

# LABOR HISTORY SYMPOSIUM

## Capitalism, Democracy, and Welfare

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## The Two Worlds of Skill, Capitalism and Welfare

The recent emphasis on contrasting foreign policy orientations in Europe and the US, so forcefully presented by Robert Kagan,<sup>1</sup> has long had its counterpart in the realm of economic policy. Indeed, Kagan's assertion that 'Europeans are from Venus, Americans are from Mars' has its most ardent adherents not among diplomatic scholars but students of political economy. For it is when discussing such weighty matters as the welfare state, labor policy, and general orientation to the market economy that Europeans (and admirers of Europe) are most comfortable promoting their collective identity and their distance from American values. As Will Hutton puts it, 'Europe's welfare states, trade unions, labor market regulations and belief in the husbanded or stakeholder enterprise—along with the role played by government—are not economic and social aberrations . . . They define Europeanness. They are non-negotiable European realities'.<sup>2</sup>

Among the most erudite and original contributors to this and other grand questions of comparative political economy is Torben Iversen. In his previous work he has added enormously to our understanding of how the independence of central banks has influenced economies, including trade union development, how recent economic trends have impacted state policy choices, and the interrelation of human capital formation and social policy. With the publication of *Capitalism, Democracy, and Welfare*, Iversen emerges as one of the leading comparative political economists writing today. His work is sophisticated yet accessible, resolutely social scientific and comparative in its approach, and it has profound implications for labor scholars. Many readers of this journal will find some of his conclusions difficult to digest, since he directly challenges some long-held ideas regarding working-class mobilization and

the origins of the welfare state, and he indirectly challenges the concept of worker agency. But *Capitalism, Democracy, and Welfare* richly rewards its readers by its elegance, its originality, and its countless insights on salient contemporary economic and political questions.

The book's core idea is straightforward: people tend not to take needless risks with their livelihoods. Without a secure social safety net to guarantee income, most people will not invest in extensive training to acquire skills that are industry-specific. The risks are simply too great: industries go into recession or permanent decline, and when they do, holders of industry-specific skills are left jobless. Likewise, employers are usually unwilling to invest heavily in such skill formation without the certainty that the skilled will work for that firm permanently. Thus people without recourse to a secure social safety net tend to learn general skills applicable to a wide variety of jobs. For Iversen, this basic economic truth suggests that the welfare state, first and foremost, should be regarded as the means to alleviate risks associated with developing job skills. Europe's more highly developed welfare states have made possible a workforce with far more specialized skills, and thereby provide European firms with an advantage in established product markets. Welfare states '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 upgrade and diversify existing product lines continuously' (pp. 14–15). Lacking a sumptuous welfare state, workers in the US have relied on more general skills, giving US firms a comparative advantage in low-cost, mass-produced services and new high-tech products. Along with greater flexibility in hiring and firing, this provides US firms with 'high responsiveness to new business opportunities and facilitates the use of rapid product innovation strategies' (p. 14).

Explaining how this divergence arose, how it continues to be sustained, and its political and policymaking implications leads Iversen into several hotly contested scholarly debates. It is here where he demonstrates his mastery of both theory and evidence, as well as originality of thought. He weighs in with telling effect on at least four major controversies: globalization and the 'race to the bottom' thesis, the influential 'varieties of capitalism' approach to political economy, the debate on the origins of the welfare state, and the relationship between electoral systems and welfare state development.

### **Race to the Bottom**

For decades neoliberals have argued that high taxes, bloated state budgets, generous welfare states, and excessive labor regulation were deterrents to capital investment and therefore economic growth and national competitiveness.<sup>3</sup> By the late 1980s and 1990s many admirers of Social Europe feared that neoliberals were right. Globalization, they told us, was busily undermining much of what made European political economy distinctive, Hutton's 'non-negotiable European realities.' Globalization requires increasingly low debts, deficits and inflation rates

(which are the bedrock of monetarism), privatization and deregulation, the liberalization of labor markets, and the scaling back of welfare programs. This economic imperative, we have been told, has incapacitated the power of the state. Whether left, right, or centre, governments now have virtually no choice but to follow the new global logic. Globalization has decimated the 'authority, legitimacy, policymaking capacity, and policy-implementing effectiveness of the state.'<sup>4</sup> Since both left- and right-wing governments are forced to cut budgets and liberalize, globalization has undermined choice in the political spectrum, collapsing differences between the left and right.<sup>5</sup>

Despite the growing body of empirical evidence that no such race to the bottom is taking place, and that the policymaking capacity of the state has been maintained, for many admirers of Social Europe, and for many labor scholars, fears of globalization's potential impact on public spending and labor market regulations persist. Iversen has been one of the most unequivocal scholars to debunk the 'race to the bottom' myth. In 2001 he demonstrated that there exists 'little evidence that globalization is a major threat to the welfare state'.<sup>6</sup> And in *Capitalism, Democracy, and Welfare* he is even more forceful and persuasive. Since the onset of globalization in the 1980s, he writes, 'the remarkable fact about the observed relationship among levels of public spending, investment, and national income in advanced democracies is that there is none. 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' (p. 7).

To be sure, the pressures of globalization have limited the effectiveness of some traditionally important measures of state control over the economy. Certain monetary and fiscal policies to fight recession, tariffs and import quotas to protect national industries, nationalization of industries, and massive subsidies to declining industries are all either more difficult or simply unthinkable in the global environment. But there remain innumerable policy choices available to nation states to control and encourage the economy within their borders. Contrary to the 'race to the bottom' thesis, nation states continue to tax capital with little fear of capital exit, since, surprisingly, there is almost no correlation between corporation tax rates and capital mobility.<sup>7</sup> *Capitalism, Democracy, and Welfare* is a significant addition to the growing body of literature demonstrating that states retain significant room for maneuver in terms of how much they spend and how they spend it.

### Varieties of Capitalism

If continued diversity rather than convergence characterizes the global economic landscape, how best does one categorize and describe the differences among capitalist nations? A great deal of academic attention has been paid to this question in recent years, most of it either in support of or in response to the 'varieties of capitalism' approach. Iversen was a contributor to the seminal volume of this influential school of thought,<sup>8</sup> and *Capitalism, Democracy, and Welfare* does reflect the conceptual strengths and peculiarities of the VOC approach.

At the heart of the VOC literature is the concept of institutional complementarities. The environment in which firms operate is not simply defined by market competition, but by five choices at the core of capitalist economies: the industrial relations system, the structure of worker motivation, the system of job training, the structure of corporate governance, and the system of interfirm relations. The key theoretical insight is that there are only two viable combinations of choices, two ‘varieties of capitalism.’ Liberal Market Economies (LMEs), such as the US, UK and other Anglosphere countries, typically have decentralized industrial relations systems, promote general skills, generate high pay inequality, and rely on capital markets rather than banks. Coordinated Market Economies (CMEs), such as Germany and the Netherlands, are characterized by more centralized bargaining, lower earnings inequality, and less dependence on capital markets. Economic growth is achievable under either capitalist model. But hybrids do not work; institutional complementarities inhibit picking and choosing ‘best practices’ from both systems. State policies and firm strategies that make sense in the Anglosphere variety of capitalism are not suited to the European environment and vice versa.

Iversen is one of the most innovative of VOC scholars. Beginning with basic decisions made by firms on whether to specialize in products that intensively use general skills or industry-specific skills, either of which might be successful in the marketplace, Iversen uses the concept of institutional complementarities to reveal the connections between skills, the labor market, industrial relations, welfare institutions, and electoral systems. But like others in the VOC camp, he wants to neatly cluster a very complex world around two poles, even though numerous advanced economies sit uneasily in this dualism. For example, with its relatively weak national labor movement and miserly social welfare provision (as a percentage of GDP), Japan seems have much in common with the Anglosphere world. Yet in terms of corporate governance and employer ability to coordinate behavior, Japan seems more like Europe. To place Japan in the CME camp seems problematic.<sup>9</sup> Perhaps the same can be said of France. While France and other state capitalist countries have indeed been forced to make particularly important changes of late, some suggest that the significance of the state in the economic arena remains distinctive enough to represent a clear difference in kind.<sup>10</sup>

Another problem often associated with the VOC approach is the inability to explain change. If institutions naturally cluster around two poles, how can one explain the profound shifts that have taken place in political economy in recent years? Iversen seeks to overcome that weakness by arguing that external shocks to a nation’s system, primarily in the form of rising service sector employment and deindustrialization, can trigger significant policy change. But change apparently goes only in one direction. It is possible for countries to move from the coordinated to the liberal model, as Britain did beginning with Margaret Thatcher’s government, and as Australia has done since. Moving in the opposite direction, from the liberal to the coordinated model, is apparently impossible, although exactly why is not entirely made clear. This is an important consideration, for Iversen’s conclusion suggests that building an expansive welfare system—with, at a minimum, universal health

care coverage, extensive labor protection, and generous unemployment insurance—is not possible in the US. This will be deeply disheartening to many American readers who would like to create exactly such a European reality on American soil.

### Origins of the Welfare State

Few contemporary questions are as contentious or as important as the future of the welfare state. Western Europe has long been depicted as the birthplace of modern welfare, the effort to shield citizens from the vagaries of the market, while the US is routinely characterized as a welfare laggard, a deviant case, where European-style welfare programs arrived late and remained half-heartedly implemented. It is well known that northern European and Scandinavian states spend in the neighborhood of twice the amount (as a percentage of GDP) as the US on social provision. And some writers are reluctant to label the US a welfare state at all, preferring to use terms such as ‘workfare’<sup>11</sup> or ‘work and relief state.’<sup>12</sup> In no other policy area is the difference between Europe and the US so abundantly clear—a Social European world of cradle-to-grave protection for all citizens, and an American world that stigmatizes and fails to provide for victims of the market economy.

Here Iversen boldly challenges traditional interpretations of why this divergence emerged. Dominant views of welfare state origins rely heavily on Esping-Andersen’s notion of ‘politics against markets.’<sup>13</sup> In this view the size and scope of welfare provision reflects the strength of the political left in any one country at a given time. The welfare state thus primarily represents redistributive justice, or expropriating from the rich. Capitalists have had the welfare state forced upon them, and, given an opportunity, would gladly escape their welfare responsibilities. Globalization has provided many capitalists with just such an opportunity to flee expansive welfare states and relocate where social costs are minimal. Yet as Iversen has helped us to see, the vast majority of capitalists have not taken this opportunity, leading him to suggest that the idea of welfare as exclusively or even primarily ‘politics against markets’ and redistributive justice is deeply flawed.

