given the steepness of union decline and the inheritance of rigid communist-era Labor Codes, a convenient way to compare the relative efficacy of organized labor is to assess its ability to contain the push for ‘flexibilization’ in the revision of labor regulations. This article compares Poland and the Czech Republic (1989–2010), where important differences emerged in revised Labor Codes in such areas as dismissals, fixed-term contracts, collective bargaining, and union rights. In all these aspects, Czech labor did significantly better in resisting flexibilization. The explanation rests on the evolution of a legacy union in the Czech Republic that was able to concentrate labor’s resources and coordinate with an electorally viable set of left parties to secure their backing for labor’s agenda. This was not possible in Poland given the deep divisions within organized labor and the shifting fortunes of left parties in a more volatile party system. The cohesiveness of labor and the viability of left parties do not explain variation in labor power everywhere. They do, however, jointly constitute a portable mechanism that enhances the strength of organized labor in post-communist countries and possibly even in late-developing countries marked by market reforms and democratic contestation.

Keywords
Czech Republic, flexibility, labor regulations, liberalization, Poland, post-communist transition, trade unions

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Introduction

‘Numbers only tell part of the story. Where many observers around the world see only decline, I see increased democracy, greater pragmatism and freedom for millions of workers to form representative organizations to engage in collective bargaining with their employers and to participate in decisions affecting society and the workplace.’

(Michel Hansenne; ILO, 1997)

The statement from the former Director-General of the International Labor Organization (ILO, 1997) may have been overly optimistic, but it rightly suggests that a decline in union membership is not automatically an indicator of labor’s impotence. In post-industrial settings, differences in trade unions’ strategies, rates of strike activity, and modes of concertation all point to alternative pathways to union renewal (Frege and Kelly, 2004; Heckscher and McCarthy, 2014). In post-authoritarian settings, despite the initial domination of legacy unions descended from the old regime, some unions learn to cooperate, devise new strategies, and learn to bargain with political and business elites (Caraway et al., 2015; Etchemandy and Collier, 2007). In the case of post-communist transitions, however, the challenge is heightened by the task of managing simultaneous and wholesale political and economic transformations following decades of central planning (Przeworski, 1991). Despite initial optimism about labor’s potential role in spearheading civil society (Kubicek, 2004) and about the transference of European Union (EU) industrial relations practices to Eastern Europe (Vickerstaff and Thirkell, 1997), the first decade of post-communism saw a precipitous decline in union density and the futility of ‘illusory corporatism’ (Ost, 2000). These conditions led many to conclude that labor was simply too weak or passive to defend workers’ interests or influence policy (Crowley, 2004; Crowley and Ost, 2001; Kubicek, 2004; Vanhuysse, 2006). Not surprisingly, this coincided with the view that businesses in Eastern Europe enjoyed significantly more flexibility than their counterparts in Western Europe (Meardi, 2002).

This article does not dispute these findings, which are based primarily on observations from the first decade of transition. Rather, it builds on more recent analyses of differences across post-communist labor relations (e.g. Avdagic, 2006; Chen and Sil, 2006; Cook, 2010; Robertson, 2004; Sznajder Lee and Trappmann, 2016), with a focus on the indicators and sources of variation in the efficacy of organized labor. Within the context of post-communist transition, given the steepness of union decline and the fluidity of newly emerging institutions and policies, familiar predictors of labor power (such as union density or rates of strike activity) are not likely to be useful. To the extent that small differences in labor power might emerge over time, these can be better tracked through the efforts to resist the employer-backed push for greater flexibility in employment practices and labor markets. True, the advance of flexibilization has created pressures to transform labor institutions everywhere. The scale and impact have been markedly greater,
however, in places where state-guided or centrally planned economies once prioritized ‘rigidity’ in labor markets in the interest of political and social stability (Sil and Candland, 2001). In the case of communist regimes, this rigidity was evident in remarkably similar Labor Codes that guaranteed full employment, placed severe constraints on dismissals and worker movement, and relied on enterprise unions to manage social benefits. Surprisingly, post-communist reformers were prepared to discard the entire apparatus of central planning, yet chose to retain and revise the Labor Code as the basic framework for labor relations. This provides us with an opportunity to engage in a structured–focused comparison (George and Bennett, 2005: 67): the ‘structure’ consists of a universe of cases that feature similar communist legacies and comparable imperatives of political and economic transformation; and the ‘focus’ concerns the question of whether and how unions in certain countries managed to resist or delay employer-led efforts to dilute worker-friendly labor regulations.

The empirical study is a paired comparison of the Czech Republic and Poland during the first two decades of transition. The two countries satisfy the conditions for a ‘most similar’ systems comparison. They are both democracies that are now EU members with market economies that are reasonably well integrated into the global economy. In typologies of post-communist economies, the two countries are usually placed in the same category as, for example, in Bohle and Greskovits (2012) who classify them as cases of ‘embedded liberalism’. Also, while business associations in both countries were organized speedily and quickly became influential, organized labor in both countries had to contend with significant declines in union density amid rising unemployment. The period under consideration spans two decades, from 1989 to about 2010. Given that the first decade of transition was a time of rapid institutional change and extreme uncertainty, the longer timeframe allows us to analyze labor politics against the more stable configurations of interests over time. Indeed, the main battles over revising the Labor Code did not get under way until after the first decade of transition, by which time the rate of union decline had slowed down, and both the political system and market economy were more consolidated. At the same time, to analyze labor politics under relatively stable conditions, it is necessary to exclude the period from 2010 onward since the onset of the financial crisis affected the two countries in different ways and led to heightened uncertainties and emergency measures that temporarily distorted the dynamics of labor politics. Within this 1989–2010 period, the comparison is aimed at establishing and explaining differences in the extent of flexibilization achieved through changes in labor law, particularly the revised Labor Code. The argument developed in the following section is intended not only to explain the different trajectories of Poland and the Czech Republic, but also to illuminate certain permissive conditions that allow organized labor to be politically efficacious in the face of union decline and pressures for flexibilization.

The first section below demonstrates that, even with common principles linked to EU accession, significant differences emerged between Poland and the Czech Republic in such areas as the procedures and costs of termination, schemes for
unemployment insurance, the use of fixed-term (temporary) contracts, the scope of collective bargaining, and union rights vis-a-vis newly established works councils. In these aspects, labor’s preferences were more closely aligned with the outcome in the Czech Republic than in Poland. The next two sections respectively highlight two mechanisms that jointly affected labor’s ability to resist flexibilization as labor politics became more routinized in post-communist settings. The first of these concerns, the cohesiveness (or lack thereof) of organized labor, at least as it impacted union-led collective action during policy or legislative debates affecting employment relations. Cohesiveness was greater in the Czech Republic, where a legacy union remained the dominant union but learned to leverage its inherited resources and membership base to advocate more effectively on behalf of employees. Polish labor, by contrast, was hurt by the presence of two large confederations that represented most of the unionized workforce but were divided in their priorities and political allegiances. The other mechanism relates to the nature and role of political parties. As the case of the Czech Republic demonstrates, the net impact of labor’s cohesiveness depends on the availability of electorally viable left parties willing to back labor-friendly positions in the legislature in exchange for electoral support from the working class. The conclusion characterizes this two-pronged argument as a special variant of the ‘labor-and-left’ thesis that was popularized in earlier studies of European labor relations (e.g. Huber and Stephens, 2001; Lehmbruch, 1984; Williamson, 1989) but the logic of which seems more relevant now to post-communist transitions (and to late-industrializing states that are at least partly democratic and pursuing sustained market reforms). While the cohesiveness of unions and their linkages to viable left parties are neither necessary nor sufficient for explaining the efficacy of organized labor power, they may be regarded as jointly constituting an important mechanism that, all other things being equal, enhances the ability of organized labor to exert influence under conditions of union decline and liberalization.

The quest for flexibilization in Poland and the Czech Republic

Labor relations under communism presumed a unity of purpose among planners, managers, and workers. Communist regimes adopted similar Labor Codes, including the Czechoslovak Code of 1965 and the Polish Code of 1974, that guaranteed all citizens the right to employment, established automatic dues-paying union membership in most enterprises, and laid out specific regulations for the dismissal or reassignment of workers. Within these frameworks, trade unions served as ‘transmission belts’ for coordinating efforts to meet production targets and managing the distribution of social benefits. But, they also played a role in ensuring that any dismissals or reassignments were carried out per regulations (Pravda and Ruble, 1986).

After 1989, in a rapidly shifting environment marked by extreme uncertainty, workers, unions, and private employers, all had to adjust to new realities, including the steady divergence in the interests of labor and business. In the course of a fluid transition, many of the usual predictors of labor power in post-industrial countries
simply did not work (Armingeon, 2006). The decline in union membership, for example, proved to be much sharper during the first decade of transition because of the sudden end to the automatic dues-check-offs, which had produced an artificially high level of union membership at communist workplaces. And, with unions no longer administering social benefits, workers were unsure of the point of union membership amidst factory closures, wage arrears, and rising unemployment. Over time, however, the rate of union decline slowed significantly, suggesting a normalization of labor relations. In the Czech Republic, for example, union membership dropped 72% between 1990 and 2000, but only 34% between 2000 and 2010; the corresponding figures for Poland were 60% and 27% (Organization for Economic and Co-operative Development (OECD), 2013). Such stark variations in the rate of union decline in different periods make it difficult to employ trends in union membership as a consistent indicator of labor’s influence across time and space in post-communist settings.

Strike rates are not a reliable indicator of labor strength in post-communist transitions either. On the one hand, the generally low level of militancy in post-communist settings is a function of specific conditions, including the inherited tradition of cooperative labor–management relations and the extreme anxiety of workers fearful of dismissals under turbulent conditions (Crowley, 2004; Crowley and Ost, 2001; Kubicek, 2004). On the other hand, where strikes have occurred with some regularity, as in Romania, these have been a function of either dire conditions or labor’s weak bargaining position (Bohle and Greskovits, 2012: 184–191; Kideckel, 2001; Robertson, 2004; Varga, 2014). Similarly, institutions set up for tripartite social dialogue, while ostensibly giving unions some voice, at best generated marginal agreements that had little bearing on workers’ livelihoods in the midst of wholesale privatization (Ost, 2000). Even in Poland, where the Solidarity trade union had ties to leading reformers and was consulted on the process of privatization (Paczyńska, 2009), the discussions were predicated on the acceptance of closures and mass dismissals that would push Poland’s unemployment rate to 20% by 2002 (Ost, 2005). Under the conditions of radical transformation, tripartite commissions simply did not function as intended, and union participation turned out to be more a formality than an indicator of influence.

Yet the shared legacy of communist-era labor relations does yield a different sort of proxy for estimating the efficacy of organized labor in post-communist settings: the extent to which unions managed to limit the advance of flexibilization in the course of revising worker-friendly labor regulations. This move is predicated on the fact that, across post-communist regimes, preexisting Labor Codes, rather than being jettisoned along with the system of central planning, continued to provide the basic framework for labor relations and became the object of contentious efforts to amend various provisions for the sake of flexibility. In this context, flexibilization is understood to mean the overall ease with which employers are able to employ or dismiss workers, to set the terms of their employment, to arrange work schedules as needed, and to define the range of issues subject to bargaining with employees’ representatives. Given that communist-era Labor Codes were
designed to establish ‘rigidity’ in labor relations, post-communist reforms everywhere included efforts to increase flexibility. Yet over time, significant variation emerged in the degree of flexibilization, with organized labor in some post-communist countries significantly more satisfied with the outcome.

Once communist regimes fell, the Labor Code remained in place, but new Acts were adopted by decree to establish collective bargaining and the right to strike. Other revisions were adopted during the 1990s without much strife to adjust the language of labor regulations to facilitate their application to a newly emerging private sector. More fundamental revisions, however, would prove to be much more contentious. Major battles were fought over the adoption of the 2002 version of the Polish Labor Code (adjusted in 2004 to conform to the EU’s Charter of Fundamental Rights) and the 2006 version of the Czech Labor Code (which already incorporated those same standards). In both cases, EU accession produced some general guidelines, such as tripartite social dialogue, the introduction of employee councils, and the balancing of flexibility with employee rights (Bluhm, 2008; Wasileski and Turkel, 2008). And in both cases business associations lobbied hard to minimize restrictions on employers, while unions sought to preserve worker-friendly clauses (Gardawski et al., 2012; Myant, 2010). Yet, in the end, important differences emerged in key elements of the revised Labor Code and related regulations, with labor in the Czech Republic faring better on both of these elements.

**Dismissals**

Although layoffs became more easy in both countries, the revised Czech Code retained far more specificity in the conditions that must be met before dismissals, even retaining some of the language from the communist era – ‘for organizational reasons’ (Wasileski and Turkel, 2008: 271). This specificity permitted more challenges from laid-off workers who could question the conditions under which they were given notice, a situation that Czech employers sought to avoid by agreeing to relatively more generous severance packages where termination was by mutual agreement (Wasileski and Turkel, 2008). The cost to employers for laying off a worker in the Czech Republic was substantially higher than in Poland owing to clauses requiring a longer period of notification (2 months) as well as a more substantial severance package (3 months’ pay). Poland made allowances of 1 month’s pay in cases where those being terminated were eligible for retirement or disability benefits, but otherwise immediately transitioned newly unemployed individuals into the unemployment insurance scheme. In terms of weekly salary, the net cost of firing an employee in the Czech Republic came out to be 65% higher than in Poland, about 22 weeks of salary as opposed to 13 weeks in the latter (Kuddo, 2009; World Bank, 2009).

**Unemployment insurance**

Unemployed Poles receive a monthly amount (€110–160, depending on the number of years worked) over a period of 6 to 18 months, depending on regional
unemployment and other household income. Unemployed Czechs begin with 65% of the monthly earnings, then 45% starting with the fifth month up to a total of 11 months, depending on age. On the surface, the compensation may appear slightly more generous in Poland. But the qualifying rules in Poland are far more stringent: 365 days of work over the preceding 18 months, as compared with the same 365 days of work over 36 months in the Czech Republic. The less stringent qualifying rules and the more substantial severance package in the Czech Republic, together with the much lower rate of long-term unemployment (European Commission, 2012), explain why the Czech scheme is regarded as more effective in protecting income and averting poverty by the European Commission’s Directorate-General for Employment, Social Affairs and Inclusion (Avram et al., 2011).

*Fixed-term (temporary) contracts*

Whereas the Polish Code removed all restrictions on the use of fixed-term contracts, the Czech Code established a 2-year limit, whether for single contracts or for repeatedly renewed contracts. Although these limits would be extended in 2012 as part of the response to the financial crisis, the restrictions on fixed-term contracts represented a modest success for Czech labor in establishing the primacy of full-time long-term employment – which came with other benefits, such as higher annual earnings, representation in collective bargaining, and more extensive dismissal/severance requirements. By 2010, the percentage of Polish employees on fixed-term contracts stood at over 27% – highest in the EU and nearly double the average across all EU-28 countries. The corresponding figure in the Czech Republic was just 8%, six points below the EU-28 average (European Commission, 2016).

*Collective bargaining agreements*

Collective bargaining, initially introduced by decree following the end of communism, was the subject of major debates, with employers in both countries wanting to drastically limit its scope. In the Czech case, unions and left parties insisted on expansive use of collective bargaining as a condition for allowing employers more flexibility with respect to work schedules, including overtime. In Poland, limits on overtime work were roughly similar but allowed for additional scheduling based on individual contracts and specific workplace regulations (Bluhm, 2008: 73). The significance of this difference is evident in the fact that, in 2009, over 40% of the Czech workforce was covered by some form of collective bargaining agreement, including regional or sectoral agreements covering multiple workplaces (Fulton, 2011). In Poland, the Labor Inspectorate noted that fewer than 2 million workers out of a workforce of 12 million were covered by collective agreements in 2008, suggesting around 15% coverage (see Towalski, 2009).
Union rights vis-a-vis works councils

In both Poland and the Czech Republic, EU directives on works councils led to separate legislative debates (since the existing Labor Code had no mention of this). In both countries, unions were concerned about their rights at the workplace and sought to block the establishment of separate employee councils. Again, the outcome was more favorable to labor in the Czech Republic. In Poland, parliamentary debates in 2005–2006 led to legislation allowing employee councils in any workplace, including those with unions, although unions were permitted to nominate representatives. In the Czech Republic, employee councils were set up in workplaces of 50 or more employees only so long as unions did not exist in those workplaces, and even then, the councils did not enjoy the same rights as unions with respect to concluding collective agreements or consulting on remunerations and appraisals of employees (Bluhm, 2008: 71).

Responses to the outcome

Perhaps the clearest indication that the 2006 Czech Code ended up being more labor-friendly than the 2002 Polish Code is in the reactions of trade unions and employers’ organizations. It may be argued that Czech employers, perhaps influenced by the German tradition of labor-management cooperation with strong workplace unions, were more open to restrictions retained in the revised Czech Code. Yet the evidence suggests that Czech business associations were deeply frustrated with the outcome. Notably, the Confederation of Industry of the Czech Republic, the largest employers’ organization in the country, complained bitterly about the regulations governing dismissals which, they argued, were in some ways more restrictive than before (Hála, 2006b). In contrast, Polish employers’ organizations, although asking for still more flexibility, were the main driving force behind the revisions to the Polish Code (Towalski, 2002). On the labor side, Czech unions worked with officials from the Ministry of Labor to draft key provisions of the revised Code, and they were broadly satisfied with the results. The leading trade union center, the Czech and Moravian Confederation of Trade Unions (ČMKOS), claims to have ‘contributed substantially to defending and preserving the protective role of the Labour Code’ in the face of ‘long-term pressure aimed at liberalisation of labour law’ (ČMKOS, 2015). In contrast, the main Polish labor federations viewed the revised Code as a clear defeat for labor, even if their lack of coordination contributed to this: Solidarity organized mass protests against the government, while the All-Poland Alliance of Trade Unions (OPZZ) faced internal dissent as its leader was accused of compromising too much with the government (Czarzasty, 2002). These reactions confirm that revised labor regulations, while certainly not reflecting labor’s ideal preferences, were closer to what the Czech unions could accept than to what Polish unions could accept.

It is reasonable to ask whether the more limited flexibilization in the Czech case might have negatively impacted Czech workers in other ways, for example by scaring
away foreign investment and reducing employment. Yet precisely the opposite has been true. In terms of per capita foreign investment inflows, the Czech Republic was the best performer among the Visegrád countries in most years between 2000 and 2010, and consistently outperformed Poland during that time. In fact, in 2010 the figure for the Czech Republic (US$969) was double that of Poland (US$484). Similarly, the unemployment rate has been consistently higher in Poland. Between 2001 and 2005 Poland’s unemployment rate averaged 18–19%, while the Czech unemployment rate averaged 7–8% (World Bank, 2016). The differential narrowed over time, in part due to the exodus of over 2 million Poles since EU accession in 2004; even so, the Czech Republic’s unemployment rate, both month-to-month and long-term, has remained lower than that of Poland (European Commission, 2012). True, investment flows and employment levels are a function of many factors, but the point here is simply that the limits on flexibilization do not appear to have hurt the Czech economy or its workforce. In the meantime, they do reflect an outcome that aligned more closely with the preferences of Czech labor than with those of Polish labor. The next two sections turn to the question of why this proved to be the case.

**Organized labor – more fragmented in Poland**

In the early years of post-communist transition, it was the legacy unions descended from the communist trade union apparatus that began with the preponderance of organizational resources and a larger membership base. But initially they had little experience with adversarial industrial relations, were contending with a flurry of new laws and policies in a new institutional setting, and were quickly losing membership. New trade union organizations frequently criticized legacy unions and sought to redistribute their assets, fueling tensions within the labor movement. Over time, as the institutional context became more stable and predictable, there was a marked increase in the awareness of the discrete interests of labor as well as the role of trade unions. The extent to which this translated into concerted labor action, however, varied significantly.

**Polish labor: Divided from the start**

Initially, it appeared that unions might exercise more influence in Poland than in other post-communist settings, mostly due to Solidarity’s popularity and resources. Even under communism, Polish unions evinced a more robust history of autonomous worker mobilization than in other communist countries, with workers frequently pressing for independent representation (Pravda, 1986). Although the government periodically responded with selective concessions, including a plan to decentralize union structures, the party organization always managed to reestablish tight control over unions. This fed the frustrations that ultimately turned Solidarity from the official trade union body into a union-led resistance movement that had to go underground after it was declared illegal in 1982 (Gardawski et al., 2012; Paczyńska, 2009: ch. 2).
In 1984, the regime sought to undercut Solidarity’s clout by creating another regime-sponsored trade union apparatus – the OPZZ. OPZZ was around for only 5 years before the end of communism and did not possess the organizational resources controlled by official communist trade unions elsewhere. In any case, the end of communism in 1989 appeared to make OPZZ irrelevant as Solidarity activists took control of the labor movement while also becoming part of a new political elite committed to a rapid transition to a market economy. Solidarity unions, although operating underground for much of the 1980s, had also amassed significant financial resources through foreign sponsors, including the United States’ National Endowment for Democracy, the Central Intelligence Agency, and George Soros’ Open-Society Foundation (Kubik and Ekiert, 2001; Paczyńska, 2009: 54). Thus, the study of labor relations in post-communist Poland initially focused mostly on Solidarity, with OPZZ relegated to a footnote.

The situation changed, however, once it became clear that Solidarity-backed political leaders were prepared to accept falling real wages and rising unemployment as the necessary cost of transitioning to a market economy (Ost, 2005). This is what enabled OPZZ to not only survive but attract new members, including workers and local unions defecting from Solidarity. Other groups also left Solidarity’s national trade union organization, including Solidarity 80, which independently organized mass anti-government protests and created an opening for ex-communists to come to power in 1993. Although Solidarity trade unionists also organized some labor protests (Ekiert and Kubik, 1999), rivalries among Solidarity, OPZZ, and smaller unions prevented labor as a whole from effectively resisting employers’ efforts to gut the social protection of workers in the early 1990s (Gardawski et al., 2012; Ost, 2005: ch. 4).

The division between OPZZ and Solidarity would become a routine feature of Polish politics from the mid-1990s on, reinforced by competing political and ideological orientations. Solidarity unions regularly sided with right-of-center parties (even as they changed labels and leaders), whereas OPZZ tended to ally with the ex-communist party that spearheaded the Democratic Left Alliance (SLD). Thus, whatever opportunities labor officials had to participate in successive governments did not strengthen the position of trade unions writ large, but instead contributed to the ‘subordination of trade union demands to the exigencies of political coalition-making’ (Trappmann, 2012: 8). Moreover, by the early 2000s, OPZZ’s membership had grown to the point that both Solidarity and OPZZ claimed over 600,000 members, accounting for more than two-thirds of a unionized workforce (Carley, 2009). This made it difficult for either center to dominate the labor movement, which would not necessarily be a problem were it not for their inability to cooperate – even on issues on which their positions overlapped. The result, at least over the first two decades of transition, was a divided labor movement that has been characterized as ‘bipolar’ (Avdagic, 2006) or ‘dualistic’ (Trappmann, 2012).
During the debates over the Labor Code, Solidarity and OPZZ saw eye-to-eye on the issue of preserving union rights with respect to collective agreements at the workplace. Beyond that, however, the two unions could not formulate a common position to push back against the employers’ associations that lobbied for greater flexibility in the revised labor regulations. Solidarity, despite its earlier support for shock therapy and privatization, resisted the proposed amendments and mobilized large-scale protests against the government when the revised Code was adopted. OPZZ, given that its political ally – the social democratic SLD – was in power, was more open to negotiating with the government; but its leadership faced internal challenges from those frustrated with the concessions made (Gardawski, 2002). In the end, although most members of both trade union centers were frustrated with the outcome, it was their own rivalry that had stood in the way of the concerted action needed to contend with the determined push for flexibilization by employers’ associations.

Czech labor: The evolution of a legacy union

The story of Czech labor unfolded quite differently. Under communism, the Czechoslovak Central Trade Union Council had been crafted in line with the highly centralized Soviet trade union apparatus, with virtually all employees automatically enrolled as union members through their workplaces (Porket, 1986). During the Prague Spring, however, 85% of incumbent officials were voted out in trade union elections as a sign of workers’ support for Alexander Dubček’s ill-fated reforms. After the Soviet invasion, the Central Trade Union Council resumed its main function as a more tightly controlled ‘transmission belt’ between the regime and the workforce. During the 1980s, Czech unions continued to function normally and did not even join Václav Havel’s Civic Forum during the ‘velvet revolution’. Only after protests against the communist regime kicked into a high gear did the unions call a general strike to call for a new government (Paczyn’ska, 2009: ch. 2).

In the first 2 years of transition, as vigorous debates unfolded over the pace and scope of neoliberal reforms, trade unions were virtually invisible. The Czechoslovak Central Trade Union Council was reorganized, first as the Czechoslovak Trade Union Confederation (ČSKOS) and then, following the Czech–Slovak split in 1993, as the ČMKOS. The latter may be regarded as a legacy union in that it inherited most of the assets and membership of branch and regional unions situated within the Czech Republic. However, neither ČSKOS nor ČMKOS exerted much influence during the early years of market reforms, including privatization, prompting some to view Czech unions as docile (McDermott, 2002: 69; Paczyńska, 2009).

Yet it is worth noting that, in relation to the issue of greatest relevance to the workforce – employment stability – a bargain was struck early on. It was not between unions and businesses, but between different wings within the Civic
Forum movement. One of those wings consisted of neoliberals led by Václav Klaus, a free-market economist who was eager to push forward with market reforms and tight fiscal policies. The other included former dissidents with social democratic orientations, as well as reform communists who had been banned from the Communist Party for their role in the Prague Spring. This latter wing included Deputy Prime Minister Valtr Komárek and Labor Minister Petr Miller, who effectively pushed Klaus to accept a pact to ensure low unemployment and establish tripartite social dialogue in which unions could later play a role (Orenstein, 2001). Moreover, the unions did win one early victory on their own that was not insignificant: in the new 1990 law on collective bargaining adopted by decree, ČSKOS managed to lobby against the creation of works councils where union organizations existed so as to preserve the latter’s bargaining power at the workplace (Pollert, 2001: 20). Thus, although Czech unions did not seem nearly as politically active in the first 4 or 5 years of transition as Solidarity was in Poland, it would be a mistake to interpret the role of unions as indicative of perennial labor weakness.

As the contours of labor politics became more routinized after the mid-1990s, ČMKOS’ role became more visible, more institutionalized, and more coordinated. While ČMKOS was a quintessential legacy union that had inherited the bulk of its resources and membership from the former communist trade union apparatus, this inheritance gradually turned into a valuable asset as the federation began to play a central role in the labor movement. ČMKOS’ resources enabled it to build a font of legal and technical expertise at its central offices, provide expert assistance to branch and company affiliates, and eventually develop a pragmatic political strategy, while ČMKOS would lose some of its branch affiliates (such as the railway workers’ union and doctors’ union) to a newer federation, the Association of Independent Trade Unions (ASO). While ASO did become the second largest federation, however, at no point did it account for more than 15% of union members; more importantly, it encompassed diverse branch unions pursuing independent labor actions without much coordination (Myant, 2010). ČMKOS has remained a central actor in the labor movement, accounting for over two-thirds of the unionized workforce (Carley, 2009), holding the most seats for labor on the Czech Tripartite Council, and serving as the sole representative of Czech labor in the International Trade Union Confederation. ČMKOS’ dominant position in the labor movement enabled it to use its resources and membership clout to secure a role in drafting amendments to the Labor Code, producing a result it was satisfied with, at least by comparison to its counterparts in Poland.

These different characteristics of the Polish and Czech labor movements do not suffice to explain the variation in revised labor regulations outlined in the above section. In cases where the revisions are the result of legislation in a more or less democratic setting, the positions of parties also come into play. In Poland and the Czech Republic, the battle over flexibilization was not fought in the streets, but in a parliament featuring regular competition among different parties that had led the government at different times. The following section turns to the character and
position of left parties in Poland and the Czech Republic insofar as they might have been sympathetic to labor’s general preferences.

**Left parties – more stable and relevant in the Czech Republic**

Amid rising prices and job loss in the early years of transition, communist successor parties in Eastern Europe did well to tap into deepening public anxiety to build a new electoral base (Cook and Orenstein, 1999). Many of these parties proved especially adept at leveraging ‘portable skills and usable pasts’ in the new context of democratic contestation (Grzymała-Busse, 2002: 265). In Poland, as disgruntled voters reeled from the initial impact of shock therapy, former communists quickly reorganized themselves as a social democratic party at the helm of the SLD. Over the first decade of transition, the SLD learned to act as a catch-all party, showing concern for the social costs of market reforms but also seeking to demonstrate its competence in advancing market reforms and meeting commitments to international financial institutions (Cook and Orenstein, 1999: 74–75). In contrast, the Czech ex-communists retained the term ‘communist’ in their name – the Communist Party of Bohemia and Moravia (KSCM) – and regularly appealed to a narrow band of voters, chiefly pensioners and public employees who stood to lose many of the social benefits they were accustomed to. While the SLD managed to form the government twice, in 1993–1997 and 2001–2005 (receiving 47% of the vote in 2001), the KSCM usually received 10–15% of the popular vote (exceeding that range only once, reaching 18% in 2002).

The causal story here, however, rests not on the resurrection of ex-communist parties, but on the electoral viability of any and all parties on the left (Rueschemeyer, 1999). In the Czech Republic, this included the Czech Social Democratic Party (ČSSD), which would become an even more important player than the KSCM in Czech politics. The ČSSD first emerged in the late 19th century, managed to win 30% of the vote in 1919, and proceeded to join several coalition governments in the interwar years (Rueschemeyer and Wolchik, 1999). After 1989, the ČSSD was resurrected by those with social democratic leanings in the Civic Forum as well as former communists who had backed Dubček’s reforms in 1968. After a slow start, the ČSSD managed to finish in first or second place in vote shares in every parliamentary election since 1996. Thus, while the story of the Polish left revolves mainly around the position of the SLD, the Czech case features two parties that, while frequently criticizing each other, often ended up on the same side in debates over social policy.

