

PART I

WELFARE PRODUCTION REGIMES

Chapter One:

A Political Economy

Approach to the Welfare State

Printing is one of the world's oldest industries, and typography is one of the oldest occupations in the industrial economy. Typographers essentially transformed stacks of typed and handwritten manuscripts into a form that permitted mass-production of books, newspapers, and journals. Half technicians, half craftsmen, they were highly skilled, well paid, and proud harbingers of Gutenberg's revolutionary invention. However, the craft was radically transformed over time: first from "hot-metal" typesetting to "analog" type-setting and then to digital CRT (Cathode Ray Tube) and laser image-setting. In the process of change, previous typesetting skills were swept aside in a matter of a decade or two, and large numbers of typesetters and other printing production workers lost their jobs -- many by an invention that the printed word helped set in motion: the computer. Lead molds, printing plates and all the other

paraphernalia that went into the original printing processes were retired to the dusty shelves of industry museums. But retirement was not an option for the majority of typographers whose livelihood depended on using the skills they had acquired through long apprenticeships and years learning by doing.

The depth of desperation these workers felt as their industry was transformed -- manifested in bitter strikes across the developed world -- can be loosely conceptualized as a product of the non-transferability of their skills and the speed with which their skills were rendered obsolete by new technology, *minus* the availability of public policies such as unemployment insurance, public health insurance, pensions, retraining programs, public job creation, etc. that all cushion the effects of skill redundancy. And this formula for desperation can, of course, be applied not just to typographers but to all workers -- past, present and future -- who have skills that are limited in application and can be made obsolete by new technology and other forces of change. Social scientists are certainly no exception to this logic. If it was not for the institution of tenure, many Kremlinologists would have had little marketable expertise following the collapse of the Soviet Union.

The point of this story is to highlight a central theme of this book: the importance of political and economic institutions for protecting the human capital in which people have invested. Job protection, unemployment benefits, income protection, and a host of related policies such as public retraining programs and industry subsidies, all help

to insure workers against the loss in asset values when external shocks in technology and labor market conditions shift the demand for skills. Indeed, having in place some form of protection is a precondition for people making investments in specific skills in the first place. High job security, wage protection backed by union power, and guaranteed health and pension benefits have encouraged generations of young people to step in their parents footsteps and choose typography as their trade. And, needless to say, the health of the printing industry depended on people willing to invest in specific skills. Likewise, the acquisition of specialized knowledge in academia, including that represented by Kremlinologists, would be very risky without some form of job security, and specialized knowledge is the lifeblood of any major research institution (as opposed to teaching colleges). Even if the institution of tenure was invented as a response to the Red Scare in the 1920s, its persistence owes much to the fact that it is functional to the production of new knowledge.

But social protection is clearly not only about insurance, it is also about redistribution and political conflict. By this I mean that whereas insurance is an institutional device for workers to consensually pool their risks and reimburse each other for potential future losses, redistribution is a device to take money from some workers and give them others without any prior consent to do so. When printers' unions went on strike across the industrialized world in the 1970s, it was to seek subsidization of their own current jobs and income, not to collect an already agreed upon insurance or to guarantee the future reproduction of old typographical skills. For the unions it was a

matter of survival, and they fought bitter battles, sometimes violent, to delay the introduction of new technology and to force employers to retain their old typographical workers. It is no accident that the first publishing houses to introduce new technology, such as LA Times and Oklahoma City Times, were ones with the weakest unions.

As the printing example highlights, the political economy of insurance and of redistribution are in fact closely intertwined. Policies adopted for insurance purposes have redistributive consequences, and, as I will argue in detail later in this chapter, redistribution can also sometimes serve insurance purposes. Indeed, a central contention of this book is that answers to many of the most pressing questions about the relationship between social protection and the economy can be found in the intersection of insurance and redistribution, or more specifically in the interplay of income, skills, and democratic politics. Close linkages exist between workers' investment in skills, the international product market strategies of firms, electoral politics, and social protection. As I have argued with Margarita Estevez-Abe and David Soskice (Estevez-Abe et al. 2001), these linkages have been organized into distinct "welfare production regimes" in different countries, each associated with its own political-economic dynamic and reinforced, not undermined as often presumed, by the international division of labor.

Standard approaches to the welfare state fail to account for the relationship between production and social protection, and they leave behind a number of key questions that any political economy approach to social protection needs to answer. For example, if social protection undermines markets, as commonly argued, why is there no apparent relationship between the generosity of such protection and economic growth? A related question is why globalization has not led to a competitive race to the bottom as many feared. Indeed, it seems to be the rise of sheltered, non-traded, services that has prompted some governments to embark on labor market deregulation. To understand why, we need to examine the intersection between welfare production regimes and the creation of comparative advantages in the international economy (Estevez-Abe et al 2001). The same is true if we want to understand why employers are not universally opposed to generous social protection, and why they continue to invest heavily in economies with high social spending despite the widely held view that such spending is detrimental to business interests.

Even traditional distributive politics, I submit, is not well understood in the existing literature. Though there is considerable evidence that class politics matters, why is distributive politics played out so differently in different countries? The fact that partisan politics is systematically biased to the left in some countries but to the right in others is not in any straightforward way related to the power of unions or the size of the traditional working class. For example, it is striking that the decline of the industrial working class and their unions has been associated with a rise, not a

collapse, in the political support for the welfare state. Also, countries with the most skewed distribution of income, where standard class arguments would predict the most radical redistribution, are in fact the least redistributive. The solution to these puzzles, I argue below, is to be found in the interplay of insurance and redistributive incentives to support the welfare state, as well as in the political institutions that translate these motives into policy. In turn, preferences for social protection are explained by the key assets, especially skills, that economic agents have invested in.

In the rest of this chapter I first provide a more thorough critique of the existing literature and introduce the key concepts and causal mechanisms in the asset or welfare production regime argument (section 1.1). I then spell out the implications of the argument for understanding the role of electoral politics (section 1.2) and the relationship between the international economy, economic change, and the rise of social protection (section 1.3). I finally explore how the approach can help explain cross-national variance in some of the key dimensions of inequality and redistribution (section 1.4).

<A> 1.1. *Towards a new approach to the study of the welfare state*

As the printing industry example suggests, the ability of management to introduce radical new technology is undermined by strong unions and labor market regulation. Indeed, the notion that these institutions, and the welfare state more generally, erode the market is a central theme among neo-classical economists and political

sociologists alike. Labor in this conception is an anonymous commodity, easily aggregated into a single factor “L”, where each constituent unit (worker) is “replaceable, easily redundant, and atomized” (Esping-Andersen 1990, 37). Logically, the opposite of market (or “commodification”) is state (or “de-commodification”). It means that “a person can maintain a livelihood without reliance on the market” (Esping-Andersen 1990, 22). The welfare state transforms L into not-L, and thereby sets workers free: Free to organize, free to oppose capital, free to be an individual rather than a commodity. Again in the words of Esping-Andersen:

“Decommodification strengthens the worker and weakens the absolute authority of the employer. It is for exactly this reason that employers have always opposed de-commodification” (1990, 22). The welfare state is “politics against markets” (Esping-Andersen 1985), and the historical strength of the political left, mediated by alliances with the middle classes, determine how much welfare state and how much market you end up with (Korpi 1983, 1989; Esping-Andersen 1990; Huber and Stephens 2001).

This is power resources model of the welfare state is the dominant approach to the study of the welfare state. It suggests that the welfare state is built on the shoulders of an unwilling capitalist class, who will be looking for any opportunities to unburden itself. This is also a central theme in the burgeoning literature on globalization where the “exit option” for capital presents precisely such an opportunity. As Wolfgang Streeck explains in the case of Germany: “Globalization, by increasing the mobility of capital and labour across national borders, extricates the labour supply from national

control and enables the financial sector to refuse doing service as a national utility” (Streeck 1997). In a similar vein, Dani Rodrik concludes that “integration into the world economy reduces the ability of governments to undertake redistributive taxation or implement generous social programs” (Rodrik 1997).