Building on the scholarship of Peter Swenson, Isabella Mares, and others,<sup>14</sup> Iversen by no means dismisses the idea that the welfare state reflected a desire for redistributive justice, but he does highlight the positive role played by employers in the shaping of welfare policies. Universalistic welfare provision is usually associated with powerful union movements and left governments, but in fact universal unemployment and accident insurance was embraced by employers in tight labor markets who wanted to remove social benefits from competition by creating uniform, national systems of insurance. Unemployment insurance and employment protection allowed for higher skill development among the workforce, which in turn increased the competitive advantage of firms in international markets. Thus ‘the welfare state is simultaneously an arena for distributive struggles *and* a source of comparative advantage’ (p. 13). This is an original insight developed persuasively throughout *Capitalism, Democracy, and Welfare*, one that will provide much food for

thought for labor and radical scholars since it directly challenges long-cherished notions of class antagonism in the formation of welfare policies.

### **Electoral Systems and Welfare State Development**

Appreciating the dual motivations behind welfare states is an important first step, but the key to understanding how expansive welfare states survive and evolve as labor movements sputter and markets change lies in the political realm, more specifically in differing electoral systems. And it is here that Iversen is at his most creative. Building on the insight of Hall and Soskice that managed capitalist economies are far more likely to have proportional rather than majoritarian electoral systems, Iversen offers a clear and original insight backed up statistically. Majoritarian electoral systems (such as those in the US, UK, New Zealand, and Canada) give rise to a preponderance of centre-right governments; proportional electoral systems (those found in continental Europe) produce centre-left governments more often than not; and centre-left governments distribute wealth to a greater extent than centre-right governments. 'The key to understanding redistribution is the long-time political dominance of the left or right, and a key to understanding long-term partisan dominance is the electoral rule' (p. 144). Once again, neither France nor Japan fit neatly into this schema, but the dichotomy does have remarkable explanatory power.

At the heart of this dichotomy is not cultural difference, but again the constellation of institutions that sustain the two divergent production regimes. Proportional, multiparty systems are much better at protecting specific interest groups, since parties representing workers, employers, and others have a real chance of sharing power. Thus parties with a vested interest in perpetuating high-skilled labor, and a welfare state required to cultivate those skills through unemployment insurance and employment protection, are quite effective in preventing any dismantling of welfare provisions. In majoritarian, two-party electoral systems like the US, popular appeals to the median voter make it far easier for governments to forget past commitments and slash their already paltry welfare provisions.

Iversen is both compelling and convincing, particularly in his last section as he demonstrates how different production regimes have responded to recent crises in the welfare state, in particular the expansion of the service sector. His grasp of existing literature on a wide array of subjects, his clarity of thought and boldness of assertion, make *Capitalism, Democracy, and Welfare* a must-read for anyone hoping to understand political and economic trends in advanced industrial economies. For those who champion Social Europe it is a *tour de force*, since it demonstrates convincingly that globalization will not produce on the continent the brutal economic landscape of the US.

For those who wish to reproduce the best of Social Europe on American soil—an expansive welfare state, revamped labor laws that could revive the labor movement, long-term job protection, enhanced job skills and thus job satisfaction, effective left-of-centre politics—Iversen offers precious little comfort. The US possesses the wrong

institutional configuration, the wrong electoral system, the wrong legacy of skill formation, and the wrong variety of capitalism to ever emulate continental Europe or even to adopt some of its most progressive features. Such a conclusion may well displease those committed to rebuilding America, and those with an enduring faith in class conflict and working-class agency. But all readers will benefit enormously from a book laden with intelligence and insight, one that asks the big questions and never equivocates.

## Notes

- [1] Kagan, *Paradise and Power*.
- [2] Hutton, *The World We're In*, 271.
- [3] Ohmae, *The End of the Nation State*.
- [4] Cerny, 'Globalisation,' 621.
- [5] Strange, 'The Defective State.'
- [6] Iversen, 'Dynamics of Welfare State Expansion,' 76.
- [7] Swank, *Global Capital*; Kite, 'Stability of the Globalized Welfare State.'
- [8] Hall and Soskice, *Varieties of Capitalism*.
- [9] Pontusson, 'Varieties and Commonalities,' 167.
- [10] Schmidt, *Futures of European Capitalism*.
- [11] Gray, *Unsocial Europe*.
- [12] Amenta, *Bold Relief*.
- [13] Esping-Andersen, *Politics against Markets*.
- [14] Swenson, *Employers against Markets*; Mares, *Politics of Social Risk*.

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## Electing To Have a Kinder, Gentler Capitalism

### Rethinking Business and Electoral Politics

America at the dawn of the twenty-first century feels frightening, atavistic, and mean: the president defends the use of torture and illegal wiretapping, the ruling ideology of laissez-faire liberalism has sanctioned the end of guaranteed protection against impoverishment, and the country seems stuck in a moment of war that nobody wants. Into this world of individualism-run-amok steps Torben Iversen, seeking to discover if a kinder, gentler collectivist capitalism—still found in European enclaves—can survive in our atavistic age. In a series of profoundly lucid meditations, Iversen identifies the economic rationale for social protections, explains how some political (and especially electoral) institutions encourage citizens to express collective support for these social protections, and ponders the future of welfare states in a post-industrial economy. Iversen's model is creative, parsimonious, and ground-breaking, especially in his musings on the intersection of production regimes and electoral systems. *Capitalism, Democracy, and Welfare* is a work of art, as elegant and sleek as the best of Danish design.

Iversen begins on well-traversed ground, by explicating the linkages between social protection and economic production.<sup>1</sup> Social protections such as unemployment insurance and employment regulations give workers the economic security to defer work in order to invest in skills formation. Workers fear loss of wages without these protections, and employers hesitate to fund skills without expectations of lifetime employment. Iversen and other scholars of the varieties of capitalism stress the importance of these protections in coordinated market economies, where firms compete in high-end markets using highly skilled workers. Yet American companies also recognize the importance of social policies to enhance the productivity of their workforce and enormous resources are devoted to these social needs by US firms in the private 'shadow welfare state'.<sup>2</sup>

Social provisions have costs, however, and tend to be under-provided; therefore, Iversen ponders the conditions under which welfare benefits will be developed to their most useful extent. This question leads us to the second, most original part of



the book, in which Iversen investigates the relationship between electoral systems and production regimes. Since protections against social risks often involve paying in now for future benefits—pensions are the classic example—future governments might logically renege on past commitments in order to appeal to voters. This non-negligible risk can be avoided, however, when political parties with close ties to interest groups hold governments to past promises. Programmatic party organizations in multiparty systems have much closer ties to specific interest groups (whether these be employers, farmers, Catholics, or workers) than parties in a two-party system, because the latter hug the political center in an effort to capture the allegiance of the median voter. This critical linkage between electoral systems and social protections contributes to the evolution of national production regimes: countries developing proportional representation systems in the early twentieth century invest more heavily in skills—a prerequisite for coordinated market economies—than those with single member district plurality systems.

Iversen's model is beautifully constructed and flows like a Bach partita in its clarity and imagination, yet it left me wondering about the broader role of electoral politics in economic development. If electoral systems mattered to production regimes in the twentieth century, did electoral politics nurture and define evolving forms of capitalism in the nineteenth century as well? Will electoral systems continue to have a significant impact on the struggles to revise the institutions of social protections for our post-industrial age? I reflect below on the relationship between party systems and production regimes both before and after the twentieth century.

### **The Great Transformation**

As a fellow seeker for the holy grail of comparative political economy—the origins of coordinated capitalism—I have found party politics to be enormously important to the evolution of American employers' associations, the failure of US experiments in coordination and the triumph of the liberal model. What needs to be explained about the nineteenth century, perhaps, is not examples of coordination (which one finds across the western world) but the rise of *laissez-faire* liberalism. The 1890s—that reputed age of innocence—was in reality an era of economic (and military) conquest and many businessmen sought developmental state policies to aid in their export adventures. Even in the United States, many firms and communities had characteristics of coordinated production regimes before the first 'industrial divide.' The skills content and production processes of many American industries resembled comparable European sectors and local captains of industry/city fathers (inspired by European community development initiatives) created state and private vocational schools to train their highly skilled workers, sponsored exhibitions to promote their regional manufactured products, and formed trade associations to negotiate collectively with their workers.<sup>3</sup>

Yet a great political transformation swept across the western world at century's end as the internationalization of markets and metamorphosis of industrial production

demanded the nationalization of public policy. Economic developmental policies were sought to promote international trade in increasingly global markets and to make workers' skills commensurate with the remarkable technological advances of the era. Communities experienced increasing difficulty in providing ample coverage for social risks, as workers migrated to urban areas and political life moved from community to society.

Given prior widespread regional experimentation in coordination, one wonders why some countries developed liberal market economies when politics was nationalized and whether electoral politics played a role in this evolution. My own ruminations on this question have led to an investigation of the origins of national peak employer associations, and to the role of party competition in deterring US employers from forming the kind of corporatist institutions for coordination and representation found elsewhere.<sup>4</sup> I find that party system characteristics mattered enormously to American employers' capacities to create coordinating institutions and to express collective interests in economic developmental and social policies.

Theoretical reasons for the causal relationship between party system characteristics and employer organizations in the nineteenth century resemble Iversen's hypotheses linking electoral rules and production regimes in the twentieth century. First, the number of parties in a system matter: in contrast to multi-party systems, parties in two-party systems compete for the median voter, cannot make credible commitments to interest groups, and create a representation gap for those interests insufficiently covered by these catch-all organizations. Just as the structure of two-party competition prevents labor party development,<sup>5</sup> it constrains the development of a dedicated business party. Gaps in party representation often give rise to alternative political organizations<sup>6</sup> and in nineteenth-century America this representation gap was filled by highly politicized business organizations. Second, the relative timing of suffrage matters to business organization. Just as early suffrage created a division of work (with sectionally dominated parties addressing political rights and unions focusing on workplace conflicts),<sup>7</sup> American employers were divided in their identities. Third, functions of employer associations also differ in two-party and multi-party systems. Employer organizations in multi-party systems help implement party goals but are less directly involved in electoral politics. In comparison, when business organizations develop to substitute for real business parties, employers' associations play a bigger role in electoral politics, a function that detracts from their perceived legitimacy in other arenas.