**Left parties in the Czech Parliament**

Many of the key figures in the resurrected ČSSD had been dissidents pushed out of the Communist Party after the Prague Spring. Thus, it is not surprising that the relationship between the ČSSD and KSCM was fraught with distrust. In 1998 the ČSSD was in a position to form a coalition government, and opted to do so not
with the KSČM but with its chief opponent on the right, the Civic Democratic Party (ODS). Nevertheless, when it came to issues of crucial relevance to labor, the ČSSD and KSČM frequently adopted similar positions. This was especially true during the ČSSD-led government of 2002–2006 when the ČSSD and KSČM, although not willing to form a coalition, jointly worked on revisions to the Labor Code and several other pieces of legislation (Hlousk and Kopeček, 2010: 24–26).

At least as importantly, while both parties experienced ups and downs, each has maintained a significant electoral presence in every parliament since 1996. Since 1996 the ČSSD has garnered 22 to 32% of the electoral vote, while the KSČM has secured anywhere from 11 to 18%. The total number of seats in the Czech parliament held by politicians belonging to the KSČM or ČSSD has ranged from a low of 41% (in 2010) to a high of 55% (in 2002). The ongoing stability of these left parties in the Czech Republic has been reinforced by the overall stability of the Czech party system, which has been regarded as one of the least volatile in Central and Eastern Europe, as indicated by the lack of huge electoral swings from one side of the spectrum to the other (Powell and Tucker, 2014).

These conditions proved favorable to Czech labor during debates over the Labor Code, not only because the left parties generally were sympathetic to its position, but also because ČSSD had strong links to ČMKOS, whose members constituted a sizable portion of the electorate. Despite its official stance of neutrality, there were numerous channels through which ČMKOS coordinated its activities with ČSSD – for example, by issuing joint calls for strikes (Perottino and Polášek, 2013: 426). And while ČMKOS claimed to be open to cooperating with any party that backed its positions, by the end of the 1990s it was clear that the party that most consistently met this criterion was the ČSSD (Hála et al., 2002: 15). During the 2006 elections, ČMKOS even shared with its members an analysis of party manifestos on key issues of relevance to workers – including wage policy, employment law, and collective bargaining – which concluded that ČMKOS preferences were more closely aligned with the positions of ČSSD and KSČM than with those of any other party (Myant, 2010: 27).

The convergence in positions of labor and the left parties was buttressed by the movement of key leaders between ČMKOS and ČSSD. In fact, the first leaders of the revived ČSSD were trade unionists who saw the party as a vehicle to provide a new voice for those in the Civic Forum who might advocate on behalf of labor (Hloušek and Kopeček, 2010; Orenstein, 2001). Richard Falbr, once a leader in a branch union, served as ViceChairman of the ČSSD at the time of its reestablishment, then was elected Chairman of ČMKOS during the 1990s, and later proceeded to run on a ČSSD ticket to get elected a Senator in 1996 and a Member of the European Parliament in 2004. Similarly, Milan Štěch was head of the main metalworkers union (OS KOVO) affiliated with ČMKOS before becoming the latter’s Chairman from 2002 to 2010 while also serving as a ČSSD Senator and becoming President of the Senate in 2008 (Perottino and Polášek, 2013). Also, Jaroslav Zavadil served as Chairman of ČMKOS from 2010 to 2013.
before being elected on the ČSSD ticket to the Czech Chamber of Deputies. Thus, when new elections in 2006 brought a center-right government wanting to defer application of the just amended Labor Code to consider further revisions, organized labor and the left parties were able to join forces quickly to prevent the deferral and ensure that certain worker-friendly provisions remained in the Code (Hála, 2006a).

**The rise and fall of the Polish left**

In Poland, the left’s relevance rose and fell with the electoral fortunes of the SLD. There were no other left parties that could consistently claim a sizable block of seats in Parliament. The Polish Peasant Party initially backed the SLD but later joined forces with the right-of-center Civic Platform Party (PO). In 1993, a separate social democratic party, Labor Union, got 7% of the vote and 41 seats in the parliament but failed to cross the electoral threshold for parliament thereafter. Other parties that embraced something resembling a leftist program were either extremely small or became drawn to the religious or cultural agenda of right-of-center parties (Rueschemeyer and Wolchik, 1999: 29–31). Thus, the SLD was the only recognizable representative of the Polish left over multiple election cycles. While it did well to form a government in 1993 and again in 2001 (when its vote share reached a high of 47%), it subsequently suffered from a string of internal problems and saw its vote share plummet to 11% in 2005 and just 8% in 2011. This was three percent age points lower than the vote share that the ex-communist KSČM managed by itself in the 2010 Czech elections. Since 2005, the main competition in Poland has been mainly between two parties on the right.

The Polish SLD did head the governments that oversaw revisions to the Polish Labor Code, first in 1996 and then again in 2002. While the first set of revisions did not attack worker-friendly regulations as strongly as the second set, the two combined to produce a much greater level of employer flexibility than in the Czech Republic (as noted above in the comparison of the revised Labor Codes in the two countries). This reflects two constraints that the SLD had to contend with: the 1993 government had to deal with implementing conditions negotiated with the International Monetary Fund and World Bank, while the 2001 government had to consider the conditions for EU accession. In both cases, the SLD governments honored their commitments and moved forward on specific targets, including on cutbacks in deficit spending. But this also meant that it failed to come through on the expectations of its supporters concerning better social safety nets and improved living standards for the poor and unemployed (Cook and Orenstein, 1999; Ost, 2005).

Moreover, when it came to dealing with unions, the SLD could only count on support from OPZZ which was locked in a struggle with Solidarity for union members. The SLD and OPZZ certainly joined forces, opposing the right-of-center parties not only on social policy but also on defending secular positions (Trappmann, 2012). But representing not even one-third of the unionized workforce, OPZZ was simply not in a position to offer enough electoral support to
counteract pressures the SLD faced from employers and international actors. In the meantime, Solidarity unions worked closely with right-of-center parties to not only do battle against the SLD, but also to focus on the promotion of conservative cultural values and right-wing ideological causes (most notably, backing for the Catholic Church and its position on abortion). The union–party ties constructed by Solidarity’s trade union activists and right-of-center political elites are not surprising, but at least through the early 2000s they dealt a serious blow to the efforts of left parties to garner working class support and to the prospects for collective action in defense of workers’ rights and livelihoods (Ost, 2005, esp. pp. 149–178; Trappmann, 2012).

Thus, although the Polish left appeared to have extremely strong prospects when the SLD gained power in 1993, it subsequently had difficulty maintaining its electoral strength, despite a second triumph in 2001. Without the sustained backing of a unified labor movement (given the aforementioned division between Solidarity and OPZZ), the SLD had to negotiate with other groups, including private employers’ associations and international financial institutions. Under these conditions, the SLD’s survival – unlike that of the ČSSD in the Czech Republic – depended on being able to act as a catch-all party (Cook and Orenstein, 1999). Ironically, this also meant that it did not maintain a recognizable electoral base that could generate some minimum level of support over successive electoral cycles. And in the end, the SLD’s time at the helm of the Polish government, even though it coincided with the debates over the Labor Code, did little to slow down the push for flexibilization.

**Conclusion: Labor and the left – once more unto the breach?**

In contrast to earlier scholarship emphasizing the common weakness of post-communist labor, this article has sought to track variation in labor’s resistance to the push for flexibilization during efforts to revise Labor Codes inherited from the communist era. The eventual outcomes of these efforts proved to be more in line with labor’s preferences in the Czech Republic than in Poland. The differences in the revised Czech and Polish labor regulations across various dimensions – the cost of dismissals, fixed-term contracts, collective bargaining procedures, union rights vis-à-vis works councils, etc. – are not large, especially by comparison to the wider range of variation evident across labor regulations worldwide. But they are significant not only in terms of employment-related consequences – such as the extent of collective bargaining coverage and the use of fixed-term contracts – but also as an indication of the varying efficacy of organized labor in post-communist settings.

In explaining the variation in labor’s effectiveness in the battle over flexibilization, the above analysis indicates that, under conditions of declining union density in the midst of post-communist transitions, two factors contributed to the outcome: (i) whether there exists a unified trade union federation that can concentrate its resources and memberships when pursuing agendas that relate to multiple workplaces and sectors, and (ii) whether one or more parties on the left consistently hold
a sizable block of parliamentary seats and are willing to support labor's agenda in exchange for electoral support. Due in part to the nature of the transition process, these conditions emerged in the Czech Republic by the late 1990s and remained in place through the second decade of the transition, including during the crucial period when amendments to the Labor Code and related regulations were being hotly debated. Similar conditions might have emerged in Poland had the transition process unfolded differently. As things turned out, Solidarity's evolution from anti-communist opposition to an eager backer of market reforms resulted in persistent divisions within organized labor and prevented it from providing a stable electoral base for the Polish left, even after the SLD's first taste of electoral success in 1993.

This result could not have been anticipated at the outset and may even be regarded as somewhat surprising. In Poland, Solidarity emerged with tremendous political capital, having led a movement that helped topple a communist regime and initiate shock therapy; but in the process, Solidarity-backed politicians came to embrace the full range of neoliberal policies, including the need for labor market flexibility, and so whatever advantages labor may have once enjoyed were quickly forfeited against the backdrop of competing dyads of parties and unions working at cross purposes. In the Czech Republic, where the neoliberal reformer Klaus initially had the upper hand and a strong commitment to full-blown market reforms, organized labor was mostly represented by a legacy union that remained on the sidelines during the 'velvet revolution' in 1989; yet that union adapted, developed more competencies, and learned to bargain with not only businesses, but with parties that proved to have some 'staying power' in the electoral arena. Workers, unions, and political parties in both countries had to adapt to a changing institutional environment, but it is in the Czech Republic that we see a less fragmented labor movement that was able to leverage its links to stable parties on the left to amplify its voice, even under conditions of union decline and pressures for flexibilization (see Figure 1).

The argument may be regarded as a special case of the 'labor-and-left' thesis, which once highlighted the role of concertation between large unions and social democratic parties in establishing corporatist institutions and advancing pro-labor agendas in Europe (Huber and Stephens, 2001; Lehmlbruch, 1984; Williamson, 1989). With the advent of post-Fordism and the concomitant decline of unions, these ties are seen to have become attenuated, or at least less consequential (Anthonsen et al., 2011; see also Lash and Urry, 1987). In post-communist settings, the labor-and-left thesis, to the extent it received a hearing at all (e.g. Avdagic, 2006), was seen as irrelevant in the midst of simultaneous transitions to democracy and market economies, especially given the volatility of emerging party systems and the seemingly quiescent posture of rapidly shrinking trade unions. While this may have been true during the first decade of transition, this article proceeds from the view that, over time, the eventual stabilization of the institutional environment warrants a reconsideration of the labor-and-left argument (Rueschemeyer, 1999). At least in the two countries compared here, it is evident that, despite continuing union decline and mounting pressures to boost flexibility, the cohesiveness of
organized labor and the electoral viability of left parties combine well to explain why revised labor regulations ended up more closely aligned with the preferences of labor in the Czech Republic than in Poland.

It is important to clarify that these two core explanatory factors are neither necessary nor sufficient for explaining variations in labor power or in the extent of flexibilization everywhere. In fact, in many developing and post-socialist countries, neither trade unions (however unified) nor left parties (however sympathetic to labor) have been able to slow down the advance of laws and policies designed to dismantle preexisting social pacts and boost labor market flexibility (Sil and Candland, 2001). And where there are some marginal successes, these may well be the result of different sets of factors depending on the nature of the regime and the relative importance of different sectors. China, Russia, and South Africa all have large trade union federations, but in all three cases, to varying degrees, the federations have been kept tightly connected to ruling parties so as to preempt large-scale social unrest (with markedly less success in South Africa). There are also left parties worldwide that moved away from preexisting commitments to the social protection of labor in favor of market reforms, whether to satisfy conditions imposed by international financial institutions or to demonstrate their ability to increase private-sector growth and foreign investment.

Yet while the ‘labor and left’ thesis may not constitute a general explanation for variation in labor politics, nor should it be treated as an idiosyncratic account relevant to only the cases examined here. Other Eastern European countries also saw central planning quickly dismantled to make way for market economies, while new patterns of political contestation took hold and new policy imperatives emerged in relation to the requirements of EU accession. Consequently, labor in
these other post-communist countries have had to contend with challenges not unlike those faced by labor in Poland and the Czech Republic – particularly the combined effects of rapid union decline and mounting pressures for flexibilization. In this regard, since the differences between the outcomes in the Czech Republic and Poland capture much of the range of possible variation, the labor-and-left thesis may be considered a plausible hypothesis to capture emerging differences in the dynamics of labor politics and the efficacy of organized labor across post-communist countries.

Indeed, the core logic of the argument is abstract enough that it can be adapted to assess labor’s relative strength/weakness in developing countries, at least insofar as certain conditions are present. These include: multi-party electoral competition, policies aimed at market reform, trade union federations that are at least semi-autonomous, and legislative battles over preexisting laws and regulations viewed as rigid and obsolete by business. These conditions essentially generate a ‘family resemblance’ between post-communist countries and developing countries engaged in liberalization, at least in terms of the politics of flexibilization (Sil and Candland, 2001). Further research is needed to determine the portability of the ‘labor-and-left’ argument across different institutional settings in the developing world. But, through carefully designed ‘contextualized comparison’ (Locke and Thelen, 1995), it is possible to explore whether and how the cohesiveness of organized labor and the electoral competitiveness of left parties might account for why labor in some countries is able to exert relatively more power and influence, even in the face of union decline and mounting pressures for flexibilization.

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Notes
1. These figures are based on total net foreign investment inflows divided by total population, with data drawn from tables provided by the World Bank (2016).
2. The second largest labor federation, ASO, was much smaller, did not always have a unified stance, and did not do anything to undermine the cooperation between ČMKOS and the left parties (Myant, 2010).
3. Polish election data are from the National Election Commission of Poland, available at: http://pkw.gov.pl/315_Wybory_do_Sejmu_i_do_Senatu

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The IFIs and Labour Reform in Post Communist Economies

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ABSTRACT Since 1999 the International Financial Institutions (IFIs) have sought to revise their policy approach to encourage participation, facilitation and dialogue with civil society organisations and trade unions. This Post Washington Consensus has been applied in transformation economies, where the IFIs have established labour market reform as a precondition for loans and grants. Such labour reforms have been deleterious to the interests of collective labour, and a continued source of contestation between unions, government, and the IFIs. This paper examines the reality of the new consensus framework with particular reference to the former Yugoslavia. Evidence is drawn from documents of the IFIs and from interviews with representatives of key union federations in the region. The article assesses the evidence against alternative theoretical frameworks from within political economy and international relations, and concludes that consensus is illusory, leaving unions consulted but then ignored.

Desde 1999 las Instituciones Financieras Internacionales (IFIs) buscaron la revisión del enfoque de sus políticas internas para reanimar la participación, facilitación y diálogo con las organizaciones de la sociedad civil y los sindicatos gremiales. Este Consenso Post Washington se ha aplicado a economías en transformación, en donde las IFIs han establecido una reforma del mercado laboral como un prerrequisito para préstamos y subvenciones. Tales reformas laborales han sido perjudiciales a los intereses de trabajo colectivo y una fuente continua de protesta entre los sindicatos, el gobierno y las IFIs. Este artículo examina la realidad del nuevo esquema del consenso con una referencia particular a la antigua Yugoslavia. Se ha extraído evidencia de documentos de las IFIs y de las entrevistas con representantes de las federaciones sindicales claves en la región. El artículo evalúa la evidencia contra los esquemas teóricos alternos dentro de la economía política y las relaciones internacionales, y concluye que el consenso es ilusorio, después de haber consultado a los sindicatos, pero luego dejándolos ignorados.

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International financial institutions (IFIs) have played a crucial part in funding shortfalls of capital within regimes of weak internal capital formation. Low savings ratios combined with state and enterprise indebtedness has meant that such economies have needed loans and grants to create conditions for economic growth. However, the conditionality attached to support has been framed by the dominant IFI market based imperative. In this framework it is deemed necessary to clear the labour market of rigidities in order to encourage foreign direct investment and to ensure a positive environment for enterprise (World Bank, 2005a). Two-thirds of the World Bank’s operations are linked to internal policy reforms, most of which shape the labour market, such as pension reform, labour code amendment, or public sector restructuring and pay (EBRD, 2004; World Bank, 2004a). This process has serious implications for labour relations. The dominant neoclassical model considers collective labour interest as a constraint to liberated labour markets (Hayek, 1980). Trade unions act as interest representatives to oppose labour market reforms that seek to liberalise protective labour codes. Unions will also use their associative power through the institutions of collective bargaining to raise the price of labour. As such it can be predicted that the power expressed by unions will prove an obstacle to reform, and the scene will be set for contestation of key aspects of conditionality, bringing collective labour into dispute not only with the IFIs but also their client states. The role of the IFIs has led Gradev (2001) to refer disparagingly to them in the case of transformation states as a ‘fourth actor’ in terms of their ability to shape the emerging industrial relations’ systems.

While the relationship between organised labour and the IFIs over the recent past has been contested, from 1999 the policy approach of the IFIs shifted to a more consultative one contained in the ‘Second Generation Reforms’. The shift took place in the aftermath of the 1997 East Asian financial crash and is a response both to the global justice movement and internal IFI concern at the seeming failure of policies to counter poverty and economic inequality. Such gathering unease with the IFIs has been exacerbated by claims that the IMF and World Bank are experiencing a crisis of confidence (Ambrose, 2007), fed not only by their inability to address poverty but also by problems of shrinking demands for services and a rise in alternative sources of funding from private investors as well as newly industrialising countries such as China and India. The Post Washington Consensus (PWC) model offers new direction by seeking to engage with civil society organisations, including trade unions, in efforts to build the perceived necessary social networks vital to democratic civil society (World Bank, 2005b). Central to this approach has been social capital theory. Fukuyama, for example, when addressing an IMF seminar on the reforms, suggested that ‘the economic function of social capital is to reduce the transaction costs associated with formal coordination mechanisms like contracts, hierarchies, bureaucratic rules, and the like’ (Fukuyama, 1999). The phraseology

Keywords: International financial institutions, trade unions, Labour relations, post Communism
suggests that the second generation of reforms is seen as a developmental tool set within a Weberian framework of state and organisational relationships.

There is interest in examining the reality of this shift as it may have affected employment relations in countries where the IFIs have influence. In order to do so this article seeks to explore the role of the IFIs within transforming economies with particular reference to the former Yugoslavia. The article first explores theoretical frameworks of the relationship between international finance, state strategy, and organised labour. Documentary policy evidence from the IFIs is reviewed, and case study evidence of the reality of contestation is presented. The article concludes by assessing the impact of the shift in IFI policy on the process of labour reform. The research method is not without difficulty, as much of the process of turning IFI agendas into policy is ‘hidden’ from view, subject as it is to social interaction among elites. The involvement of the IFIs is therefore examined through documentary evidence and chronological recording of outcomes. A review of state-led labour market reform is presented and finally the response from various trade union organisations, at both national and international affiliate level is recorded. The documentary data has been assembled from trade union and International Confederation of Trade Unions (ICFTU) documents, World Bank and IMF documents, and is supplemented by a series of interviews with trade union representatives and employers from within the region. Reference is also made to key labour market statistics.

Theoretical Frameworks

While the dominant perspective of policy elites has been neoliberal, critiques of such policy have been located either within a newly emerging framework of cosmopolitan social democracy or from a neo-Gramscian perspective. These alternative frameworks are presented below.

Neoclassical Endogenous Growth Theory

The IFI framework of economic development can be located in neoclassical endogenous growth theory (de la Dehesa, 2006, pp. 10–15). The theory prescribes that economic growth is possible in developing economies if labour market rigidities are cleared to give maximum incentive for entrepreneurship and financial risk-taking on behalf of enterprises (World Bank, 2005a). It is assumed that developing economies will converge towards developed ones through exploitation of comparative advantage and through imitation of best practice. An open economy is more likely to achieve best practice; hence, alongside deregulation of labour markets, state policy should include liberalisation of external tariffs and financial controls. In order to attract and retain foreign direct investment, the role of the state should be reduced from its former preoccupations, implying privatisation of formerly state owned functions, the marketisation of services, and low taxation. A convergence ‘peak’ is postulated to which all economies can then transpire through best practice initiatives (Forteza & Rama, 2001). Incremental advances in growth to reach this ‘peak’ may also be dependent on endogenous factors, such as skill enhancement and technical innovation (Romer, 1986). This assumes an emphasis on supply-side solutions and the gradual emergence of competitive, rather than comparative advantage in international trade. Such theory has been central to IFI policy and practice in both transformation economies and the former Yugoslavia. The IFI view of the region of South East Europe, for example, is encapsulated in the World Bank’s Report (2004b) on Building Market Institutions in South Eastern Europe where it is stated:
Deregulation, decentralization of collective bargaining to firm-level dialogue, improved flexibility of dismissal procedures, simplified wage adjustment and overtime pay, and introduction of fixed-term contracts are some of the reforms being debated to improve the transparency and functioning of the labor institutions in the region. Such initiatives, as well as formalization of the gray economy, are key to fighting the unemployment problem in the SEE8.

The IFI approach is concretely expressed in the World Bank’s intention to construct a new Global Architecture of Governance in line with former bank President James Wolfensohn’s outline of a Comprehensive Development Framework (Wolfensohn, 1999). This promised a benchmarking of practices whereby IFI policy is encouraged in recipient (and donor) countries. The key areas of influence are summarised as follows. First is to encourage privatization whereby participating and recipient countries sell off publicly owned utilities and services in order to reduce government expenditure and encourage efficiency in production. Followers of trade union strategy in transformation economies report that unions have welcomed privatization, albeit with the necessary safety nets to look after those losing their jobs in the process (Pollert, 1999, 2000; Thirkell et al., 1998; Upchurch, 2006). The social cost of privatization is a crucial area of concern for unions and one which they would be expected to seek to engage with in any process of social dialogue. Second, the IFIs have encouraged labour market flexibility with the aim of relaxing laws on dismissals; removing barriers to recruitment; downgrading national minimum wages by lowering, capping or decoupling the minimum wage from average wages; and eliminating limits on part-time working and working hours. An analysis of labour codes throughout the region has suggested that the former Yugoslav countries have ‘relatively flexible regular employment legislation’ but higher than average inflexibility with respect to temporary contracts (Micevska, 2004). All the former CEE countries and those of the former Yugoslavia are estimated to have more ‘restrictive’ labour laws than is the case in the EU (Fortezza & Rama, 2001). A key policy focus has thus been government-led legislation to revise or rescind aspects of the labour codes in the region. Third, have been proposals to restructure and reform the public services by introducing user fees for services; means testing of social benefits; reducing the public sector wage bill by cutting jobs and/or restricting wage growth; and altering pay systems to merit based rather than seniority based pay. These proposals have had implications not only for public servants but also for a whole range of state (and trade union) functions. They have been accompanied by attempts to increase public sector transparency and reduce corruption, by reforming human resource management procedures and practices within public sector organisations. Fourth, has been pension reform, which involves system restructure with the net effect of reducing the value of pension payouts and/or increasing pension enactment age. This has proved to be a highly contentious area, especially in formerly state owned enterprises, which are either continuing to fail or have been recently privatised.

Cosmopolitan Democracy and the IFIs

The shift in IFI policy approach from 1999 is a reflection not only of the acknowledged failure of the IFIs to address poverty but also the gathering storm of ‘Northern’ global justice protests beginning in Birmingham in 1998. It followed on from the 1997 East Asian financial crash, which at one time threatened to severely damage Western based economies leading to sober reflection in the Washington-Treasury axis, especially with regard to the continued ability of the IFIs to finance reconstruction (Lavigne, 1999). In addressing this period the former ‘insider’ at the World Bank, Joseph Stiglitz, admonished the IFIs and pointed to their subservience to the economic...
interests of creditors over that of recipients (Stiglitz, 2002). The implication being that the IFIs needed to be reformed to allow more transparency and democracy in their work.

The second cosmopolitanised (the ‘Post-Washington’ or ‘augmented’ Consensus) model addresses these problems directly. In this model the IFI–labour relationship acts in pluralist fashion, whereby conflict between labour and the IFIs is contained and resolved institutionally. It parallels wider moves within supranational institutions to debate policy options in joint forums with the International Labor Organisation (ILO), and in the construction of International Framework Agreements (IFAs) between employers, states, NGOs, and Global Union Federations (Hammer, 2005). Ackers (2002) and Ackers and Wilkinson (2003) identify globalisation as a redefining force and have offered a ‘neo-pluralist’ or ‘new institutionalist’ paradigm, which they argue is vital to develop if trade unions are to retain societal legitimacy through such processes as workplace partnership and social dialogue. This is significant in wider terms, as it raises further questions about the form and content of social dialogue frameworks within transformation states, and what, if any, role the IFIs might play in the process. There is indeed a deeper sense that the World Bank is prepared to engage with new theoretical paradigms emanating from within international relations of ‘cosmopolitan social democracy’ generated by global governance theorists, which call for more transparency, democracy, and social justice within IFI deliberations (e.g. Held, 2002, 2004; Woods, 2002). Citing Anthony Giddens the Bank refers to the development of:

... a more cosmopolitan form of society that acknowledges a newly emerging power structure where government, the market and civil society all need to be constrained in the interests of social solidarity and social justice. (World Bank, 2005b, p. 19)

However, the concept of cosmopolitanism spans across a range of socio-political alternatives. In its moderate formation ‘Third Way’ cosmopolitanism, or neo-pluralism, has been critiqued for accommodating to, and legitimising, neoliberalism (Callinicos, 2001). In its more progressive form the concept envisages a proactive civil society ‘from below’ whereby CSOs, including trade unions, would seek to form alliances against the hegemony of neoliberal restructuring in a counter-hegemonic project following a neo-Gramscian framework (Cox, 1999; Falk, 1998).

**Neo-Gramscian Interpretation**

Critical analyses would suggest that the hegemony of the IFI position is located structurally and ideologically. From a radical perspective Gowan (1995, 1999) suggests a ‘Faustian’ dominance of US military-industrial-political interest in policy formation, and Harvey (2003) alludes to the asset-stripping nature of the process as ‘accumulation by dispossession’. Such critiques refer to the disciplining effect on labour that the IFIs have through conditions attached to Structural Adjustment Programmes and Millennium Development Goals. These views can be described as supporting a dominant-subservient model of the relationship between the IFIs and labour. A financial dominance results from a crisis of overproduction in the West whereby capital has shifted to less developed countries in an effort to revive international levels of profitability and capital accumulation (Brenner, 2002; Harvey, 2003). Labour is disciplined within this process as capital mobility increases whilst labour mobility is restrained within a world economy abounding with excess capacity (Mann, 2003). In other words, the potential structural power of collective labour is severely constrained by IFI policies, which act to create excess global labour supply. Gill (2000) argues that this disciplining of labour, reflected both in work intensification and a rising rate of exploitation, is nevertheless contradictory in that it
inspires new forms of labour resistance. Neoliberalism thus becomes highly contested and capable of mutation and realignment (Peck & Tickell, 2007). This resistance can be the root source of social movement type unionism of increasingly disenfranchised and dispossessed workers in both ‘North’ and ‘South’, who seek to go ‘beyond the workplace’ and even ‘beyond the nation state’ in an effort to respond to the pervasive societal effects of neoliberalism (Moody, 1997; Silver & Arrighi, 2001).

In addition to creating a base for the realities of shifting workplace power, the IFIs have been accused by those from a neo-Gramscian perspective of producing a new ideological dominance. It is suggested that there is a collusion of new values grouped under the neoliberal umbrella, which closes down space for dissent. This *pensée unique* is expressed in concrete form by the IFIs and the power that they wield over transforming states subjugated by their dependence on IFI support. Such subjugation poses a problem for resistance as it is argued to involve the creation of a new ‘transnational class’ (Van der Pijl, 1993, 1997), who are included in the globalisation process at the expense of those who might wish to take an oppositional stance. Within transformation states this new ‘transnational class’ might even be the old elite who have conveniently reformed their ideology in an attempt, as Hankiss (1990) and Haynes and Husan (2002) have argued, to ‘step sideways’ from command to market economy. The process has some sophistication. Woods (2006, p. 122), for example, in describing IFI involvement in Russia, refers to the search for ‘sympathetic interlocuters’ who might oil the country specific agendas of the IFIs. Of course, rather than being a unified transnational elite, individual state elites compete among themselves for a share of foreign direct investment (FDI) and other external investment funds, but this process of competition only has the effect of pushing them even further down the neoliberal road in a race to the bottom. Gramsci (referring to Italian fascism’s absorption of American management techniques) described such a process as ‘passive revolution’ or *transformismo*, whereby a new order is created *from above* which crushes political or economic space for internal dissent and opposition (Gramsci, 1978; see also Cox, 1993; Morton, 2007). In other words, the IFIs might act not only as agents of Western economic dominance but also consolidate a new institutional architecture by ideological means. A new civil society is created ‘from above’, which accommodates itself to the imperatives of neoliberalism. This wide-ranging process of accommodation also has the capacity to infect alternative or competing social projects. Most tellingly social democracy may be profoundly affected, and mutates to what has been described as ‘social liberalism’ in the field of social and industrial policy. The previous accommodation between state, capital, and labour is tipped to the advantage of capital at the expense of labour and is accompanied by a withdrawal of the state from many of its previous welfare activities (Bourdieu, 1998; Deacon & Hulse, 1997; Jessop, 2002a). Some argue that this combination of ideological imposition, power in practice, and the consequent global institutional architecture consolidates a new dominance of finance based capitalism (Cammack, 2002; Moore, 2005; Soederberg, 2002). However, while the IFIs have created the new framework the net outcome is not merely in the interests of finance capital, but rather in the general economic and industrial interests of Western, particularly US-based industrial capital.