Indeed, if welfare capitalism is primarily about de-commodification and exploitation of the rich one should have expected capitalists to shun productive investment in large welfare states well in advance of the onset of globalization in the 1980s. Perhaps globalization has made the tradeoff between redistribution and investment steeper because of an expanded menu options for capital, but as argued by Lindblom (1980), Przeworski (1986) and others, economic performance has always depended on the cooperation of capital. Yet, the remarkable fact about the observed relationship between spending, investment, and national income in advanced democracies is that there is none (Lindert 1996). Or if there is one it is so weak that it does not appear to have imposed much of a constraint on governments’ ability to spend and regulate labor markets. Among democracies, the countries with the largest welfare states are no poorer, or richer, than countries that spend much less.

In recent years an alternative approach to the welfare state has emerged, which emphasizes the role of employers. Contrary to the power resources model, Peter Swenson (2002) shows through careful archival research that employers played a very pro-active role in the early formation of social policy. Swenson argues that in tight

labor markets employers will seek to take social benefits out of competition by creating a uniform, national social insurance system. When labor markets are slack, high-cost producers may feel compelled to impose costs on low cost producers through mandatory social insurance arrangements. Swenson argues that the first logic helps explain early welfare reforms in Sweden, while the latter helps explain salient features of the New Deal legislation in the United States.

In a similar vein, Isabela Mares (2003) has argued that companies and industries that are highly exposed to risks will favor a social insurance system where costs and risks are shared, leading these employers to push universalistic unemployment and accident insurance. This is remarkable because universalism is usually associated with strong unions and left governments. Mares also suggests, and this is something emphasized in this book, that social protection may encourage the acquisition of skills in the labor force, which in turn enhances the ability of some firms to compete in international markets. This has led, for example, to some high-skill firms favoring generous unemployment insurance.

In a recent dissertation on the German welfare state, Philip Manow (2002) has likewise advanced the thesis that the German system of social protection, through a process of institutional co-evolution, emerged as an important complement to the collective bargaining system, which in turn underwrote union wage restraint and international competitiveness. By delegating much of the responsibility for social

policy to the social partners, the institutional incapacity of the German state to guarantee full employment (as a result of federalism, an independent central bank, etc.) was compensated for by a social system that provided very high levels of insurance in the event of unemployment and other shocks to income. In earlier work Peter Baldwin (1990) also challenges the notion that the welfare state was erected by the industrial working class alone, against the will of the middle classes. Much universalism in the “social democratic” welfare states of Scandinavia, for example, was due to pressure by farmers and other non-workers at the turn of the century to be included in social programs and to ensure that these served as instruments of insurance as much as tools of redistribution.

The evidence presented by Lindert, Mares, Swenson, Manow, and Baldwin strongly suggests that social protection cannot be conceived in exclusively in terms of simple dichotomies between the state and the market, or between commodification and de-commodification. We need a “politics *of* markets” rather than a “politics *against* markets,” or, more precisely, a theory that acknowledges that social protection can improve the operation of markets as well as undermine them. Building on Estevez-Abe et al. (2001), this is precisely what this book aims to provide. It develops an approach to production and labor markets in which the role of social protection is explicitly modeled. The theory reconciles the controversy between the power resources perspective and the new employer-focused approaches, and it also links the

study of the welfare state to recent work on the importance of democratic institutions for social policy.

At the heart of the difficulties in the standard view of the welfare state is an essentially neoclassical conception of markets. Although unskilled day workers can sensibly be analyzed as an undifferentiated factor “L”, and although such labor can be exchanged efficiently in something that approximates spot markets, new institutional economics consider these conditions the extreme of a continuum. At the other extreme you find workers with highly asset-specific investments in skills -- L_s , where $s=(1, 2, 3, \dots, n)$ refers to differentiated skills -- coupled with non-market institutions that protect and manage these investments.

It is of course not only workers who make investments in specific assets, so do firms, merchants, and virtually any agent involved in economic exchange. And because economic agents are engaged in exchange, and because they sometimes own the assets jointly, most assets are co-specific in the sense they tie together the welfare of people and make them dependent on one another. For every worker whose livelihood is tied to a specific skill there is an employer who depends on the worker with those skills. As argued by Polanyi (1944), Williamson (1985), North (1990), and others, when an economy is characterized by heavy investment such co-specific assets economic agents are exposed to risks that makes efficient market exchange problematic. A precondition for such an economy to work efficiently is a dense

network of institutions that provide information, offer insurance against risk, and permit continuous and impartial enforcement of complex contracts. In the absence of such institutions, exchange is possible only at a small scale in local trading communities where people know each other well and engage in repeated face-to-face interactions.¹ At a larger scale, markets left to their own devices will either fail to produce much exchange, will be accompanied by costly and continuous haggling, or will involve only very homogeneous types of assets (L as opposed to L_s).

Nowhere is the importance of institutions more evident than in the labor market where the welfare state plays a key mediating role. Social protection is particularly important in solving market failures in the formation of skills. Without implicit agreements for long-term employment and real wage stability, investment in skills that are specific to particular jobs, firms, or industries will be sub-optimal. In the absence of insurance, workers shun such investments because unanticipated shocks to the economy, whether due to recessions or technological change, can prevent workers from reaping the returns on their investments. Employers will also be reluctant to invest in their employees's skills, or in equipment that requires those skills, unless they believe that institutions are in place which prevent poaching and discourage unions from exploiting the potential holdup power that specific skills confer.

The importance of asset specificity is already well understood for explaining other policy areas. For example, property owners will be more inclined to hold their wealth

in liquid assets that can be quickly moved from one jurisdiction to another when there is little credible protection of property rights (Bates, Brock, and Tiefenthaler 1991). Even when basic property rights are well protected, investments vary significantly in the degree of their asset specificity. When investors cannot trust suppliers or employees on whose cooperation they depend, they will shun investments in relation-specific assets and rely instead on anonymous market transactions where one supplier or employee can easily be replaced by another. Conversely, when investments in physical assets are specific to a particular location, supplier network, or employee relationship, firms are more prone to lobby the state for protection against uninsurable risks (Frieden 1991; Alt et al. 1999).² In the most general “varieties of capitalism” (VoC) formulation, national or regional institutions act as complements to the strategies of firms, allowing them to make better use of their assets (Hall and Soskice 2001).

A similar logic applies to human capital. When skills are specific to a particular firm, industry or occupation, their owners are exposed to risks for which they will seek non-market protection such as protection of jobs, standardized wage rates, or state-guaranteed benefits. Skills that are portable, by contrast, do not require extensive non-market protection, and when there is little protection, investing in such skills is the best insurance against adverse market conditions and technological change. Yet, despite its intuitive appeal, asset specificity plays virtually no role in existing explanations of the welfare state. Labor is “L” and workers are “replacable, easily

redundant, and atomized.” Correspondingly, politics is labor against capital, L against C. By contrast, the approach offered in this book emphasizes the critical importance of the level and composition of human capital (L_s) for explaining the welfare state. The *level* because it determines income and hence workers’ demand for redistribution; the *composition* because it determines workers’ exposure to risk and hence their demand for insurance. It is natural to label this an asset theory of the welfare state, although political institutions are also important as we will see in a moment.

The link between assets and the welfare state explains the continued and even growing importance of social policy in advanced, and therefore human capital intensive, economies. In 1999, for example, American workers over the age of 25 with a four-year college degree earned an average of \$47,400 dollars compared to \$26,500 by workers with a high school degree and \$16,900 by workers who had less than a high school degree (US Census Bureau 2000). Ignoring other group differences, having a college degree is equivalent to a three percent real return on a net fortune of about \$925,000 (compared to someone with less than a high school degree). For comparison, the median net worth of an American household, most of which is tied up in real estate wealth, is \$53,000 (Wolff 1998).³ And, of course, some of this wealth reflects accumulated past returns on skills. Human capital is, thus, easily the most important asset for a majority of people.