Finally, characteristics of party competition have a bearing on the degree of cooperation between employers and other class factions. Dedicated business and labor parties may cooperate more where political power is fragmented across multiple parties and coalition government is the norm, than these groups do in two-party systems where definite ruling parties emerge after each election. The partitioning of manufacturers, workers, and farmers into different dedicated parties may historically have allowed industrialists to express greater support for managed capitalism and to recognize shared interests with workers in transforming the agricultural economy and in exporting to world markets.

The origins of the National Association of Manufacturers (NAM) illustrate the impact of party competition on efforts to organize and to coordinate employers. NAM was created to fill a representational gap, to organize manufacturers' collective interests, to mobilize employers' support for Republican economic developmental policies even in Democratic regions of the country, and to substitute for a real political party. An expanding group of American manufacturers supported expanding state administrative capacity to promote international trade and industrial development, and wished to convey the employer perspective on national policy proposals. NAM was also created for electoral purposes, as it was established at the behest of the McKinley campaign and was, from the start, intimately linked to the dynamics of electoral competition. The association was to build support for McKinley's presidential run, by unifying manufacturing interests across geographical sections, even in the south and west where economic elites voted Democratic.<sup>8</sup>

NAM's initial structure and policy positions reveal a deep interest in coordination and cooperation. Organizers designed the group as a corporatist intermediary between business, labor, and government, that would represent 'the entire manufacturing interests of the country' and not to constitute 'a competitor of any other organization.' Only associations (sectoral and regional business associations) were permitted originally to belong to the group.<sup>9</sup> The leadership promoted 'industrial betterment ideas' and a cooperative stance toward organized labor.<sup>10</sup>

Yet NAM's corporatist ambitions were dashed on the shoals of the two-party system; in particular, NAM's organizational growth was constrained by the failure of Congress to legislate the association's agenda of economic development. Because employers lacked a dedicated business party to represent their interests in a coalitional government, NAM's concerns were viewed as Republican rather than as business issues. The bills to create the Department of Commerce and Industry faltered yearly in Congress, due to Democratic opposition.<sup>11</sup> NAM's repeated efforts to gain a national charter (and to be recognized as the legitimate representative of manufacturing) were also rejected by Congressional leaders who viewed the organization as an agent of Republican and sectional interests.<sup>12</sup> While NAM was formed to offer political support for expansion of economic state capacity, the failure of these initiatives left the newly formed association without much to offer. NAM's dubious reputation as a partisan political agent of the Republican party seeking to establish a base in Democratic states also contributed to the organization's declining fortunes. After nearly a decade, the organization finally abandoned its initial corporatist vision, and adopted anti-labor and laissez-faire liberal rhetoric. This critical juncture signaled a setback for coordination in the US political economy and strengthened the liberal impulse among American employers. Thus the demise of an alternative coordinated path in the American political economy and the hegemonic triumph of market liberalism was, in part, due to the limitations of the American party system.<sup>13</sup>

**After the Fall**

The essential question of the twenty-first century is whether the institutions for coordination during the golden age—proportional representation, coordinated production regimes and welfare states—will continue to deliver harmony and happiness for those lucky few living within these systems. If party system characteristics were important in the nineteenth and twentieth centuries, will these continue to define politics in the twenty-first? Will electoral arrangements enable some governments to fend off the tragedy of the social commons?

Iversen offers a brilliant analysis of the relative threats of globalization and deindustrialization to the welfare systems of the golden age. The economic transition from industry to services has been accompanied both by falling rates of productivity growth and by expanded training needs, as workers require new skills for the service economy. Governments are faced with a trilemma in this period of slower productivity growth: should they cut spending, abandon wage equality, or risk the fiscal crisis of the state?

Yet Iversen has less to say about the impact of party systems in solving these dilemmas, largely because multiple coalition outcomes exist. He reasons that governments with strong vocational training systems and/or PR systems will react differently to shocks than governments with weak vocation training and majoritarian systems; yet alternative scenarios exist even within the coordinated regime type. In some countries, the fates of low- and high-skilled workers are closely coupled (through solidaristic wage bargaining), and proportional representation voting makes it easy for these groups to form center-left political alliances. But economic shocks (such as the move to services) make these ties harder to sustain and, in other countries, low-skilled workers are so adversely affected by tight labor market regulations (and consequent falling employment) that these workers form alliances with professionals (the center right) to push for deregulation of employment protections in exchange for mildly redistributive unemployment protections.

What then might we conclude about the future of collective capitalism and the role of electoral systems in negotiating new equilibria? Iversen devotes greater attention to the logic of alternative coalitional deals than to the processes by which deals are constructed, and I would like to hear more about the politics by which future win-win solutions might be achieved. As for the future of collective capitalism and electoral systems, several alternatives seem possible.

First, coordination, political parties, and even national politics may be on the decline in the twenty-first century. Leaving aside the potential world-altering exogenous shocks that keep mothers awake at night (religious wars, global warming, pandemic flu), there are good reasons to believe that political parties will become less salient to future directions in national political economies. The very concept of the 'national economy' is becoming increasingly suspect: multinational corporations (with total sales approaching the GDP of small states) now seek such diverse and distant locales to create components of their final products, that the

'Made in America' (or Germany) appellation loses all meaning.<sup>14</sup> Third parties and social movements are on the rise, as changing cleavages and new political issues structure politics.<sup>15</sup> International and private political structures are increasingly encroaching on hitherto national systems of economic and social regulation.<sup>16</sup> As parties lose their faithful, the notion of credible commitments may become wishful thinking.

Second, even if nations retain their privileged position in organizing politics, the survival of collective capitalism will depend on the ability of states to respond to changing economic conditions, to cure earlier welfare traps, and to implement successfully their policy reforms. Iversen speculates that trade liberalization of services may be a means of counteracting the trilemma, although I wondered how this might be accomplished. Denmark offers a somewhat optimistic scenario (at least in the short term) in its efforts to fashion a new equilibrium between growth and equity. Recent labor market reforms ask employers to help re-employ the socially excluded, match unemployed persons' skill levels to employers' job requirements and subsidize disabled workers to do unproductive tasks within the companies. These win-win arrangements would expand employment, reduce government social expenditures (by getting people off the welfare rolls), allow companies to fill (with low wages) unproductive positions that were sacrificed in the push for global competition, and maintain wage equality (because the new low-wage positions are subsidized by the state). Thus these reforms link long-term unemployment to projected labor shortages and the enhanced skills needs of the post-industrial economy.<sup>17</sup> This scenario is appealing, yet it may be a small-state solution and may require a more substantial commitment of resources than most countries are willing to make.

Finally, even if the 'right' policy prescription is discovered, the ultimate success of continuing coordination may depend on the ability of the state to renegotiate social pacts and to build new coalitions of broad majorities. Political parties may be less important to these processes of renegotiation than other institutional channels or policy paths. In some instances governments and social partners are able to redesign existing institutions for new purposes.<sup>18</sup> For example, Danish employers have been quite active in recent social reforms, in part due to the flexibility of Danish corporatism. Recognizing the declining importance of collective bargaining, employers' peak associations have moved into new areas and levels to remain vital to their members' political identities.<sup>19</sup> Policy traditions also seem to persist in the subtleties of programmatic design, and in citizens' and social partners' expectations about state administrative capacities.<sup>20</sup>

Perhaps institutional and policy legacies from the golden age will preserve a spirit of coordination and cooperation in some countries, making new solutions resemble past efforts. Perhaps we may have reached some sort of tipping point, in which national politics and collective capitalism are both on the decline. In any event, Torben Iversen has done his bit to make the world a better place, by providing us with a brilliant, inventive, and extraordinarily clear analysis of many linkages between capitalism, democracy, and the welfare state.

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## Notes

- [1] See also Hall and Soskice, *Varieties of Capitalism*; Martin, 'Nature or Nurture?'; Martin, *Stuck in Neutral*; Huber and Stephens, 'Welfare State and Production Regimes'; Estevez-Abe, Iversen, and Soskice, 'Social Protection'; Mares, *The Politics of Social Risk*; Swenson, *Labor Markets*.
- [2] Martin, *Stuck in Neutral*; Hacker, *Boundary Wars*.
- [3] Piore and Sabel, *The Second Industrial Divide*; Hansen, 'Caps and Gowns'; Berk and Schneiberg, 'Varieties in Capitalism.'
- [4] Martin, 'Sectional Parties.'
- [5] Shefter, 'Trade Unions.'
- [6] Lawson and Merkyl, *When Parties Fail*.
- [7] Shefter, 'Trade Unions.'
- [8] National Association of Manufacturers, 'Reports of Officers'; Martin, 'Sectional Parties.'
- [9] 'The National Association of Manufacturers and Other Organizations,' 148.
- [10] Search, 'President's Report,' 23–4; Martin, 'Sectional Parties.'
- [11] 'Committee on Commerce and Industry.'
- [12] Search, 'President's Report,' 13.
- [13] Martin 'Sectional Parties.'
- [14] Berger, *How We Compete*.
- [15] Inglehart, *Culture Shift*.
- [16] Slaughter, *A New World Order*.
- [17] Martin, 'Reinventing Welfare Regimes.'
- [18] Thelen, *How Institutions Evolve*; Campbell, *Institutional Change*.
- [19] Martin and Swank, 'Does the Organization of Capital Matter?'
- [20] Martin, 'Reinventing Welfare Regimes'; Cox, 'Social Construction.'

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## Collective Group Interests and Distributive Outcomes: Competing Claims about the Evolution of the Welfare State

Two divisive questions in the field of comparative political economics help us situate Torben Iversen's splendid book. They concern the *aggregation of conflicting collective actors* and the *distributive character of policies* that result from the interaction among collective actors (see Table 1). Building on a Marxian genealogy, the dominant power-resource theories associated with scholars such as Walter Korpi, Gøsta Esping-Andersen, Evelyne Huber and John Stephens argues that the encompassingness and progressive redistributive impact of welfare states result from patterns of working-class mobilization, mediated by partisan electoral competition and left governments (cell 1).