**Emergent Evidence of the New IFI Approach**

Evidence of the policy shift emerged from the decision on the part of the two major IFIs to declare poverty reduction to be their overarching goal at the Annual Meetings of the IMF and World Bank held in September 1999. Two subsequent key World Bank documents consolidate the new thinking. The first document emanated from the World Bank’s Social Protection
Advisory Service as a discussion document in 2004 (Egulu, 2004). The paper, written by one of the ICFTU African representatives, focuses on the ‘weaknesses and shortcomings which have limited the effective participation of trade unions’ in the World Bank programmes and calls for ‘... more dialogue between the labour movement and the IFIs, strengthening trade unions, building union capacity and more analytical work on labor market policies and core labor standards’ (Egulu, 2004, Executive Summary). The concern about lack of trade union involvement followed an evaluative document of the World Bank of countries in transition, which noted the positive effect that trade union lobbying had on limiting corporate corruption so that ‘... greater emphasis should be placed on building local constituencies—not merely entrepreneurs, but workers and reform-minded politicians as well—capable of demanding further policy reforms’ (World Bank, 2004c, p. 20). Under the revised approach recipient states are required to draw up a Poverty Reduction Strategy Paper (PRSP) to identify targets for poverty reduction outcome indicators. This is then translated into a Country Assistance Strategy (CAS), which includes country political initiatives in return for financial assistance. This runs in parallel with changes in the IMF, where in the field of macro-economic fiscal and monetary adjustment the former Enhanced Structural Adjustment Facility (ESAF) is now called the Poverty Reduction and Growth Facility (PRGF). The new approach is now meant to have a wider rubric, inclusive of poverty reduction. The targets will become conditions to be assessed by the IFIs to determine the country’s access to debt relief and loan support. In addition, the IFIs are anxious to encourage the involvement of both states and CSOs in drawing up the PRSP whereby both the IMF and World Bank stipulate that the PRSP is to be formulated by the borrowing government, rather than by the IFIs. The World Bank approach to ‘civil society’ has been clarified in a second key document that includes both NGOs and trade unions within a ‘definition’ of civil society organisations (World Bank, 2005b). The document states that the Bank’s activities should include ‘facilitation, dialogue and consultation, and partnership’ (Ibid., p. ix). The report is clearly a response from the Bank to the global justice movement to which the Bank gives recognition. Some NGOs, however, have questioned the sincerity of the new approach. The European Network on Debt and Development, for example, after conducting a survey of PRSPs, found that while they do focus on safety net provision the macroeconomic policy remains indistinguishable from the previous era. Özis and Şenses have similarly argued: ‘The Post Washington Consensus represents a response by the dominant establishment to the deficiencies of the neoliberal agenda and an attempt by them to overcome such deficiencies through a set of reforms that takes the existing structures of power as given’ (2005, p. 285). Observers have criticised the degree of participation with civil society as ‘little more than consultations with a few prominent and liberal CSOs’ (Bello & Guttal, 2005, p. 6). Rodrik refers to the ‘augmented’ Washington Consensus in these terms:

The trouble with the Augmented Washington Consensus is that it is an impossibly broad, undifferentiated agenda of institutional reform. It is too insensitive to local context and needs. It does not correspond to the empirical reality of how development really takes place. It describes what ‘advanced’ economies look like, rather than proscribing a practical, feasible path of getting there. In short, the Augmented Washington Consensus is infeasible, inappropriate, and irrelevant. (2002, p. 1)

The question then arises as to what degree has the new model of the IFI refined or advanced its role as a ‘fourth actor’ in labour relations? Is there real change from which trade unions and labour interests can seek to improve their position, or is the IFI strategy merely a cosmetic ‘flanking mechanism’ (Jessop, 2002b) designed to incorporate and institutionalise worker opposition
within civil society? The following section seeks to address these questions by reference to the actuality of IFI activity in selected cases from the former Yugoslavia.

Initial evidence from the ICFTU suggests that the new participatory approach of the IFIs has had little impact on trade union efforts to moderate or change intended labour market reform. A Statement issued by the ICFTU and the Global Unions’ Federations (GUFs) in 2005 claims that ‘Although the IFIs frequently proclaim that the “Washington Consensus” of the 1980s and 1990s is dead, classic structural adjustment conditions continue to be attached to the HIPC (Heavily Indebted Poor Countries) programme and many IFI loans’. Giving the examples of highly indebted countries such as Zambia and Uganda the Report found that ‘In a recent survey of Poverty Reduction Support Credit (PRSC) loans granted by the World Bank to thirteen low-income countries, the European Network on Debt and Development found that in eleven out of the thirteen cases the Bank imposed privatization conditions. In some cases, the PRSC conditions contradicted policies adopted in government-prepared Poverty Reduction Strategy Papers (PRSP)’. It is not only highly indebted countries that appear to be suffering from continued neoliberal prescriptions. The same Global Unions report concludes that in Turkey in May 2005, ‘the IMF approved a new $10 billion loan which included 29 new financial and structural conditions, including the generation of a sizeable primary fiscal surplus, privatization of $1.5 billion worth of state-owned assets within eight months, placing strict controls on public sector hiring, undertaking a review of civil service wages, and adopting new pension and social security reform legislation. The IMF also called for “improved labour market flexibility”’(IMF, 2005a). Additionally, an ICFTU Survey of unions in the CEE and Newly Independent States (NIS) of the former Soviet Union in 2001–2003 found that the IFIs do not operate ‘in an open, accountable, transparent way’ and that ‘although a certain level of participation of trade unions . . . was achieved in the last three year period . . . there is still a lack of consultative mechanisms’ (ICFTU 2003, p. 7). Such IFI intransigence is located in the dominant influence of the World Bank’s Doing Business framework approach. The prescriptions emanating from successive Doing Business reports state that ‘rigid’ labour markets impede market competition. These messages pervade the World Bank’s Doing Business rankings whereby content analysis is utilised to assess input indicators of labour market rigidity and barriers to entrepreneurialism.10 As expected the indicators for ‘hiring and firing’ place labour protection as a negative source of business efficiency and provoke hostile responses from trade union federations on a national and international basis. It has led the ICFTU’s director to demand ‘that the whole topic of labour regulations should be removed from the purview of the Doing Business report’ particularly as:

*Doing Business* has been used to push countries to bypass tripartite consultation mechanisms for reforming labour laws and, despite the publication’s implicit endorsement of the core labour standards, has been used to encourage countries to eliminate measures which have been put in place to implement core labour standards, such as programmes to end discriminatory practices. (Bakvis, 2006)

**The Former Yugoslavia**

The former Yugoslavia provides an ideal laboratory to explore the role and influence of the IFIs on industrial and labour relations. Yugoslavia developed significant external debt commitments in the 1980s, and the IMF had been active in enforcing conditionality on Yugoslavia in return for continued financial lifelines. In 1989 this conditionality, agreed with the Belgrade nomenklatura, included wage freezes, cuts in government spending, and the elimination of socially owned, worker-managed companies. Chossudovsky (1997) observes that the ensuing social tensions, combined with the forced inability of Belgrade to continue to finance provincial
social welfare programmes, was a key factor in the secessionist breakaway by Slovenia and the ensuing civil wars.

After the wars the newly formed states were quickly reintegrated into the international financial community by becoming new members of IFIs and associated organisations such as the IMF, World Bank, European Bank for Reconstruction and Development (EBRD), and the WTO. However, the ‘internal’ market of Yugoslavia was fractured as a result of the wars, and in one state, Serbia and Montenegro, the period of UN sanctions and NATO bombing had further depressed the economy. The need for external financing to rebuild the shattered economies of the region was paramount, and reliance on the IFIs to help provide this funding was to the fore.

Arandarenko (2004, p. 49) has argued that the IFI agenda had imposed itself in the Western Balkans (including the former Yugoslavia) not because of the terms of conditionality, but because: ‘In terms of articulation and elaboration—not necessarily in terms of content and prescriptions—the World Bank’s agenda is simply superior to others. World Bank messages are simple ... and easily translated into workable action programmes’. Such an interpretation may be overly simplistic and too reliant on a form of social capital reductionism. In a more sober analysis, Woods (2006, p. 63) has placed emphasis on IFI ‘groupthink’ in which ‘faith-based blindness’ and reliance on a ‘template’ leads to ignorance of local sensitivities and, more importantly, possible mistakes in the message. Greater forces of political economy are at work, which provide an explanation of IFI dominance. Considerable variation exists in the labour markets of the new countries of the former Yugoslavia, which have already been identified by Arandarenko (2004). As can be seen in Table 1, levels of gross national income (GNI) per capita vary enormously across the region, with Slovenia the richest nation and BiH the poorest (closely followed by Macedonia). Across most of the region (apart from Slovenia) industrial production has struggled to reach the levels of the pre-conflict period, unemployment is high and the informal economy has burgeoned. Comparing 2003 with 1989, real gross industrial output in BiH (excluding Republika Srpska) fell by 86.5%, by 48.3% in Croatia, by 61.2% in Serbia and Montenegro, and by 54.5% in Macedonia (UNECE Common Database). Within the same countries total employment fell over the same period by 39.6% in BiH, by 26.7% in Croatia, by 21.9% in Serbia and Montenegro, and by 48.2% in Macedonia. This decline of production and employment is a typical feature of most transformation states in the CEE and NIS (Rainnie et al., 2002). However, the degree of decline has been worse in the former Yugoslavia as it has been accompanied by the debt overhang, making possibilities for internally led and funded regeneration more remote, and reliance on either FDI or IFI finance more important. Total external financial support for the whole South East Europe region (former Yugoslavia plus Romania, Albania and Bulgaria) amounts to approximately 6.5 billion Euros in each year since 2000 with a notable shift in funding away from bilateral sources (including the EU) towards the IFIs. In 2005 it was estimated that the IFIs would provide 60% of all loans and grants, compared to 40% in 2000. There has also been a shift to loan rather than grant funding over the same period (Office for South East Europe, 2005). As well as loans and grants from ‘official sources’ funding has been sought from private investors. Not to be forgotten as an additional source of inward income is workers’ remittances from abroad, which, as Table 1 indicates for some countries (e.g. BiH and Serbia and Montenegro) outstrip both FDI and official loans and grants in total value. All of the countries concerned have engaged in variable forms and processes of social dialogue between unions, governments, and employers with varying degrees of success and failure (with the greatest claimed ‘success’ in Slovenia). The process of social dialogue has been encouraged both by entry into the International Labour Organisation and its Recommendation No. 113, and
Table 1. Selected economic indicators, Western Balkans

<table>
<thead>
<tr>
<th></th>
<th>EU EuroZone</th>
<th>Bosnia and Herzegovina</th>
<th>Croatia</th>
<th>Macedonia, FYR</th>
<th>Serbia and Montenegro</th>
<th>Slovenia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population, total million</td>
<td>(306)</td>
<td>314</td>
<td>3.9</td>
<td>4.4</td>
<td>2.0</td>
<td>8.1</td>
</tr>
<tr>
<td>GDP (current US$ billion)</td>
<td>(5.4)</td>
<td>(19.8)</td>
<td>(3.4)</td>
<td>(11.6)</td>
<td>(19.8)</td>
<td>(26.2)</td>
</tr>
<tr>
<td>GDP growth (annual %)</td>
<td>(2)</td>
<td>(4)</td>
<td>(4)</td>
<td>(-5)</td>
<td>(5)</td>
<td>(3)</td>
</tr>
<tr>
<td>GNI per capita, Atlas method (current US$)</td>
<td>(21,227)</td>
<td>(1,480)</td>
<td>(4,390)</td>
<td>(1,710)</td>
<td>(1,290)</td>
<td>(10,410)</td>
</tr>
<tr>
<td>Unemployment (%)²</td>
<td>45.5</td>
<td>12.7</td>
<td>37.2</td>
<td>31.6</td>
<td>6.1</td>
<td>(5)</td>
</tr>
<tr>
<td>High-technology exports (% of manufactured exports)</td>
<td>(17)</td>
<td>n/a</td>
<td>(10)</td>
<td>(1)</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Foreign direct investment, net inflows (current US$ billion)</td>
<td>0.3</td>
<td>1.8</td>
<td>1.0</td>
<td>1.5</td>
<td>n/a</td>
<td>0.5</td>
</tr>
<tr>
<td>Official development assistance and official aid (current US$ bn)</td>
<td>0.64</td>
<td>0.11</td>
<td>0.25</td>
<td>(1.3)</td>
<td>(0.13)</td>
<td>n/a</td>
</tr>
<tr>
<td>Long-term debt (current US$ billion)</td>
<td>2.5</td>
<td>12.0</td>
<td>1.3</td>
<td>(6.8)</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Workers received remittances (US$ billion 2005)</td>
<td>1.8</td>
<td>1.2</td>
<td>0.2</td>
<td>4.7</td>
<td>0.2</td>
<td>n/a</td>
</tr>
<tr>
<td>Internet users (per 1,000 people)</td>
<td>(279)</td>
<td>(12)</td>
<td>(117)</td>
<td>(35)</td>
<td>(74)</td>
<td>(301)</td>
</tr>
<tr>
<td>Gini Coefficient for Income (1998 and 2006)³</td>
<td>USA</td>
<td>n/a</td>
<td>(29.0)</td>
<td>n/a</td>
<td>n/a</td>
<td>(28.4)</td>
</tr>
</tbody>
</table>

Notes: 1. Excluding Kosovo. 2. Unemployment rates are official figures, actual unemployment may be less due to presence of informal/grey economy. 3. The higher the coefficient then the greater the income inequality.

by pressure from the European Union, either as a precursor for possible entry into the EU, or as part of the EU’s Stability Pact for South Eastern Europe and its ‘Initiative for Social Cohesion’. Durić (2002) provides a comprehensive review of developments in social dialogue in the region, stressing both the weakness of the process but also its potential importance in developing new ‘civil society’ within a post conflict and post Communist arena.

Reducing Labour Protection

Government measures to introduce changes to labour codes, including protective arrangements for dismissed workers have been a central feature in the transformation economies, including those of the former Yugoslavia. Examples gathered from documents of ICFTU and from interviews with trade union representatives in the region, illustrate the difficulties where changed legislation has been contested by the unions with indirect or direct interference from the IFIs.

Croatia’s first post-independence labour law was passed in 1996 and amended in 2001, guaranteeing the right to strike after unions have gone through dispute arbitration. However, new government proposals to change the labour law in Croatia flowed directly from a five-point reform programme announced by the World Bank in December 2001. The new law was proposed outside of the existing tripartite consultative structures and without any discussion or contact between the IFIs and the trade unions. It included reduced job security rights, reduced protection against dismissal, reduction of severance pay and elimination of tripartite negotiations for the minimum wage. Initial strikes against the proposals began in 2002 involving telecomm and postal employees, and health service employees. The proposals later provoked a joint union protest of the five union federations outside the Parliament buildings in Zagreb in February 2003 and a threatened general strike but also led to a direct approach from Guy Ryder, ICFTU General Secretary, to the World Bank President James Wolfensohn in an unsuccessful effort to rescind the proposed law. The regional director of the Bank in Croatia had claimed in an article published in the Zagreb press that ‘within the EU the countries with the most flexible labour legislation had had the highest growth rates, while those with labour policies that provide for workers’ protection are among countries with the lowest growth rates’. The director subsequently met with the leader of the SSSH union federation (Union of Autonomous Unions of Croatia) where the argument that labour flexibility was good for growth was repeated by the director. The IFI position was paralleled by the government after Deputy Prime Minister Goran Granic’s statement that the current labour law was one of the main obstacles to having more foreign investment. Under threats of further union action against the labour reforms the government backed down and opened negotiations with the unions leading to a watering down of the original proposals in the Bill. IFI involvement in drafting the new Bill has always been denied by the IFIs themselves. Evelin Toth Mucciacciaro, director of international affairs at the Union of Autonomous Trade Unions of Croatia, however, claims that the IFIs always claim ‘that changing the Labour Law was exclusively the desire of the Government’ (cited in ICFTU, 2006). More direct inference of IFI involvement is provided by Jasna Petrovic, the editor in chief of the ICFTU’s CEE Network Bulletin who claimed in an article in 2002 that the World Bank had used an ‘American democratic foundation’ to ‘finance the assignation of a labour “expert” to the Croatian government’s Office for Social Dialogue, where his first job was ‘to organise a meeting on amendments on labour legislation with arguments of Europeanisation and standardisation’. Evidence of IFI policy can also be gathered from IMF documents urging the Croatian government to give priority to pension and health sector reform and to ‘create appropriate regulatory frameworks’ for privatisation as well as ‘economy-wide wage restraint’
In a document associated with a US$202 million structural adjustment loan the World Bank in its 2003 Country Economic Memorandum also suggested the need for labour market liberalisation to lower the cost of individual dismissals and lower severance payments, and, more pertinently, to ‘decentralise and deregulate industrial relations’ and to ‘move away from industry level bargaining toward firm level bargaining’ (World Bank, 2003).

As a potential way out of the economic crisis following the wars in Serbia, the government has been keen to co-operate with the triad of IFIs by both renewing its membership of the IMF in December 2000 and rejoining the World Bank and the European Bank for Reconstruction and Development (EBRD). A World Bank-European Commission sponsored Donors’ Conference held in June 2001 raised $1.3 billion for economic restructuring. Two-thirds of the country’s $4.4 billion Paris Club debt was written off in an agreement concluded in November 2001. Despite this write-off Serbia’s total debt remains considerable at US$18 billion compared with a GNP of 10.5 billion. Ten billion of the debt is private, mostly to private banks. Further tranches of money have been loaned as reform programmes have been enacted. Progress with the IFIs remains difficult, however, because of the unresolved question of internal identification of alleged ‘war criminals’ to the Hague Court. The entry into the international financial community has not been without its price. The key focus of dispute between the unions and the state in Serbia has been the implementation of the 2001 Labour Law, and the associated rights to representation and to strike. The right to strike is recognised, although restricted for those in ‘essential services’ who must give at least 15 days warning of a strike. The new law also makes it much easier to dismiss workers, in line with efforts to remove labour market ‘rigidities’. The 2001 law was constructed within a framework of social dialogue in so far that the trade union federations were informed of the nature of the new legislation in its draft form. However, both the main union federations, Nezavisnost and SSSS (Confederation of Trade Unions of Serbia), complained of ineffective consultation mechanisms and felt the need to resort to open protests and strikes against the law. Both the World Bank and IMF had been active in drafting changes to the proposed legislation before it was issued to the unions and when it was finally relayed to the unions by the labour minister he claimed it as ‘very good law’ because it would provide ‘a friendly environment for investment’. Slavko Lukovic, the general secretary of Nezavisnost, stated that the unions were not told of the World Bank’s involvement officially, but learnt of the changes by ‘visiting the Bank’s website’. Commenting favourably on the new Law the EBRD stated ‘The new labour law that came into force in December 2001 is very free-market oriented ... The most important feature is that, in comparison with the previous labour legislation, the new law is more liberal regarding employment procedures and termination of employment, thus giving more flexibility to employers. It eliminated those features that were viewed as overly protective for workers and highly restrictive for managerial functions’ (EBRD, 2004, p. 15). The ILO had also made 170 observations on the new law of which less than 10% were accepted, further fuelling the suspicions and anxieties of the unions. The neoliberal intent of the 2001 Labour Law, and the ineffectiveness from the union standpoint of the process of social dialogue, appears to have confirmed the weakness of social dialogue as a vehicle for progress by the unions. In May 2004, however, the new government made a move to strengthen the formal structures of social dialogue by introducing a draft law for a revamped Social and Economic Council to include representatives from the government, employers’ organisations, and the three union federations. Key union demands are the removal of a clause in the existing law stipulating the need to gain the enterprise director’s written approval before any claim for representativeness can be lodged. The difficulties surrounding conditionality, particularly the IMF insistence on fiscal tightness, are a probable reason for the decision of the
The Serbian government to pay off its debts to the IMF in April 2007. Analysts predict the likelihood of Serbia seeking loans instead from the private sector (Bozinovich, 2007).

The State of Bosnia and Herzegovina (BiH, generally referred to here as Bosnia) represents a complicated dynamic of change and development. The state remains divided into the two entities of the Federation of Bosnia and Herzegovina, and the majority Bosnian Serb Republika Srpska, plus the internationally supervised Brcko District. Whilst it is a sovereign state control also rests with the Office of the High Representative (OHR) until recently led by the British Liberal Democrat politician Paddy Ashdown. Bosnia joined the IMF in 1992 and the World Bank in 1993 from which it began receiving loans in 1996. Originally classified by the Bank as a post-conflict nation, it has since July 2004 has been reclassified as a transition country. The unstable nature of the country resulting from the wars has meant the country is subject to considerable NGO activity as well as substantial assistance from the US government under the USAID programme. In fact USAID is by far the largest financial donor, and exercises considerable influence as a result, both by building infrastructure and encouraging ‘institution building’. Bosnia receives the lowest proportion of FDI per capita in the region, and so is particularly dependent on IFI support. Bosnia has so far received eight World Bank adjustment loans and is subject to 43 investment projects totalling more than one billion US dollars. In addition Bosnia has loans still outstanding to the IMF of $99 million, which are subject to conditions to reform the credit and banking system. Both the IMF and the World Bank have also sought to reform the labour market. In its most recent document relating to Bosnia the IMF Directors refer to the need for:

... labor market institutions... to be transformed to encourage job creation during and after the corporate reforms. In this context, regulations allowing the indefinite accrual of wage rights, regardless of attendance for work, should be rationalized, and restrictions on the dismissal of workers relaxed. Directors were of the view that wage indexation should also cease, so as to moderate wage growth and engender a better balance between wage and employment growth. (IMF, 2005b)

The country is subject to a 2004–2007 CAS under the new World Bank approach, and hence ‘ownership’ of Bosnia’s associated PRSP is that of the government (rather than the Bank). In developing the PRSP it should now be expected that the Bank’s new rubric of ‘facilitation, dialogue and consultation, and partnership’ should be observed. The actual process of drafting the PRSP, published in 2004, did involve consultations with NGOs and government related agencies. Some doubts have been expressed as to the value of the consultation process. For example, a report by the Save the Children states that it believes ‘... the BiH PRSP was written by consultants and is being withheld from public view’. A report prepared for the UK government Department for International Development (DFID) also refers to European Union ‘concern at the (Washington-driven) proposed timetable ... that would result in a poor quality PRSP which donors could not coordinate’ (Coyle & Evans, 2003). As far as the trade unions were concerned consultation meetings began in April 2002 when trade union representatives were consulted by the Ministry of Foreign Trade and Economic Relations. A number of further meetings with unions took place on a bilateral level before World Bank officials agreed to meet leaders of the three union federations (from the Federation, Republika, and District). At this meeting, on any contentious issue, the unions were told to ‘Go to your Government and discuss this’. This marked a change from when they had previously met the Bank to discuss the drafting of the 1999 Labour Law, when according to the Regional Officer of the ICFTU in Sarajevo—‘World Bank representatives would leave the room and phone Washington to see if the proposals were acceptable!’ The first draft of the PRSP contained a chapter on labour
market issues, including the intention to ‘ease minimum wage requirements and abolish the seniority salary supplement’. Despite union objections the final version, issued in April 2004, contained the following statement:

In the coming period, all levels of government in BiH will be required to drastically reduce public expenditures and particularly public sector wages. In this context, and in order to reduce existing wage system anomalies, it will be necessary to gradually reduce such benefits as hot meals, vacation subsidies and, at later stage, to eliminate compensation for past labor.21

The three unions subsequently submitted a document commenting on the PRSP in April 2005 in which they outlined the case for continuing privatisation, process transparency, adequate social protection, and workers’ rights.22 Outwith the PRSP, disputes over other substantive issues remain unresolved. The unions fell into dispute with the government over labour standards and called a joint protest demonstration outside government buildings in Sarajevo over the introduction of the 2004 Law on Bankruptcy and Liquidation, which reduced severance payments and job continuity rights. Most importantly, recent government proposals to ‘de-couple’ the minimum wage from average earnings reflect the wider agenda on labour market reform proposed by the IMF.

Trade unions in Macedonia found themselves in dispute with their government in 2001/2002 over planned changes to the law on severance payments for workers made redundant from loss-making ventures. The union federation calling the dispute, the Federation of Trade Unions of Macedonia (SSSM), claimed that the old regulations had been ignored in a number of cases under direct pressure from the IMF. The SSSM met with government officials in January 2002 and called for direct negotiations with the IMF on the disputed payments and followed this request with a series of road blockades in the Skopje region led by workers from a number of local factories. The old legislation allowed older workers with over 25 years of service to receive special protection, the payment of due wages and contributions, as well as more extensive rights for the unemployed. SSSM immediately launched initiatives for amendments to the relevant legislative provisions. Following the protests and blockades, another meeting was held with government representatives but no progress on the issue of severance or on the meeting with IMF representatives was achieved. The SSSM then sought a meeting with representatives of the loss-making companies and announced a series of new protests. As with Serbia, the government of Macedonia decided to pay off its debt to the IMF in 2007.

A similar protest was instigated by the trade union federation Confederation of Independent Trade Unions of Montenegro (SSSCG) in Montenegro over the drafting of a new Labour Law. The first draft had been agreed between the unions, the government and employers in 2001 and had got to the Montenegrin Parliament for final approval and legislative action. However, progress on the new Parliamentary Bill was halted when the government claimed that it did not comply with various ILO standards. The Bill was then redrafted to include new clauses encouraging flexibilisation of contracts designed, it was claimed by the government, to discourage informal working. These new proposals were aimed at reducing the value of severance payments and maternity leave and redefining the coverage of the legislation to include part-time work. The union federation claimed that the sudden change, conducted without union consultation and under the false guise of the ILO, was actually at the behest of the IMF, who were simultaneously negotiating the terms of a new loan to the Montenegrin government. In May 2002 the SSSCG consequently organised street protests and a petition opposing the new Bill.
These case vignettes are of interest for two reasons. First, they exhibit a similar pattern of government proposals to amend labour law and an inference of either direct or indirect IFI influence in the legislative process. Second, they indicate a high level of contestation by the trade unions. Third, they indicate a preparedness of government to by-pass or ignore existing tripartite structures. In effect governments have vacillated between a consensus approach and a unilateral approach to labour reform, adopting a unilateral approach only when it was clear that there would be a failure to secure trade union agreement to change.

Assessment

The objective of this article has been to try to assess the precise role of the IFIs in shaping labour markets and employment relations, and to relate the evidence to theoretical frameworks. First, the evidence would suggest that there is a common theme to the IFI approach to labour market reform, which includes privatisation of state-owned enterprises; a programme of flexibilisation of contacts and regulations on hiring and firing; decentralisation of collective bargaining away from former national systems; a reduction in the public service wage bill; a dilution of the minimum wage; and an increase in wages and salary differentials in an effort to retain professionals and incentivise staff. There remains continued commitment to the ‘trickle-down’ approach to economic development albeit now supplemented with supply-side economics focussing on improving health, education provision, and the building of both social and human capital. This implies an active private, rather than public sector role and this, together with the associated labour market reforms continue to impose negative structural constraints on workers’ employment rights and job security. IFI policies may continue to exacerbate poverty levels, by increasing unemployment (at least in the short-term), and by institutionalising low pay by diluting the minimum wage, increasing wage differentials on a nil cost basis, and dismantling the collective bargaining power of unions. Indeed, the World Bank admits as much in its own collected evidence in reporting that:

... union density ... appears to have little or no impact on comparative labour market performance
... there is, however, one significant exception ... high union density is associated with compression of wage distribution and a reduction of earnings inequality. (World Bank, 2003)

However, trade unions have a difficult strategic problem to face in that they are most often active supporters of the privatisation process and market reform on the ‘Western model’, and wish for an influx of foreign ownership to solve the problems of low internal capital accumulation. Their ability to construct an opposing stance to the policies of the IFIs is consequently constrained by their acquiescence to the market imperative.

Second, the evidence would suggest that the IFIs’ new approach to civil society empowerment still has not effectively included the collective labour interest represented by trade unions. Where processes of national social dialogue have been in place (albeit tentative in most cases) governments have been prepared to ignore or by-pass consultation arrangements whenever the policies demanded by the IFIs are likely to be opposed by unions. Unions have been left out in the cold and resorted to street protests, strikes, and demonstrations as a result. The union relationship with the IFIs has been similarly constrained, meetings and dialogue have taken place, but effective and meaningful consultation, with the ability to change minds and alter proposals has appeared to be generally absent. The argument presented here would support the proposition that the new turn in the IFIs towards CSO empowerment, at least for trade unions and collective labour interests, is designed to demobilise opposition to the
continuing ideological dominance of neoliberal market reform. Rather than embrace the concept of cosmopolitan social democracy the reality is that participation is being utilised to ‘institutionalise’ a particular market-based ideology. The concept of ‘civil society’ in this instance is ‘from above’ rather than in its Gramscian ideal ‘from below’. Within this process there is a collusion of interest between the IFIs and the newly empowered governments who have technical ownership of the CAS and PRSP, but who have ‘bought-in’ to neoliberalism either because they have little alternative choice or because they perceive they will benefit from the outcomes. We could describe the result as utopian liberalism, whereby the reality of the liberal market economy is obscured and transcended by the illusion of consensus (Upchurch & Weltman, 2007). This presents a different conclusion to Arandarenko’s (2004) social capital based contention, which, by its own logic assumes the possibility of neo-pluralist outcomes in the region. The problem being that social capital is neither ideologically or class-neutral, but must be assessed within existing power structures (Das, 2006). As Martin and Cristescu-Martin (2004) also suggest, the observable ‘system incoherence’ of transformation economies is incompatible with conventional pluralist systems thinking. Such an analysis does not bode well for the future of social dialogue. Many commentators have attempted to explain the fragility of social dialogue in post-Communist countries as a result of labour weakness brought about by fragmented unions and negative historical legacy (e.g. Ost & Crowley, 2001). To complement ‘labour weakness’, the preceding analysis would suggest that the problems of social dialogue are located in structural constraints whereby powerful and influential IFIs, despite their commitment to ‘institution building’, have a smothering effect on collective labour interest due to their overwhelming commitment to free market-based capital accumulation strategies. Where social dialogue mechanisms and forums are established they are more likely, as Tatur (1995) argues, to be forms of ‘paternalist neo-corporatism’, whereby the state attempts to seek legitimisation of neoliberalism (cf. Thirkell et al., 1998). The weak base of the trade unions thus creates a dilemma whereby participation in mechanisms and processes of social dialogue allows them to acquire legitimacy, but only at the expense of their ability to effectively represent the collective interest of labour.