Do people also worry about protecting the value of these assets? The answer obviously varies from individual to individual according to the level and mobility of their skills, but there is no question that many workers face a substantial risk that their training can be made partially or entirely redundant by new technology or other forces of change (as in the example of typographers above). Taken as a whole, manufacturing employment has been cut in half since the 1960s, and a large portion of the jobs that remain require substantially different skills. Although hard to quantify, there is every reason for workers and their unions to concern themselves with insurance against income losses as a result of redundant skills.⁴ And such insurance cannot be provided exclusively through the market due to problems of moral hazard, adverse selection, and other market failures. Writing complete contracts to cover all contingencies in a labor market characterized by incomplete information and highly specific investments is precisely what transaction cost economics rules out. Nearly all unemployment insurance, for example, is provided through public insurance, and while insurance companies will sell you a health insurance (unless you are already ill), there is no effective private insurance against losing your ability to pay for the insurance. For the far majority of people in advanced democracies, insurance against job and income loss comes from the state and, to a lesser extent, from individual savings.

<A> **1.2.** *Bringing electoral politics back in*

As implied above, employers who are pursuing product market strategies that require specific skills also have a vested interest in social policies that reduce the risk of acquiring those skills (Mares 1998; 2001; Swenson 2002; Estevez-Abe 1999a). The focus on employers, however, tends to leave the democratic state, electoral politics in particular, under-explored. The power of employers is primarily “structural” in nature, but governments have to win elections to stay in power, and it cannot be assumed the electoral incentives of politicians are perfectly aligned with their economic incentives (Elkin 1985; Block 1994). In Swenson’s (1998) account of the New Deal, for example, politicians are faithful representatives of employers’ long-term interests, yet they face an urgent need to accommodate popular demands for political action. Indeed, Swenson acknowledges that business often oppose such action, yet it somehow ends up benefitting from it.⁵ But electoral politics operates according to its own dynamic, and more often than not this dynamic is powerfully affected by popular demand for redistribution. As Stephen Elkin explains, “the democratic impulse is egalitarian, because rule by all requires not only political equality but also economic equality sufficient not to vitiate the premise of equal participation” (1985).

One of the great strengths of the power resources model is that it has a credible account of electoral politics. But the role of democratic politics has to be reconsidered in the context of a different understanding of the economy and of employer interests. The emphasis on class interests ignores the importance of insurance motives in people’s demand for social protection, and, as noted above, it

leaves us with the puzzle of why democracies with high inequality are not more redistributive than democracies with low inequality. The key here is to understand that redistribution, the focus of the power resources model, and insurance, the focus of institutional economics and VoC, are intimately related. Insurance against the loss of income is not only conducive to investment in risky assets, but also have the effect of redistributing income. This is obviously the case of the unemployed, who have no income, but it applies much more widely to any social protection, such as health insurance or pensions, that is not completely dependent on current employment and income. *Ex ante*, or behind the veil of ignorance as Rawls would say, people may support policies for purely insurance reasons, which, *ex post* (after the veil is raised), will redistribute income. Conversely policies that are deliberately redistributive will simultaneously serve insurance functions. The unemployed, the sick, the old, and those with low pre-fisc income more generally, will rationally press for redistribution. But by doing so many of those who are employed, healthy, young, and enjoying a high incomes will enjoy some measure of insurance against losing these goods.

This Janus-face of the welfare state means that it is unlikely to be understood as either a tool of power or simply as a complement to the economy. It is simultaneously an arena for distributive struggles and a source of comparative advantage. Those who see only the first face will tend to conclude that it is an impediment to market capitalism and that it can only survive if capital is held captive and labor is politically strong. Those who see only the second face tend to reduce democratic politics, and

electoral politics in particular, to a symbolic game where the welfare state always mirrors the needs of the capitalist economy (or employers), trumping the pursuit of competing interests. To understand the welfare state we have to explain how popular preferences for social insurance and redistribution are rooted in peoples' position in the economy, how these preferences are aggregated into social policies, and how policies in turn affect individuals' investments into assets that shape economic performance and interests. Chapter Three presents a theory of social policy preferences in which individuals who have made risky investments in skills demand insurance against the possible future loss of income from those investments. Modeling popular preferences for social protection as a function of the assets people own in the economy is the first departure from the power resource approach to mass politics.

The second departure is my attention to the specific design of democratic institutions. Consider, for example, that since social insurance may only be enjoyed by the current median voter *some time in the future*, the median voter has an incentive to support such insurance *only* if future median voters do the same. The current median voter, therefore, faces a problem of how to commit future median voters. This translates into a *time-inconsistency problem* for the government because it has an incentive to renege on its promise to the current median voter when it seeks to attract the support of the future median voter. Again, the reason is that the median voter at any given time, when choosing a policy for the present, does not have an interest in high transfers. This problem is addressed in Chapter Four.

One solution points to the role of institutions that can hold governments to its promises about future policy. The organization of political parties and their relation to private groups is particularly important in this respect. Another solution builds on the close relationship between redistribution and insurance. Because redistribution also serves insurance purposes, institutions that promote redistribution serves as (imperfect) solutions to the time-inconsistency problem. In Chapter Four I make use of recent work on the economic effects of political institutions by Persson and Tabellini (2000) and others to show that redistribution is intimately related to the electoral system (and that electoral system is also closely associated with the presence of responsible and programmatic parties).

<A> 1.3. *Globalization, deindustrialization and the expansion of social protection*

As noted above, it is a puzzle that globalization has not led to convergence in social protection. The coupling of social protection and skill systems helps us understand the puzzle by pointing to their effect on the international product market strategies of companies and the creation of comparative advantages in the global economy.

Specifically, where there is a large pool of workers with advanced and highly portable skills and where social protection is low, companies enjoy considerable flexibility in attracting new workers, laying off old ones, or starting new production lines. This flexibility allows for high responsiveness to new business opportunities and facilitates the use of rapid product innovation strategies. Such capacities are lower for firms in economies that rely heavily on non-transferable skills and that protect these skills

through restrictions on the ability of firms to hire and fire workers. On the other hand, these types of welfare-production regimes give a comparative advantage to companies that compete in markets where there is a premium on the ability to develop deep competencies within established technologies and to continuously upgrade and diversify existing product lines -- what Wolfgang Streeck in a seminal article has dubbed “diversified quality production” (Streeck 1991).

The international division of labor not only perpetuates particular product market strategies, but is likely to also feed back into political support for existing social protection regimes. As countries specialize in production that uses abundant factors intensely, demand by the owners of those factors for protection of their value rise. Contrary to the popular notion of a social “race to the bottom,” differences across countries, therefore, need not disappear with a deepening of the international division of labor -- a proposition implied by Hall and Soskice’s concept of comparative institutional advantage (Hall and Soskice 2001). Social spending in continental Europe continues to be much higher than in Ireland and the Anglo-Saxon countries, and in many areas the gap has increased. Moreover, whereas labor markets have become even more deregulated in the latter countries, employment protection for full time employees has stayed high and largely unchanged in the former (OECD 1999).⁶

The asset theory of social protection also suggest a different explanation of the expansion of the welfare state than is suggested by either power resources model or

by theories emphasizing the role of the international economy. One of the most remarkable facts about the welfare state is that public spending did not vastly differ between the US, continental Europe, or Scandinavia in the early 1960s (Rothstein 1998; Esping-Andersen 1999). “In the 1960s,” writes Rothstein, “the difference between these countries in total public spending was much smaller [than today] – the level in the United States was about 28 percent compared to a mean of 29 percent for the Scandinavian countries”. This does not mean that basic differences in unemployment, employment, and wage protection through labor market institutions did not exist at that time. They did, but the role of the state in the social insurance system through taxes and transfers was not terribly dissimilar.

The tremendous expansion of social spending since then, and the increased variation across countries, can be gleaned from Table 1.1. It shows total government spending as a percent of GDP across 17 OECD countries, the standard deviation of spending in these countries, and the difference in spending between Sweden and the US from 1960 to 1995. Note that spending rose by about 70 percent during this period, from 29 percent in 1960 to 49 percent in 1995, but the variation in spending grew even faster. Thus, the standard deviation in spending increased by about 85 percent in this period, and the difference between Sweden and the US ballooned from 3 percent to 26 percent of GDP -- a ten-fold increase.