Theories of democratic class compromise in the 1950s and of neo- or liberal corporatism in the 1970s and 1980s depart from this perspective by characterizing bargaining outcomes as efficient rather than distributive. Centralized class

**Table 1** Constructing Theories of the Welfare State

		<i>COLLECTIVE POLITICAL INTEREST ARTICULATION: Bipolar or multi-polar alignments?</i>	
		Business versus labor cleavage	Multi-polar economic group mobilization (firms, sectors, occupations, tax contributors/beneficiaries, etc.)
<i>WELFARE STATE BARGAINING OUTCOMES: Distributive or Efficient?</i>	Distributive	1 <i>power-resource conflict</i> (Korpi, Esping-Andersen, Huber and Stephens)	3 <i>distributive group conflict</i> (Baldwin, Pierson)
	Efficient	2 <i>democratic class compromise</i> (Lipset, neo-corporatist theory)	4 <i>efficiency coalitions among multiple groups</i> (Swenson, Mares) <i>varieties of capitalism</i> (Hall, Soskice)

organization of workers and employers, combined with left governments, enables their leaders to enter and to enforce bargains that enhance the supply of collective goods. Generous social policies facilitate peaceful labor relations, increase productivity, and thus encourage business to invest and promote economic growth (cell 2). Conversely, another departure from power resource theory continues to see social policy-making as a distributive game, but sees disaggregate sectoral and occupational interests bargaining over social policy even in neo-corporatist systems. Politicians assemble winning group coalitions with the objective to enhance their chances for reelection (cell 3).

A new cohort of political economists has now challenged the postulate of bipolar class interest aggregation as well as the zero-sum view of social policy simultaneously (cell 4). Instead, they engage in formal game theory as well as historical process tracing to account for social policy as a result of interaction among multiple collective actors. The policy outcomes often enough tend to be more efficient, in the sense of Pareto-superiority, than distributive.

Influential strands in the *Varieties of Capitalism* VoC literature<sup>1</sup> tend to subscribe to this basic view as well, but with a distributive amendment. Certain groups, identified in terms of sectors or occupations, can impose their efficient bargains through policy and institutional choice on entire national economies and define a polity's 'competitive institutional advantage' within the global economy. Torben Iversen's work is steeped in this VoC paradigm, but goes beyond the analysis of production regimes in at least three ways. First, he argues that social policies in contemporary welfare states are *complementary* to capitalist production regimes, characterized by types of industrial relations, vocational training,



corporate innovation, and business governance. Second, he incorporates electoral politics as a critical mechanism to produce economic and social policies. Third, he argues that external shocks—deindustrialization and the rise of service sector employment—disequilibrate existing efficient political-economic bargains and trigger distributive struggle about policy and institutional reform. These trajectories proceed, however, in path-dependent fashion from the status quo of production and welfare regimes.

Iversen thus elaborates and qualifies an efficiency-oriented analytics of political economy to find a meaningful place for distributive political conflict, particularly through the system of party competition. His book's rallying cry 'is not "politics against markets," as commonly assumed, but politics *with* markets' (p. 73, emphasis in the original). I agree with a great deal of Iversen's analysis, particularly in chapters 5 (deindustrialization and social policy) and 6 (trilemma of policy options in the service economy), but I would like to take issue with the efficient-based account of varieties of welfare states in chapters 3 and 4. I would like to raise questions about both the micro-logic of political-economic preference formation as well as the macro-politics of social policy formation. Even if Iversen's arguments may be correct, his book does not provide the clinching evidence to drive this home. I am sure Iversen and others working in his paradigm will try to close those gaps in the future.

### **The Micro-Level Account: Asset Specificity and Redistributive Preferences**

Both wage earners and capitalists are keen on encompassing and redistributive welfare state institutions, where labor productivity depends on workers' acquisition of specialized skills that cannot easily be redeployed across firms or sectors of the economy. Such asset-specific human capital is forthcoming, however, only if wage earners can hedge against the risks of job loss cutting off the stream of income expected from their initial human capital investment. The time horizon of human capital investment, adverse selection and moral hazard rule out private insurance against such risks. Instead, social policies of income protection through employment guarantees or generous unemployment insurance plus encompassing industrial relations systems promoting wage solidarity help employees hedge against risky skill investments.

At the micro-level, the theory has the testable implication that wage earners with highly specialized skills, manifested by strong vocational education, rather than with general skills embodied in secondary and post-secondary school and university degrees are particularly ardent supporters of risk-hedging and redistribution through social policy. Iversen (pp. 93–95) develops an ingenious occupational measure of skill specificity derived from deep four-digit occupational classifications and corrected for general education. The idea is to measure the relative size of the labor market in which the holder of an occupation can move to find alternative employment. But a replication and modification of Iversen's analysis reveals three problems.<sup>2</sup> First, base

occupations scored as moderately or highly asset-specific include not only many lines of skilled manual workers, but also many jobs the description of which suggests unspecific skills or plain unskilled or semi-skilled labor. Second, in statistical estimations of support for spending in areas of social protection, such as those reported by Iversen in his table 3.4, adding a class dummy for blue-collar work yields two results. Skill-specificity of respondents remains a significant but substantively much diminished coefficient predicting support of (un)employment protection. But no such effect remains for respondents' preferences over health insurance and pensions. Third, support for encompassing public health and pension insurance varies much less across occupations than support for (un)employment protection benefiting a subset of vulnerable skill groups and economic sectors.

Is it theoretically justified to add a blue-collar dummy to Iversen's model specification? And what does that addition mean, after controls for income, skill level, and asset specificity have been applied? The residual picked up by the blue-collar dummy has to do with the unique experiences, fears, and aspirations that come with work in manual labor in manufacturing industries. Compared to office employees, blue-collar wage earners tend to be concentrated in larger workshops that make it possible to build a collective sense of solidarity and preference for egalitarian distribution more easily. Blue-collar work also does not require and instill social qualifications of interpersonal interaction at the workplace that is essential even for unskilled service sector work, and makes it difficult for blue-collar workers to move into such occupations if they lose employment. The sense of 'entrapment' in a shrinking labor market is what blue-collar manual labor picks up net of all the other variables already incorporated. Hence, if asset specificity evaporates as a predictor of social policy preferences, once a blue-collar dummy is added as predictor of social policy preferences, it implies that the fact of manual labor itself, more than the particular kind of labor, drives social policy preferences.

Why would asset specificity remain a weakly significant predictor of preferences for unemployment and employment protection, but not health insurance and pensions, once a blue-collar dummy is added? This difference may, in fact, follow from the logic of risk-hedging Iversen submits to account for the preferences of respondents with specialized skills. Workers become more vulnerable to unemployment if they invest in specific skills. Hence they demand policies of employment protection to insure against that risk. But does workers' investment in specific skills also drive up their vulnerability to the vagaries of illness and old age? This is surely not true. Hence the presence or absence of generous health and pension plans should leave workers indifferent between investing in specific skills or general skills, unless we assume that spells of ill health devalue specific skills and force wage earners to accept lower paid jobs. Also from the employer's perspective, public generous health and pension plans may add little to nurture investment in specific skills. Instead, employers would want to provide *private* health and pension benefits to promote skill upgrading and company loyalty of skilled workers.

If wage earners with asset-specific skills expect a shorter work life than general workers during which they can earn a sufficiently high wage to contribute to private

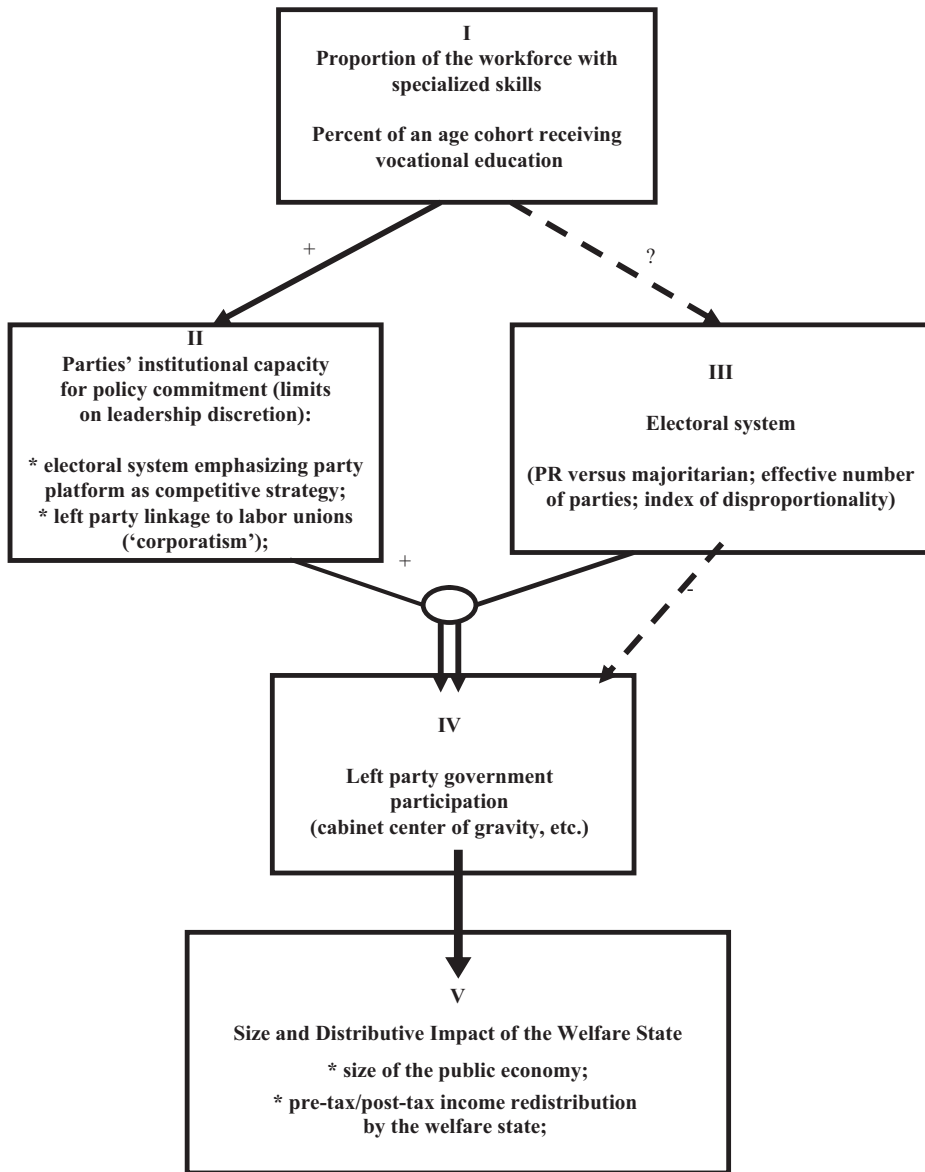
or public pension schemes until their specific skills become obsolete, (un)employment protection takes care of this problem. Without (un)employment protection, specialized workers may demand generous tax-financed Beveridge-type basic flat-rate pension benefits, but not heavily wage earnings-related pay-go pension schemes. As far as I can tell, I can detect little relationship between the generosity of flat-rate or means-tested basic pensions, on the one hand, and national skill profiles of the labor force.