This is not to argue that the trade unions should ignore the processes of CSO empowerment but rather that they should seek to build their capacity to engage the IFIs in open debate about the social and economic consequences of their policies. Indeed, the ITUC and the Global Union Federations now claim some progress in encouraging the IFIs to embrace the discourse of Core Labour Standards (ICFTU, 2006). However, any ‘counter normative’ socio-economic argument constructed by organised labour will need to be combined with a combative agenda to mobilise against labour market ‘reform’. Trade unions are the largest civil society organisations in transforming economies, with high potential associative power. But while their structural power remains constrained by economic factors unions will need to push outwards to embrace other social movement actors in their defence. As such a more openly politicised union response is demanded.

Notes
2 Current estimates from the ILO show ‘… that in developing countries in 1997 around 534 million persons can be considered working poor. This was about the same number as in 1986 (536 million). Thus, in 1997 around 25% of the employed labour force in developing countries were working poor, the great majority of whom were living in low-income countries. The dynamics of the working poor population show that their numbers have increased in low-income countries, but decreased in middle-income countries. There seems to be also a polarization between
those low-income countries where the number of working poor are declining and those where they are increasing
thus exacerbating world inequalities’ (Employment Analysis—poverty, income and the working poor, Geneva: ILO,
2005).
3 Since November 2006 renamed as the International Trade Union Confederation (ITUC).
4 Time Series Measurement of poverty levels can be found at the UN statistical database (http://
millenniumindicators.un.org).
5 The OECD Economic Outlook 2005 (Paris: OECD) states ‘On current trends, however, OECD countries will still
have around 36 million job-seekers in 2006 (or 6.4% of the labour force), compared with 37 million in 2004 (or
6.7% of the labour force): about 35% of people of working age are without a job, and there are few signs of a
significant improvement in the next two years’. The ILO in its report A Fair Globalisation—Creating
Opportunities for All (Geneva: ILO, 2005) stated that ‘In 2003, official figures for global unemployment
reached a record high of over 185 million people.’
6 The brief of the IMF does not go as far as social protection and focuses on macro-economic policies. This is in
contrast to the micro-orientation and poverty reduction brief of the World Bank.
7 Referring to the development of the World Social Forum the document suggests that: ‘There was an overall shift
toward more peaceful engagement in the wake of the violence which occurred in 2000 and 2001 at the international
meetings in Prague, Quebec, and Genoa, and particularly after the September 11, 2001 terrorist attacks, but
experience shows that some groups remain committed to using obstructive tactics or even violence. With these
more militant groups, there is little basis for the Bank to expect that constructive relations are possible or
desirable. However, the evolution of the World Social Forum (WSF) and other civil society forums suggest that
even some of the more radical social movements may be maturing, recognizing the need to move beyond using
protest as an advocacy tool and engaging policy makers in serious debate about policy alternatives.’ (Ibid. p. xi).
9 The IFIs’ Role in Implementing Global Commitments to Achieve the Millennium Development Goals, Statement
by Global Unions to the 2005 Annual Meetings of the IMF and World Bank (ICFTU, Washington, 24–25
September 2005).
10 See the World Bank/IFC site at http://www.doingbusiness.org/.
041122annualreport.pdf.
12 See http://www.icftu.org/list.asp?Language=EN&Order=Date&Type=CEETURBulletin&Area=CEEU.
13 Quoted in http://www.icftu.org/list.asp?Language=EN&Order=Date&Type=CEETURBulletin&Area=CEEU.
14 ‘Central and Eastern European Workers Struggle to Hold Their Ground in Hard Economic Times’, an Interview
mm2002/02may/may02interviewpetrovic.html
15 Quoted in interview with author by Slavko Lukovic, General Secretary of Nezavisnost, June 2004.
16 The union was formed as an independent oppositionist union during the Milosevic period.
17 Author’s interview notes, June 2004.
18 Mid-term Development Strategy of Bosnia and Herzegovina (PRSP) 2004–2007, Sarajevo: Bosnia and
Herzegovina Council of Ministers of BiH, Government of Federation of Bosnia and Herzegovina, Government
of Republika Srpska, Office of the BiH Coordinator for PRP, April 2004.
19 SCF (UK) submission to PRSP.
20 Author’s interview notes with ICFTU office in Sarajevo.
21 Mid-term Development Strategy of Bosnia and Herzegovina (PRSP) 2004–2007, Sarajevo: Bosnia and
Herzegovina Council of Ministers of BiH, Government of Federation of Bosnia and Herzegovina, Government
of Republika Srpska, Office of the BiH Coordinator for PRP, April 2004.
22 ‘Employment and the Reduction of Poverty in Bosnia and Herzegovina Recommendations by the Unions of BiH’. 5
April 2005, Sarajevo: SSSBiH/SSRS/SDBiH.

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pp. 2–19.


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Causes and Consequences of Income Inequality: A Global Perspective

Era Dabla-Norris, Kalpana Kochhar, Nujin Suphaphiphat, Frantisek Ricka, Evridiki Tsounta
Causes and Consequences of Income Inequality: A Global Perspective

Prepared by Era Dabla-Norris, Kalpana Kochhar, Frantisek Ricka, Nujin Suphaphiphat, and Evridiki Tsounta (with contributions from Preya Sharma and Veronique Salins)

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**EXECUTIVE SUMMARY**

"We should measure the health of our society not at its apex, but at its base." Andrew Jackson

Widening income inequality is the defining challenge of our time. In advanced economies, the gap between the rich and poor is at its highest level in decades. Inequality trends have been more mixed in emerging markets and developing countries (EMDCs), with some countries experiencing declining inequality, but pervasive inequities in access to education, health care, and finance remain. Not surprisingly then, the extent of inequality, its drivers, and what to do about it have become some of the most hotly debated issues by policymakers and researchers alike. Against this background, the objective of this paper is two-fold.

First, we show why policymakers need to focus on the poor and the middle class. Earlier IMF work has shown that income inequality matters for growth and its sustainability. Our analysis suggests that the income distribution itself matters for growth as well. Specifically, if the income share of the top 20 percent (the rich) increases, then GDP growth actually declines over the medium term, suggesting that the benefits do not trickle down. In contrast, an increase in the income share of the bottom 20 percent (the poor) is associated with higher GDP growth. The poor and the middle class matter the most for growth via a number of interrelated economic, social, and political channels.

Second, we investigate what explains the divergent trends in inequality developments across advanced economies and EMDCs, with a particular focus on the poor and the middle class. While most existing studies have focused on advanced countries and looked at the drivers of the Gini coefficient and the income of the rich, this study explores a more diverse group of countries and pays particular attention to the income shares of the poor and the middle class—the main engines of growth. Our analysis suggests that

- Technological progress and the resulting rise in the skill premium (positives for growth and productivity) and the decline of some labor market institutions have contributed to inequality in both advanced economies and EMDCs. Globalization has played a smaller but reinforcing role. Interestingly, we find that rising skill premium is associated with widening income disparities in advanced countries, while financial deepening is associated with rising inequality in EMDCs, suggesting scope for policies that promote financial inclusion.

- Policies that focus on the poor and the middle class can mitigate inequality. Irrespective of the level of economic development, better access to education and health care and well-targeted social policies, while ensuring that labor market institutions do not excessively penalize the poor, can help raise the income share for the poor and the middle class.

- There is no one-size-fits-all approach to tackling inequality. The nature of appropriate policies depends on the underlying drivers and country-specific policy and institutional settings. In advanced economies, policies should focus on reforms to increase human capital and skills, coupled with making tax systems more progressive. In EMDCs, ensuring financial deepening is accompanied with greater financial inclusion and creating incentives for lowering informality would be important. More generally, complementarities between growth and income equality objectives suggest that policies aimed at raising average living standards can also influence the distribution of income and ensure a more inclusive prosperity.
I. CONTEXT

1. **Rising inequality is a widespread concern.** Inequality within most advanced and emerging markets and developing countries (EMDCs) has increased, a phenomenon that has received considerable attention—President Obama called widening income inequality the “defining challenge of our time.” A recent Pew Research Center (PRC 2014) survey found that the gap between the rich and the poor is considered a major challenge by more than 60 percent of respondents worldwide, and Pope Francis has spoken out against the “economy of exclusion.” Indeed, the PRC survey found that while education and working hard were seen as important for getting ahead, knowing the right persons and belonging to a wealthy family were also critical, suggesting potential major hurdles to social mobility. Not surprisingly then, the extent of inequality, its drivers, and what to do about it have become some of the most hotly debated issues by policymakers and researchers alike.

2. **Why it matters.** Equality, like fairness, is an important value in most societies. Irrespective of ideology, culture, and religion, people care about inequality. Inequality can be a signal of lack of income mobility and opportunity—a reflection of persistent disadvantage for particular segments of the society. Widening inequality also has significant implications for growth and macroeconomic stability, it can concentrate political and decision making power in the hands of a few, lead to a suboptimal use of human resources, cause investment-reducing political and economic instability, and raise crisis risk. The economic and social fallout from the global financial crisis and the resultant headwinds to global growth and employment have heightened the attention to rising income inequality.

3. **This note.** The objective of the note is two-fold. *First,* it shows why policymakers need to focus on the poor and the middle class. Building on earlier IMF work which has shown that income inequality matters for growth, we show that the income distribution itself matters for growth as well. In particular, our findings suggest that raising the income share of the poor and ensuring that there is no hollowing-out of the middle class is good for growth through a number of interrelated economic, social, and political channels. *Second,* we investigate what explains the divergent trends in inequality developments across advanced economies and EMDCs, with a particular focus on the poor and the middle class. In that context, we are filling a gap in the literature since existing studies typically focus only on advanced economies or a smaller sample of EMDCs. This approach allows us to suggest policy implications depending on the underlying drivers, and country-specific policy and institutional settings.

4. **Roadmap.** Section II provides an overview of the macroeconomic implications of high inequality of outcomes and opportunities and shows why policymakers’ focus on the income shares of poor and the middle class can prove growth-enhancing. Section III provides a rich documentation of recent trends in both monetary and nonmonetary indicators of inequality across advanced economies and EMDCs, while Section IV investigates the drivers of the rise in inequality, including from an empirical perspective. Section V concludes and discusses policy implications.
II. MACROECONOMIC CONSEQUENCES: WHY WE CARE

5. **Outcomes and opportunities.** The discourse on inequality often makes a distinction between inequality of outcomes (as measured by income, wealth, or expenditure) and inequality of opportunities—attributed to differences in circumstances beyond the individual’s control, such as gender, ethnicity, location of birth, or family background. Inequality of outcomes arises from a combination of differences in opportunities and individual’s efforts and talent. At the same time, it is not easy to separate effort from opportunity, especially in an intergenerational context. For instance, parental income, resulting from their own effort, determines the opportunity of their children to obtain an education. It is in this spirit that Rawls (1971) argued that the distribution of opportunities and of outcomes are equally important and informative to understand the nature and extent of inequality around the world.

6. **Is inequality a necessary evil?** Some degree of inequality may not be a problem insofar as it provides the incentives for people to excel, compete, save, and invest to move ahead in life. For example, returns to education and differentiation in labor earnings can spur human capital accumulation and economic growth, despite being associated with higher income inequality. Inequality can also influence growth positively by providing incentives for innovation and entrepreneurship (Lazear and Rosen 1981), and, perhaps especially relevant for developing countries, by allowing at least a few individuals to accumulate the minimum needed to start businesses and get a good education (Barro 2000).

7. **Why is rising inequality a concern?** High and sustained levels of inequality, especially inequality of opportunity can entail large social costs. Entrenched inequality of outcomes can significantly undermine individuals’ educational and occupational choices. Further, inequality of outcomes does not generate the “right” incentives if it rests on rents (Stiglitz 2012). In that event, individuals have an incentive to divert their efforts toward securing favored treatment and protection, resulting in resource misallocation, corruption, and nepotism, with attendant adverse social and economic consequences. In particular, citizens can lose confidence in institutions, eroding social cohesion and confidence in the future.

8. **Income distribution matters for growth.** Previous IMF studies have found that income inequality (as measured by the Gini coefficient, which is 0 when everybody has the same income and 1 when one person has all the income) negatively affects growth and its sustainability (Ostry, Berg, and Tsangarides 2014; Berg and Ostry 2011). We build on this analysis by examining how individuals’ income shares at various points in the distribution matter for growth drawing on a large sample of advanced economies and EMDCs (Table 1). A higher net Gini coefficient (a measure of

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2 This analysis is based on a sample of 159 advanced, emerging, and developing economies for the period 1980–2012 using a simple growth model (with time and country fixed effects) in which growth depends on initial income (convergence hypothesis), lagged GDP growth, and inequality (as measured by net Gini or the income shares accruing to various quintiles) estimated using system GMM. Augmenting this model with standard growth determinants, such as human and physical capital, does not affect our main findings. See Annex for data sources.
inequality that nets out taxes and transfers) is associated with lower output growth over the medium term, consistent with previous findings. More importantly, we find an inverse relationship between the income share accruing to the rich (top 20 percent) and economic growth. If the income share of the top 20 percent increases by 1 percentage point, GDP growth is actually 0.08 percentage point lower in the following five years, suggesting that the benefits do not trickle down. Instead, a similar increase in the income share of the bottom 20 percent (the poor) is associated with 0.38 percentage point higher growth. This positive relationship between disposable income shares and higher growth continues to hold for the second and third quintiles (the middle class). This result survives a variety of robustness checks, and is in line with recent findings for a smaller sample of advanced economies (OECD 2014). In the remainder of this section, we discuss potential channels for why higher income shares for the poor and the middle class are growth-enhancing.

<table>
<thead>
<tr>
<th>Table 1. Regression Results of Growth and Income Distribution</th>
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<tbody>
<tr>
<td><strong>Variables</strong></td>
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<td>----------------</td>
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<tr>
<td>Lagged GDP Growth</td>
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<tr>
<td>GDP Per Capita Level (in logs)</td>
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<tr>
<td>Net Gini</td>
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<tr>
<td>1st Quintile</td>
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<tr>
<td>2nd Quintile</td>
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<tr>
<td>3rd Quintile</td>
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<tr>
<td>4th Quintile</td>
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<tr>
<td>5th Quintile</td>
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<tr>
<td>Constant</td>
</tr>
<tr>
<td>Country Fixed Effects</td>
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<tr>
<td>Time Dummies</td>
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<tr>
<td>#. of Observations</td>
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<tr>
<td>#. of Countries</td>
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</table>

Source: Solt Database; World Bank; UNU-WIDER World Income Inequality Database; and IMF staff calculations.
Note: Standard errors in parentheses, *p < 0.1; **p < 0.05; ***p < 0.01. Estimated using system GMM, which instruments potentially endogenous right-hand-side variables using lagged values and first differences. The regressions include country and time dummies to respectively control for time-invariant omitted-variable bias and global shocks, which might affect aggregate growth but are not otherwise captured by the explanatory variables.
9. **Inequality affects growth drivers.** Why would widening income disparities matter for growth? Higher inequality lowers growth by depriving the ability of lower-income households to stay healthy and accumulate physical and human capital (Galor and Moav 2004; Aghion, Caroli, and Garcia-Penalosa 1999). For instance, it can lead to under-investment in education as poor children end up in lower-quality schools and are less able to go on to college. As a result, labor productivity could be lower than it would have been in a more equitable world (Stiglitz 2012). In the same vein, Corak (2013) finds that countries with higher levels of income inequality tend to have lower levels of mobility between generations, with parent’s earnings being a more important determinant of children’s earnings (Figure 1). Increasing concentration of incomes could also reduce aggregate demand and undermine growth, because the wealthy spend a lower fraction of their incomes than middle- and lower-income groups.  

10. **Inequality dampens investment, and hence growth, by fueling economic, financial, and political instability.**  
   - **Financial crises.** A growing body of evidence suggests that rising influence of the rich and stagnant incomes of the poor and middle class have a causal effect on crises, and thus directly hurt short- and long-term growth. In particular, studies have argued that a prolonged period of higher inequality in advanced economies was associated with the global financial crisis by intensifying leverage, overextension of credit, and a relaxation in mortgage-underwriting standards (Rajan 2010), and allowing lobbyists to push for financial deregulation (Acemoglu 2011).  
   - **Global imbalances.** Higher top income shares coupled with financial liberalization, which itself could be a policy response to rising income inequality, are associated with substantially larger  

---

3 Widening income disparities can depress skills development among individuals with poorer parental education background, both in terms of the quantity of education attained (for example, years of schooling) and its quality (that is, skill proficiency). Educational outcomes of individuals from richer backgrounds, however, are not affected by inequality (Cingano 2014).  

4 See Carvalho and Rezai (2014) for a discussion of the empirical and theoretical underpinnings of this assertion.  

5 In a theoretical setting, Kumhof and Ranciere (2010) and Kumhof and others (2012) show that rising inequality enables investors to increase their holding of financial assets backed by loans to workers, resulting in rising debt-to-income ratios and thus financial fragility. The latter can eventually lead to a financial crisis.
external deficits (Kumholf and others 2012). Such large global imbalances can be challenging for macroeconomic and/or financial stability, and thus growth (Bernanke 2011).

- **Conflicts.** Extreme inequality may damage trust and social cohesion and thus is also associated with conflicts, which discourage investment. Conflicts are particularly prevalent in the management of common resources where, for example, inequality makes resolving disputes more difficult; see, for example, Bardhan (2005). More broadly, inequality affects the economics of conflict, as it may intensify the grievances felt by certain groups or can reduce the opportunity costs of initiating and joining a violent conflict (Lichbach 1989).

11. **Inequality can lead to policies that hurt growth.** In addition to affecting growth drivers, inequality could result in poor public policy choices. For example, it can lead to a backlash against growth-enhancing economic liberalization and fuel protectionist pressures against globalization and market-oriented reforms (Claessens and Perotti 2007). At the same time, enhanced power by the elite could result in a more limited provision of public goods that boost productivity and growth, and which disproportionately benefit the poor (Putnam 2000; Bourguignon and Dessus 2009).

12. **Inequality hampers poverty reduction.** Income inequality affects the pace at which growth enables poverty reduction (Ravallion 2004). Growth is less efficient in lowering poverty in countries with high initial levels of inequality or in which the distributional pattern of growth favors the non-poor. Moreover, to the extent that economies are periodically subject to shocks of various kinds that undermine growth, higher inequality makes a greater proportion of the population vulnerable to poverty.

III. **STYLISTIZED FACTS: WHAT DO WE KNOW ABOUT INEQUALITY OF OUTCOMES AND OPPORTUNITIES?**

13. **Measuring inequality.** Income inequality—the most widely cited measure of inequality of outcomes—is typically measured by the market (gross) and net (after tax and transfers from social insurance programs) Gini, and by tracking changes in the income shares of the population (for example, by decile/quintile). Information on the assets held by the wealthiest offers a complementary perspective on monetary inequality. Inequality of opportunities is often measured by tracking health, education and human development outcomes by income group, or by examining access to basic services and opportunities. In this section, we document recent trends in both monetary and nonmonetary indicators of inequality across a large sample of advanced and EMDCs.

**Inequality of outcomes: Income**

14. **Global inequality remains high.** Global inequality ranges from 0.55 to 0.70 depending on the measure used (Figure 2). The high level of global inequality reflects sizeable per capita income disparities across countries, which account for around three quarters of global inequality (Milanovic 2013). Some measures of global inequality exhibit a declining trend in the last few decades in response to rising incomes for those living in China and India, where hundreds of millions of people have been lifted out of poverty. However, other measures of global income inequality—adjusted for
top incomes which tend to be underreported in most household surveys—appear to be broadly stable since the early 1990s.

**Figure 2. Global Inequality and the Distribution of Income**

<table>
<thead>
<tr>
<th>Three concepts of inter-national income inequality</th>
<th>Distribution of income at different points in time, 1988-2008</th>
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<tbody>
<tr>
<td>Gini coefficient</td>
<td>Distribution of income at different points in time, 1988-2008</td>
</tr>
<tr>
<td>0.75</td>
<td>Distribution of income at different points in time, 1988-2008</td>
</tr>
<tr>
<td>0.7</td>
<td>Distribution of income at different points in time, 1988-2008</td>
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Sources: Lakner and Milanovic (2013); Milanovic (2013); and IMF staff calculations.
Note: Unweighted inter-country inequality (blue line) is calculated across GDPs obtained from household surveys of all countries in the world, without population-weighting. The population-weighted inter-country inequality (red line) takes into account population weights. Finally, the global inequality concept (green dotted line) focuses on individuals, instead of countries. The calculation is based on household surveys with data on individual incomes or consumption.

15. **Globally, the middle class and the top 1 percent have experienced the largest gains.** Examining changes in real incomes between 1998 and 2008 at various percentiles of the global income distribution, Lakner and Milanovic (2013) show that the largest gains accrued for the global median income (50th percentile) earners and for the top 1 percent. This coincides with the rapid growth of the middle class in many emerging market economies, and the concentration of top earners in advanced economies, respectively. Moreover, income gains rapidly decrease after the 50th percentile and become stagnant around the 80th–90th global percentiles before shooting up for the global top 1 percent (Krugman 2014). In what follows, we focus on recent trends in within-country inequality which drives these global developments.

16. **Widening income inequality within countries.** Measures of inequality based on Gini coefficients of gross and net incomes have increased substantially since 1990 in most of the developed world (Figure 3). Inequality, on average, has remained stable in EMDCs, albeit at a much higher level than observed in advanced economies. However, there are large disparities across EMDCs, with Asia and Eastern Europe experiencing marked increases in inequality, and countries in Latin America exhibiting notable declines (although the region remains the most unequal in the world). Redistribuition, gauged by the difference between market and net inequality, played an important, albeit partial, role in cushioning market income inequality in advanced economies. During

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6 See Tsounta and Osueke (2014) and IMF (2014b) for a discussion of the declining inequality trends in Latin America and Middle East and North Africa regions, respectively.
1990–2012, market income inequality in advanced economies increased by an average of 5 ¼ Gini points compared to a 3 Gini point increase in the net Gini coefficient.

17. **Income deciles under the microscope.** Changes in income inequality across advanced economies and EMDCs have been driven by different developments in income shares by deciles. Figure 4 shows that rising income inequality (positive numbers on the vertical axes) in most advanced and many emerging market economies has been driven primarily by the growing income share of the top 10 percent (see also Piketty and Saez (2003) for the United States). Indeed, the top 10 percent now has an income close to nine times that of the bottom 10 percent. These effects have been magnified by the crisis (OECD 2014). The story is somewhat different in EMDCs. Rising inequality for this group of countries is primarily explained by a shift in incomes of the “upper middle class to the upper class” (for example, in China and South Africa). Figure 4 shows that in EMDCs with falling inequality (negative numbers on the vertical axis), the main beneficiaries (that is, with the largest increase in their income shares, shown on the horizontal axis) were those at both the bottom and the middle of the income distribution (for example, Peru and Brazil).

18. **Top 1 percent on the rise.** The top 1 percent now account for around 10 percent of total income in advanced economies. (Figure 5; Piketty and Saez 2011; Alvadero and others, 2013). While data on top income shares is scant for most EMDCs, available evidence suggests that the share of top incomes has risen in China and India. The growing share of the top 1 percent in advanced economies reflects both higher inequality in labor incomes as well as capital gains—returns from investments (Atkinson, Piketty, and Saez 2011). Indeed, about half of the income of the top 1 percent constitutes non-labor income compared with 30 percent for the top 10 percent as a whole. For instance, corporate profits have been translated into strikingly high executive salaries and
bonuses, exacerbating income inequality (Brightman 2014), a pattern that is observed across both advanced and large emerging market economies (Figure 6).

**Figure 4. Change in Gross Gini and Income Decile**

**Advanced Economies**

(1988-2008)

**Emerging Markets**

([1988-93] - [2005-08])

Sources: Milanovic WYD Database; Solt Database; and IMF staff calculations.

Note: The horizontal axis shows the income decile with the largest change in the income share between the latest and earliest available data (typically 2010s versus 1980s). The vertical axis shows the change in the gross Gini for the corresponding period. AEs = advanced economies; CIS = Commonwealth of Independent States; LAC = Latin America and Caribbean; MENA = Middle East and North Africa; SSA = sub-Saharan Africa.
19. **Middle class squeeze.** A shift in the allocation of labor income towards the higher and lower ends of the distribution has resulted in a shrinkage of the income share accruing to the middle 20 percent in many advanced economies (Australia, Canada, and Sweden are important exceptions), and some large emerging market economies (Autor, Katz, and Kearney 2006; Figure 7). Indeed, pretax incomes of middle-class households in the United States, the United Kingdom, and Japan have experienced declining or stagnant growth rates in recent years. Additional pressures on the middle class reflect a declining share of labor income—the predominant source of income for the majority of households. Indeed, average wages have risen at a slower pace than productivity growth amid large economic rents (for example, high profitability and large increase in executive compensation) accruing to the top end of the income distribution (Figure 8).
20. **Sources behind the middle class squeeze vary.** In advanced economies, the largest driver has been the declining share of middle-skilled occupations relative to low- and high-skilled occupations (Autor, Kerr, and Kugler 2007; Goos, Manning, and Salomons 2009). In EMDCs, the middle class squeeze in some countries reflects income polarization (Duclos, Esteban, and Ray 2004; Zhang and Kanbur, 2011). In China, for example, more than one-third of all wealth is concentrated in the top 1 percent, while the majority of the population remains poor despite strong economic growth (Hairong 2014). Widespread informality and persistently large geographical differences in economic performance have also played a particularly important role in shaping income inequality in EMDCs.

21. **Poverty has declined in many countries, but is on the rise in advanced economies.** In many EMDCs, poverty—measured in terms of the share of population living below a pre-defined poverty line—has declined, despite rising income inequality in some (Figure 9). In contrast, recent data suggest that poverty rose in advanced countries since the 1990s (OECD 2011). The ratio of the

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**Figure 8. Disconnect: Real Average Wage and Productivity**

- **Labor Productivity**
- **Real Average Wage Index**

**Selected Advanced Economies**

- Germany
- Italy
- Japan
- Korea
- Netherlands
- Spain
- United States
- United Kingdom

**Selected Emerging Markets**

- Czech Republic
- Hungary
- Mexico
- Slovak Republic

Sources: The Conference Board; International Labour Organization; and IMF staff calculations.

Note: Earnings reflect gross remuneration—in cash and in kind—paid to employees deflated by the consumer price index. Labor productivity represents real output per hours worked.
earnings of the 90th percentile to the earnings of the 10th percentile—another method of measuring inequality among the bottom 90 percent—grew in most advanced economies over the period between 1980 and 2011 (Autor 2014), particularly in the United States and the United Kingdom.

**Figure 9. Poverty Rates by Regions**

<table>
<thead>
<tr>
<th>Change in Poverty Rate (since 2000)</th>
<th>Poverty rate(^1), 2010</th>
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<tr>
<td><strong>(Percent of population)</strong></td>
<td><strong>(Percent of population)</strong></td>
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<tr>
<td>Sub-Saharan Africa</td>
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Source: Tsounta and Osueke (2014).
Note: EM = Emerging market economies.
1/ National coverage of poverty headcount (percent of population living in households with consumption or income per person below the poverty line of $76 per month or $2.5 per day).

**Inequality of outcomes: Wealth**

22. **Rising concentration of global wealth.** Estimates suggest that almost half of the world’s wealth is now owned by just 1 percent of the population, amounting to $110 trillion—65 times the total wealth of the bottom half of the world’s population (Fuentes Nieva and Galasso 2014).\(^7\) For instance, a third of the total wealth in the United States is held by 1 percent of the population (Figure 10, left panel). In most countries with available data, the share held by the 1 percent wealthiest population is rising at the expense of the bottom 90 percent population (Figure 10, right panel).

**Figure 10. Top 1% and Bottom 90% Wealth Distribution, 1980–2010**

Sources: Piketty (2014); and IMF staff calculations.

\(^7\) Wealth or net worth is defined as the value of financial assets plus real assets (principally housing) owned by households, less their debts.
CAUSES AND CONSEQUENCE OF INEQUALITY

23. **Inequality is more extreme in wealth than income.** In both advanced economies and EMDCs, income Ginis, on average, are half the size of wealth Ginis (Figure 11). Possible explanations for the higher wealth Ginis include stagnant wage growth, which makes it difficult for middle- and lower-income workers to set aside money for saving, and a lower propensity to consume by the rich. While many studies suggest that growing wealth inequality in advanced economies is largely driven by rising wealth concentration at the top (Piketty 2014; Saez 2014), various explanations have been posited for the rise in EMDCs, ranging from wealth polarization between urban and rural areas in China to inequality among class and caste in India (Zhong and others 2010; Credit Suisse 2013).

**Inequality of Opportunity: Health Services**

24. **Inequality in health outcomes is widespread in developing economies.** While health outcomes are broadly similar across income groups in advanced countries, large disparities exist in EMDCs (Figure 12, left panel). For example, the infant mortality rate is twice as high in the poor than in the rich households (in terms of wealth) in emerging market economies. Similarly, female mortality rates tend to be disproportionately higher for lower-income groups.

25. **Inequality in health care access and use is more pervasive in developing countries.** Commonly used indicators to gauge access and use of health care are generally favorable in advanced countries, irrespective of the income level of the population. For EMDCs, however, data on access to skilled health personnel for births suggest that there are large disparities in health access across income levels within developing countries, and to a lesser extent in emerging market countries (Figure 12, right panel). However, even in advanced economies, income inequality is increasingly being reflected in lower life expectancy. This is particularly striking in the United States, where income today is a stronger predictor of life expectancy than it was a generation ago (Murray, Lopez, and Alvarado 2013).