<Table 1.1>

The power resources model attribute this growing gap to differences in working class power. But as noted in the introduction to this chapter it is awkward to emphasize the role of the industrial working class in the postwar rise of the welfare state because it has everywhere been on the decline. In Chapter Five I show that there is also little empirical evidence for the other prominent argument that the growth of the welfare state is due to increased exposure to risks in the international economy (Cameron 1978; Garrett 1998; Rodrik 1998). As I have argued with Tom Cusack (Iversen and Cusack 2000), the asset theory points a quite different force of change, one that in some respects the opposite of globalization: the transition to a largely sheltered service economy. Because deindustrialization represents a serious threat to those workers who have made significant investments in firm or industry specific skills -- a threat that cannot easily be addressed within the “private” system of protection in the labor market – it is associated with a rise in electoral demands for public compensation and risk sharing. And although deindustrialization has occurred everywhere, its speed has varied considerably across countries.

More importantly, the effects of deindustrialization have been mediated by the skill regime, as well as by the institutional capacity of the political system for credible commitment. Building on recent work on unemployment by Blanchard and Wolfers (2000) I demonstrate this institutional conditioning of common shocks with a variety of empirical tests in Chapter Five.

The growing electoral pressure for government spending has also provided politicians and political parties an opportunity to shape the structure of social protection according to ideological preferences. In this respect I am entirely in line with scholars such as John Stephens and Geoffrey Garrett who underscore the importance of partisan politics. As Anne Wren and I have argued (Iversen and Wren 1998), a particularly contentious partisan issue has concerned the extent to which the state should expand publicly provided services. Because high protection countries with extensive wage and employment regulation have created relatively few jobs in low-productivity services, and because this is where the potential for job growth (especially for women) is greatest, social democratic parties have favored an expansion of jobs in public services while Christian democratic parties have emphasized transfers and social services provided through the family. Liberal parties, by contrast, have advocated deregulation.

A critical issue examined in Chapter Six is the relationship between social protection, especially a relatively flat wage structure, and employment. Although high-protection countries have been very successful in international markets, belying the notion that high protection reduce competitiveness, they have been poor employment performers in non-traded private services (Iversen and Wren 1998). At the same time, good employment performers such as the US have paid a heavy price in the form of greater inequality. The underlying problem, I argue, is that lack of international trade in services has undermined the ability of countries to take advantage of their

comparative advantage. High protection countries, for example, have squeezed out low-skill jobs without an offsetting expansion of high-skill jobs. I call the emerging response “selective and shielded deregulation”, which means that greater flexibility in parts the labor market (especially for part-time and temporary employment) is coupled with new tax and transfer policies to shield the inequalizing consequences. I assess the limits and possibilities of this strategy and compare it to the welfare reforms characterizing Anglo Saxon countries.

<A> 1.4. *Implications for Inequality and Redistribution*

As pointed out above, there is a close affinity between the insurance and distributive aspects of the approach. Building on Estevez-Abe et al. (2001), in this section I suggest how the asset argument can be extended to unravel three sets of previously neglected logics by which welfare production regimes affect distribution. These propositions help explain several of the remaining puzzles noted in the opening to this chapter. They are elaborated and tested more extensively in subsequent chapters.

First, general skill systems are more likely to generate wage inequality and "poverty traps" because they limit opportunities and incentives for skill acquisition at the low end of the academic ability distribution. The skill system is also related to the wage-setting system, which strongly affects the earnings distribution. This helps explain why welfare production regimes are linked to wage dispersion. Secondly, demand for insurance against social risks leads to significant redistribution of income through the

welfare state, and redistributive pressures are accommodated by their insurance benefits. This helps explain why the welfare state is so broadly supported in some countries, despite modest levels of inequality. Finally, gender inequality in the labor market is intimately related to skill and social protection regimes, and such inequality, contrary to wage inequality, tends to be higher in specific skills systems. The skill argument helps us understand why that is the case. All in all, specific skills systems tend to be notably more egalitarian and redistributive than general skills systems, but labor markets in these countries tend to be more gender segregated.

** 1.4.1. Skills and wage inequality.**

It is striking, though not surprising, that all countries with a strong emphasis on industry-specific skills have developed effective wage coordination at the industry level. Conversely, general skills countries, and countries with a strong emphasis on firm-specific skills (Japan in particular), lack such coordination. Very extensive evidence has in turn been accumulated that the structure of the wage bargaining system has important consequences for the wage structure (see especially Rowthorn 1993; Iversen 1999; Wallerstein 1999; and Reuda and Pontusson 2000). As implied by the skill argument, intra-occupational compression of wages serves as a complement to employment and unemployment protection because it helps insure against a big drop in income if a worker loses her job. Collective bargaining at the industry or higher levels also gives low income groups influence over the distribution of wages that they lack in the market. Such influence tends to promote equality.⁷

But the skill system itself is also important as suggested in Figure 1.1. The graph uses the incidence of vocational training as an indicator of the extent to which workers are acquiring specific vocational skills as apposed to general academic skills.⁸ Note the strong empirical association between skills and earnings equality. Because specific skills systems generate high demand for workers with good vocational training, young people who are not academically inclined enjoy career opportunities that are largely missing in general skills systems. Whereas a large proportion of early school leavers in the former acquire valuable skills through the vocational training system, in the latter most early school leavers end up as low-paid unskilled workers for most or all of their working lives.

<Figure 1.1>

This pattern also implies that young school goers in specific skills systems have strong incentive to work hard in school, whereas the same is not true for students in general skills systems who do not expect to go on to college.⁹ Although there are clearly alternative interpretations, data from standardized international literacy tests are consistent with this idea as suggested in Figure 1.2. Countries are ranked by their share of poor performers, the rough division between general and specific skills countries has been indicated with brackets.¹⁰ Whereas the percentage with the lowest score averages 20 in Ireland and the Anglo-Saxon countries, the comparable figure in countries emphasizing more specific skills is 10. The correlation between vocational

training intensity and the percentage with low test scores is .73. Likewise, those who leave school without an upper secondary education tend to have much higher test scores on job-relevant skills (here measured by document literacy) when they are in specific skills rather than in general skills systems: 46 percent of early school leavers in the former have high literacy scores compared to only 28 percent in the latter.

<Figure 1.2>

In combination, the wage bargaining system (i.e., whether it is industry coordinated or not) and the skill system (i.e., whether it is specific skills or general skills biased) provide a powerful explanation of earnings inequality. This points to the importance of paying attention to factors outside the welfare state that affect distribution. Much of the welfare state literature fails to do this, notwithstanding its almost exclusive focus on distribution. In the welfare production regime argument, non-state institutions are integral parts of the story even though the main functions of these institutions may be insurance and efficient management of co-specific assets.

 1.4.2. Social insurance and redistribution

As I noted above, workers who are behind Rawls's veil of ignorance do not know with certainty how they will fare in terms of future employment and income. In this situation, risk-averse people will demand insurance against loss of employment and income. If these preferences are translated into policy, *when* the future arrives the *ex*

post distribution of income will be more egalitarian than the *ex ante* distribution. A generous tax and transfer system will therefore result in redistribution of income *even* if the system is solely intended for social insurance purposes. A related logic works from redistribution to insurance. If pressure for redistribution produces a more egalitarian after tax and transfer distribution of income, such redistribution will serve an insurance function. This is particularly important to understand because redistribution, unlike provision of social insurance, does not imply a time-inconsistency problem. Also it helps us understand why countries with a lot of redistribution perform better than we would expect from a standard neoclassical analysis.

Chapter Four explores this interaction between redistribution, insurance and the economy in detail. One proposition is that much observed redistribution can be attributed to the political support for insurance. Here the basic idea can be illustrated with some data on pre- and post-tax and transfer income from the Luxembourg Income Study (see Bradley et al. 2002 for details).¹¹ The inequality measure is the gini coefficient, and redistribution is the percentage reduction in the gini from the pre-to post-tax and transfer distribution of income. To ensure that the measure is related to the concept of wage protection, the data only includes the working age population. The data are available for 14 advanced democracies and represent averages for a period starting in the late 1970s and ending in the mid 1990s (time coverage varies by country).