In light of these considerations, it makes theoretical sense that asset specificity washes out as a predictor of citizens' preferences over public health care and pension plans, once we hold constant for blue-collar status. It is unlikely that a functional, efficiency-based micro-logical explanation can serve as a foundation to explain the different size of welfare states at a time, when the overwhelming share of benefits goes through health care and pensions to elderly citizens for whom employment vulnerability is not an issue.

### **The Macro-Level Account: Asset Specificity, Democracy, and Welfare State Size and Redistributive Capacity**

Figure 1 summarizes in simplified fashion what I take to be the essentials of Iversen's arguments laid out in chapter 4. Countries in which specialized skills, tracked at the macro-level by the proportion of age cohorts receiving vocational education, predispose elements of the electorate to support encompassing, redistributive welfare states tend to have institutionalized parties that can commit to long-term strategies by cutting down on the discretionary autonomy of party leaders. Specialized labor thus molds an electoral instrument that advocates generous social policy schemes. Institutionalized parties result from union support ('corporatism') and closed-list proportional representation in the electoral system.<sup>3</sup> The relationship between specialized skill formation and electoral system does not figure into the current book, but Iversen has started to cover this subject in new and still highly tentative collaborative work.<sup>4</sup>

For formal modeling purposes, Iversen assumes the existence of three classes (lower, middle, upper) and two parties in majoritarian party systems, but three in PR systems, plus an array of assumptions needed to derive equilibrium results. The key intuition, however, is that from the perspective of middle-class voters with preferences for moderate redistribution, in majoritarian systems, supporting a left party government yields a much greater risk that actual redistribution is far from the middle-class voter's ideal point than supporting a right party. This applies particularly if left parties are highly institutionalized. Conversely, in PR systems the middle class has its own party that can restrain a left coalition partner, even where leaders have little autonomy vis-à-vis their own following. As a consequence, majoritarian systems have a smaller proportion of left party governments and deliver less social policy and redistribution than closed-list PR systems.



**Figure 1** Casual Mechanisms Affecting the Nature of Welfare States

Iversen delivers correlations and regressions that indisputably confirm his theoretical model. But how plausible are the unobserved mechanisms assumed for the model to work? Based on historical work, we can easily conceive of an alternative account of the mechanisms that buttress the macro-relations in Figure 1. Future research needs to focus on empirical implications that are distinctive to Iversen’s efficiency-based account of social policy formation. Let me highlight here the rival accounts only.

Iversen (p. 131) claims that labor unions in skill-specific systems bind labor party leaders to the long-term social policy agenda by making contributions to the party 'because specific skills require an infrastructure of institutions to ensure the provision of such skills (in particular vocational training systems) as well as to cope with the hold-up problems endemic to specific asset investment' (link boxes I and III). Setting aside the functionalist language, it is unclear whether historical facts bear out this theoretical construct. It may be true that superior capacities for collective action made skilled laborers everywhere the core of organized labor. But often enough parties, not unions, created the strong mutual link. Union and party power grew particularly strong in countries where oxlate industrialization quickly created a large mass of unskilled laborers. Labor unions and parties grew strong precisely where they were able to counteract the particularism of craftsmen and incorporate unskilled labor in industrial (rather than trade) unions and socialist party organizations. Furthermore, it often was craftspeople who were least enthusiastic about public income protection programs, as they had the greatest capabilities, opportunities, and resources to provide such protection through private non-profit insurance (friendly societies, craft-based unions). And insurance against loss of employment so crucial for skilled labor support of social policy was almost everywhere the last major insurance system coming on-line. Such systems became generous only several decades after skill-based cooperative capitalism had embarked on its distinctive human capital investment strategy, when they were not really needed because of high employment rates. It is thus unlikely that skilled labor was at the cradle of the welfare state shaping insurance programs and pushing protection schemes. Skilled labor does play a role, but only in industrial latecomers where socialist politicians can help to channel its capacity to overcome collective action problems toward incorporating unskilled labor.

We do not know yet whether Iversen's and Soskice's effort to explain electoral system choice based on the interest of asset-specific skilled labor and its political representation will work out (link boxes I → III in Figure 1). At the level of historical evidence, traditional distributive stories appear to do a reasonably good explanatory job to explain transition to PR. Rapid late industrialization made it easier not only for unskilled and skilled manual workers to converge around socialist parties, but also for cross-class parties to compete for the working-class vote based on non-economic appeals, such as religion or region. These parties were sharply divided from market-liberals and agrarians such that a majoritarian system could deliver legislative majorities to socialists early and suddenly. Ex ante—in an era of often fierce religious and rural/urban conflict—it was far from obvious that rational office-seeking politicians across non-socialist parties should believe that their interests were best served by merging into one single 'bourgeois' party that would deprive socialists from political governance under plurality rule for most of the time. Such politicians opted rather for maximizing their own legislative representation in a crowded field of competitors and thus accepted electoral reform.

Why are PR systems with institutionalized parties more likely to procure center-left party (coalition) government and greater redistribution

(linkage boxes IIxIII → IV → V)? Many options exist to counter the efficiency-based account submitted (or implied) by Iversen. Let me spell out only the possibility that the effect of PR on left governments and redistribution is a *period effect* only. It is quite implausible to claim that PR systems were more prone to expand welfare states and redistribute income in the first half of the twentieth century. There may also be little reason to believe that electoral institutions may bring about this result since the 1990s. Self-interested middle-class voters should be most afraid of left party government when (1) labor commands great organizational strength (i.e., the discretion of political leaders is low), (2) economic performance is favorable and creates plenty of fiscal slack that can be applied to new public policy purposes, and (3) the status quo of income distribution is sufficiently far 'to the right' (little progressive redistribution) so that middle-class voters see little chance that a conservative government could dramatically reduce tax progressivity.<sup>5</sup>

Conditions fuelling middle-class fear of the left indeed reached their zenith by the 1960s and 1970s. Since then, the organizational power of labor has declined, public fiscal balances have deteriorated, and the income distribution achieved by the 1970s even under majoritarian systems enabled conservative parties to promise dramatic reductions of income progressivity in electoral campaigns. Once again, middle-class voters might be more afraid of the income status quo shifting power of the right than of the left. It may be no accident that even in plurality systems where parties of the right have been long dominant, it is precisely the middle class that has often been most supportive of the political left.<sup>6</sup>

## Conclusion

Iversen's book provides an elegant intellectual edifice tying different strands of research together. I find its clarity of assumptions and deductions aesthetically pleasing. At the same time, neither historical nor systematic statistical evidence is sufficient to bear out the validity of the causal claims made in Iversen's book. I find enough holes in the account to bet that a rival explanation based on class politics and distributive struggles can still provide a credible alternative. In my view, technological innovations of recent decades make it implausible to ground social reform policy on the continuing viability and importance of highly asset-specific vocational education. Both as a political and as an economic force, asset-specific labor is finished and forward-looking policy bargaining scenarios in which asset-specific labor plays a vital role (e.g., pp. 269–71) sound implausible to me. Because specialized human skills based on vocational education are obsolete in most sectors and work organizations, even countries characterized as cooperative market economies turn to more flexible labor markets, tighter social benefits claims, and much higher investments in general education to upgrade the post-secondary skills of the labor force. Denmark under frequent social democratic government leadership is a case in point. By contrast, continental countries with strong vocational education systems under the leadership of center-right cross-class parties have achieved little social policy reform and have let

their systems of higher education run down with the overall consequence of anemic growth over prolonged periods of time.

Neither efficiency considerations prescribed by some established variety of capitalism nor electoral institutions per se drive these choices among alternative policy trajectories. Politicians compete in rival partisan camps and try to form winning coalitions in a complex electoral landscape with multiple organized groups. This is a point that Iversen drives home himself in much of his argumentation concerning the recent dynamics of welfare states in advanced capitalism (chapters 5 and 6). Accounts based on distributive politics, even though not in a simple class-based bipolarity, assert hegemony over efficiency-oriented theories. In the literature on institutional choice, the pendulum has decisively swung from efficiency-oriented explanations to distributive explanations.<sup>7</sup> Also in the comparative study of welfare states and employment policies, let us not underrate the importance of distributive conflict as a key force shaping policy outcomes and economic performance.

## Notes

- [1] Hall and Soskic, *Varieties of Capitalism*.
- [2] See Kitschelt and Rehm, 'Socio-economic Group Preferences.'
- [3] The dummy variable of proportional representation (p. 156) correlates at 0.88 with Iversen's index of institutional capacity for commitment (p. 177) and at 0.75 with the score of incentives to campaign on party platforms, one of two elements of the index.
- [4] Cusak, Iversen, and Soskice, 'Specific Interests.'
- [5] Note that my formulation does not violate the reasonable model assumption that parties of the rich cannot effect a net redistribution of income away from the poor to the rich. But they can dramatically lower the progressive redistribution of public policy. Of course, Iversen (p. 270) even invokes the possibility of an economic foundation of the alliance between low-income unskilled workers and wealthy professionals against the skilled middle on a platform of labor market deregulation.
- [6] To make this counter-intuitive pattern intelligible, one has to recognize that political competition is not only about economics. The right might find other, non-economic dimensions of competition on which it can attract voters who would support the left, if economics was the only electoral consideration. Ironically, in many countries—majoritarian or PR—the plurality of working-class voters now supports the right.
- [7] Cf. Knight, *Institutions and Social Conflict*; Moe, 'Power and Political Institutions.'