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8 Based on national balance sheets in nine advanced economies, Piketty and Zucman (2014) find that wealth-income ratios have doubled over the past 40 years.
Inequality of opportunity: Education

26. Declining education inequality in EMDCs. The education Gini—a measure of the variation of average years of education for different income levels—has declined significantly in EMDCs, over the last 60 years (Figure 13, left panel). This is largely driven by improvements in access at the lower-end of the income distribution (Castello-Climent and Domenech 2014). Despite this improvement, education outcomes remain much worse for disadvantaged groups, partly because of pro-rich biases in the incidence of public spending (Dabla-Norris and Gradstein 2004). Indeed, almost 60 percent of the poorest youth population (aged 20–24 years) in sub-Sahara Africa has fewer than 4 years of schooling compared to 15 percent in the richest quintile (Figure 13, right panel). In contrast, education inequality, on average, is unchanged in most advanced economies over the last decade, although rising university costs have contributed to lower access to education by the poor in some countries. In the United States, for instance, college costs grew must faster than most households’ income since 2001 (Federal Reserve 2014).
Inequality of opportunities: Financial services

27. Disparities in financial services access. There are large disparities in the use of financial services between advanced economies and EMDCs and across income levels within a country (Figure 14). More than 80 percent of adults in advanced economies have an account at a formal financial institution—twice more than in EMDCs. Within EMDCs, the share of adults with an account or a loan at a formal financial institution is largely skewed toward the top income earners. The rest rely on their own limited savings to invest in education or become entrepreneurs, suggesting that financial inequality and income inequality go hand in hand. In many EMDCs, low-income households and small-scale firms often face challenges in accessing financial services due to lack of financial knowledge, complicated processes, onerous paperwork, and other market failures. Moreover, available financial products tend to be more limited and relatively costly.

![Figure 14. Financial Inclusion in Advanced and Developing Countries](image)

Sources: World Bank, Global Financial Inclusion Database; and IMF staff calculations.

Note: AEs = advanced economies; DCs = developing countries; EMs = emerging market economies.

IV. INEQUALITY DRIVERS

A. Factors Driving Higher Income Inequality

28. Global trends: the good side of the story. Over the past four decades, technology has reduced the costs of transportation, improved automation, and communication dramatically. New markets have opened, bringing growth opportunities in countries rich and poor alike, and hundreds of millions of people have been lifted out of poverty. However, inequality has also risen, possibly reflecting the fact that growth has been accompanied by skill-biased technological change, or because other aspects of the growth process have generated higher inequality. In this section, we discuss potential global and country-specific drivers of income inequality across countries.

29. Technological change. New information technology has led to improvements in productivity and well-being by leaps and bounds, but has also played a central role in driving up the
skill premium, resulting in increased labor income inequality (Figure 15). This is because technological changes can disproportionately raise the demand for capital and skilled labor over low-skilled and unskilled labor by eliminating many jobs through automation or upgrading the skill level required to attain or keep those jobs (Card and Dinardo 2002; Acemoglu 1998). Indeed, technological advances have been found to have contributed the most to rising income inequality in OECD countries, accounting for nearly a third of the widening gap between the 90th and the 10th percentile earners over the last 25 years (OECD 2011). Evidence from larger emerging market economies also shows a similar trend of a growing earnings gap between high- and low-skilled workers despite a large rise in the supply of highly educated labor (which should reduce the gap).

![Figure 15. Technological Progress and Skill Premium in OECD Countries](image)

**Use of Information and Communication Technology (ICT)**

ICT capital services per hour worked, 1990 = 100

**Skill Premium in Selected Economies 1/**

Upper secondary or post-secondary non-tertiary education = 100

Source: Organisation of Economic Co-operation and Development.

1/ Skill premium measures the relative earnings from employment after completing tertiary education compared to the earnings after completing upper- and post-secondary non-tertiary education.

30. **Trade globalization: two sides of a coin.** Trade has been an engine for growth in many countries by promoting competitiveness and enhancing efficiency. Nonetheless, high trade and financial flows between countries, partly enabled by technological advances, are commonly cited as driving income inequality (Figure 16). In advanced economies, the ability of firms to adopt labor-saving technologies and offshoring has been cited as an important driver of the decline in manufacturing and rising skill premium (Feenstra and Hanson 1996, 1999, 2003). Trade openness could potentially have mixed effects on the wages of unskilled labor in advanced countries. It raises the skill premium, but could also increase real wages by lowering (import) prices (Munch and Skaksen 2009). At the same time, increased trade flows could lower income inequality in EMDCs by increasing demand and wages for abundant lower-skilled workers. Thus, disentangling the impact of trade on inequality is challenging as it depends on relative factor abundance and productivity differences across countries, and the extent to which individuals obtain income from wages or capital.
31. **Financial globalization.** Financial globalization can facilitate efficient international allocation of capital and promote international risk sharing. At the same time, increased financial flows, particularly foreign direct investment (FDI) and portfolio flows have been shown to increase income inequality in both advanced and emerging market economies (Freeman 2010). One potential explanation is the concentration of foreign assets and liabilities in relatively higher skill- and technology-intensive sectors, which pushes up the demand for and wages of higher skilled workers. In addition, FDI could induce skill-specific technological change, be associated with skill-specific wage bargaining, and result in more training for skilled than unskilled workers (Willem te Velde 2003). Moreover, low-skill, outward FDI from advanced economies may in effect be relatively high-skilled, inward FDI in developing economies (Figini and Görg 2011), thus exacerbating the demand for high-skilled workers in recipient countries. Financial deregulation and globalization have also been cited as factors underlying the increase in financial wealth, relative skill intensity, and wages in the finance industry, one of the fastest growing sectors in advanced economies (Phillipon and Reshef 2012; Furceri and Loungani 2013).

32. **Financial deepening.** Financial deepening can provide households and firms with greater access to resources to meet their financial needs, such as saving for retirement, investing in education, capitalizing on business opportunities, and confronting shocks. Financial deepening accompanied by more inclusive financial systems can thus lower income inequality, while improving the allocation of resources (Dabla-Norris and others 2015). Theory, however, suggests that financial development could benefit the rich in the early stages of development, but the benefits become more broadly shared as economies develop (Greenwood and Jovanovic 1990). Indeed, some studies have found that financial development, measured as the relative share of the banking and stock market sectors in the economy, boosts top incomes the most in the early stages of development (Roine, Vlachos, and Waldenström 2009). Moreover, inequality can increase as those with higher incomes and assets have a disproportionately larger share of access to finance, serving to further increase the skill premium, and potentially the return to capital (Claessens and Perotti 2007).
33. **Changes in labor market institutions.** More flexible labor market institutions can foster economic dynamism by reallocating resources to more productive firms and enabling firm restructuring. However, greater flexibility can pose challenges for workers, especially those with low skills, and hence play an important role in explaining inequality developments (Alvaderro and others 2013). A decline in trade union membership (union rate) could reduce the relative bargaining power of labor, exacerbating wage inequality (Frederiksen and Poulsen 2010; Wilkinson and Pickett 2010; Figure 17). Jaumotte and Osorio-Buitron (2015) and forthcoming IMF work finds that a reduction in the minimum wage relative to the median wage is associated with higher inequality in advanced economies, while a decline in unionization rate is strongly associated with the rise of top income shares. Moreover, some studies have pointed to the role of wage dispersion and a higher share of part-time and temporary employment in driving inequality in labor earnings in some advanced economies (OECD 2012). For many labor market policies, such as reforms to employment protection legislation, the impact on inequality is less clear cut as they affect both the dispersion of earnings and the level of employment in sometimes conflicting ways. In many EMDCs, the combination of rigid hiring and firing and employment protection regulations and weak income protection systems often encourages informality, fueling wage inequality. However, evidence from a large sample of countries suggests that de facto labor market regulations (such as minimum wages, unionization, and social security contributions), on average, tend to improve the income distribution (Calderón and Chong 2009; OECD 2011).

34. **Redistributive policies.** Governments in advanced economies have historically mitigated inequality through public policy—primarily progressive taxes and social transfers such as public retirement benefits (CBO 2011). However, many advanced countries have now seen an increase in net income inequality, indicating gaps in existing tax-and-transfer systems to counteract rising market inequality. The progressivity of tax systems has declined in some advanced economies over the past few decades, with the result being that high-income households and corporations now face

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9 There is a difference between coverage rate of collective bargaining agreement and union density because in many advanced economies multi-employer bargaining and public policies extending the negotiated contract to nonorganized firms guarantee coverage rates in excess of density rates.

10 Stronger labor market institutions could increase unemployment rates, reduce the wage differential between high-skill and low-skill workers, and affect the labor share of income. The overall impact on income inequality, however, can be ambiguous: they increase unemployment, which tends to raise inequality, they can reduce wage dispersion, which tends to lower it, and they increase the wage share, which can have an ambiguous effect on inequality.
lower effective tax rates (Hungerford 2013). Indeed, Figure 18 indicates that rising pre-tax income concentration at the top of the distribution in many advanced economies has also coincided with declining top marginal tax rates (from 59 percent in 1980 to 30 percent in 2009). Conditional cash transfers have become an important policy tool for directing resources towards the lower end of the distribution in EMDCs (IMF 2014a), but their redistributive impact varies widely across countries, reflecting both differences in the size and progressivity of these transfers.

35. **Education.** Education can play an important role in reducing income inequality, as it determines occupational choice, access to jobs, and the level of pay, and plays a pivotal role as a signal of ability and productivity in the job market. From a theoretical perspective, the human capital model of income distribution (Mincer, 1958; Becker and Chiswick, 1966) suggests that while there is an unambiguously positive association between educational and income inequality, the effect of increased educational attainment on income inequality could be either positive or negative depending on the evolution of rates of return to education (that is, the skill premium). Moreover, there can be opposing forces at play stemming from “composition” (that is, increasing the share of high-wage earners) and “wage compression” (that is, decline in the returns to higher education relative to lower levels) effects. Overall, the evidence suggests that the inequality impact of education depends on various factors, such as the size of education investments by individuals and governments and the rate of return on these investments. It is in this spirit that Rajan (2015) notes that “prosperity seems increasingly unreachable for many, because a good education, which seems to be today’s passport to riches, is unaffordable for many in the middle class.”

### B. Empirical Analysis

36. **This section investigates the drivers of income inequality.** The discussion above suggests that a variety of inter-related factors can impact inequality and have potentially differential effects across countries and income groups. In this section, using a simple panel econometric... 

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11 Tax regimes can influence the mix of compensation, tilting it towards lower taxed forms of compensation, and thereby boost disposable income, particularly at the top. For example, capital gains are often taxed at a lower rate than other income and, in a few countries, they are not taxed at all. Stock options also benefit from preferential tax treatment in many advanced economies.

12 We are unable to also investigate the drivers of wealth inequality due to data unavailability for a broad sample of advanced economies and EMDCs.
approach with year and country fixed effects, we investigate the drivers of within country changes in income inequality for a sample of almost 100 advanced economies and EMDCs over the period 1980–2012 (see Box 1 for empirical specification). In contrast to other studies, we focus on a large group of countries to assess whether the determinants of inequality vary across advanced, emerging markets and developing economies, and across different measures of inequality. In addition to the Gini coefficients of both market and net inequality, we build on our earlier result that the income distribution itself matters for growth by examining the determinants of the disposable income shares (after tax) of the poor (bottom 10 percent), the middle-class (fifth decile), and the rich (top 10 percent). This allows us to focus on the factors driving income concentration in recent years, especially changes in the income shares of the poor and the middle class.

37. **Drivers of gross and net inequality.** Table 2 (Columns 1 and 2) presents the results of the regression analysis for gross and net inequality. Our results on the role of globalization and technological progress in driving inequality are broadly in line with the findings in the literature. In particular, trade openness is associated with lower inequality (albeit not in a statistically significant way), while greater financial openness and technological progress are associated with rising income inequality, likely reflecting the fact these disproportionately benefit high-tech and labor-skilled sectors. Indeed, we find that financial globalization and technological progress are associated with an increase in the top 10 percent disposable income share across all countries (Column 3).

38. **Differential impacts of financial deepening across country groups.** The impact of financial deepening, as proxied by the ratio of private credit to GDP, on both market and net inequality varies across advanced economies and EMDCs, in line with Roine, Vlachos, and Waldenström 2009. In particular, our results suggest that financial deepening is associated with higher income inequality in EMDCs. This likely reflects the fact that while financial deepening has accelerated over the past two decades, the record on financial inclusion may not have kept pace in these countries. Indeed, Figure 19 indicates that financial deepening was associated with higher market and net income inequality in countries with low levels of financial inclusion (typically EMDCs), possibly reflecting that large amounts of credit are often concentrated among the largest firms and wealthier households. By contrast, financial deepening is associated with less of an increase in market inequality (and lower net inequality) in advanced economies, reflecting easier access to credit for households and firms.
Box 1. Assessing the Drivers of Income Inequality Around the World

Our empirical approach is based on a simple model of within-country variation in inequality, controlling for differences in levels across countries using five-year panels over the period 1980–2012. Specifically, the analysis builds on Jaumotte, Lall, and Papaconstantinou (2013) and is based on the following specification:

\[
\text{inequality}_{it} = \beta_0 \text{trade}_{it} + \beta_1 \text{financial}_{it} + \beta_2 \text{technology}_{it} + \beta_3 \text{credit}_{it} + \beta_4 \mu_{AE} \ast \text{credit}_{it} \\
+ \beta_5 \text{skill premium}_{it} + \beta_6 \mu_{AE} \ast \text{skill premium}_{it} + \beta_7 \text{education gini}_{it} \\
+ \beta_8 \text{labor flexibility}_{it} + \beta_9 \text{female mortality}_{it} + \beta_{10} \text{government spending}_{it} + \theta_i + \mu_i \\
+ \epsilon_{it}
\]

in which \(\text{inequality}_{it}\) refers to the relevant inequality measure used for country \(i\) at time \(t\), \(\text{trade}\) proxies for trade globalization, measured as the sum of exports and imports as a share of a country’s GDP, \(\text{financial}\) captures financial globalization, measured as the sum of foreign assets and liabilities relative to GDP, and \(\text{technology}\) measures the share of information and communication technology (ICT) capital in the total capital stock. \(\text{Credit}\) captures domestic financial market development, and is proxied by the ratio of private credit to GDP. Since the effect of financial development could vary across advanced economies and EMDCs, we also include an interaction term between the credit variable and a dummy variable which takes the value of 1 for advanced economies, and zero otherwise. Given data limitations, and in line with Mincer’s (1958) wage specification, we use the average years of education in the population aged 15 and older as a proxy for the \(\text{skill premium}\). As noted in the literature, the effect of skill-biased technological change could vary across advanced economies and EMDCs. To capture this, we also include an interaction term between the skill premium variable and a dummy variable that takes the value of 1 for advanced economies, and zero otherwise. We also include a measure of labor market flexibility from the World Economic Forum that measures the extent by which regulations govern firing and hiring, collective bargaining, and minimum wages.

Additional control variables attempt to capture aspects of inequality of opportunities, including the beginning of period \(\text{education Gini}\) (a proxy for access to education); the quality and availability of health system is measured by the beginning of period \(\text{female mortality}\) (aged 15–60) rate. Given data limitations, as a proxy for redistributive policies, we include the beginning of period Fraser Institute index that measures total \(\text{government spending}\) as a share of GDP (see also Perotti [1992]). The terms \(\theta_i\) and \(\mu_i\) represent a full set of time and country dummies, respectively, and \(\epsilon_{it}\) captures all the omitted factors. Country fixed effects allow us to focus on within-country changes instead of cross-country level differences. In addition, time dummies are included to capture the impact of common global shocks such as business cycles or growth spurts. All specifications include lagged GDP growth and share of employment in agriculture and industry as additional controls. Lagged GDP growth is included in the specifications as there could be a two way causality between output growth and inequality.

While causality is difficult to establish with full confidence, the results survive a variety of robustness checks for omitted variables, endogeneity problems, and estimation methods and are broadly in line with findings from the literature that focus on smaller country samples. For example, we checked the robustness of our results by including dummies for financial crises, GDP per capita, and alternative measures of the skill premium, trade, and financial openness. For some Organisation for Economic Co-operation and Development (OECD) countries with available tax and benefits data, we also considered alternative measures for redistributive policies as well as top marginal personal income–tax rates. The results, not reported here but available upon request, suggest that lower marginal tax rates are associated with higher market and net inequality and a higher income share of the top 10 percent.
Higher skill premium is associated with widening inequality in advanced economies. In advanced economies, increases in the skill premium exacerbate market income inequality, reflecting the fact that education gains accrue disproportionately at the higher end of the income distribution.\(^{13}\) The statistically insignificant effect of the skill premium in driving net income inequality, however, could reflect the fact that the net Gini is underestimating increases in inequality at the top of the distribution (Kakwani 1980). Indeed, an *increase in the skill premium is associated*
with a significantly higher disposable income share of the top 10 percent. This effect is found to be statistically insignificant in EMDCs, and is in line with studies that find an absence of a correlation between income differentials and the quantity of skills in these countries, likely reflecting large differences in factor endowments and capacity to absorb new technologies across EMDCs (Behar 2013).

40. **Easing of labor market regulations is associated with higher market inequality and income share of the top 10 percent.** In particular, a decline in organized labor institutions and the resultant easing of labor markets measured by an increase in labor market flexibilities index by 8½ percent—from the median to 60th percentile—is associated with rising market inequality by 1.1 percent. The relationship between the top 10th percentile income share and easing of labor market regulations is also positive and statistically significant (Column 3) for our sample of countries, likely reflecting the fact that labor market flexibility benefits the rich and reduces the bargaining power of lower-income workers. This result confirms Jaumotte and Osorio-Buitron (2015) and forthcoming IMF work which find that weakening of unions is associated with a higher top 10 percent income share for a smaller sample of advanced economies. Indeed, empirical estimations using more detailed data for OECD countries (not reported here, but available upon request) suggest that, in line with Jaumotte and Osorio-Buitron (2015) and forthcoming IMF work, more lax hiring and firing regulations, lower minimum wages relative to the median wage, and less prevalent collective bargaining and trade unions are associated with higher market inequality. The impact of labor market institutions on inequality, however, is somewhat blunted by government actions as shown by the statistically insignificant coefficient in the net Gini regression (Table 2, Column 2).

41. **Government actions can contribute to greater equality.** In particular, we find that an increase in our proxy for government redistributive spending relative to total spending by 7.1 percent (that is, a shift from the median value to the 60th percentile) is associated with a 0.6 percent decrease in income inequality. While total government spending can be a poor proxy for the progressivity of tax-transfer systems, this result continues to hold for other measures of redistribution for a smaller sample of OECD countries (not reported here, but available upon request), suggesting that the composition of government spending is important for reducing inequality. Moreover, healthier societies, as proxied by a lower female mortality rate, tend to have lower income inequality. While causality is difficult to establish, the latter finding suggests that greater and more equal access to quality health services allows people to be more productive, thus lowering income disparities.

42. **Overall contributors to changes in inequality.** Based on the estimated models, the contributions of the various factors to the change in the market Gini coefficient can be calculated.  

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14 This finding is also in line with recent research that finds that wage inequality falls during periods when union density is increasing and rises when union membership is in decline (World Bank 2013).

15 Joumard, Pisu, and Bloch (2012) look at the role of taxes and transfers while OECD (2012b) looks at how education policies, progressive taxes and transfers can tackle inequality.

16 These estimates are calculated as the average annual change in the respective variable multiplied by the corresponding coefficient estimate in Table 2, Column 1.
We find that less-regulated labor markets, financial deepening, and technological progress largely explain the rise in market income inequality in our full sample over the last 30 years (Figure 20). Globalization (that is, financial openness) has played a smaller but reinforcing role, while improvements in health outcomes mitigated around ½ percent of the almost 3 percentage points average increase in the Gini coefficient. The relative importance of the skill premium, globalization, technological progress, and financial deepening in driving inequality, however, varies across advanced economies and EMDCs.

![Figure 20. Decomposition of the Change in Market (Gross) Income Inequality (Gini points, current versus mid-1980s)](source: IMF staff calculations. Note: EMDCs = emerging market and developing countries.)

43. **What has been driving income shares of the poor and the middle class?** Given the importance of the poor (bottom 10 percent) and the middle class for boosting growth, we investigate what explains changes in the income shares for these income groups across different countries. On average, the income shares of the poor and the middle class have risen much more slowly than that of the top 10 percent, which explains the rising income inequality observed in many countries. Looking more closely into the determinants (Table 2, Columns 4 and 5, and Figure 21), we find:

- Better access to education (as captured by declining educational inequality), improved health outcomes, and redistributive social policies help raise the income share of the poor and the middle class irrespective of the level of economic development of a country.\(^\text{17}\) By contrast, easing of labor market regulations and technological progress dampen the income share of the poor and the middle class, consistent with other studies. This result is not surprising, since the poor are often disproportionally employed in lower-paying and less secure jobs (often in the informal sector) and tend to benefit more from labor market regulations such as minimum wages and firing restrictions. This points to the policy role of making education more accessible (Bruckner, Dabla-Norris, and Gradstein 2015), while ensuring that changes in labor market institutions do not excessively penalize lower-income individuals. Moreover, to the extent that

\(^{17}\) In a recent speech, Rajan (2015) refers to economic inclusion—easing access to quality education, nutrition, health care, finance, and markets to all our citizens, as a “necessity for sustainable growth,” in addition to “obviously, a moral imperative.”
redistributive policies can play a role in reducing inequality, they can be supported by making the tax systems more efficient and progressive and improving targeted spending.

There are important differences in inequality drivers between advanced economies and EMDCs, suggesting the need to tailor policies to country-specific conditions. In particular, we find that financial deepening has played a role in raising the income shares of the poor and the middle class in advanced economies, but not in EMDCs, likely reflecting differences in credit allocation and the extent of financial inclusion. In contrast, reducing gaps in access to education has been one of the most important drivers of higher income shares for the bottom 10 percent and the middle class in EMDCs. A complementary way to look at the income share of the poor is to examine the drivers of the interplay between inequality and the poverty rate—defined as the population living below $2 a day (Box 2). Our findings suggest that greater equality in access to education lifts the poverty elasticity of economic growth.

Financial globalization and a higher skill premium have accounted for a more significant share of the widening income gap between the top 10 percent and the poor and the middle class in advanced economies than in developing countries. Policies to raise skills and reforms to increase human capital are thus important for improving living standards and reducing labor income inequality in advanced economies. In contrast to conventional wisdom, our results suggest that globalization has played a less significant role in driving down income shares of the bottom 10 percent and the middle class in EMDCs (see also Box 2), suggesting that the benefits of globalization discussed earlier potentially outweigh the costs in some of these countries.
Box 2. Drivers of Poverty

Another way to look at the income shares of the poor is to examine the drivers of poverty rate—defined as the population living below $2 a day (PPP-adjusted)—and look at the interplay between poverty and inequality. The literature points to various sources for poverty reduction, including higher economic growth (Kraay 2006) and a rise in the income share of the poor (Ravallion 2004). A large strand of the literature also explores how inequality affects poverty reduction via its growth impact; see for example, Bourguignon (2003) and Fosu (2010).

Using a sample of almost 100 EMDCs for the period 1985–2010, we investigate what is behind the declining share of people living below the $2 a day poverty line over the last 30 years. Following Bourguignon (2003), we first investigate the importance of inequality and growth on poverty reduction. Our results suggest that while the impact of the change in inequality, as measured by the Gini, does not appear to be significant per se, higher initial inequality lowers the growth elasticity of poverty reduction (Table 3, Column 1). Moreover, a higher initial level of education inequality dampens the growth elasticity of poverty, while a higher employment growth in manufacturing, as seen in emerging market economies in Asia for instance, is associated with a lower share of the population living below the poverty line (Column 2). We also find that greater trade openness can amplify the growth elasticity of poverty, albeit not in a statistically significant way, while financial openness amplifies it in a significant way (Column 3).

### Table 3. Regression Results on Determinants of Poverty Change

<table>
<thead>
<tr>
<th>Variables</th>
<th>Population Share Living Below $2/day (percentage change)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
</tr>
<tr>
<td>GDP per capita growth</td>
<td>-0.278***</td>
</tr>
<tr>
<td></td>
<td>0.094</td>
</tr>
<tr>
<td>Initial Gini * GDP Per Capita Growth</td>
<td>0.005**</td>
</tr>
<tr>
<td></td>
<td>0.002</td>
</tr>
<tr>
<td>Change in Gini</td>
<td>0.296</td>
</tr>
<tr>
<td>Initial Education Gini * GDP Per Capita Growth</td>
<td></td>
</tr>
<tr>
<td>Employment in the Industrial Sector Growth</td>
<td></td>
</tr>
<tr>
<td>Change in Trade Openness</td>
<td>1.009</td>
</tr>
<tr>
<td>Change in Trade Openness * GDP Per Capita Growth</td>
<td></td>
</tr>
<tr>
<td>Change in Financial Openness</td>
<td>0.509</td>
</tr>
<tr>
<td>Change in Financial Openness * GDP Per Capita Growth</td>
<td></td>
</tr>
<tr>
<td>Constant</td>
<td>0.122</td>
</tr>
<tr>
<td></td>
<td>(0.155)</td>
</tr>
<tr>
<td>#. of Observations</td>
<td>282</td>
</tr>
<tr>
<td>R-squared</td>
<td>0.422</td>
</tr>
<tr>
<td>Adjusted R-squared</td>
<td>0.405</td>
</tr>
</tbody>
</table>

Sources: Solt Database; UNU-WIDER World Income Inequality Database; World Bank; World Economic Outlook; and IMF staff calculations.

Note: Heteroskedasticity-consistent standard errors in parentheses, *p < 0.1; **p < 0.05; ***p < 0.01.

Prepared by Veronique Salins
44. **Caveats.** We should of course be cautious about drawing definitive policy implications from cross-country regression analysis, as different policies are likely to have varying effects across countries and at different points in time. Measurement limitations in comparing inequality across time and countries also need to be considered. In addition, it is hard to go from the sorts of correlations presented in the note to firm statements about causality as there can be a two-way causality running from growth-to-income inequality. Indeed, in-depth country-specific analyses suggest that a number of inter-related factors drive growth, the income level, and income inequality. Despite these limitations, our analysis points to a policy role for tackling inequality.

V. POLICY DISCUSSION AND FINAL REMARKS

45. **No one-size-fits-all.** Policymakers around the world need to consider policies to tackle inequality. Raising the income share of the poor, and ensuring that there is no hollowing-out of the middle class is actually good for growth. Our empirical analysis also suggests that the drivers of inequality and their impact differ across countries for different income groups. As such, the nature of appropriate policies would necessarily vary across countries, and would also need to take into account country-specific policy and institutional settings, and capacity/implementation constraints. Recent work by the World Bank (2015) also highlights the importance of adopting a psychological and social perspective on policymaking that takes into account what policy is implemented and how.

46. **Squaring equity and efficiency concerns.** Lowering income inequality does not need to come at the cost of lower efficiency. Previous IMF work has shown that there does not need to be a stark efficiency-equity tradeoff (Ostry, Berg, and Tsangarides 2014). Redistribution through the tax and transfer system is found to be positively related to growth for most countries, and is negatively related to growth only for the most strongly redistributive countries. This suggests that the effect of redistribution on enhanced opportunities for lower-income households and on social and political stability could potentially outweigh any negative effects on growth through a damping of incentives.

47. **Fiscal policy can be an important tool for reducing inequality.** Fiscal policy plays a critical role in ensuring macrofinancial stability and can thus help avert/minimize crises that disproportionately hurt the disadvantaged population. At the same time, fiscal redistribution, carried out in a manner that is consistent with other macroeconomic objectives, can help raise the income share of the poor and middle class, and thus support growth. Fiscal policy already plays a significant role in addressing income inequality in many advanced economies, but the redistributive role of fiscal policy could be reinforced by greater reliance on wealth and property taxes, more progressive income taxation, removing opportunities for tax avoidance and evasion, better targeting of social benefits while also minimizing efficiency costs, in terms of incentives to work and save (IMF 2014a). In addition, reducing tax expenditures that benefit high-income groups most and removing tax relief—such as reduced taxation of capital gains, stock options, and carried interest—would increase equity and allow a growth-enhancing cut in marginal labor income tax rates in some countries. In EMDCs, better access to education and health services, well-targeted conditional cash transfers and more efficient safety nets can have a positive impact on disposable incomes of the poor (Bastagli, Coady and Gupta 2012). In many cases, this increasing public spending would need to be
undertaken in tandem with rising revenue mobilization, reduced tax loopholes, and tax evasion, and lower less-well-targeted spending (such as oil subsidies).

48. **Education policies are key.** In a world in which technological change is increasing productivity and simultaneously mechanizing jobs, raising skill levels is critical for reducing the dispersion of earnings. Improving education quality, eliminating financial barriers to higher education, and providing support for apprenticeship programs are all key to boosting skill levels in both tradable and nontradable sectors. These policies can also help improve the income prospects of future generations as educated individuals are better able to cope with technological and other changes that directly influence productivity levels. In advanced economies, with an already high share of secondary or tertiary graduates among the working-age population, policies that improve the quality of upper secondary or tertiary education would be important. In developing countries with currently low levels of education attainment, policies that promote more equal access to basic education (for example, cash transfers aimed at encouraging better attendance at primary schools, or spending on public education that benefits the poor) could help reduce inequality by facilitating the accumulation of human capital, and making educational opportunities less dependent on socio-economic circumstances.

49. **Fostering financial inclusion safely.** Financial deepening in EMDCs needs to be accompanied by greater inclusion to make a dent in inequality. Governments have a central role to play in alleviating impediments to financial inclusion by creating the associated legal and regulatory framework (for example, protecting creditor rights, regulating business conduct, and overseeing recourse mechanisms to protect consumers), supporting the information environment (for example, setting standards for disclosure and transparency and promoting credit information-sharing systems and collateral registries), and educating and protecting consumers. Country experiences also suggest that policies such as granting exemptions from onerous documentation requirements, requiring banks to offer basic accounts, and allowing correspondent banking are useful in fostering inclusion. The promotion of credit without sufficient regard for financial stability, however, can result in crises, as evidenced by the subprime mortgage crisis in the United States, with disproportionately adverse effects on the poor and the middle class. Moreover, it illustrates the broader point that deep social issues cannot be resolved purely with an infusion of credit. Policies thus need to strike a balance between fostering prudence stability, and inclusion, while encouraging innovation and creativity.

50. **Well-designed labor market policies and institutions can reduce inequality, and, at the same time, not be a drag on efficiency.** Policies that reduce labor market imperfections and institutional failures that affect job creation can help support poor and middle-income workers. For instance, appropriately set minimum wages, spending on well-designed active labor market policies aimed at supporting job search and skill matching can be important. Better use of in-work benefits for social benefit recipients also help reduce income disparities. Moreover, policies that reduce labor market dualism, such as gaps in employment protection between permanent and temporary workers—especially young workers and immigrants—can help to reduce inequality, while fostering greater market flexibility. More generally, labor market policies should attempt to avoid either excessive regulations or extreme disregard for labor conditions. Labor market rules that are very
weaken or programs that are nonexistent can leave problems of poor information, unequal power, and inadequate risk management untreated, penalizing the poor and the middle class (World Bank 2012). In contrast, excessively stringent regulations can compound market imperfections with institutional failures, and weigh on job creation and efficiency.