Figure 1.3 shows the reduction in pre- and post-tax and transfer inequality as a function of the level of taxes and transfers. As expected, there is a positive relationship ($r=.68$), and, although we do not know from this relationship how much is due to a deliberate attempt to produce redistribution as opposed to insurance, Huber, Stephens and their associates have found a strong positive relationship between tax and transfers and redistribution after controlling for the partisan preferences of governments and a host of other factors (Bradley et al. 2002). In fact, their findings indicate that the level of taxes and transfers (what they term welfare state generosity) is one of the most important determinants of both redistribution and poverty reduction. But welfare state generosity itself is left unexplained. The asset theory implies that generosity is strongly affected by the structure of skills and the demand for insurance to which they give rise.

<Figure 1.3>

The second step in the argument, therefore, is to relate skill structure to the level of taxes and transfers. Again using vocational training rates as a rough indicator for national skill structure, Figure 1.4 shows that skills are indeed closely related to the magnitude of tax and transfers ($r=.86$) and indirectly to redistribution ($r=.50$). Despite the emphasis on insurance over distribution, skill structure is, thus, important for explaining not only pre-tax/transfer income equality as shown above) but also welfare state redistribution.

<Figure 1.4>

But this does not mean that the power resource story is irrelevant because, again, the causality also runs in the opposite direction. That is to say, if investment in specific skills is a function of the availability of income insurance, redistribution via the tax and transfer system will tend to produce, in equilibrium, a skill profile that is more specific. Without redistributive insurance, investment in general skills is the best defense against adverse changes in the labor market. And there is strong empirical evidence that countries which are dominated by left governments also redistribute more (Hibbs 1977; Korpi 1983; 1989; Boix 1998; Bradley et al., 2002).

This raises the question, however, why some countries are dominated by left governments while others are dominated by right governments. If the left and right take turns in government, it would provide no institutionalized support for investment in risky assets. But Chapter Four argues that partisanship is determined by the differences in coalitional dynamics resulting from differences in electoral systems. Table 1.2 shows the strong empirical relationship between electoral system and partisanship using a new data set on parties and legislatures assembled by Cusack and Engelhardt (2002) and Cusack and Fuchs (2002). The figures are the total number of years with right and left governments in 17 advanced democracies between 1945 and 1998. Among majoritarian systems, 75 percent of governments were center-right, whereas in PR systems 70 percent were center-left (excluding “pure” center

governments). The numbers in parentheses convey a sense of the evidence at the level of countries, classifying countries according to whether they have an overweight (more than 50 percent) of center-left or center-right governments during the 1945-98 period.

<Table 1.2>

The importance of the pattern revealed in Table 1.2 for the argument in this book is that the electoral system is, in fact, related to the production system. Peter Katzenstein (1985) pointed out this association many years ago by linking social corporatism to PR. More recently, Hall and Soskice (2000) have argued that “coordinated market economies” are much more likely to have PR institutions than “liberal market economies.” Here the association is explained by the equilibrium relationship between electoral institutions, redistribution, insurance, and investment in specific skills. In terms of the argument of this book, if the government is induced by the electoral system to engage in redistributive spending, it serves as an insurance against the loss of income when specific skills are rendered obsolete by technological and other forms of change. Chapter Four argues that PR is a key commitment mechanism in political economies that depend on workers making heavy investments in highly specific skills.

 1.4.3. Skills and gender inequality

When we compare access to high-skilled and high-paid jobs, it is well documented that women are at a disadvantage. Economists usually ascribe this disadvantage to “statistical discrimination” by employers: If women are more likely to interrupt their careers for child birth and raising, and if individual women do not have access to effective commitment mechanisms, all women will be treated as a less valuable source of labor for employers. As argued by Estevez-Abe (1999b; 2002), however, this disadvantage clearly depends on the skills involved. If employers can easily find workers with the skills they need in the external labor market, career interruptions are of less consequence. Indeed, in a competitive neo-classical labor market, every employed worker has a perfect substitute willing to work for the same wage (it is labor a “L”). Any employee is therefore readily replaceable. It is when employees bring skills that cannot be easily substituted (“L_s”) that career interruptions become critical to the employer. In terms of providing training and offering promotions, employers in this setting have an obvious incentive to discriminate against women. This is reinforced by women’s own investment decisions since the returns on specific skills will be negatively related to the prospect of interrupted careers. This implies a heavily gendered structure of educational choices that is probably reinforced through socialization (Estevez-Abe 2002).

Figure 1.5 relates a measure of the specialization of skills in different occupations to the percent share of women in these occupations using ILO’s International Standard Classification of Occupations (ISCO-88).¹² The numbers are averages for the 13

countries where comparable ISCO-88 data are available. Bolded occupations are those that have disproportionately large numbers of low-skilled and low-paid jobs.

<Figure 1.5>

As expected, there is a strong negative relationship with men dominating occupations that, as implied by this measure, require highly specialized skills. This basic pattern is repeated in every one of the 13 cases. Not surprisingly occupations with specialized skills are found in agriculture and manufacturing rather than in services. Also note that since men on average participate more in the labor market than women, most occupations have an under-representation of women. Women are also overrepresented in jobs that require relatively low general skills (and that tend to be low paid), but women have at the same time achieved near-parity with men in professional occupations (in the US there is complete gender parity among technicians and associate professionals).¹³

An important part of the gender story that is not captured by Figure 1.5 is the cross-national variance in the labor market position of women. There are already numerous studies documenting such cross-national variance (e. g. Chang 2000; Melkas and Anker 1998; Breen and Garcia Penalosa 2002). What the evidence suggests is that specific skill systems exhibit high levels of occupational gender segregation (Estevez-Abe 2002). Comparative survey data from the International Social Survey Program,

for example, show that the correlation between vocational training activity and women's share of private sector employment is $-.71$ for 12 OECD countries in 1997 (ISSP 2000).

The weak position of women in the private labor market in specific skills countries is modified by public policies deliberately designed to counter them, especially public provision of social services and hence employment opportunities for women. This is what enables the Scandinavian countries to have high female participation rates despite having a male-dominated private sector (Esping-Andersen 1990, 1999; Iversen and Wren 1998). At the same time, however, women in countries with large service-oriented welfare states become "ghettoized" into the public sector instead of competing equally with men for the best private sector jobs.

The implication of this logic is that conflict over public sector service provision, parental leave policies, and education is likely to be gender related. Especially in specific skills countries, women will have a strong interest in an active state that provides daycare services and counter the disadvantages of women in the private job market. Also, while women depend on generous leave policies to balance family and work, for such policies not to put women in a serious disadvantage in the competition for the best jobs they must require men to shoulder some of the burden of caring for infants (essentially forms of mandatory parental leave). Finally, since women have a comparative advantage in general skills, we should expect them to be more supportive

of public spending on general education than men. I explore these hypotheses in Chapter Three.

<A> 1.5. *Recap.*

This book builds on new institutionalist theory in both economics and political science (especially Hall and Soskice's VoC perspective) to offer a general political economy approach to the study of welfare capitalism. The book demonstrates that social protection in a modern economy, both inside and outside the state, can be understood as protection of specific investments by both workers and firms in human capital. It then shows that such an understanding allows the development of a systematic explanation of popular preferences for redistributive spending, the economic role of political parties and electoral systems, and labor market stratification (including gender inequality). In doing so it helps resolve the debate between power resources theory and the new work on employers and the welfare state by systematically linking demand for redistribution and demand for social insurance, and by tying social protection to the way firms compete in the international economy. Contrary to the popular idea that global competition undermines cross-national differences in the level of social protection, the book argues that these differences are made possible by a high international division of labor. Such a division is what allows firms to specialize in production that requires an abundant supply of workers with specific (or general) skills, and hence high (low) demand for protection.

The rise of non-traded services, however, undermines this specialization and leads to pressure for more flexible labor markets. The reason is that when specific skills countries can no longer achieve a complete specialization in production that uses such skills intensely, governments concerned about employment must create regulatory and institutional conditions that are conducive to the expansion of general skills jobs, especially at the low end of the wage scale. In turn, this raises the critical issue of how governments can deregulate a portion of the labor market without undermining the comparative advantages of generous social protection, and without causing a significant rise in inequality.