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## Partisan Government, Employers' Interests, and the Welfare State: a Critical Review of Torben Iversen's *Capitalism, Democracy, and Welfare*

Iversen's book is without a doubt a seminal contribution to the growing literature examining the interface between the production regimes, principally the Varieties of Capitalism (VoC) approach,<sup>1</sup> and welfare state regimes.<sup>2</sup> Iversen's work represents an advance on previous work because he takes steps to solve an impasse posed by this literature. All of these works note that there is a strong association between industry-coordinated market economies (CMEs) and social democratic and Christian democratic welfare states and liberal market economies (LMEs) and liberal welfare states (see Table 2).<sup>3</sup> All also note that there is a mutual enabling fit between the social policies of these regimes and the production regime characteristics, particularly the characteristics of the labor market regimes. Thus, the generous social democratic and Christian democratic welfare states 'fit' with the low levels of wage dispersion, high levels of employment protection, and high skill levels (particularly on the bottom of the skill distribution) of the CMEs (see Table 2).<sup>4</sup>

There is, however, an important lacuna in this literature and recent attempts to overcome it have revealed deep disagreements between the now mainstream theory in comparative welfare state studies, power resources theory, and the new explanations of social policy differences across countries. The lacuna is the absence of an explanation of the origins of the varieties of capitalism by proponents of that approach. The main ambition of these works has been to elaborate the functional fits between the various characteristics of the different production regimes. The VoC approach shifted the focus of comparative political economy of advanced industrial societies from union strength and structure characteristic of the corporatism literature to employers' organizations and behavior of firms. In doing so, the VoC approach severed the tie that the corporatism literature had to the welfare state literature on the questions of the structural and historical origins of the structures of the political economies of the OECD countries, as one prominent theory of the origins of corporatism argued the strong unions and social democratic government, that is working-class power resources, were the main causes of the development of corporatism,<sup>5</sup> though there were competing theories in which class power resources did not play a central role.<sup>6</sup>

When scholars influenced by the VoC approach did turn to the question of the origins of social policies, it was natural that they re-examined the employers' interests



**Table 2** Welfare State, Labor Market, and Political Characteristics by Welfare State/Production Regime

	Left Cabinet	Christian Democratic Cabinet	Reduction in Gini due to Taxes & Transfers	Public HEW Employment	Transfer Generosity Index	Unemployment Replacement Rate (net)	Neocorporatism	Wage Dispersion	Employment Protection Laws	Representation System	Vocational Education	Low Literacy	Total Employment
<u>Social Democratic Welfare States - Industry CMEs</u>													
Sweden	39	0	47	20	37	80	0.847	2.1	3.5	PR	36	7	79
Norway	36	2	31	15	35	66	0.919	2.0	2.9	PR	37	8	72
Denmark	26	0	38	18	34	65	0.614	2.2	2.3	PR	31	8	75
Finland	19	0	44	9	31	63	0.904	2.4	2.2	PR	32	11	69
Mean	30	1	40	16	34	69	0.821	2.2	2.7		34	9	73.8
<u>Christian Democratic Welfare States - Industry Coordinated Market Economies</u>													
Austria	30	18		4	29	33	0.957	3.5	2.2	PR	22		66
Belgium	15	26	37	6	30	65	0.660	2.3	3.2	PR	53	17	56
Netherlands	11	30	31	4	34	74	0.530	2.6	2.7	PR	43	10	62
Germany	12	25	22	4	31	60	0.764	2.7	3.2	PR	34	10	67
Switzerland	12	14	10	5	25	71	0.551	2.7	1.1	PR	23	17	84
<u>Mixed Economies</u>													
France	13	4	26	7	30	72	0.361	3.3	3.0	Run-off	28		59
Italy	5	38		5	24	43	0.396	2.3	3.6	PR	35		55
Mean	14	22	25	5	29	60	0.603	2.8	3		34	14	64
<u>Liberal Welfare States - LMEs</u>													
Australia	18	0	28	7.0	18	30	0.201	2.8	0.9	SNTV	9	17	67
Canada	0	0	24	7	25	46	0.026	4.2	0.8	SMP	5	17	68
Ireland	5	0	32		22	37	0.111	4.1	0.9	STV	6	24	51
New Zealand	16	0			23	29	0.063	3.1	0.9	SMP	7	20	66
UK	16	0	24	8	24	21	0.067	3.4	0.6	SMP	11	23	69
USA	0	0	19	5	18	29	0.006	4.3	0.2	SMP	3	22	71
Mean	9	0	25	7	22	32	0.079	3.7	0.7		7	21	65

(continued)

Table 2 Continued

	Christian Democratic Cabinet	Left Cabinet	Public HEW Employment	Transfer Generosity Index	Unemployment Replacement Rate (net)	Neocorporatism	Wage Dispersion	Employment Protection Laws	Representation System	Vocational Education	Low Literacy	Total Employment
Group Coordinated Market Economy												
Japan	0	3.0	2.1	35	0.803	3.1	2.1	SNTV	16	74		

Notes: All data is for the early to mid 1990s except public HEW employment which is for 1985.

Left Cabinet: Scored 1 for each year when the left is in government alone, scored as a fraction of the left's seats in parliament of all governing parties' seats for coalition governments, 1946–93.

Christian Democratic Cabinet: Religious parties' government share, coded as for left cabinet.

Reduction in Gini due to taxes and transfers:  $(1 - \text{post tax and transfer inequality/pre tax and transfer inequality}) \times 100$ .

Public HEW Employment: Public Health, Education, and Welfare Employment as a% of the working age population (15–64 years).

Transfer Generosity Index: Scruggs, *Welfare State Entitlements Data Set*, replication and revision of Esping-Andersen's de Commodification index.

Unemployment replacement rates: Net unemployment replacement rate for one-year spell of unemployment, calculated from Scruggs, *Welfare State Entitlements Data Set*.

Neo-corporatism: Indicator developed by Kenworthy 'Quantitative Indicators of Corporatism.'

Wage dispersion: 90–10 ratio among full-time wage and salary workers, OECD Electronic Data Base on Wage Dispersion.

Employment Protection Legislation: OECD index of overall employment protection laws.

Vocational Education: Share of age cohort in either secondary or post-secondary vocational training (Estevez-Abe et al., 'Social Protection,' 170).

Low Literacy: Average% scoring in the lowest category on three tests (document, verbal, quantitative) the OECD/Statistics Canada Study.

Total employment: Total employment as% of the working age population (15–64 years).

Full reference to data sources not specifically cite above can be found in Huber and Stephens, *Development and Crisis* or Bradley and Stephens 'Employment Performance.'

and actions,<sup>7</sup> attributing a significant role to employers in shaping generous social policies, putting them at direct loggerheads with power resource explanations. According to these scholars, the reason why CMEs have generous social policy regimes is because employers' interests in CMEs are different than in LMEs. So, for example, faced with tight labor markets, employers favor active labor market policy and legislated social insurance, which takes these benefits out of wage competition; or faced with slack labor markets and strong employment protection laws, they favor generous systems of early retirement in order to be able to lay off older workers and rationalize production. The broader claims of this new literature have been hotly contested, not only by proponents of power resources theory<sup>8</sup> but also by welfare state scholars from other approaches.<sup>9</sup>

Iversen's work also addresses the issue of the causes of variation in social policy from a VoC perspective, but in a fashion that combines insights of both power resources theory and its employer-centered critics and thus transcends that debate. With power resources theory, Iversen (pp. 17, 24, 153–55) agrees that partisan government is a decisive factor in shaping welfare states. Moreover, in his discussion of the trilemma of the service economy (chapter 6, also see p. 17) he follows Esping-Andersen<sup>10</sup> in attributing the development of the 'three worlds of welfare capitalism' to the patterns of long dominance of social democratic, Christian democratic, and right and center government in different countries (see Table 2). However, he parts ways with at least the initial statements of power resource theory and finds common ground with the employer-centric theories of social policy development as he does not see generous social policies, at least some generous social policies, as a point of contention between employers and workers in CMEs.

On the contrary, the opposite is true with regard to the systems of skill training and unemployment and employment protection. Since CMEs have a competitive advantage in export manufacturing demanding high skill levels (such as, in the late twentieth-century diversified quality production), especially among manual workers, both employers and workers have common interest in the system of skill training. The system of vocational education is one element of this (see Table 2), but it is connected to apprenticeships and/or on-the-job training in which the workers develop skills which are specific to their industry or even firm. However, workers will be reluctant to invest in these industry or firm-specific skills unless they are guaranteed their investments will pay off. Thus, employment protection legislation, which gives workers job security, and generous unemployment insurance, which allows workers time to search for jobs which utilize their skills or upgrade their skills, are in the interest of both workers and employers. Accordingly, it is not surprising that globalization does not lead to convergence on social protection. Since CME welfare states support the export production niche of CMEs, globalization leads to maintenance of current social protection systems or even further divergence between LME and CME welfare states.

Another common ground between Iversen's analysis and power resources theory, especially early contributions to the theory,<sup>11</sup> is that public opinion on issues matters for electoral outcomes and thus indirectly influences social policy outcomes.

This appears in two facets of his analysis. First, on the basis of analysis of survey data for ten OECD countries, Iversen shows that workers with industry and firm-specific skills are more supportive of more government spending on pensions, health care, unemployment, and support for declining industries to protect jobs. By implication, in countries where more workers have specific skills (i.e. CMEs), the electorate will be more supportive of a generous welfare state, which in turn will result in more generous social policy through the mechanism of partisan government.

Second, Iversen argues that electoral systems give systematic advantages to one side of the partisan spectrum because of the way they affect the behavior of the median voter. This hypothesis is based on a complex argument about political institutions, the time-inconsistency problem, and credible commitment, and it is supported by some formal modeling. I do not have the space here to recapitulate this argument, so let me skip to the conclusion: Proportional representation results in more support for the center left while majoritarian electoral systems result in more support for the center right because of the way they affect the calculus of the median voter. Since partisan government matters for welfare state outcome, the representation system has an indirect effect on those outcomes.

The upshot of the centrality of electoral process and partisan government for welfare state outcomes in Iversen's analysis is that employers, though actually favoring social protection in certain areas, do not appear as the agents of legislative change. Reading between the lines a bit, there is a class struggle in his analysis but it is not between capital and labor. Rather it is between the owners of marketable mobile assets (both skills/education and property) whose position in markets and income distribution leads them to oppose both insurance and redistribution, and the asset-poor and/or owners of specific assets whose asset portfolios lead them to support insurance and redistribution.<sup>12</sup>

In the interest of space, let me very briefly summarize the remaining arguments in the book. In chapter 5, Iversen analyzes pooled time series data with social spending as the dependent variable and shows that deindustrialization, not globalization, is the motor behind the expansion of social spending. Moreover, he shows that domestic factors and not globalization are the main causes of deindustrialization. In the final chapter, he revisits his now widely cited analysis of the 'trilemmas of the service economy,' arguing that in post-industrial economies, countries can no longer combine high employment, wage equality, and fiscal restraint. Future growth in employment will have to come in the private service sector, a substantial part of which is not only low-productivity and low-wage, but also has low potential for productivity growth. Thus, unlike the industrial economy in which low-wage jobs could be phased out through productivity growth, the post-industrial economy imposes a trade-off between employment and wage compression.