51. **In EMDCs, making labor markets more inclusive and creating incentives for lowering informality is a key challenge.** Workers in these countries often lack equal access to productive job opportunities and do not benefit evenly from economic growth. Many individuals with low skills, in particular, remain trapped in precarious jobs, often in the informal and unregulated economy. In such jobs, even full-time employment tends to be insufficient to lift households out of poverty. Thus, creating accessible, productive, and rewarding jobs is key to escaping poverty and reducing inequality. Informal workers need to have the necessary legal, financial, and educational means to access formal sector employment. Higher formal sector employment also requires better incentives for firms to become formal. Policies to reduce tax, financial, and regulatory constraints can expand formal sectoral employment by reducing the incentives for firms to operate informally, both by increasing the benefits of participating in the formal sector and by reducing the costs of doing so (Dabla-Norris and Inchauste 2008).

52. **Complementarities between growth and income equality objectives.** Reforms aimed at raising average living standards can also influence the distribution of income. Indeed, tackling inequality goes beyond the remit of labor, social welfare, financial inclusion, and tax policies. The key to minimizing the downside of both globalization and technological change in advanced economies is a policy agenda of a race to the top, instead of a race to the bottom—an agenda that includes policies to encourage innovation, reduce burdensome product market regulations that stifle competition and technology diffusion, move goods produced upwards in the value chain, and ensure that this rise benefits everyone. In developing countries, raising agricultural productivity, rapid accumulation of capital, and technology diffusion in labor-intensive sectors can substantially lift growth and ensure that the fruits of prosperity are more broadly shared (Dabla-Norris and others 2013). Sustaining growth in emerging market economies will require more intensive patterns of growth, greater flexibility to shift resources within and across sectors, and the capacity to apply more knowledge and skill-intensive production techniques. Policies to improve skills for all, to ensure that a nation’s infrastructure meets its needs, and to encourage innovation and technology adoption are thus all essential to driving growth and ensuring a more inclusive prosperity.
ANNEX I. DEFINITIONS AND SOURCES OF VARIABLES

This annex provides the definition and the sources of the main variables used in the econometric analysis (Table A1).

<table>
<thead>
<tr>
<th>Indicator Name</th>
<th>Description</th>
<th>Data Source</th>
<th>Period</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Inequality and Poverty variables</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Market Gini</td>
<td>Gini index of distribution of income before taxes and transfers</td>
<td>Standardized World Income Inequality database</td>
<td>1980-2011</td>
</tr>
<tr>
<td>Net Gini</td>
<td>Gini index of distribution of income after taxes and transfers</td>
<td>Standardized World Income Inequality database</td>
<td>1980-2011</td>
</tr>
<tr>
<td>Shares of income (deciles/quintiles)</td>
<td>Share of net income accruing to each decile / quintile of the income distribution</td>
<td>UNU-WIDER database</td>
<td>1980-2012</td>
</tr>
<tr>
<td>Poverty Headcount ratio growth</td>
<td>Growth of the share of the population living with $2 per day or less</td>
<td>World Bank’s Povcal database</td>
<td>1980-2012</td>
</tr>
<tr>
<td><strong>Economic variables</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP growth</td>
<td>Annual growth of real GDP</td>
<td>World Bank’s World Development Indicators database</td>
<td>1980-2013</td>
</tr>
<tr>
<td>GDP per capita</td>
<td>Real GDP per capita based on constant local currency</td>
<td>World Economic Outlook</td>
<td>1980-2012</td>
</tr>
<tr>
<td>GDP per capita growth</td>
<td>Annual percentage growth rate of GDP per capita based on constant local currency</td>
<td>World Bank’s World Development Indicators database</td>
<td>1980-2011</td>
</tr>
<tr>
<td>Trade Openness</td>
<td>Exports plus imports (goods and services), in percent of GDP</td>
<td>WEO Database</td>
<td>1980-2013</td>
</tr>
<tr>
<td>Financial Openness</td>
<td>External assets plus liabilities, in percent of GDP</td>
<td>External Wealth of Nations Database, WEO Database</td>
<td>1980-2013</td>
</tr>
<tr>
<td>Credit</td>
<td>Domestic credit to the private sector in percent of GDP</td>
<td>World Bank’s World Development Indicators database</td>
<td>1980-2012</td>
</tr>
<tr>
<td>Industrial employment growth</td>
<td>Growth of the employment in industry as a percentage of total employment</td>
<td>World Bank’s World Development Indicators database</td>
<td>1980-2012</td>
</tr>
<tr>
<td>Government spending</td>
<td>Simple average of the three relevant sub-indexes (transfers and subsidies, public consumption and public investment) of the size-of-the-government index</td>
<td>Fraser Institute</td>
<td>1980-2010</td>
</tr>
<tr>
<td>Technology</td>
<td>Share of information and communication technology capital in the total capital stock</td>
<td>Jorgenson, Dale and Khuong Vu (2011)</td>
<td>1980-2010</td>
</tr>
<tr>
<td>Labor market institutions</td>
<td>Simple average of firing and hiring and collective bargaining indexes</td>
<td>World Economic Forum</td>
<td>1980-2010</td>
</tr>
<tr>
<td>Education gini</td>
<td>Gini index of distribution of educational attainment</td>
<td>World Bank’s Education Statistics</td>
<td>1980-2010</td>
</tr>
<tr>
<td>Skill Premium</td>
<td>Average number of total years of schooling</td>
<td>Barro-Lee education attainment dataset</td>
<td>1980-2013</td>
</tr>
<tr>
<td>Female mortality</td>
<td>Probability of dying between the ages of 15 and 60 for women</td>
<td>World Bank’s World Development Indicators database</td>
<td>1980-2010</td>
</tr>
</tbody>
</table>
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CAUSES AND CONSEQUENCE OF INEQUALITY


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Keywords
securitization, financial regulation, global imbalances, capital mobility

Abstract
Economists have explained the 2007–2008 global financial crisis with reference to various market and regulatory failures as well as a macroeconomic environment of cheap credit during the precrisis period. These developments had important political causes that scholars of international political economy (IPE) should have been well positioned to study before the crisis. How well did they anticipate the crisis? Although none foresaw all the causes, a number of IPE scholars correctly identified many of the dangers associated with new models of securitization as well as accompanying regulatory failures and the politics underlying them. IPE scholars were less successful in identifying the macroeconomic roots of the crisis, particularly the role of international capital flows in fueling the U.S. financial bubble, but some scholars did usefully explore the politics that contributed to the latter phenomenon. The study of IPE scholarship in this episode contains useful lessons for the field’s future.
INTRODUCTION

The global financial crisis of 2007–2008 was the most severe since the Great Depression of the 1930s. Some of the world’s best-known financial institutions collapsed or were nationalized, while many others survived only with massive state support. More than any other financial meltdown in the postwar period, the crisis affected major financial centers across the entire world (Reinhart & Rogoff 2009). It also generated a collapse of international trade more severe than any since the 1930s, and a broader economic downturn that involved all regions of the globe.

After listening to economists discuss the crisis during a tour of the London School of Economics in November 2008, Queen Elizabeth II famously asked (Sunday Times 2008): “If these things were so large, how come everyone missed them?” Her question crystallized a widespread view that the economics profession largely failed to predict the massive event and had much to learn from its failure. The sentiment has provoked a wide-ranging debate among economists about what specific lessons can be learned from the crisis—that is, how understanding the crisis ought to shape the future direction of their discipline.

A similar debate has begun among political scientists working within the field of international political economy (IPE). Echoing the Queen, Cohen (2009, pp. 437, 436, 440–41, 438) argues that IPE scholars had a “dismal” record in anticipating the crisis, and he compares their “myopia” to the failure of international relations scholars to predict the collapse of the Soviet Union two decades earlier. He is particularly critical of the “American school” of IPE, whose “mid-level theory building” and “reductionist” style of method precluded a focus on structural instability and systemic change. Although some working within the “British school” were more focused on the growing instability of global finance, Cohen argues they too have little to celebrate: “Predictions were loosely framed and often maddeningly imprecise. Few analysts foresaw the specific sequence of events that unfolded; many were downright wrong about the details; certainly none got the timing right.” This collective failure, in Cohen’s view, should provoke a wide-ranging discussion about the lessons to be learned and the field’s future direction.

Mosley & Singer (2009, p. 420) question whether Cohen’s judgment of scholarly failure is too harsh, since IPE scholars “are generally not in the business of predicting financial crises or recessions.” This may be true, but as Rajan (2010, p. 7) notes, “almost every financial crisis has political roots.” In explaining this latest crisis, he and many other prominent economists call attention to the political dimensions of many of the causes, showing a renewed appreciation for the study of political economy (Sheng 2009, Johnson & Kwak 2010, Roubini & Mihm 2010). Although political scientists working in the field of IPE may not be in the business of predicting financial crises, they should have been well positioned to identify some of these causes in ways that anticipated what was to come. Cohen is right to ask whether they in fact were so positioned and what can be learned from the experience.

In this essay, I explore these questions. Although Cohen is correct that IPE scholars failed to anticipate the causes of the crisis in a comprehensive manner, I argue that the field’s record was not quite as dismal as he initially suggested. Just as the economics discipline contained some individuals with unusual foresight, there were a number of IPE thinkers who identified many of the key sources of the crisis. After briefly outlining the chronology of the crisis, I highlight two complementary sets of explanations put forward in postcrisis economics literature. The first focuses on various market and regulatory failures, whereas the second explores the significance of a macroeconomic environment of cheap credit during the years leading up to the crisis. Both of these developments had important causes that IPE scholars
identified before the crisis.\textsuperscript{1} Their analyses, as well as some of the oversights in precrisis IPE literature, provide important lessons for the field, which I summarize in the conclusion.

THE POLITICS OF MARKET AND REGULATORY FAILURES

The crisis of 2007–2008 unfolded in several stages (Roubini & Mihm 2010). It began in the United States with the bursting of a housing bubble and the growth of mortgage defaults, particularly those involving subprime mortgages that had been extended in growing numbers at the height of the bubble to less creditworthy borrowers. These defaults increasingly affected the stability of financial institutions with exposure to these mortgages as well as financial products tied to these mortgages (described below). Several hedge funds were the first to collapse in May and June 2007, and by August, serious concerns broke out in money markets about the exposure of a wide range of financial institutions in the United States and Europe that had invested heavily in mortgage-related financial products. By mid-September, panic even broke out at the retail level, with Britain experiencing its first bank run (Northern Rock) since the nineteenth century.

Despite official efforts to calm the markets with large doses of liquidity, the crisis only deepened in March 2008, when the major U.S. investment bank Bear Sterns had to be rescued by U.S. authorities. Three developments in September 2008 then triggered a total collapse of market confidence. Early in the month, the U.S. government placed the two giant government-sponsored mortgage lending agencies, Fannie Mae and Freddie Mac (“Fannie and Freddie”), under a form of public “conservatorship” because of the enormous losses they were experiencing. By the middle of the month, the U.S. investment bank Lehman Brothers was forced into bankruptcy. Shortly thereafter, the world’s largest insurance company, American International Group (AIG), was rescued and nationalized by the U.S. government.

It was at this point that the severity of the crisis began to be felt much more strongly beyond the North Atlantic region. Because of their difficulties, U.S. and European banks pulled back their international loans, triggering severe financial problems and debt crises in countries that had been borrowing heavily from abroad. International trade credits also dried up, bringing exports and imports to a standstill in many sectors and countries. Financial contagion was felt particularly strongly in countries whose financial systems were already vulnerable because of home-grown housing bubbles, financial excesses, and/or large current account deficits. Iceland was a particularly dramatic example, but there were many others, such as Britain, Germany, Ireland, Spain, the Baltic countries, Dubai, Singapore, Australia, and New Zealand. The impact of the financial crisis also spread globally through various spillovers operating through the “real economy,” such as collapsing exports, commodity prices, and remittance payments.

Although economists largely failed to predict this global economic seismic shock, they have since made up for their oversight by generating a large and growing literature explaining the crisis. Many economists point to market failures that generated excessive risk taking and a financial bubble during the years leading up to the crisis. Although some of the specific failures were unique to this era, those with a historical perspective have usefully highlighted broad parallels with past crises. Drawing on Kindleberger’s (1978) classic work, they note that financial manias are usually set off by a change in expectations or “displacement,” often caused by some kind of innovation. That innovation then generates overtrading and the emergence of a bubble driven by a kind of excessive optimism and herd behavior. When the bubble eventually bursts, panic ensues.

\textsuperscript{1}Some of the cited references were published in 2008, but these were generally written and accepted for publication before the outbreak of the crisis.
The Promise and Perils of Securitization

In the case of this latest bubble, the key innovation is widely seen by economists to have emerged in the financial sector itself in the form of new kinds of securitization (Roubini & Mihm 2010). One kind involved privately issued complex mortgage-backed securities (MBSs). MBSs had been pioneered in the United States in the 1970s by the government-sponsored Fannie and Freddie, which had issued simple bonds backed by packages of mortgages they held. But after the early 1990s, the volume of MBSs began to grow rapidly as a wide range of private firms entered the market, offering securities that were structured in increasingly complex ways. After being bundled together, packages of mortgages—including subprime mortgages after 1997—were sliced up by these firms into MBSs with distinct risk profiles that were sold and traded worldwide. The resulting MBSs themselves also began to be divided and repackaged together into new collateralized debt obligations (CDOs) whose cash flows derived from the other bonds.

The rapid growth in the trading of credit risk through these increasingly complex securities was not restricted to mortgages but also included other “asset-backed securities” linked to car loans, student debt, credit cards, and so on. In addition to being divided up and traded through these new instruments, credit risks were also hedged via new kinds of derivatives, most notably the credit default swap (CDS). This product was invented in 1991, and it effectively insured holders of bonds against the risk of default (by offering to pay the buyer of the CDS contract the full value of the bond on which the CDS contract was written in the event of a default). Many buyers of CDSs did not in fact own the underlying bond but simply wanted to speculate on the likelihood of default on specific bonds. A large market was even created before the crisis in CDS contracts based on indexes of bonds. By the end of 2007, the size of CDS contracts had grown dramatically to a gross nominal value of more than $60 trillion, a figure larger than the world’s overall gross domestic product (although net exposure was lower because many contracts offset each other) (Financial Services Authority 2009, p. 81). Most of the explosive growth of CDSs and other derivatives during the past two decades involved “over-the-counter” (OTC) products negotiated privately on a bilateral basis between the buyer and the seller.

These new kinds of securitization generated great enthusiasm among market players not only because of the profits to be made but also because of the belief that these new products were boosting the stability and resilience of the financial system as a whole by dispersing risk and deepening markets for risk. Many top regulators and public officials shared this belief. As then–Chairman of the U.S. Federal Reserve Alan Greenspan put it in 2004, “not only have individual financial institutions become less vulnerable to shocks from underlying risk factors but also the financial system as a whole has become more resilient” (quoted in Kapstein 2006, p. 141-2). The crisis raised serious questions about this line of argument.

To begin with, as mortgage lenders increasingly passed on the mortgages they originated (rather than holding them), they began to overlook prudential concerns in their quest to generate fees that came from selling ever larger volumes of loans. As credit risk was transferred to parties far removed from the original source and bundled in increasingly complex ways, its quality also often became more obscure and underpriced. Investors frequently lacked full understanding of complex securities they purchased or the quality of the loans underlying the asset-backed securities in which they invested. They relied heavily on credit-rating agencies, which often issued overly positive ratings because they too found it difficult to evaluate risks accurately and/or because of various conflicts of interest (e.g., they were paid by, and relied on information from, the issuers).

Securitization also increased the number and significance of financial actors who fell outside of traditional prudential regulations covering commercial banks. As defaults on
subprime mortgages began to rise in 2007, the first institutions to collapse were unregulated, highly leveraged hedge funds that had become involved in the trading of some of the riskiest tranches of CDOs. Next in line were various structured investment vehicles created off balance sheet by commercial banks to invest in various complex products and funded with short-term commercial paper issues. As the value of the investments of these “shadow banks” came into question, investors refused to fund the vehicles further. Also suddenly vulnerable were various nonbank mortgage lenders who had funded their loans from investors in MBS products. In addition, the collapse of confidence in mortgage-related securities began to highlight the vulnerability of lightly regulated investment banks, which had become deeply involved in the buying and selling of complex securities and derivatives.

The growing troubles of the large investment banks then highlighted a further problem with securitization: the large-scale buying and selling of complex securities and derivatives had increasingly taken place among a very small number of financial institutions, thereby concentrating risks rather than dispersing them. When Bear Sterns’ troubles escalated in March 2008, the significance of this concentration of risk became clear. U.S. authorities concluded that because of the investment bank’s interconnections with other major institutions via complex securities and CDS contracts, it was too systemically important to be allowed to fail. In September, the demise of Lehman Brothers, a firm that was deeply involved in derivatives and complex securities, confirmed that the collapse of an interconnected investment bank could generate a market meltdown.

The financial difficulties of AIG presented another dramatic example of the concentration of risk in lightly regulated firms within the new securitized world. That institution had sold vast quantities of CDSs without setting aside enough capital or liquidity reserves. In the words of U.S. Federal Reserve Chairman Ben Bernanke, it had ended up acting “like a hedge fund sitting on top of an insurance company” (quoted in Paulson 2009, p. 236). At the time of its rescue, AIG had more than $2.7 trillion in notional derivatives exposure from 12,000 contracts, of which $1 trillion was with only twelve financial firms (Sorkin 2009, p. 236–37). Authorities were forced to recognize that, as Sorkin (2009, p. 394) puts it, “AIG had effectively become a linchpin of the global financial system.”

Securitization contributed to the severity of the crisis in two further ways. First, the huge mountain of securities and derivatives built on U.S. mortgages not only magnified the financial impact of the bursting of the U.S. housing bubble but also spread it worldwide. Approximately half of the MBSs and CDOs created by Wall Street were sold to foreigners, especially European banks and hedge funds (Roubini & Mihm 2010, p. 119). Second, once the crisis broke out, the far-flung diffusion of MBSs and CDOs also intensified the panic because of widespread uncertainties about which institutions actually held these products and what their levels of exposure were. The lack of transparency was only compounded by the opacity of the enormous OTC derivatives markets. At the time of Lehman’s collapse, for example, no one knew the precise size of the CDSs on its bonds or who held these contracts. As Tett (2009, p. 226) puts it, “the CDS market had turned into a vast, opaque spider web of deals in which banks, shadow banks, and brokers alike had become dangerously ensnared, interlinked by fear.”

A major cause of the global financial crisis was thus the transformation in financial systems unleashed by new models of securitization. In the words of Roubini & Mihm (2010, p. 272), “the crisis was less a function of subprime mortgages than of a subprime financial system . . . the global financial system rotted from the inside out. The financial crisis merely ripped the sleek and shiny skin off what had become, over the years, a gangrenous mess.” Although the U.S. financial system witnessed many of the greatest excesses, it is worth emphasizing that the problems associated with securitization trends were not unique to that country’s firms.
and markets. Not only were many foreign financial institutions deeply involved in U.S. financial markets, but many other countries—particularly in Europe—had been experiencing similar trends in their own home markets.

What Were the Regulators Doing?
Blame for these developments rests not only with market participants but with regulatory authorities who failed to address the dangers that had been building in the global financial system. The failure was particularly striking because this was an era in which regulators worked intensively to build and strengthen internationally coordinated prudential standards that were designed to create more shock-proof global financial markets. These efforts had begun with the creation of the 1988 Basel Accord, which set out common capital standards for international banks (updated between 1998 and 2004 into “Basel II”). They then accelerated in the wake of the 1994 Mexican and 1997–1998 East Asian financial crises, when policymakers from the G7 countries began to promote the global adoption of international best-practice standards. These standards applied to a wide range of prudential issues relating to bank supervision, securities regulation, insurance, accounting, auditing, payments systems, and corporate governance. In addition, the institutional environment in which international regulatory and financial stability issues were discussed was strengthened with the creation of the Financial Stability Forum (FSF) in 1999. This body brought together in one place for the first time the key international standard setting entities and other national and international officials concerned with financial stability, and it was tasked with anticipating and preventing the accumulation of system-wide risk.

Despite these initiatives, the content of the emerging “international financial standards regime” (Walter 2008) had important limitations. Although common international capital standards were developed for banks, those standards did not apply to the institutions that were becoming more and more systemically important because of securitization trends, such as investment banks, insurance companies, and hedge funds. Regulators in the United States and Europe also did not rein in banks’ creation of structured investment vehicles, even though these entities enabled evasion of the Basel capital requirements. Both U.S. and European regulators also allowed banks to lower their reserves through the purchase of CDS contracts, despite the fact that many issuers of those contracts—such as AIG—were not subject to the same capital requirements as banks (Tett 2009, pp. 45–49, 60–64).

These weaknesses were part of a broader trend in which regulators increasingly supported more “market-friendly” approaches to regulation that trusted private actors to self-regulate (Porter 2005). In some sectors, such as OTC derivatives, accounting, and hedge fund management, standards developed by private bodies were endorsed by policymakers. In other key areas, such as credit rating, international standard setters developed only voluntary rules for the industry. Even the international standards that encouraged mandatory regulation by national public authorities, such as bank capital rules, increasingly moved in the same direction. In 1996, Basel I was amended to allow large banks to use their internal value-at-risk models to calculate capital charges for market risk. The 2004 Basel II agreement then reinforced this approach, allowing large banks to use internal risk models to determine the amount of capital to put aside for overall credit risk. It also assigned credit-rating agencies a formal role in credit risk assessment for banks and elevated “market discipline” to become one of its three pillars of regulation (alongside formal capital requirements and supervision).

Given the problems accumulating in the markets, these regulatory trends could not have come at a worse moment. The growing reliance of regulators on market-based mechanisms for valuing risk and assets also had dangerously procyclical effects. During the boom, risk valuation models drawing on market prices signaled a relatively low-risk environment and thus encouraged further buying. Once the crisis
began, however, the same models unleashed a vicious downward cycle by prompting mass selling. The new requirements under international accounting rules to use “fair value” accounting have also been criticized for having had the same effect because they forced institutions to value assets at their market value at any given moment.

These international trends were reinforced by various deregulatory initiatives at the national level, of which moves in the United States proved particularly important for the global system (Johnson & Kwak 2010, Roubini & Mihm 2010). In 1999, the U.S. Congress largely repealed the separation of investment and commercial banking that had been established after the Great Depression. This change facilitated the greater participation of commercial banks in the securitization trends and intensified competitive pressures among firms. The next year, Congress locked in a laissez faire regulatory environment for OTC derivatives. In 2004, the U.S. Securities and Exchange Commission lifted a 12:1 leverage ratio for investment banks, a move that enabled them to engage in greater risk taking. Finally, in the years leading up to the crisis, U.S. authorities did not do enough to stop the growth of poor mortgage lending practices in the private sector, especially vis-à-vis subprime loans. The deregulatory trends in the United States were echoed in many other countries, most notably the United Kingdom, which trumpeted its “light-touch” regulatory environment.

**IPE Scholarship Before the Crisis**

How well did IPE scholars identify the problems being generated by securitization and regulatory trends during the lead-up to the crisis? Particularly prescient was Kapstein (2006), who questioned the conventional wisdom that securitization was making the global financial system safer in a 2006 article surveying what he called the contemporary “financial risk environment.” Kapstein noted that the opacity of derivatives created risk exposures for financial institutions that were difficult to monitor, and that banks were using CDS contracts to reduce capital requirements in ways that shifted risks to the sellers of the insurance. He also highlighted the new off-balance-sheet risks as well as the potential procyclicality of Basel II in a downturn. In addition, Kapstein argued that increasingly large banks might be generating new risks because of their growing interconnectedness, their managers’ difficulties in monitoring firm activities, too-big-to-fail mentalities, and potential exposure to a housing market collapse. He warned of a possible future crisis involving “the collapse of a trillion dollar institution, with myriad tentacles of complex financial engagements reaching deeply into firms, markets, and households” (Kapstein 2006, p. 148). Such a crisis, he argued, would require a massive bailout involving legislative support. This, in turn, would encourage domestic politicians to become much more interested in regulatory issues than they had been before the crisis.

A number of other specialists in the IPE of finance also anticipated important parts of the story. Strange (1998) warned of a major crisis because global markets were increasingly out of the control of regulators and supervisors. Among other developments, she called particular attention to the dangers posed by the delegation of regulatory functions to private actors in international standards and by the growing opacity of, and leverage within, OTC derivative markets. Before the crisis, Underhill (1995) had also been a longstanding critic of the endorsement of self-regulation in international standards, and, along with some colleagues, he developed a strong critique of Basel II’s procyclicality and its endorsement of internal risk models (Claessens et al. 2008).

Blyth (2003) also criticized the procyclicality of banks’ internal risk models as well as the decision of Basel regulators to give them

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2 Some also blame the U.S. policy makers for pressuring Fannie and Freddie to buy more subprime loans, but others argue that the growth of subprime lending was mainly underwritten by private lenders rather than these agencies (Johnson & Kwak 2010, pp. 144–46; Roubini & Mihm 2010).
He worried too that the complexity of derivatives made risk monitoring particularly difficult, and he predicted that their growth would mean that future crises would be “amplified through the system in unpredictable ways” (Blyth 2003, p. 248). Three years later, a book by Bryan & Rafferty (2006, p. 209) also surveyed the political economy of derivatives and argued that “derivatives have made it likely that any financial crisis will have a more pervasive and speedy impact than was previously the case.” Best (2005) similarly warned about the opacity of derivatives and the links they created across markets. More generally, she expressed skepticism about the trend of “privatizing risk” and supporting market-friendly regulation, highlighting the difficulties for market actors of accurately determining any institution’s risks at any given time.

Other IPE scholars also focused on some of the lightly regulated private actors that were becoming increasingly significant in global markets. Sinclair highlighted how securitization trends were boosting the influence in global financial markets of credit-rating agencies, and he warned about giving them too large a regulatory role given that their ratings were procyclical and often flawed because of conflicts of interest and various biases (King & Sinclair 2003, Sinclair 2005). Harmes (2001a, 2002) also called attention to the growing power of hedge funds and argued that their herd behavior and overleverage could be a source of financial instability and systemic risk. He urged stricter mandatory regulation, arguing that voluntary standards and market discipline were unlikely to constrain their risky activities.

Finally, some IPE scholars also identified the importance of securitization trends in the housing sector before the crisis. Particularly noteworthy was the work of Langley (2006), who called on scholars to pay more attention to growth of the MBS market in the United States and United Kingdom. In an analysis he subsequently expanded in a 2008 book, Langley urged his IPE colleagues to recognize that international capital flows were increasingly linked to the housing-related borrowing and saving in these two countries. He highlighted how MBSs (and other asset-backed securities) had become major parts of Anglo-American capital markets and described the process by which mortgages were transformed into MBSs and CDOs and spread across the world. He also identified the key role of credit-rating agencies in the process and ways in which banks, such as Northern Rock, were using off-balance-sheet accounting to evade Basel capital rules. Although he did not predict the crisis, he was skeptical of market actors’ claims that they could capture, measure, and manage the risks involved in mortgage lending.

Explaining the Regulatory Trends

IPE scholars not only identified key problems emerging but also offered important political explanations of the trends they saw, particularly the trend toward more market-friendly regulation. Perhaps the most common explanation in precrisis IPE scholarship of the latter was...
that it reflected the power of private financial interests at both the national and international levels. Plenty of evidence of private influence pushing in this regulatory direction has been unearthed at the national level, particularly since the outbreak of the crisis (Johnson & Kwak 2010). Before the crisis, a number of IPE scholars also noted the growing capture of international policy-making processes by powerful market players organized in transnational lobby groups (Porter 2005, Tsingou 2006, Claessens et al. 2008, King & Sinclair 2003).

Anticipating many postcrisis popular analyses, IPE scholars also highlighted reasons why financial regulatory policy was particularly prone to “capture” by private interests, such as its complexity, its less obvious distributional consequences (for all but the financial sector), the prevalence of revolving doors between the financial industry and regulators, and an institutional setting in which regulators often had considerable autonomy from domestic politics. A number of analysts also pointed to some larger structural developments that they argued helped to explain the growing political clout of financial interests. One was the heightened mobility of financial capital, which strengthened the structural power of the financial industry in regulatory affairs (Underhill & Zhang 2008). Another was the fact that the financial sector had become an increasingly important source of profit accumulation and growth in capitalist societies since the 1980s, a development that some scholars linked to the exhaustion of the postwar production-centered regime (Bello 2006). Others attributed the growing significance of private standards and self-regulation to a broader weakening of the territorial nation-state and the emergence of a broader post-Westphalian world order (LiPuma & Lee 2004).

To some analysts, these structural explanations of private financial power appear less convincing in the postcrisis era because states have suddenly been tightening regulation over the financial sector at both the national and international levels, including in areas that had largely self-regulated before the crisis, such as credit rating, OTC derivatives, and hedge funds. Because many aspects of this trend have taken place in the face of the opposition of private financial interests, the influence of the latter now appears to some scholars more contingent on domestic politics and less a product of deeply rooted long-term structural developments (Helleiner & Pagliari 2010, Clapp & Helleiner 2011). As Kapstein (2006) predicted, the massive bailouts in the United States and Europe mobilized domestic societal groups and national politicians to pressure regulators for tighter rules. Although private sector voices had strong influence during the precrisis years of relative financial stability, regulators were now prompted to appease domestic legislative bodies and respond to broader domestic demands for stability in order to preserve their long-term autonomy, prestige, and future job prospects. Instead of seeing regulators as structurally subject to capture, this perspective sees them as “bureaucrats who attempt to resolve conflicting public and private sector interests in such a way as to maintain and enhance their positional power within their domestic political structures” (Kapstein 2006, p. 123; see also Singer 2007).