<A> 1.6. *Outline of book.*

The book is divided into three parts. This first is an overview that includes this chapter. Chapter Two presents a comparative-historical analysis that traces the rise of the postwar social protection system to compromises between interests rooted in the industrial economy. It also provides much of the comparative data that are used in this and subsequent chapters. Those who are familiar with these data and economic history can jump to the subsequent chapters. Part II focuses on the comparative statics of the argument and explores cross-national differences and the micro-foundations of these differences. Chapter Three develops an asset-based theory of the sources of individual social policy preferences and shows how skills and gender are key in explaining these preferences. Chapter Four considers the translation of these preferences into policies through the political system, emphasizing the role of political

parties and electoral systems. Part III focuses on dynamics of the argument. Chapter Five explains the rise of the welfare state since the 1960s as a politically mediated outcome of the shift from industry to services. Chapter Six explores the distributive and political consequences of this shift, as well as the recent reforms to which it has given rise.

ENDNOTES FOR CHAPTER 1

1. Marshall's concept of industrial districts likewise emphasizes repeated interactions in localized settings as a precondition for efficient outcomes (Marshall 1922).
2. Alt et al. (1999) show empirical evidence that lobbying rises with the asset specificity of industries. See also Alt et al. (1996) for a more theoretical treatment of this and related arguments concerning the importance of asset specificity.
3. These are 1995 numbers expressed in 1999 dollars.
4. One of the difficulties of quantifying the specificity of skills is that wage and social protection systems are set up to reduce the riskiness of specific skills. Skill certification and wage standardization by skill categories, for example, are a way for unions to prevent individual workers from experiencing large drops in income. Variability of wages is therefore not an indicator of asset specificity. Chapter Three goes to considerable length in developing alternative measures of skill specificity and to tie such specificity to social policy preferences.
5. See Hacker and Pierson (2002) for an extensive critique of Swenson and related work on the role employers in the rise of the welfare state.
6. There are however significant reforms in the regulation of part-time and temporary employment, as well as in a range of social transfer programs, that will be discussed in Chapter 6.
7. However, this also reduces wage differentials between skills categories, which is contrary to the goal of maintaining high wage protection for the employed (i.e.,

maintaining stable wage differentials across occupations). The problem was particularly great in Sweden, and led to a revolt against centralized (though not coordinated) bargaining among skilled workers and their employers (Iversen 1996; Pontusson and Swenson 1996).

8. The incidence of vocational training is the share of an age cohort in either secondary or post-secondary (ISCED5) vocational training. *Source*: UNESCO (1999). Measures of skills will be discussed extensively in subsequent chapters.

9. This idea was suggested to me by David Soskice.

10. Country coverage is limited. One country, Switzerland is excluded from Figure 1.2 because the test was administered in different areas using only one of the three official languages, so many people had to take the test in a non-native language. This practice appears to have significantly affected test scores (OECD and Statistics Canada 2000, 56). If included, Switzerland is positioned below Belgium, where a similar issue may be at play.

11. I'm using the Bradley et al. (2002) data where pre-tax and transfer income consists of income from wages and salaries, self-employment income, property income, and private pension income, while post-tax and transfer income is disposable personal income, including all market income, social transfers, and taxes.

12. Ignoring military personnel, ISCO-88 contains nine broad occupational groups, which are subdivided into numerous sub-groups depending on the diversity of skills represented within each major group. At the most detailed level, there are 390 groups, each supposedly characterized by a high degree of skill homogeneity. By

dividing the share of unit groups in a particular major group by the share of the labor force in that groups we can get a rough measure of the degree of specificity of skills represented by each major group. See Chapter Three for details.

13. Within the professions, however, it is still the case that women tend to be in jobs and positions with lower pay and skills – teachers in primary and secondary education rather than in higher education; nurses rather than doctors, junior rather than senior associates, etc – and they are notably underrepresented among senior officials and managers.

TABLES AND FIGURES FOR CHAPTER 1

Table 1.1. Government spending and variation in spending across 15 OECD countries (1960-93)

| | Government spending as percent of GDP | Standard deviation of spending | Difference between Swedish and US spending |
|--------------------------------------|---|--------------------------------------|---|
| 1960 | 28.7 | 4.9 | 3.0 |
| 1965 | 31.8 | 5.2 | 8.1 |
| 1970 | 35.2 | 6.4 | 9.1 |
| 1975 | 42.2 | 6.9 | 13.1 |
| 1980 | 45.3 | 8.9 | 25.6 |
| 1985 | 48.0 | 9.1 | 27.1 |
| 1990 | 46.3 | 8.4 | 24.6 |
| 1995 | 49.0 | 9.0 | 31.0 |
| Ratio of 1995 level to 1960 level | 1.71 | 1.85 | 10.38 |

Notes: Government spending is government consumption of services, less military spending, plus government transfers, less interest payments and subsidies.

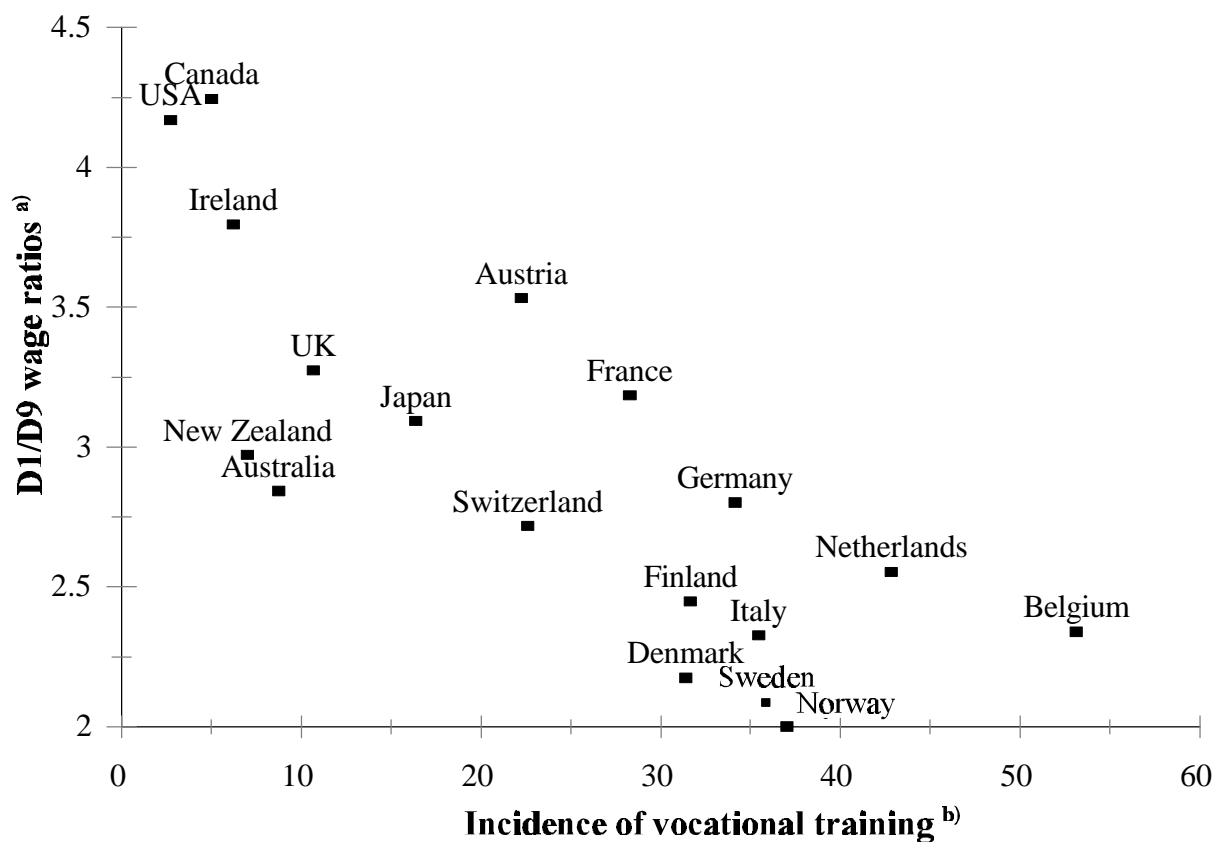
Source: OECD, *National Accounts*, Part II: Detailed Tables (various years).