No original work is without its faults, and on several points I think the empirical support presented to support the book's theories could be stronger. The analysis of the micro data on support for the welfare state is flawed on two accounts. First, as Mehrtens shows,<sup>13</sup> country average levels of opinion on the items Iversen analyzes are not related to welfare state effort, though other items in the International Social

Survey Program (ISSP) are, including one ('government's responsibility to provide a decent living for the unemployed') that is relevant to Iversen's concern with unemployment protection. Second, Mehrtens and Lee both question the validity of the specific skills measure and show that when general education and occupation are added to the equations the coefficient for specific skills weakens and is rarely even significant, despite the very large number of cases.<sup>14</sup>

Nevertheless, I think the theory can be rescued with its ambitions pared back some. Table 3 presents the correlation of a number of items from Table 2 as well as the support for the ISSP item concerning the unemployed mentioned in the last paragraph. With the grey cells, I have indicated what I think is strong support for the hypothesis that variations in skill composition (with vocational education being an indicator of specific skills) lead to high levels of unemployment and employment protection. Not only are the correlations between these items very high, employment and unemployment protection exhibit much lower correlation to either of the partisan government variables. By contrast, the two aspects of the welfare state that Iversen (p. 153) and my co-authors and I<sup>15</sup> have shown are strongly related to left government, redistribution and public welfare state services, are not that strongly related to vocational education. In the case of Scruggs' transfer generosity index and the public opinion variable, both partisanship and vocational education are strongly related to the variables, so it would be unwise to come to any conclusion in the absence of multivariate analysis of pooled data. However, the correlations are consistent with the hypothesis that part of the reason why vocational education is related to unemployment and employment protection and transfer generosity is that public support for the welfare state is higher in countries with high levels of specific skills.

A second area in which I think we need further empirical research before we accept Iversen's conclusions is his analysis of the link between electoral systems and support for the left and right. Table 4 presents data on votes, seats, and cabinet shares. From the Table, one can see that left parties are weaker in single-member district systems, as Iversen predicts. This relationship is produced by four countries, the United States (0% left vote), Canada (17%), Ireland (16%), and Japan (32%). In Australia,

**Table 3** Correlations of Welfare State, Labor Market, and Political Characteristics

	1	2	3	4	5	6	7	8	9
1 Left cabinet									
2 Christian democratic cabinet	-0.14								
3 Vocational education	0.42	0.61							
4 CME	0.46	0.39	0.80						
5 Redistribution	0.60	-0.16	0.47	0.35					
6 Public HEW employment	0.74	-0.47	0.23	0.19	0.66				
7 Transfer generosity index	0.68	0.21	0.78	0.73	0.58	0.59			
8 Unemployment replacement rates	0.39	0.25	0.77	0.70	0.34	0.43	0.81		
9 Employment protection laws	0.41	0.56	0.88	0.73	0.54	0.24	0.73	0.67	
10 Public support for unemployed	0.58	0.08	0.61	0.53	0.65	0.63	0.70	0.58	0.57

**Table 4** Average Vote, Parliamentary Seat, and Cabinet Share by Party Group

	Proportional Representation	Single Member District
<u>Left parties</u>		
Votes	42%	30%
Seats	44	29
Cabinet Share	46	19
<u>Right parties</u>		
Votes	27	43
Seats	28	47
Cabinet Share	21	55

Cell entries are averages for 1946–2000.

New Zealand, Britain, and France, the left vote is very similar to the left vote in proportional representation systems. While there seems to be little question that proportional representation would increase left vote in all four countries with a low left vote, because small parties in single member districts face the wasted vote problem, it is very likely that the left would be considerably weaker in the United States, Canada, and Ireland for social, structural, and historical reasons and not because of the median voter mechanism posited in Iversen's theory. From Table 4, one can also see that, in the single-member district systems, a 13% difference in vote share translates into a 26% difference in cabinet share. There is some right seat overrepresentation but most of the difference is due to the discrepancy between the seats and cabinet share which is probably simply a product of the system favoring larger parties. In the proportional representation system, there is some evidence of support for Iversen's theory but modified to focus on the party with the support of the median voter. We do see here that left parties and center parties (the absent category) are overrepresented in the cabinets, indicating propensity of center parties to choose left parties rather than right parties as coalition partners.

Given the emphasis on partisanship in the text of the book, the reader may be surprised that in Iversen's analysis of deindustrialization and welfare spending (chapter 5), the partisan effects are surprisingly weak. As Huber and I show, this is to be expected in the case of annual changes in spending.<sup>16</sup> That Iversen (pp. 201–8) finds inconsistent partisan effects when he shifts to analyzing variation in the level of spending is explained by his measurement of partisan government at  $t - 1$  rather than a long-term cumulation as in Table 2 and the inclusion of country dummies. Huber and I measure partisanship with long-term cabinet share and do not include country dummies and, as a result, get very strong partisan effects, which is consistent with the patterns one can see in Tables 2 and 3.<sup>17</sup> I am not saying that Iversen's analytical setup is wrong; these are hotly debated points in recent writing on pooled time series methodology in comparative political economy. Rather, I simply want

to bring it to the reader's attention that these differing results can be explained by differences in methodological decisions.

The final chapter is on the trilemma of the service economy and the political challenges of defending the European Social Model in the context of the service economy. Iversen's trilemma argument points to difficulties in creating future employment growth in post-industrial economies where such growth must come from private service sector expansion. My own current quantitative research on the determinants of employment in OECD countries strongly supports Iversen's argument.<sup>18</sup> We find that the determinants of private service employment contrast sharply with the determinants of industrial employment. Wage equality, payroll taxes, total taxes, employment protection, and union strength all become liabilities as countries move from the industrial economy to the service economy. As Iversen notes, the Nordic countries have been able to increase employment by increasing employment in public health, education, and welfare services. This has an additional beneficial effect for employment as many of these services, such as day care and elder care, have allowed people, mostly women, to combine work and family. However, as Iversen again notes, this comes at the expense of high taxes, and the Nordic countries are now at the saturation point and cannot expect to be able to raise taxes to increase employment in the future. Thus, social democrats must look to reforms, such as his 'selected and shielded deregulation' (pp. 257–68) and third way activation policies,<sup>19</sup> for ways in which private service employment can be expanded while preserving the European Social Model.

## Notes

- [1] See Soskice, 'Divergent Production Regimes;' Hall and Soskice, 'An Introduction to Varieties of Capitalism.'
- [2] E.g., see Kitschelt et al., 'Convergence and Divergence;' Estevez-Abe et al., 'Social Protection;' Huber and Stephens, *Development and Crisis*, chapter 4.
- [3] Japan, a group coordinated market economy according to Soskice, fits less easily into this typology, especially in regard to its welfare state regime, so I leave it aside here. Thus, when I refer to CMEs, I mean the European industry CMEs.
- [4] Definitions of the variables in Table 2 are given in the note accompanying it.
- [5] Stephens, *The Transition from Capitalism to Socialism*; Western, 'A Comparative Study;' Hicks, *Social Democracy*.
- [6] Katzenstein, *Small States*.
- [7] E.g., see Mares, *The Politics of Social Risk*, Swenson, *Capitalists against Markets*.
- [8] Huber and Stephens, *Development and Crisis*, 199; Korpi, 'Class Conflict.'
- [9] Hacker and Pierson, 'Business Power.'
- [10] Esping-Andersen, *The Three Worlds of Welfare Capitalism*.
- [11] Stephens, 'Class Formation;' Stephens, *The Transition from Capitalism to Socialism*; Korpi, *The Democratic Class Struggle*, Esping-Andersen, *Politics Against Markets*.
- [12] Contrary to Moene and Wallerstein, 'Inequality, Social Insurance, and Redistribution,' Iversen (pp. 21–22) argues, quite correctly in my view, that empirically it is not possible to separate welfare state programs aimed at insurance and those aimed at redistribution.
- [13] Mehrtens, 'Three Worlds of Public Opinion?'
- [14] Mehrtens, 'Shared Values?;' Lee, 'Class-based Explanations.'

- [15] Huber and Stephens, *Development and Crisis*; Bradley et al., 'Distribution and Redistribution.'
- [16] Huber and Stephens, *Development and Crisis*, 57–58, 77.
- [17] If one's hypothesis is an effect of the level of one variable on the level of another variable as it is in our analysis, Plümpner, Throeger, and Manow ('Panel Data Analysis,' 331, 334) argue that one should not use country dummies, despite the fact that excluding them runs the risk of omitted variable bias.
- [18] E.g., see Bradley and Stephens, 'Employment Performance.'
- [19] Green-Pedersen et al., 'Neo-Liberalism.'

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## Skill Specificity and the Modern Macroeconomics of Unemployment: Using the Iversen Tool-Kit

### Introduction

Among a number of key insights in Iversen's work, the importance for political analysis of skill specificity is central. This is spelt out in a number of ways during the course of this seminal book. Two institutional implications are developed at length. First, skill specificity is associated with a strong welfare state. Second, it is associated with consensus-based political systems. Apart from its many substantive contributions, the book gives political scientists a new 'tool-kit' to work with, based on the linkage between investment in specific skills, the welfare state and the encompassing consensual political framework. What I do here is to suggest how the Iversen tool-kit can be used in modern macroeconomics. In particular, this note points out how the core idea of skill specificity and its institutional implications can tie into the increasingly paradigmatic New Keynesian macroeconomics, and shows how

it may play an important part in explaining the role of inadequate aggregate demand in understanding current high unemployment in large coordinated economies, Germany and Japan. The note is a tentative one and much research needs to be done to pin down the argument in a fully convincing way; but I believe it is an important one and one which well illustrates the usefulness of the Iversen tool-kit.

Much work has been done in economics on the supply-side relationship between institutions and unemployment. Many economists, of course, have argued that the welfare state raises unemployment by increasing the cost of labour and reducing the incentive to seek work. In the varieties of capitalism literature, several contributions have sought to show how the interaction of coordinated wage bargaining and non-accommodating central banks can be beneficial to unemployment.<sup>1</sup> Mares,<sup>2</sup> working in a similar tradition, makes a striking argument showing both positive and negative effects over time. Again these are supply-side arguments. Little work has been done on the linkage between this literature and an *aggregate-demand*-based explanation of the sharp rises in unemployment in large coordinated economies in the last decade.

Thus this contribution to the symposium will focus on the relationship between Iversen's political institutional analysis of the implications of skill specificity and the increasingly dominant New Keynesian macroeconomic paradigm.<sup>3</sup> It will be argued that there is a simple relationship which goes to the core of the new macroeconomics—that the response of consumer expenditure to adverse developments may depend on skill specificity. It is further argued that the effect on unemployment is amplified through a sequence of complementary institutional mechanisms, including the welfare state and the political system, as well as demand management institutions.