Alongside the influence of financial interests, precrisis IPE scholarship also attributed the trend toward market-friendly forms of regulation to ideational factors. Analysts highlighted how many top officials genuinely believed, as noted above, that securitization was creating a more resilient and risk-free financial environment. This belief dovetailed with broader triumph of free market ideology after the end of the Cold War and was buttressed by technical economic ideas such as the efficient-markets hypothesis and other aspects of modern finance theory (Blyth 2003, Best 2005, Mackenzie 2006). This cluster of ideological and technical beliefs was particularly strong among U.S. officials, but it was also quite widespread among what Tsingou (2006) calls the “transnational policy community” of experts, technical officials, and private sector actors who dominated international regulatory debates before the crisis. This ideational
context not only generated support for market-friendly regulation at the official level but also helped encourage excessive optimism within financial markets at the time (Reinhart & Rogoff 2009). Some IPE scholars have also explained the latter with reference to deeper ideational influences within Anglo-American culture, such as the discursive power of “risk management” and its link to identities of liberal subjectivity (Langley 2008), as well as the growth of a “mass investment culture” in which members of the general public increasingly associated their own prosperity with that of financial markets (Harmes 2001b, Johnson & Kwak 2010, pp. 104–18).

Finally, some analysts explained support for market-friendly regulation in more statist terms as a U.S.-driven or Anglo-American project. Because of the international importance of their financial markets, the United States and Britain had unique power to determine international regulatory outcomes by controlling access to those markets, implementing unilateral deregulatory moves, and vetoing international initiatives they did not like. They also had strong representation and influence in many of the key international forums in which regulatory issues were discussed. U.S. and British support for precrisis regulatory developments was attributed partly to the strong influence in these countries of private financial interests and the ideational trends noted above. But scholars also argued that policy makers in these states believed that these trends would benefit their states disproportionately. Not only would their powerful firms and attractive markets flourish in a more market-oriented global financial order, but free-flowing capital would be attracted to their territories to help fund current account and fiscal deficits (Blyth 2003, Kirshner 2006, Wade 2007; see also Strange 1986).

Taken together, these three broad political factors—private interests, ideational influences, and Anglo-American power and interests—offered important explanations for pre-2007 global regulatory trends (Blyth 2003, Kirshner 2003). But there was also an important lacuna in precrisis literature that was revealed once the crisis broke out. Although the crisis was global in scope, there was considerable variation in countries’ experience. As Roubini & Mihm (2010, p. 9) put it, the crisis “was not indiscriminate in its effects; only countries whose financial systems suffered from similar frailties [as the United States] fell victim to it.” The financial systems of a number of countries—including Canada, right next door to the epicenter of the crisis—remained relatively stable through the crisis, and this outcome was widely attributed to regulatory choices made before the crisis. These differentiated experiences highlight the need for more comparative analysis of financial regulatory politics (Mosley & Singer 2009). National financial systems remain regulated in quite distinct ways, despite globalization pressures and the emergence of the international standards regime after the late 1990s (Walter 2008). This kind of comparative work will also help encourage IPE scholars to move beyond the Anglo-American focus of much of the precrisis literature.

To explain precrisis regulatory trends, one final aspect of international regulatory politics deserves more attention: the politics within the FSF. In the wake of the East Asian crisis, many policy makers hoped that this new institution would play a major role in promoting global financial stability. These hopes were clearly dashed, but there is almost no academic literature in IPE (or beyond) explaining why. A thorough analysis of the politics of the FSF is also needed because the G20 leaders have now upgraded the FSF into a more substantial body, the Financial Stability Board (FSB), with a formal charter, more staff, and a strengthened organizational structure. The FSB is being touted by top policy makers as a “fourth pillar” of the international economic architecture alongside the World Bank, International Monetary Fund (IMF), and World Trade Organization (Helleiner 2010). Understanding the history of the FSF, on which the FSB is built directly, will help IPE scholars better interpret the prospects for this institution.
THE POLITICS OF CHEAP CREDIT AND GLOBAL IMBALANCES

Market and regulatory failures were not the only inducements to excessive risk taking during the lead-up to the crisis. Also important in many countries was a macroeconomic environment of cheap credit during the half decade before 2007. In the past, low interest rates have often acted as a catalyst for financial bubbles, encouraging excessive debt accumulation and leverage, as well as the pursuit of riskier investments. They played the same role in this crisis, acting as a kind of fuel that set in motion many of the market processes described in the previous section. Some analysts blame the cheap credit environment solely on domestic policy mistakes made by central banks, such as the U.S. Federal Reserve, which is said to have kept interest rates too low in this period (Taylor 2009). Others, however, take a more international view, focusing on the role of international capital flows and global imbalances. Given their international focus, IPE scholars should have been particularly well placed to study this latter cause. How well did they do?

International Sources of the U.S. Financial Bubble

Let us first examine how international capital flows contributed to the crisis. During the last two decades, financial crises in developing countries were often caused by large inflows of foreign capital, which created cheap credit conditions and contributed to financial bubbles within the country. Many of the countries affected worst by the 2007–2008 crisis had a similar experience during the years leading up to the crisis. Particularly important for the global system was the experience of the United States, which absorbed large amounts of foreign capital before the crisis from various countries in Asia, Europe, and the Middle East with large current account surpluses and high savings.

These capital inflows drove down the cost of credit in the United States, helping to explain why long-term interest rates and fixed mortgage rates remained low even after the Federal Reserve began to raise the federal funds rate in 2004–2006 (Roubini & Mihm 2010). Capital inflows contributed to the U.S. financial bubble not just at this aggregate macroeconomic level but even in a more direct fashion in the housing sector. Alongside U.S. Treasury bills, the most popular U.S. financial assets for foreign investors to purchase were MBSs, especially the “agency” bonds issued by Fannie and Freddie, which many foreigners assumed to be backed by the U.S. government (Setser 2008, p. 28; Thompson 2009).

Before the crisis, a number of IPE scholars explored the macroeconomic significance of growing foreign investment in the United States. Some even predicted that this situation might generate major global financial instability, perhaps triggered by a U.S. financial crisis (Kirshner 2008) or the bursting of a speculative bubble that was emerging in the U.S. financial system (Dieter 2007). Like most of their economist colleagues (e.g., Eichengreen 2006), however, IPE scholars working in this area anticipated quite a different crisis than the one that ultimately happened. These scholars were more focused on how foreign capital was helping to fund the growing current account and fiscal deficits of the United States, and they considered whether a sudden withdrawal of foreign support could generate a “hard landing” involving a dollar collapse and skyrocketing interest rates (see also Andrews 2008, Cox 2004, Helleiner 2008). From this perspective, the key macroeconomic danger posed by foreign investment was not that it was excessive but rather that it could be insufficient. The domestic U.S. financial bubble was relevant to the analysis only insofar as it might act as a trigger for a collapse of foreign confidence. Although these analyses were right to draw a link between global imbalances and an impending global financial crisis, the crisis that unfolded was caused by too much foreign investment in the United States rather than too little. (The bursting of the U.S. bubble also did not trigger a withdrawal of foreign capital, and it was accompanied by a
dramatic lowering of U.S. interest rates as well as an appreciating dollar, as discussed below.)

The IPE scholars who came closest to identifying the correct causal link between foreign investment and the U.S. bubble were analysts who examined foreign involvement in the U.S. mortgage market. One of these was Langley (2006, 2008), who highlighted how MBSs proved particularly attractive to foreign investors. More important, however, was the work of Schwartz (2007). He identified foreign capital inflows as drivers of the U.S. housing boom in work written before the crisis broke out, which he developed further in his 2009 book *Subprime Nation*. He argued that cheaper credit, induced partly by foreign capital inflows, generated a particularly strong stimulative effect on the U.S. economy because of high levels of home ownership and mortgage debt, as well as the structure of U.S. housing finance, which enabled easy mortgage refinancing.

Neither Langley nor Schwartz predicted the crisis, and neither identified how capital flows drove a broader financial boom involving derivatives and the shadow banking system. But their work was important in identifying one aspect of the link between foreign capital inflows and the U.S. bubble. Their insight stemmed from a common desire to move beyond conventional IPE approaches, which often conceptualized global finance as some anonymous, distant, and abstract force “out there.” That approach had already begun to be critiqued effectively by many of the scholars discussed in the previous section, who studied various actors, institutions, and social practices in the leading global financial markets. Langley and Schwartz went further to show how those global markets were linked to more micro dynamics of domestic financial systems and what Langley (2008, p. 284) calls “our everyday ‘real’ economic practices” of saving and borrowing. This analytical focus led them to see key causal dynamics that others in the field missed. Indeed, before the crisis, most IPE scholars would have considered the details of local housing finance to be primarily a domestic subject beyond the focus of their field.

IPE scholars may have overlooked the ways in which foreign capital inflows were helping to generate an unsustainable financial bubble for two other reasons as well. One was their tendency to discuss the political economy of financial crises in developing countries separately from that in developed countries. Although IPE scholars were very familiar with the role of foreign capital in generating bubbles in developing countries, they failed to extend this understanding to the U.S. situation. Second, the literature on the role of capital flows in developing-country crises had been focused primarily on speculative private capital movements. As I discuss in the next section, however, many of the key investors pumping foreign capital into the United States before 2007 were foreign governments. For those IPE scholars who had become accustomed to blaming private speculators, out-of-control private markets, and “neoliberalism” more generally, this phenomenon was less familiar territory (Helleiner & Lundblad 2008).

**Why Did Foreigners Support the United States?**

Although they failed to see how global financial flows were generating a U.S. financial bubble, IPE scholars did a better job at exploring the politics that encouraged foreigners to invest so heavily in the United States in this period. Some of the foreign support came from private investors from high-income countries with large current account surpluses, such as Germany and Japan. These countries’ focus on export-led growth has been explained by the structural features of their domestic political economies, such as the power of their export lobbies, political resistance to boosting domestic demand, and the inefficiency of domestically oriented small firms (Rajan 2010, Schwartz 2009). IPE scholars highlighted how private investors from these countries were attracted to put money in the United States in this period because of the dollar’s international role and the unique depth, liquidity, and security of U.S. financial markets, factors that contributed to what Strange (1988) called America’s “structural power” in
What attracted more attention from IPE scholars was the fact that foreign capital flows to the United States also came increasingly from foreign governments in the immediate years before the crisis, most notably those of China, Japan, oil-exporting countries (including Russia), and some other developing economies (particularly in Asia). In the case of oil exporters, the boom in oil prices after 2002 generated surplus funds, which these countries sought to invest securely and profitably in U.S. markets. Some IPE scholars also suggested that the U.S. investments of the oil-exporting Gulf states were tied to their broader security alliance with the United States (Momani 2008).

Past IPE scholarship has shown how the dollar reserve holdings of West Germany in the 1960s and those of Saudi Arabia in the 1970s were linked explicitly to broader bilateral security relations with the United States (Spiro 1999, Zimmermann 2002), and some have explained Japan’s large dollar reserve holdings in this way as well (Murphy 2006). Other explanations were put forward to account for the willingness of China and many other developing countries to invest so heavily in the United States during this period. Their investments stemmed from these countries’ rapidly growing foreign exchange reserves after 1999, which they recycled into U.S. assets such as Treasury bills or agency bonds. The Chinese case was particularly important because of the speed and scale of the accumulation of its reserves, which increased almost tenfold in a decade to become the world’s largest. Before the crisis, China’s reserves stood at over $1.5 trillion (of which approximately 70%–80% was in dollar-denominated assets).

One of the most prominent political explanations of the accumulation of dollar reserves by China and other developing countries before the crisis was in fact developed by three economists: Dooley, Folkerts-Landau, and Garber. They argued that these countries’ policies were driven by their goal to promote rapid export-oriented industrialization. In order to boost the competitiveness of their countries’ firms, governments maintained undervalued exchange rates by accumulating foreign exchange reserves. Those reserves were then strategically recycled into U.S. assets in order to help keep their major foreign market economically healthy enough to continue purchasing their exports. These economists drew a parallel to the reserve accumulation of many Western European countries and Japan during the 1960s under the Bretton Woods exchange rate system (Dooley et al. 2003).

A number of IPE scholars endorsed this “Bretton Woods II” explanation for reserve accumulation, and some refined it to highlight the domestic Chinese interests that were served by the arrangement. Instead of assuming Chinese policy makers were pursuing their country’s “national interests,” Schwartz (2009) argued that it was necessary to look at the interests of the Communist Party elite who derived private profits from their control—or their children’s control—of export industries, while deflecting to the mass public the costs of U.S. support (e.g., losses on dollar holdings, inflationary pressures). Hung (2008) also pointed out the role of the powerful coastal export sector in backing the country’s exchange rate policy.

Others interpreted the rapid growth of reserves as a tool to preserve national political autonomy in the wake of the traumatic 1997–1998 East Asian financial crisis. From this perspective, policy makers sought to build a war chest of reserves to defend themselves against volatile capital flows as well as dependence on the IMF, whose role in the crisis was widely seen in the East Asian region as unhelpful, too intrusive, and overly influenced by U.S. policy makers’ goals (Bowles & Wang 2006, p. 247; Cohen 2008a, p. 461; Setser 2008, p. 19; Wolf 2008). This desire for “self-insurance” generated what Rajan (2010, p. 82) called a “supercharged export-led growth strategy” to earn...
foreign exchange. U.S. assets were particularly useful for the reserve function given the dollar’s role as the world’s most widely used currency. From this more nationalist perspective, the holding of U.S. assets might also have been driven by the objective of cultivating some leverage over the United States. Although the Bretton Woods II theorists spoke of the “mutually beneficial gains” involved in the United States’ relations with its major creditors (Dooley & Garber 2005, p. 148), more nationalist views agreed more with Larry Summers’ description of it as a “balance of financial terror” (Thompson 2009; Cohen 2008a, p. 462).

From the self-insurance perspective, then, reserve accumulation reflected countries’ growing distrust of the international system, a distrust only compounded by the absence of serious governance reform at the IMF and the exclusion of these countries from key international financial standard-setting bodies and the new FSF. IPE scholars have not attempted to systematically evaluate the accuracy of the self-insurance perspective against the Bretton Woods II hypothesis, and this would be a difficult task because the two goals reinforced each other in ways that may be difficult to disentangle. Was reserve accumulation a byproduct of the goal of boosting exports, or was the push for export growth serving the goal of boosting reserves? The relative importance of these motivations undoubtedly differed across countries and may have changed over time. The advantage of the self-insurance story, however, is that it explains why reserve growth suddenly grew sharply after 1999. Recent statistical work by economists also suggests strong support for this explanation (Obstfeld et al. 2010).

IPE scholars also suggested one final motivation for reserve accumulation that may have become more important as time went on, particularly in the case of China. As its reserves grew ever larger, Chinese policy makers were forced to recognize that any initiative to diversify reserves risked triggering market reactions that undercut the value of their country’s remaining massive investments (Andrews 2008, Cohen 2008a, p. 462). With its claims on the United States equal to approximately one third of the Chinese gross domestic product by the time the crisis broke out, China may have been increasingly subject to what Kirshner (1995) called a kind of “entrapment,” with its fate increasingly tied up with that of the dollar.

What About the Costs?

Although there were various benefits to official reserve accumulation (as explained by geopolitical, Bretton Woods II, self-insurance, and entrapment interpretations), there were also important costs that IPE scholars highlighted in the lead-up to the crisis (Dieter 2007, Helleiner 2008, Kirshner 2008; see also Eichengreen 2006). As foreign reserves grew in size, they risked generating inflationary pressures because of the difficulties of sterilizing them. The value of reserves was also eroded by the dollar’s depreciation after 2002, a depreciation that looked likely to continue given the external debt and current account deficits of the United States. As the costs of reserve holdings grew, analysts also highlighted the risk that some reserve holders might be tempted to be the first to sell in order to minimize their losses before others made the same move, a dynamic that could generate a herd-like selling of the dollar. Such a disorderly dumping of dollars seemed all the more likely because of the existence of a new attractive alternative reserve currency, the euro, and the absence of the kinds of alliance ties and intergovernmental networks of officials that had worked to contain this kind of behavior during the Bretton Woods period. Indeed, some analysts highlighted the possibility that countries dissatisfied with U.S. foreign policy might be tempted to sell reserves for strategic reasons, a possibility that Johnson (2008) suggested was already under way in Russia before the crisis.

It was these risks that led to the predictions of a possible dollar collapse noted above. Those predictions anticipated that major creditor countries might soon judge these costs to be higher than the benefits of holding large dollar reserves. In the end, however, creditors held the opposite view—by a large margin. The danger
to the United States before 2007 was not a foreign pullout but rather foreigners’ excessive enthusiasm for U.S. assets. The crisis that broke out was a product of the fact that creditors were too generous rather than too frugal.

Even once the U.S. financial crisis broke out, there was no foreign withdrawal, despite worries among analysts and policy makers at the time. In most emerging-market countries over the previous two decades, the bursting of domestic financial bubbles was accompanied by capital flight, which only exacerbated these countries’ financial crises by generating exchange rate depreciation and higher interest rates. But foreign funding of the United States—both public and private—continued during the crisis, even as the United States lowered interest rates dramatically. Indeed, the dollar even strengthened as the crisis became more severe after mid-2008. This outcome prevented the crisis of 2007–2008 from being even more severe than it was both for the United States and for the world economy as a whole.

IPE scholars have not yet produced detailed explanations for the foreign support provided during the crisis. Future scholarship may discover that it reflected the geopolitical, Bretton Woods II, self-insurance, and entrapment considerations discussed before the crisis. But it seems very likely that one of the most important explanations was the structural position of the United States in global financial markets. Despite the enormity of the U.S. financial troubles at the time, the U.S. Treasury bill remained the investment of choice for financial institutions and investors scrambling for liquidity and security in the midst of the panic (Reinhart & Rogoff 2009, p. 222). This development highlighted not only America’s structural power but also the failure of the euro to inspire more confidence. The euro’s problems were caused by its weak political foundations, a fact that several IPE scholars had highlighted before the crisis (Cohen 2003, Pauly 2008). Because the Maastricht Treaty had failed to specify mechanisms for the prevention and resolution of euro-zone financial crises, national governments across Europe scrambled to support distressed firms in an ad hoc and uncoordinated manner, leading markets to wonder whether the integrated financial space and monetary zone might unravel. The lack of a single fiscal authority also prevented Europe from developing a financial market that could challenge the U.S. Treasury bill market as the key fulcrum of global financial markets.

The U.S. Side of the Story

If there were a number of possible reasons why foreigners exported such large volumes of money to the United States in the years leading up to the crisis, why did the United States accept the money given the dangers that it posed to its financial system? Some analysts have suggested that the United States in fact had little choice, that it was essentially a victim of the choices of foreigners to send their money to the United States. This view often draws on a famous 2005 speech by Ben Bernanke in which he attributed the growth of U.S. current account deficits and capital inflows to excessive savings in the sending countries (Wolf 2008). But efforts to cast the United States as a passive victim in the face of a “global savings glut” overlook the role of U.S. macroeconomic and regulatory policy mistakes in contributing to its own financial crisis (Roubini & Mihm 2010, pp. 249–50; Stiglitz 2010, p. 9; Taylor 2009). They also neglect the involvement of the United States in mediating and encouraging foreign capital inflows, through its Treasury bill sales and the role of Freddie and Fannie in creating a global market for securitized mortgages (Gotham 2006), as well as through its broader support for global financial liberalization. More generally, Reinhart & Rogoff (2009, p. 209) note that analysts need to explore why U.S. authorities during the bubble years did not ask themselves: “Can there be too much of a good thing?”

Reinhart & Rogoff (2009, p. 213) themselves see the U.S. policy stance as reflecting an ideational complacency—or even “conceit”—among top U.S. policy makers who believed that their “financial and regulatory system could withstand massive capital inflows on a
sustained basis without any problems.” Before the crisis, IPE scholars such as Walter (2008) also noted this overconfidence in the superiority of the U.S. financial system during this period. Walter argued that it was boosted particularly by the East Asian financial crisis, which encouraged U.S. policy makers to see their financial system as a model for the world (see also Johnson & Kwak 2010, pp. 40, 55). The prominence of a laissez-faire approach to financial regulation noted in the previous section also contributed to the U.S. complacency.

Like other past experiences of emerging-market countries, capital inflows also served many U.S. interests. Financial firms benefited from being at the center of what Schwartz (2009) calls the “global arbitrage,” selling securities to foreign investors (Setser 2008, p. 26). The housing-led boom was popular at a mass level among Americans, for whom home ownership served as a key means for building personal wealth, particularly in an era of growing inequality and economic insecurity (Rajan 2010, Seabrooke 2006). In the political arena, foreign capital helped to fund ballooning fiscal deficits generated by tax cuts and increased defense spending during the Bush administration. The Bush administration’s strategy of relying on foreign capital to live beyond its means was not unique to this era; IPE scholars have long noted a shift in U.S. policy since the 1960s toward what Gilpin (1987) called a more “predatory” form of hegemony to fund fiscal and current account deficits. The difference in this period was that some of the sources of foreign support shifted (Calleo 2009, Cox 2004).

There was thus a strange complementarity between political developments within the United States and those within the major creditor countries that encouraged large sums of capital to flow from the latter to the former during the years leading up to the crisis. Supercharged export-led growth strategies of governments in the creditor states were complemented by American fiscal overstretch and official complacency in the wake of the East Asian crisis. At the societal level, export-oriented interests in the former found common cause with Wall Street and home-buying Americans. At a more structural level, financial repression within most creditor states found its perfectly matched opposite in the uniquely deep and liquid U.S. financial markets. And hovering over the entire politics of global imbalances in this period were some geostrategic relationships between the United States and its creditors, which may have come into play.

In summary, IPE scholars may have not foreseen the mechanism by which global imbalances would generate a crisis, but some of them did develop insights about the politics that generated and sustained the imbalances before the crisis. There remains, however, much more to be explored on this topic. More detailed research is needed into the politics of reserve accumulation before the crisis in order to adjudicate between geopolitical, Bretton Woods II, self-insurance, and entrapment explanations. We also need a better understanding of the distributional politics within the United States during this period, particularly of the domestic losers from capital inflows (e.g., some manufacturing sectors) and why their voices were so little heard. Work that compares the U.S. experience with those of many developing countries that experienced bubbles in previous decades might be particularly insightful for this purpose (Sheng 2009). More analysis is also needed of the politics within other countries receiving large inflows of foreign capital in this period, which generated similar, though less systemically significant, bubbles as that in the United States (Seabrooke & Schwartz 2008).

One final issue that needs to be addressed is why more leadership was not forthcoming from the one multilateral institution that has a mandate to tackle the issue of global imbalances: the IMF. Under the original Bretton Woods system, the IMF had been given a mandate to encourage countries to “shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.” After the Bretton Woods exchange rate regime broke down in the early 1970s, the IMF’s role in this area faded. But one year before the outbreak of the 2007–2008 crisis,
the IMF attempted briefly to play a leadership role in this area, hosting a “multilateral consultation” process that involved China, the euro area, Japan, the United States, and Saudi Arabia and was designed to address global imbalances. In the end, this initiative had little impact and it has received little attention from IPE scholars. But this outcome needs to be explained because it was an important “nondecision” (Strange 1986, 1998) in the history of the causes of the crisis.

CONCLUSION

How well did IPE scholars anticipate the global financial crisis of 2007–2008? It is certainly true that no IPE scholar predicted its timing, its details, and its causes in a comprehensive manner. But the record of the field was not entirely dismal during the years leading up to the crisis. A number of IPE scholars correctly identified many of the key market and regulatory failures that ended up contributing to the crisis. They warned about many of the dangers associated with securitization, such as risk practices in mortgage securitization, the perils of relying on credit rating agencies, the growing systemic significance of unregulated or lightly regulated firms and sectors, the amplification of crises across markets and countries, the opacity of OTC derivatives, and the concentration of risk in large and interconnected firms. In the regulatory realm, they critiqued authorities for failing to update regulations to take account of many of these dangers and for relying more generally on market-friendly forms of regulation. They also developed analyses of political causes of regulatory trends, arguing that they reflected the power of private financial interests and ideational trends as well as U.S. and British power and interests.

IPE scholars were less successful in identifying the more macroeconomic causes of the crisis, particularly the role of international capital flows in helping to generate the U.S. financial bubble. But a number of scholars did usefully explore the politics that contributed to this phenomenon, notably the complementarity that existed (a) between financial repression in creditor countries and U.S. structural power in global financial markets, (b) between turbocharged export-led growth strategies and U.S. fiscal overstretch and regulatory conceit, and (c) between export interests in surplus nations and America’s Wall Street and home-buying citizens. Some predicted that the growing global imbalances might generate a global financial instability, but they incorrectly anticipated a dollar crisis because of their judgment that the politics supporting reserve accumulation in creditor states were quite fragile. Political support for reserve accumulation proved instead to be too robust. This was a misjudgment—one echoed by many economists—but hardly a case of “myopia.”

What lessons can be learned for the future of the field of IPE from the record of IPE scholarship in anticipating the crisis? Cohen (2009) suggests that IPE’s poor record in anticipating the crisis highlights the need for a major shift in direction at an epistemological level. He is particularly critical of the epistemology of the “American school,” which emulated neoclassical economics with its reductionist assumptions and rationalist modeling, thereby discounting the possibility of major systemic change. He calls on members of this school to consider more historical, institutional, or interpretive kinds of analysis, and he urges them to read more widely in the “British school” tradition, which has embraced that approach. Reinforcing this point is Palan (2009), who argues that the British school was much more successful in seeing the crisis coming, and he attributes this to its greater focus on history and structural change, its greater skepticism of neoclassical economics, and its more empirical and inductive orientation.

In some respects, my analysis suggests a similar conclusion. Far more of the articles I have cited were published in what these authors consider British school journals than in their American school counterparts. A number of the authors I have mentioned are also ones that Cohen and Palan associate with the British school. Indeed, it is striking that the two senior
scholars whom Cohen sees as pioneering the British school—Susan Strange and Robert Cox—each frequently called attention to financial fragility as a major structural feature of the global political economy during the years preceding the crisis. Interestingly, the British International Studies Association’s IPE Group also awarded its annual book prize in 2007 to a detailed analysis of the new centrality of derivatives markets in global finance: Mackenzie’s (2006) *An Engine Not a Camera*.

At the same time, however, a number of the scholars whom I have cited were also trained and/or inspired by many of the thinkers Cohen (2008b) describes as founders of the American school, not least of whom is Charles Kindleberger. These are scholars who have not embraced the more recent trends in the American school toward rationalist modeling and remain committed to the broader approaches to the field that the founders of the American school themselves embraced at the time of its creation. Many of these scholars now seem to be positioned in a kind of “missing middle” category (Ravenhill 2008) between the newer American school approach and that of the British school—what Katzenstein (2009) describes as a “mid-Atlantic” position. Although the “American versus British school” typology thus raises some questions, the literature described in this essay does suggest support for Cohen’s endorsement of more historical, institutional, and/or interpretive methods.

Does the experience of scholarship before the crisis suggest support for some of the other more traditional intellectual divides in IPE? Looking at the list of scholars I have cited, it is striking that representatives of many of the big paradigms, such as liberalism, realism, Marxism, constructivism, and poststructuralism, all had important insights. So too did scholars on both sides of other divides, such as those between systemic and domestic perspectives or between structuralist and agency-centered approaches. The record of precrisis scholarship thus makes a strong case for analytical eclecticism (see also Cohen 2009, Katzenstein 2009). And included in this eclecticism should be an openness from political science IPE scholars to insights from economists (who developed important political economy explanations before the crisis, and have done so even more after the crisis) as well as from scholars in other disciplines.

In addition to these general methodological points, the crisis has also obviously strengthened the case for IPE scholars to pay more attention to the study of global finance. For those who are already specialists in this area, I have highlighted some more specific lessons that emerge from the precrisis literature. One is the importance of opening the black box of global finance to explore the specific practices and products, institutions and rules, as well as ideas and culture that make up global markets. Second, more attention needs to be paid to the links between global markets and financial practices at more local and everyday-life levels. Third, IPE scholars need to be careful not to assume that “capital mobility” is always driven by private actors, since many public authorities are playing increasingly important roles as investors in global markets.

I have also highlighted some issues that require more research if we are to gain a fuller understanding of the causes of the financial crisis itself. Much more comparative work—particularly outside of the Anglo-American context—is needed to understand how countries experienced the crisis in quite different ways because of distinct regulatory regimes, different political responses to capital inflows, and unique patterns of integration in the global economy. Some precrisis understandings of private “capture” of regulators also may need to be re-evaluated in light of postcrisis trends. To better understand the growing global imbalances in the pre-2007 period, more research is required into the politics of reserve accumulation in major creditor states. The distributional politics within the United States during this period also needs further study, particularly in a comparative context that includes the experience of developing countries over the past two decades. In addition, at the multilateral level, IPE scholars should explore the politics of the
FSF’s functioning during its first decade as well as the failure of the IMF’s 2006 multilateral consultation exercise.

Finally and more generally, scholars might consider developing more comprehensive analytical tools to explain global financial crises from an IPE perspective. Because crises on the scale of the 2007–2008 crisis happen so rarely, IPE thinkers have not spent much time trying to develop these tools. If they had, the field might have avoided the situation where a number of IPE scholars identified partial causes of the crisis of 2007–2008 without anyone recognizing the whole picture. In particular, few scholars succeeded in drawing together the politics of the macro story of the global imbalances with the politics of the micro-level market and regulatory failures. The best-known analytical tool that IPE scholars have to explain major system-wide financial crises is the one developed by Kindleberger (1973) to explain the last global financial crisis of this scale: the Great Depression of the 1930s. But his “hegemonic stability theory” was really more a theory to explain how existing crises could be prevented from spiraling out of control through leadership activities such as maintaining open markets, encouraging counter-cyclical long-term capital flows, and acting as an international lender of last resort. The development of a more comprehensive understanding of the political economy of the underlying causes of global-scale financial crises remains an important task for future IPE researchers.

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Economic patriotism: reinventing control over open markets

Ben Clift & Cornelia Woll
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Economic patriotism: reinventing control over open markets
Ben Clift and Cornelia Woll

ABSTRACT We analyse how tensions between international market integration and spatially limited political mandates have led to the phenomenon of economic patriotism. As discrimination in favour of insiders, economic patriotism goes beyond economic nationalism and can include territorial allegiances at the supranational or the local level. We show how this prism helps to understand the evolution of political intervention in open economies and present the ambition of this collection.