Table 1.2. Electoral system and the number of years with left and right governments (1945-98).

| | | Government partisanship | | Proportion of right governments |
|------------------|--------------|-------------------------|------------|---------------------------------|
| | | Left | Right | |
| Electoral system | Proportional | 266 (8) | 116 (1) | 0.3 |
| | Majoritarian | 86 (0) | 256 (8) | 0.75 |

Note: Excludes centrist governments and PR cases with single party majority governments.

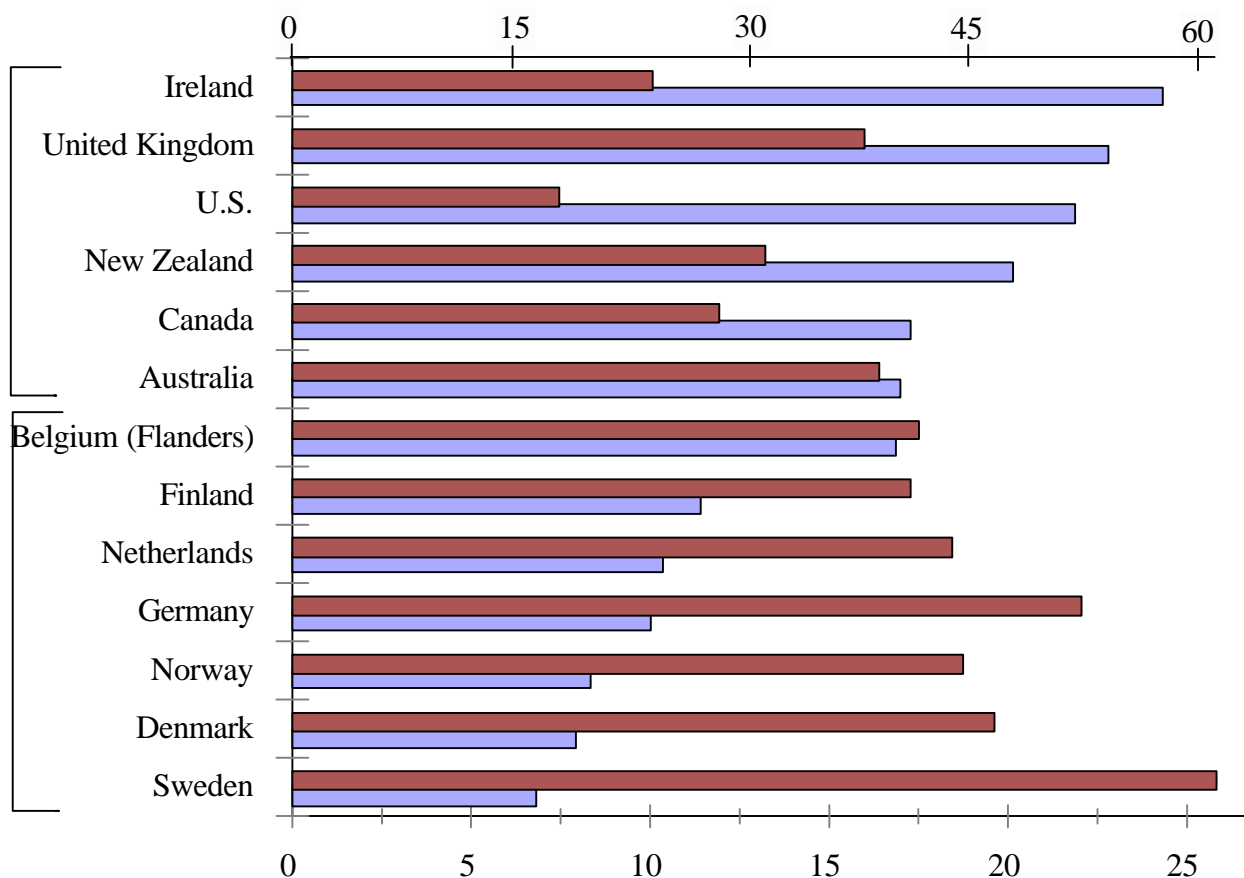
Figure 1.1. Vocational training and wage inequality



Notes: a) The earnings of worker in the top decile of the earnings distribution relative to a worker in the bottom decile of the earnings distribution; b) The share of an age cohort in either secondary or post-secondary (ISCED5) vocational training. *Source:* UNESCO (1999).

Source: OECD, *Electronic Data Base on Wage Dispersion*. Undated.

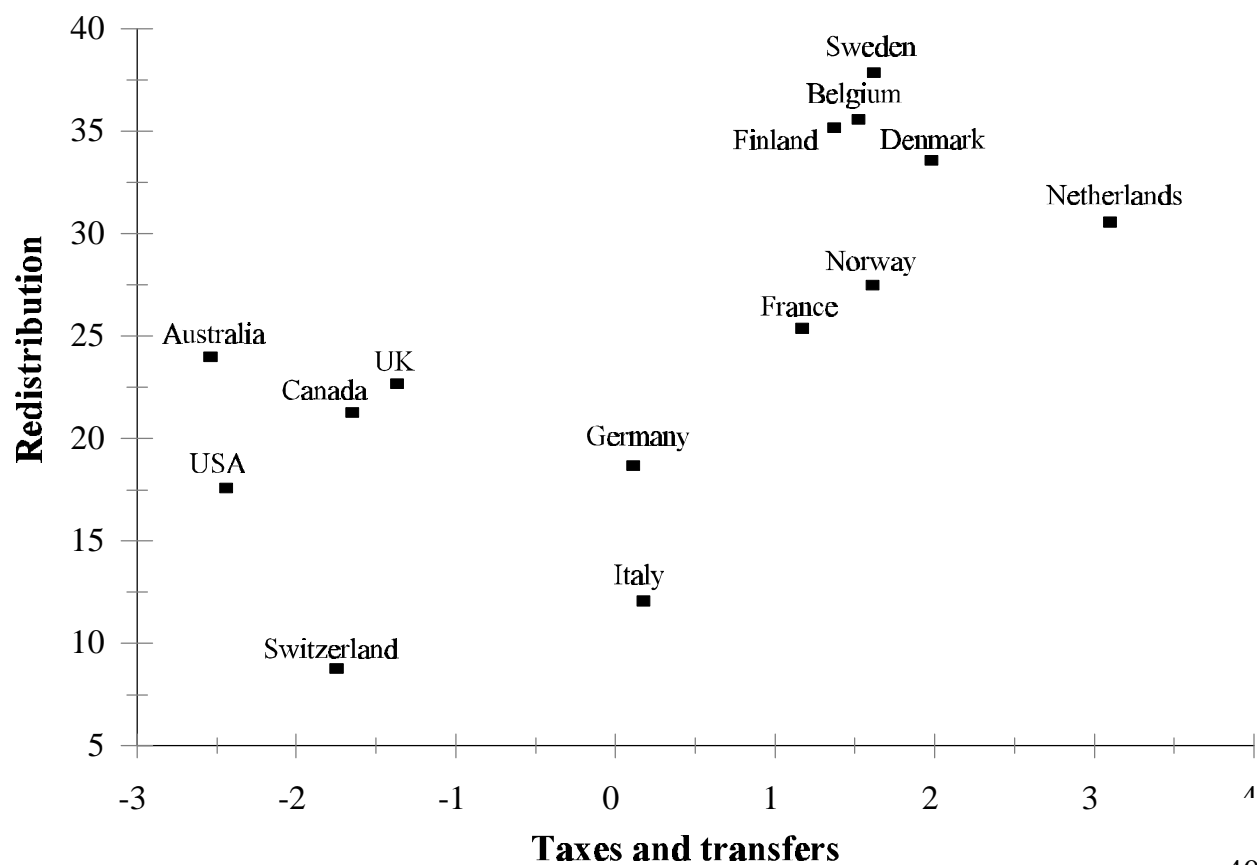
Figure 1.2. The percentage of adults with poor literacy scores (bottom scale), and the percentage of adults with low education and high scores (top scale). 13 OECD countries, 1994-98.