KEY WORDS Economic nationalism; European market integration; industrial policy; intervention; mercantilism; regulation.

INTRODUCTION
When the financial crisis hit in 2008, the only thing more striking than the vertiginous hikes in public expenditure was the enormous range and scope of new interventionism. After decades of triumphant neo-liberalism, and policy-makers embracing self-regulating markets, suddenly the co-ordinates of economic policy rectitude were thrown into flux. The credit crunch brought the tensions within liberal international economic governance into sharp focus. Long-buried measures reappeared in political toolkits.

Some of this political intervention was entirely novel. Governments were intervening to stimulate consumption, prop up credit markets and prevent the failure of the international financial system, including pursuing unprecedented monetary expansions through untried ‘quantitative easing’ techniques. States were taking on huge amounts of debt, publicly funding private financial institutions, dictating new rules for executive pay and even nationalizing banks. Very sizable state aid packages supported not only major financial institutions but also struggling major automobile producers. These national rescue packages, bank recapitalizations and selective industry bailouts generate frictions between governments and liberal competition authorities.

What has happened to the long-standing consensus on minimal government intervention and the benefits of liberal markets? In the 1990s, authors from very different backgrounds all pointed out the apparently unstoppable rise of economic imperatives, heralding the demise of politics (e.g., Friedman 2005; Wallach and Sforza 1999; Yergin and Stanislaw 1999). Supranational
institutions such as the European competition authorities or the World Trade Organization’s (WTO) Dispute Settlement Body seemingly assured the continuous integration of markets. Yet today, the world looks much more fragmented than these accounts predicted. Open markets are constantly challenged, international economic co-operation is faltering and political intervention is decidedly local, not global.

Of course, economic interventionism never ceased completely, even in countries adamantly supporting the liberalization of markets. But the consensus of the 1990s had a lasting effect on how economic policy decisions could be justified. Tellingly, the notion ‘industrial policy’ almost disappeared from political vocabulary during this time.

In 2005, Dominique de Villepin, then French prime minister, labelled the defence of local prerogatives in integrated markets ‘economic patriotism’. Reminiscent of Listian economic nationalism (List [1841] 1974), economic patriotism suggested that economic choices should be linked with concerns for one’s homeland. The arrival of this terminology within the political lexicon of policy elites before the Great Recession illustrates profound if not self-evident contradictions between international market integration and spatially limited political mandates.

In this collection, we argue that the present crisis may have revealed these contradictions, but the underlying causes have roots that extend far beyond the global financial crisis. In a world characterized by an overlapping network of economic governance regimes, politicians face the ‘paradox of neo-liberal democracy’ (an idea developed by Colin Crouch [2008]): their political mandate is to pursue the political economic interests of their citizenry under conditions of complex economic, legal and regulatory interdependence where large parts of economic governance are no longer exclusively within their control. Faced with the constraints imposed by international trade regulation or competition authorities which increasingly proscribe traditional industrial policy as analysed by Shonfield (1965), governments had to become creative with policy strategies.

In this collection, we use economic patriotism as a prism to investigate how actors negotiate compromises between abstract economic objectives and territorially bound political obligations. We define economic patriotism as economic choices which seek to discriminate in favour of particular social groups, firms or sectors understood by the decision-makers as insiders because of their territorial status. Economic patriotism entails a form of economic partiality: a desire to shape market outcomes to privilege the position of certain actors. Unlike economic nationalism, economic patriotism is agnostic about the precise nature of the unit claimed as patrie: it can also refer to supranational or sub-national economic citizenship. Indeed, we argue that transfers between these levels are increasingly common.

We defend two arguments about economic patriotism that diverge from its popular reception. First, economic patriotism, like economic nationalism, needs to be defined by its territorial references and its underlying conception of political economic space, not by its supposed policy content. Although
Liberals have long used economic patriotism as a term of abuse, equating it with protectionism, this obscures the importance and the multiple facets and forms of the contemporary phenomenon, varying widely across countries and regions. In particular, it does not allow analysing when politicians chose liberal economic policies as a selective strategy to further territorial ‘insider’ interest (Helleiner 2002; Helleiner and Pickel 2005; Shulman 2000).

Second, although economic nationalism is as old as the nation-states themselves, we are currently observing some novel departures. Present-day economic patriotism is a response to the reconfiguration of economic governance and the interdependence of markets that only fully developed following increasing economic liberalization in the wake of the breakdown of Bretton Woods, the deepening of European integration in the 1980s, and the fall of communism in 1989. The integration of markets and the concurrent weaving together of regulatory frameworks put pressure on national economic intervention to eschew old-style industrial policy. Governments therefore had to become creative to assure traditional economic policy objectives with new means. In particular, they can now transfer economic objectives from the national to the regional level, such as the European Union (EU), which can lead to liberalization within the EU for the sake of protection towards the outside, as in agriculture. The multiple policy instruments in support of local, national or regional economic actors are today more fragmented and less coherent, but no less prevalent.

This collection examines the re-emergence, the evolution and the forms of economic patriotism in the global economy, with particular emphasis on Europe, where the overlap between economic jurisdictions is especially pronounced. We argue that economic patriotism is a universal phenomenon endemic within interdependent markets and economic jurisdictions. Despite using de Villepin’s vocabulary, this is not simply a study of French chauvinism. It also seeks to answer why German politicians, despite low levels of patriotism, have treated foreign investors as locusts; why economically liberal British prime ministers proclaim ‘British jobs for British workers’; why America, the archetypal liberal market economy, returns to ‘buy American’. We attempt to answer these questions by paying attention to the deeper political economic causes to these contemporary phenomena. The taboo-breaking attempts to protect local economies suffering from the global financial crisis are a logical extension of this conundrum: they are remarkable in size, but not in nature.

The remainder of this introduction divides into four parts. A first section situates this study of economic patriotism within the comparative and international political economy literature and cautions against a monolithic conception of economic liberalism. The second section develops economic patriotism as an analytical concept and delimits it from related notions such as economic nationalism. A third section explores different forms of economic patriotism, and provides a typology for mapping the qualitative transformation of economic patriotic political intervention in the economy. In doing so it sets out how political control of the economy is being reinvented. A fourth section maps out the structure of this collection and summarizes its contributions.
The apparent struggle between economic liberalism and parochial protectionism has occupied political debates and public discourse. In contrast, academic writing on the consequences of economic globalization is more nuanced and has moved beyond a simple dichotomy between open and closed borders. Scholars interested in the evolution of political economic orders have engaged with the globalization literature to demonstrate that convergence to a unique liberal market model is unlikely (Kitschelt et al. 1999). Studies have highlighted the importance of national economic policy styles, neo-corporatist arrangements, the institutional organization of the political economy or production regimes, and a vigorous debate erupted in the 1980s and 1990s to determine how the different capitalist models adapted to the increasing interconnection of markets (Amable 2003; Crouch and Streeck 1997; Hall and Soskice 2001; Perraton and Clift 2004). While some authors insisted on path-dependencies of existing models, others highlighted how firms and individual sectors adjusted differentially (Berger 2005; Piore and Sabel 1984). The varieties of capitalism literature focuses on institutional complementarities within national models and specifies ideal types of national market governance in an open economy (Hall and Soskice 2001; Hall and Thelen 2005; Höpner 2005). In sum, the debates in comparative political economy and industrial sociology pointed to relatively stable sets of institutional arrangements, which characterized socioeconomic governance within countries, shaped their adjustment to market opening and conditioned institutional change (Streeck and Thelen 2005). One of the most forceful lessons of this literature is that there is not one ideal type political economy that all countries will emulate, despite undeniable pressures towards liberalization.

We are therefore interested in understanding how the implementation of liberal market policy varies across countries and sectors. Curiously, neither industrial sociology with its focus on firms and sectors, nor the varieties of capitalism literature with its emphasis on institutional stability have much to say about governmental strategies (but see Porter [1990]). Several authors have criticized the silence of the comparative political economy literature about the role of the state (Hancke et al. 2007: 4, 14–16; Levy 2006: 22–24; Schmidt 2009). In contrast, our account of economic patriotism entails a more encompassing vision of state action and activism than the governmental defence of institutional comparative advantage suggested, sotto voce, in Hall and Soskice (2001). Economic patriotism offers a conception of market relations as always subject to political acts of market-making and market-shaping, and of states as primary authors of interventionism. This is particularly relevant in open economies, where governments and firms are constantly arbitrating about the most adequate level of political and economic authority (Fioretos 2011).

Put differently, within the general move towards market-based solutions and amidst an increasing density of transnational jurisprudence to maintain open
markets, the question for governments everywhere is what kind of economic liberalism to espouse in order to defend local economic interests in interconnected markets, and what kinds of state action or activism are needed to achieve it. We thus propose a more state-centric account of socio-economic governance. Economic liberalism does not imply the disappearance of the state, as we are frequently reminded (Evans et al. 1985; Levy 2006; Schmidt 2009). Analysing comparative capitalisms using economic patriotism avoids two cul de sacs: firstly that of viewing socio-economic governance today as a whether-or-not story of market integration (Strange 1997); and secondly assuming the ‘co-convergence’ on either the liberal or the co-ordinated model (Hall and Soskice 2001; for a critique see Hay [2004]; Crouch 2005). Instead we conceive of the terrain as political choices between a more differentiated range of possible paths of adaptation, each orchestrated to a significant degree by governmental action.

Scholars working from an international political economy (IPE) perspective have theorized who the winners and losers of market integration are in order to determine which policy coalitions should form to support further integration (Gourevitch 1986; Rogowski 1989). Moreover, they draw attention to how market interdependence shifts domestic politics by redistributing power resources among political and economic actors (Gourevitch 1978; Keohane and Milner 1996). According to these studies, pro- or anti-integration political stances are motivated by interest group pressures and class struggle, which in turn is a function of the country’s economic endowment (Hiscox 2002).

The IPE literature’s focus on ‘open economy politics’ (Lake 2009) gives us important indications about the coalitions that should be opposed to further integration. Unfortunately, it is not well attuned to studying how such support or opposition affects the multitude of instruments that politicians and economic actors have at their disposal. With its origins in open economy economics analysis of trade and finance, much IPE theorizes in terms of ‘open’ or ‘closed’ markets. As the comparative literature has highlighted, these terms are insufficiently nuanced for understanding the present-day economic regulation (Fioretos 2011). We concur, and argue that the IPE literature fails to capture the great variety of instruments and adaptation strategies which emerge from this collection of contributions. As the following contributions demonstrate, regulation of economic activity is today much more internationally intertwined and can no longer be neatly separated into national governance and trade relations. Instead, much regulation has become transnational and the majority of international negotiations today revolve around ‘beyond the border’ issues (Drezner 2007; Farrell and Newman 2010).

In this context, governments have had to innovate to reinvent their modus operandi of economic interventionism, for example by employing urban policy to serve competitiveness objectives (OECD 2006; Crouch and Le Gales 2012). The variegated nature of these policy choices, the state-orchestrated market-shaping and the complexity of the policy terrain of contemporary economic governance are not captured by the dichotomous opposition
between open and closed borders which inform traditional IPE approaches. Our analysis more effectively captures the quest for the right kind of regulation: how can policy élites liberalize in a way that benefits mostly its own, how can an industry remain shielded from foreign competition without contravening international liberal market rules? How much regulation is necessary to maintain foreign investment without losing control over crucial companies? With its more fine-grained appreciation of the policy choices, economic patriotism as a conceptual lens helps move beyond the open vs closed borders or liberalization vs protection debates that can stultify studies of economic nationalism.

The fundamental differentiation between our approach and much comparative and international political economy literature is the understanding of the mutual constitution of state and market. The conception of state–market relations underlying this analysis of economic patriotism is informed by Karl Polanyi’s work and economic sociology, both insisting on the inescapably embedded nature of market activity (Block 2003; Block and Evans 2005). Polanyi’s insight that liberal markets need constant state intervention implies that economic liberalism is not a singular, monolithic political economic tradition, but comes in many variants. As Andrew Gamble (1999: 144) put it, ‘it may not be possible to live in a world without capitalism, but capitalism need not be a single fate’. Liberal market capitalism rests upon sustained, extensive and politically contested legal and legislative interventionism in economic activity by the ‘liberal state’ (Polanyi 2001: 79–80, 136–9). Polanyi noted of the 19th-century expansion of laissez-faire:

Laissez-faire itself was enforced by the state. The [eighteen] thirties and forties saw not only an outburst of legislation repealing restrictive regulations, but also an enormous increase in the administrative functions of the state. (Polanyi 2001: 145)

Our approach thus implies an embedded understanding of state–market relations, and highlights the reconfiguration of economic and political space which provides their context. Analysing economic patriotism allows studying the multiplicity of solutions enacted for governing the economy, in particular by focusing on the status of territorial boundaries in political decision-making. Based on these foundations, the third section will set out how to explain and understand patterns of change within economic intervention. Before that, however, we define the concept in more detail to clarify its analytical leverage.

DEFINING ECONOMIC PATRIOTISM

Intuitively, economic patriotism evokes the subordination of economic objectives to the protection of homeland interests. Used as a synonym for economic nationalism, it has been equated with (neo-)mercantilism. Throughout the post-war era, economic nationalism was a common opprobrious term among liberal economists used to discredit policies (see Levi-Faur 1997a). A more recent
literature on economic nationalism has argued vigorously, through empirical studies and a re-examination of Friedrich List’s 1841 classic The National System of Political Economy, that economic nationalism needs to be defined by its nationalist references, not its supposed protectionist policy content (Abdelal 2001; Crane 1998; D’Costa 2009; Helleiner and Pickel 2005; Mayall 1990). List himself, they argue, did not define his argument through policy recommendations (Helleiner 2002; Levi-Faur 1997b). List may be renowned for advocating infant industry protection, but his main contention with economic liberals was a conceptual dispute. Liberalism’s ‘theory of a cosmopolitan economy’ considered policy from the perspective of individuals and aimed to increase prosperity for humanity. This, he pointed out, ignored the importance of nations as intermediaries between individuals and humanity. Rather than developing a ‘science that teaches how the entire human race may attain prosperity,’ he wanted to limit his ‘teaching to the inquiry of how a given nation can obtain . . . prosperity, civilisation and power’ (List [1841] 1974: book II, ch. XI). The key point, for List, is that political intervention and the shaping of market outcomes in inextricably part of capitalism, even liberal capitalism. That is why, for List, ‘free trade’ is not really free:

As long as some nations will persist in regarding their special interests as of greater value to them than the collective interests of humanity, it must be folly to speak of unrestricted competition between individuals of different nations. (List [1841] 1974: 261)

This emphasis on citizens’ national identities and their historical and cultural characteristics underpins the difference between economic nationalism and the statist perspective of realism. Economic policy decisions can be rooted in ‘representations of economic life as well as socio-cultural memories’ and thus be nationalist without being about augmenting power or state-building (Crane 1998: 56; see also Abdelal 2001). Studying the variations and evolution of economic nationalism therefore requires a careful focus on national references rather than policy content, locating analysis historically and culturally within distinctive sets of state–society relations.

One of the most important lessons of this recent literature is the study of ‘liberal economic nationalism’ (Helleiner and Pickel 2005), wherein nationalist calculations (e.g., a desire for national autonomy, unity or identity) can inform engaging in international economic regimes and liberal commitments. Dirigiste France is said to have supported liberal European integration to strengthen its global role, former Soviet countries adopted liberal policies to gain autonomy from Russia and construct independent national identities, and Great Britain and later the United States might have endorsed free trade, not to promote global welfare but to establish a world-wide economic pre-eminence.

Whilst embracing this corrective, we insist that the full complexity of the phenomena which interest us cannot be adequately addressed with the notion ‘economic nationalism’. Focusing on economic patriotism rather than economic nationalism frees us from the shackles of methodological and conceptual
nationalism. In Europe, insistence on the defence of economic interests increasingly lists European interests alongside national ones. Indeed, economic patriotism can shift scales and espouse a ‘fortress Europe’ (George 1996) or aim to create ‘European champions’. Inversely, it can also shift downward to local interests, even if this implies a disadvantage to other producers in the same country (Goff 2007). For example, the defence of labels of protected origins in the World Trade Organization (WTO) constitutes local economic patriotism – or Lokalpatriotismus, which is common in German language. The possibility to shift scales illustrates that the ‘paradox of neo-liberal democracy’ is not only a problem for policy-makers, it also offers possible solutions by allowing them to shift attention to a different level of political authority.

In defining economic patriotism, it is nonetheless useful to begin with economic nationalism. According to Ernest Gellner (1984: 1), ‘nationalism is a political principle, which holds that the political and national unit should be congruent’. The same holds true for patriotism. However, as a theory of political legitimacy, patriotism attributes an intrinsic moral value to the defence of the homeland, even if it does not specify its boundaries. Economic patriotism thus suggests a value ordering where the homeland ranks higher than individual economic interests. As in all studies of motivations, disentangling individual or collective preferences from pure rhetoric can be difficult. However, the moral implications encourage discrimination against outsiders, which is more easily observable. We therefore concentrate on economic discrimination against territorial outsiders.

For lack of space, we are focusing our attention on state-led activity, and supra-national initiatives undertaken by political élites. There are, of course, many other forms of economic partiality rooted in the activities, for example, of consumers, employers, workers or social movements (see Chang 1999; Costa et al. 2007; Dubuisson-Quellier 2008; Porter 1990).

**FORMS OF ECONOMIC PATRIOTISM**

We use the concept of economic patriotism as an umbrella to highlight some fundamental characteristics of economic intervention. Within that, categorizing different forms of economic patriotism is a useful heuristic device, which facilitates the analysis of trends within economic interventionism. In order to specify the distinct forms that economic patriotic activism can take, it is important to distinguish, first, between the discourse and practice of economic patriotism, second, between different types, and third, between the policy content and targets.

The salience of economic patriotism in political discourse is striking, as is the considerable gap that can exist between public declarations and actual intervention. When French president Nicolas Sarkozy urged French automakers to locate their plants at home rather than the Czech Republic in February 2009, many suspected that he counted on European officials, pointing to free movement principles, to make his suggestions inconsequential. Indeed a major reason
for economic co-operation beyond nation-states is to constrain national politicians always under pressure to respond to their electorates. Contributions in this collection interrogate the relationship between political rhetoric and interventionist practice, to evaluate whether economic patriotic discourse amounts to more than ‘cheap talk’ about parochial intentions in a global era. Analysis of these discursive dimensions unearths that disjunctures between the rhetoric and the reality of economic patriotism can take different forms, including sur-reptitious partial interventionism in support of the homeland, unadvertized for fear of being accused of economic heresy or xenophobia. Economic patriotism can thus characterize both discourse and practice, and the two might not necessarily coincide.

Second, we can distinguish different forms of economic patriotism, which we separate by their reference points. Patriotic action can appeal to one’s nation or some other territorial unit. Along this first dimension, we find: (1) supranational economic patriotism; (2) economic nationalism; and (3) local economic patriotism. Furthermore, economic patriotism can be conservative, i.e., looking to preserve the status quo or ‘static efficiency’ or offensive, i.e., seeking to enhance ‘dynamic efficiency’ (Chang 1999) and outward-looking in some innovative way. (4) Conservative economic patriotism refers to the traditional protectionism. Outward looking, or (5) liberal economic patriotism, by contrast, entails selective or strategic liberalization in a way that privileges a particular set of economic actors. Alternatively, it can also aim to support the competitiveness of national firms or citizens operating abroad (see D’Costa 2009). It is possible to cross these two dimensions to get a sense of the possible variation that can exist.

Economic patriotism can aim to shield producers and/or preserve extant comparative advantages at each level, even the supranational one, which the debate about defensive regionalism and ‘fortress Europe’ has highlighted. In cases where regional markets are not integrated, however, supranational economic patriotism can entail considerable liberalization, even if the political objective is ultimately the creation of a trading block able to defend the regional interests in world markets. Depending on the starting point, the nature of the economic intervention is thus quite different at all three territorial levels.
At the national level, we find the categories identified by the recent literature on economic nationalism. At the sub-national level, we again distinguish between the defence of existing local production advantages and the creation of local advantages in the process of integrating markets, typically through the creation of sub-national champions. Interestingly, the creation of such champions necessarily implies that the government discriminates in their favour and neglects other sub-national actors, as the contribution by Crouch and Le Galès in this collection shows.

Categorizing different forms of economic patriotism distinguishes the nature of intervention in a very general way. However, to study intervention within one country and over time, it is also necessary to address the policy content and the different instruments which political authorities employ to support the economy. This brings us to our third distinction between policy content and policy targets. Again, we begin by acknowledging that interventions exhibit different degrees of compatibility with market objectives: we posit a continuum from relatively liberal to protectionist economic policies. Conflict over policies often revolves around the fluid boundary between favouring territorial insiders and resisting outsiders. Some policies are designed to support insiders without in principle excluding outsiders, but still in effect strengthen the position of national or regional target groups. Other policies are explicitly designed to block outsiders from participating on an equal footing with insiders, but they can do so with distinctly national criteria or with reference to characteristics that are not territorially bound in principle, although they might be in practice. If we cross these two dimensions, we obtain the Table 2.

Table 2: Classifying the policy content of economic patriotism

<table>
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<tr>
<th>Ideological affinity</th>
<th>Liberal</th>
<th>Protectionist</th>
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<tr>
<td>Policy target</td>
<td>Favouring of insiders</td>
<td>Q1 e.g., selective liberalization in strategic sectors</td>
</tr>
<tr>
<td>Resistance to outsiders</td>
<td>Q2 e.g., risk regulation or competition rules that prohibit standards common abroad</td>
<td>Q4 e.g., classic barriers to trade</td>
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</table>

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by liberalizing in a way that entails regulation which targets the practices of foreign competitors (Q2). On the right-hand side, we find policies seeking to preserve the status quo, either by maintaining traditional product or process regulation beneficial to insider companies (Q3) or using classic trade barriers (Q4).

Our argument is that the integration of markets and international jurisprudence put pressure on the instruments available to governments. Where economic regimes are multi-layered and contain legal enforcement rights, the political control over the economy therefore had to be reinvented. As Jonah Levy (2006: 2) puts it, ‘while old forms of state intervention may be discredited and cleared away, new interventions often emerge to take their place. The state also rises.’ Deregulation, of course, involves not simply removing restrictions but active re-regulation: the new regulatory frameworks differ between countries, regions and sectors in ways that are designed to promote particular outcomes. Deregulation has not and could not ever simply be a case of eliminating controls; the huge raft of legislation and directives required to institute the Single European Market exemplifies this (Vogel 1995). This need for re-regulation gave politicians the means to continue influence over the economy in pursuit of territorially beneficial outcomes.

Since international agreements target mainly outright protectionism with clear discriminatory effects, our hypothesis is that economic patriotism will shift from measures that fall in quadrant 4 of Table 2 towards quadrants 3 and 2, and in some select cases quadrant 1. Furthermore, we expect protectionist measures to favour insiders (Q3) to move away from clearly identifiable insider support such as direct subsidies and to turn increasingly into aid that is in principle open to everybody irrespective of nationality, but in practice particularly attractive to homeland producers. The nature of the precise instruments chosen should vary considerably across policy domains.

Thus, our typology and our hypotheses identify growth areas for economic patriotic interventionism, and areas of retrenchment. Quadrant 4 – classic trade barriers – belong to the protectionist toolkit of traditional economic nationalists, and international jurisprudence and safeguards have reduced the efficacy and viability of these policy instruments. Activism within quadrant 1 remains possible under international rules, indicating likely increases in re-regulation to shape market outcomes in a manner advantageous to territorial insiders.

Policies that belong in quadrants 2 and 3 are less easily pigeonholed. For this reason, these kinds of interventions have stirred an intense debate about the ‘hidden protectionism’ inherent in regulatory policy-making (Jordana and Levi-Faur 2004; Vogel 1995). The majority of negotiations in international economic integration today concern not fully fledged liberalization or outright protectionism, but effects of domestic regulation for the free movement of capital, labour, goods or services (Drezner 2007). Some regulation enshrines traditional product or process standards, thus favouring insiders already acquainted with the system (Q3). Licensing procedures or professional qualifications, such as the German ‘Meister’ for example, do not discriminate explicitly against
foreigners but defend national quality standards that are difficult to meet for producers or service providers abroad. A virulent debate has ensued about the necessity of maintaining specific standards. However, conflicts are resolved only on a case-by-case basis where a diverse set of regulatory instances determine which standards truly serve legitimate social values (e.g., risk management or environmental protection), and which are simple protectionism clothed in convoluted political rhetoric.

Regulation that is not designed to favour insiders, but that prohibits process or product standards common abroad (Q2) constitutes another form of economic patriotic intervention. Is it protectionism to refuse textiles produced with child labour, when the countries affected by such a decision can be clearly identified? Can European Union 'precautionary principle' food standards norms prohibit hormone-treated beef, even though almost all United States beef is targeted by such a decision? Even some ardent economic liberals consider that such regulation of market rules is not always in contradiction with liberal principles, despite its discriminating effects. Ignoring these intense regulation debates characteristic of national, European and international negotiations by simply labelling all that is not laissez-faire liberalism as hidden protectionism is an unsatisfactory solution. Instead, the struggle over the 'right kind of regulation' needs to be understood as the result of the need to provide political answers to citizen concerns despite ambitions to facilitate economic integration. Within modern political economies, this is where what we might call the new politics of industrial policy plays out — and it is a crucial terrain of economic patriotism, both in discourse and in practice. We extend our analysis beyond simple protectionism to all cases where politicians enact economic partiality to privilege particular territorially defined groups at local, national and supra-national levels.

Let us conclude by underlining what kind of policies are beyond the limits of economic patriotism. By definition all economic policies that are apply uniformly to economic actors irrespective of their supposed origin fall outside our remit. Moreover, when the defence of territorial interests is not the primary factor in the political decision, it would be of little analytical value to speak of economic patriotism. While cynics might argue that all economic policies aim to serve major political constituencies or industrial sectors, it is conceivable that some choices are truly informed by economic theories about optimal, welfare-enhancing policies. Such theory-driven rather than pragmatic economic policy would then clearly fall outside of the realm of economic patriotism (for further discussion, see Clift and Woll [2012]).

THE CONTRIBUTIONS AND STRUCTURE OF THIS COLLECTION

This collection analyses and compares political intervention in economic activity across countries and sectors, concentrating on how interventionism is refracted through different variants of liberal market capitalism. It begins by
analysing who perpetuates economic patriotism as a discourse and a strategy, focusing on governments, public officials (Rosamond) and socio-economic actors (Fetzer). Analysing economic patriotism allows examining the multiple ways political actors seek to articulate economic policy objectives with territorial boundaries and how socio-economic actors, such as firms and trade unions, respond to these constraints and use them to seek legitimacy in their political struggles. Next, sectoral studies explore different forms of economic patriotism in housing finance (Seabrooke), battles over stock market ownership (Callaghan and Lagneau-Ymonet), financial market governance (Morgan) and urban policy (Crouch and Le Galès). The final two contributions analyse economic patriotism transferred to the supranational level: in agriculture (Grant) and the defence industry (Hoeffler).

The contributions exemplify different ways to engage economic patriotism – through country comparison, sectoral case studies, and focusing on shifting political boundaries – illustrating different methodological possibilities and the explanatory purchase they afford. They are also illustrative of the different forms of economic patriotism we have identified in Table 1. Rosamond, Grant and Hoeffler focus on supranational economic patriotism. Agriculture provides a defensive example, whereas European defence co-operation in reveals the strategic industrial policy objectives behind liberalization and market integration. Seabrooke, Callaghan and Lagneau-Ymonet, and Morgan study economic nationalism, the first two by means of cross-country comparison, and Morgan through a case study of the City of London. All three demonstrate the evolution of economic patriotism strategies over time from protectionist and inward-looking to support for liberalization. Finally, Fetzer and Crouch and Le Galès focus on sub-national actors. Fetzer demonstrates how firms and trade unions discursively deploy economic patriotism to protect themselves, while Crouch and Le Galès show the strategic creation of city champions that are supposed to further national interests in an integrated economy.

However, to illustrate that economic patriotism is not always as pervasive as one might expect, both Hoeffler’s study of defence co-operation and Callaghan and Lagneau-Ymonet’s analysis for the foreign take-over of the French stock exchange show the limits of the phenomenon, even in areas where we should have expected it to be strong.

**CONCLUSION**

Economic governance in open economies presents formidable challenges. The current crisis has revealed the intensity of the stakes, but gives little indication about the most appropriate political organization for interdependent economies. Analysing crisis responses only as a return to protectionism ignores the most crucial aspects of today’s post-Ricardian world. It focuses on national boundaries, but assumes away that intricate web of economic interdependence that also puts pressure on policy-makers. The challenge that sovereign debt
crises in countries such as Greece or Ireland pose to European economic governance are just the most recent examples illustrating that advanced industrial countries cannot just withdraw from previous integration efforts.

Politicians and other stakeholders are therefore increasingly self-assertive about the need to reconcile both objectives: facilitate the integration of markets and protect the interest of stakeholders within a particular territory. It is telling that even core advocates of liberalization now rediscover the potential benefits of political intervention. In 2009, the chief economist at the World Bank debated the value of industrial policy in developing countries (Lin and Chang 2009). More recently in August 2010, even The Economist discussed the most useful ways of pursuing industrial policy.3

The novel terminology of economic patriotism offers an analytical lens to study how policy-makers seek to resolve the tension between interdependent economies and political territoriality in a variety of political economic settings. It brings into focus the reconfiguration of political economic space which the interdependence of markets and multi-levelled economic governance regimes entail. These are necessary to an adequate understanding of the dialectic between the politics of liberalization and the regulatory, legal and political processes of market-shaping intervention in open economies. Understanding this dialectic, we argue, is crucial for interpreting the political economy of responses to the current economic and finance crisis within affluent democracies.

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NOTES
2 Again, territorial interest and environmental or social interests might overlap, and politicians will always favour those solutions that allow pursuing them at the same time. In these cases, the litmus test will be conflicts where eventually one of the objectives has to be chosen over the others.

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