Notes: The top bars (using top scale) show the percentage of adults who have not completed an upper secondary education but have high scores on document literacy. The bottom bars (using bottom scale) show the percentage of adults taking the test who get the lowest score, averaged across three test categories.

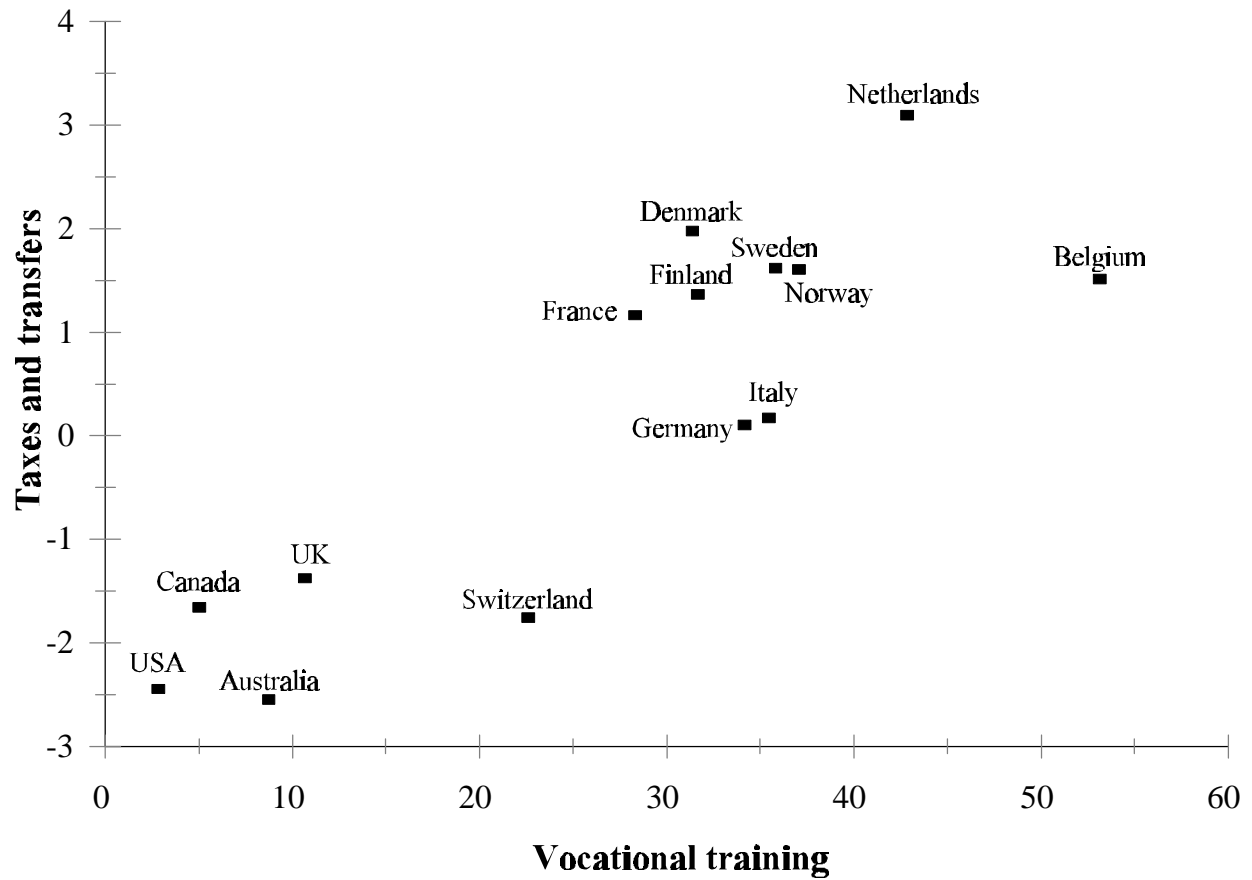
Source: OECD and Statistics Canada, Literacy in the Information Age. Final Report of the Adult Literacy Survey. Paris: OECD, 2000.

Figure 1.3. Redistribution as a function of taxes and transfers in 14 democracies.



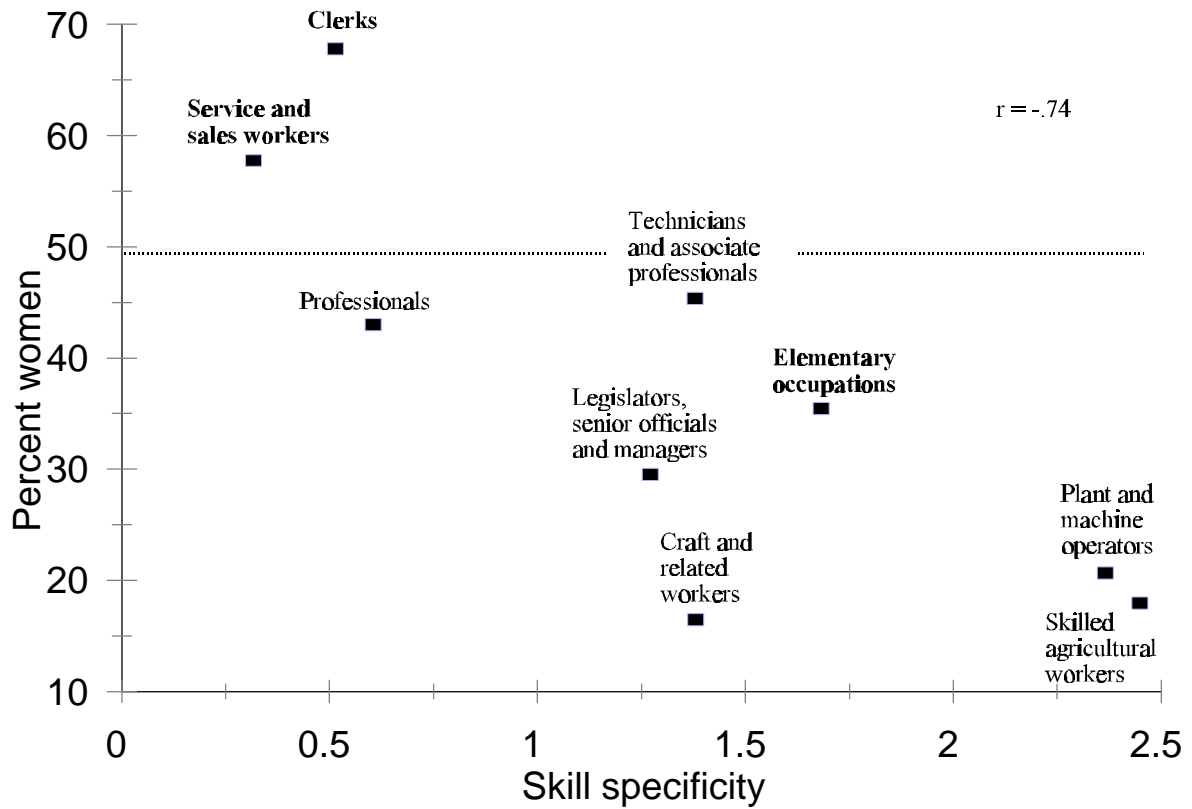
Notes: Redistribution is the percentage reduction in the gini coefficient from pre-to post-tax and transfer for households with working-age adults. Taxes and transfers is total taxes as a percent of GDP plus total transfers as percent of GDP, after both measures have been standardized. Both measures were developed by Bradley et al (2002) based on LIS data and OECD national accounts data.

Figure 1.4. Taxes and transfers as a function of vocational training activity.



Sources: Same as in Table 1.1 and Figure 1.3.

Figure 1.5. Skill specificity and occupational gender segregation.



Source: International Labour Organization, *Labour Statistics Database*. ILO 1998-2004.