Neither political systems nor welfare states played a major role in the original development of the varieties of capitalism literature; instead the analysis concentrated on production regimes.<sup>4</sup> Iversen, focusing on human capital, has developed the argument that a precondition for skill specificity, especially if acquired through deep investments early in a career, is the need for extensive guarantees: of wage protection, against the possibility that the returns on the skills acquired will decline over time; of employment protection, against the possibility that employment in which the specific skills are needed will be lost; and of unemployment protection, that there will be adequately compensated time for the unemployed to find appropriate re-employment. In other words, a quite different argument is developed for the welfare state than before. The welfare state now becomes a guarantee that it is safe to invest in specific skills. It then becomes no surprise that, in the language of the varieties of capitalism, Coordinated Market Economies (CMEs) with their strong emphasis on vocational training and hence specific skills should be associated with strong welfare states; CMEs have either continental or social democratic welfare states, but not liberal, in Esping-Andersen's classification<sup>5</sup>: there is a complementarity between production regimes and welfare states. If—very loosely—the male work force, where Iversen sees the deeper investment in skill specificity, is considered alone, the effective welfare state does not look too dissimilar across these coordinated

North European economies. The major differences come in the gendered way in which comparative welfare states impact on women; this question, developed at length in the book, and dividing continental (or Christian democratic) welfare states from social democratic, is an element in the subsequent argument here.

The welfare state thus provides the guarantees needed for a workforce to invest in specific skills. This has critical implications for the political system. It implies that the CME constituency which supports the welfare state may stretch across the voting population: by contrast to liberal market economies such as the UK and the US, in which skills are primarily general, and where the median voter is typically hostile to welfare state expenditures seen as benefiting low-income groups, the median voter in coordinated market economies with specific skills is typically supportive. But political support for the welfare state is not only to be found in the labour force; business, especially large organised business, while seldom explicit, is aware of the importance of welfare state guarantees to the stability of the labour market and training system. For businesses also have large specific investments in their workforces. This associated support is reinforced by and reinforces the consensus operation of CME political systems, with proportional representation, representative parties and accepted roles for the major business and union interest groups in policy making.<sup>6</sup> This too will play a part in the subsequent argument here.

### **The Basic Argument**

With the Iversen tool-kit, this section sets out the argument in the form of a contrast between Germany with the UK and the US; (the analogy with Japan will be evident throughout).

#### *Specific Skills and Consumer Behaviour*

Here is the basic argument: Germany went through major deflationary shocks in the 1990s. In no previous decade in the second half of the twentieth century have the German authorities engaged in such sustained deflationary policies. The Bundesbank reacted by 1994 against the inflationary and deficit effects of reunification, and the revaluation of the Mark led to a substantial shakeout of less skilled employees—itsself exacerbated by longer term technological change and low rates of return; further, as a result of Maastricht and the conditions of EMU entry, fiscal policy in Germany and across Europe remained sharply non-accommodating. The consequence of these sustained deflationary shocks was an increase in unemployment and a slowdown of growth. Both Maastricht and rising unemployment, together with increasing early retirement and additional demographic pressure on the pensions system, caused the public finances to fall below target and led successive governments towards welfare state reform.

*Specific Skills and Consumer Behaviour: Amplifying Adverse Demand Shocks*

Employees with specific skills reacted with particular concern to the slowdown in growth, the rise in unemployment and the fear of welfare state reforms to unemployment benefits and to pensions. As Iversen stresses, for workers with specific skills it will generally be harder to find appropriate re-employment if they lose their jobs. Moreover, there is a negative externality in a labour market dominated by specific skills. If most of the workforce has long-term employment, the number of vacancies within a given category of employment is likely to be limited; and companies may anyway seek to fill vacancies via apprenticeships. Thus mid-career labour markets for many categories may be quite limited or 'illiquid'. The most obvious comparative example of this is with lifetime employment in Japan: in the relevant categories, mid-career labour markets do not exist, short of accepting a position in a subsidiary company.

In Germany as in Japan illiquidity of mid-career labour markets applies more to the relatively more highly skilled—since companies have already invested more in them and, since it pays companies to invest more in them, they have longer tenure; less skilled workers, but still with apprenticeship certificates, face more open occupational labour markets—which is what portable qualifications should equip them to do. We return to this distinction below. In any case, given serious concerns about unemployment and with governmental pressure for welfare state reform in unemployment benefits and pensions (in Japan equivalently ending 'lifetime' employment), those with specific skills who remain employed—in fact the great majority—respond by building up savings. In economic terminology, savings results not from an interest rate incentive to *substitute* future for present consumption but from *precautionary* savings, and in response to actual recent cuts in state pensions entitlements *life-cycle* savings.

*The Welfare State and the Political System*

Iversen's analysis of the guarantor-insurance role of the welfare state for those with deep specific skills in a coordinated market economy explains why this substantial proportion of the workforce should feel insecure as its welfare state benefits start to be questioned. Many employees factor in the possibility of early retirement or part-time work from their mid 50s should economic conditions become difficult—both schemes which depend on welfare state provision. By contrast to liberal market economies such as the UK or US where a workforce with more general skills could imagine at a similar age responding to economic difficulty by finding alternative employment, labour markets for older workers do not exist on any substantial scale in Germany.

These fears are exacerbated by the nature of political institutions in coordinated economies. As mentioned earlier, the consensus nature of political institutions in a country like Germany is not accidental, again an insight of Iversen's work; it reflects an economic environment in which institutional change requires wide agreement if the environment is to continue to encourage investments in specific assets. That in

turn implies that to generate sufficient support for significant institutional change, any government has to persuade those adversely affected that the crisis is one of great severity. Government rhetoric in much of the late 1990s and subsequently has been dominated by emphasis on the critical nature of the welfare state. Thus the perceived need by those employed to build up their savings is increased. Ironically, in this domain of welfare state reform, consensus-based political institutions aggravate the problem.

### *Consumption as Driver of Modern Business Cycles*

A critical component of the story is the reaction to a more uncertain world of the consumption of employees with specific skills. This mirrors a marked shift in the behaviour of business cycles in large economies over recent decades, from investment- and sometimes export-driven cycles to cycles driven by consumer expenditures—the largest component of GDP demand. The growth in the UK and the US in the 1990s, to take the most evident examples, were driven by consumption growth, accompanied by debt accumulation and exceptionally low rates of household savings. To take the latest OECD data for 2005 on the ratio of net personal savings to household incomes the US ratio is  $-0.2$ , the UK ratio is  $5.1$  (but this is gross not net), while Germany is  $10.6$  and Japan  $6.7$ ; in other LMEs, the figures are  $-2.2$  in Australia and  $-0.4$  in Canada; and in other large CMEs Italy is  $12.1$  and France  $11.6$ .<sup>7</sup> Thus in comparative terms, the insecurity-driven slowdown of consumption in Germany (and Japan and Italy), plays an important part in understanding different employment performance between the liberal market Anglo-Saxon economies and the large coordinated market economies. The specificity of skills, aggravated by uncertainty about the future of the protective welfare state, itself generated by the consensus nature of the political system, is the analytic tool which enables us to understand this.

### **Demand Management Institutions and New Keynesian Macroeconomics**

The previous section raises the obvious question: If unemployment in Germany is just the consequence of demand insufficiency, why has it not been eliminated by macro demand management? The dominant modern macroeconomic theory, often referred to as New Keynesian (NK), argues that adverse demand shocks will indeed raise unemployment.<sup>8</sup> But if monetary policy is working effectively, these shocks will be reversed: unemployment will be pushed back to equilibrium and any consequent falls in inflation below target will be eliminated. So-called ‘disequilibrium’ unemployment should be a temporary phenomenon of at most two to three years.<sup>9</sup>

Several assumptions underlie this NK mechanism. Most critically, central bank policy is based on ‘symmetric responses’ to the deviation of inflation from its target rate: Interest rates should be raised when inflation is pushed above target by a fall in unemployment below equilibrium, raising unemployment and thus lowering inflation; so too, symmetrically, they should be lowered when inflation falls as a result

of increased unemployment—until unemployment has been brought back down to equilibrium there will be a need for loose monetary policy.

### *Conservative Central Banks and Coordinated Wage Bargaining*

Once we turn to the reality of politics, things are not so simple. As Iversen pointed out,<sup>10</sup> there is a positive correlation between the conservatism of central banks and the extent of coordination in wage bargaining. This should not surprise us, he argued: When there are only a small number of coordinated actors at the top of key unions and employer associations they can respond to explicit threats by central banks to tighten monetary policy if inflation increases, in ways which the myriad of uncoordinated micro agents setting wage and price increases in the UK or the US cannot. Hence with coordinated wage bargaining it will pay the central bank to make aggressive threats. A counter-intuitive implication Iversen draws is that equilibrium unemployment should in the long run be lower in economies with coordinated wage bargaining and tough central banks.<sup>11</sup> As is argued by Estavez-Abe et al.,<sup>12</sup> coordinated wage bargaining is intimately connected with specific skills: for it offers wage protection—the guarantee that locking oneself into an occupation, and often into a particular company as well, will not lead to a decline in relative wages. Thus some form of coordinated wage bargaining is a protective precondition for a labour market with specific skills. The connection can be made in another way as well: an economy of highly skilled employees with company-specific skills gives workers and their unions significant power; and to this a conservative central bank is needed to offer counterbalancing power.

But if conservative central banks work well with coordinated wage bargaining in periods when demand fluctuations around equilibrium are low, their conservatism may lead to dangerous instability in the presence of deeper adverse shocks. First, if the central bank has an asymmetric response function, it will be wary about the type of dramatic interest rate reductions employed for example by the US Federal Reserve Bank in response to recessionary shocks. Second, if the adverse shock is deep, cuts in short-term interest rates may be inadequate to bring unemployment back down to equilibrium, especially if this process is itself accompanied by shock-amplifying expectations and consumption responses. An economy can thus slip into the Japanese negative inflation trap, which works as follows: What matters for aggregate demand is the real not the nominal interest rate; the real interest rate is equal to the nominal less the expected rate of inflation, and since there is a lower bound of zero on the nominal interest rate, there is a lower bound on the real equal to the negative of the expected rate of inflation. The expected rate of inflation is usually well proxied by the actual rate, so that as soon as inflation is negative the lower bound on the real rate becomes positive; but if equilibrium unemployment cannot be restored, and inflation thus stabilised, inflation will continue to fall, and the real rate of interest and the rate of unemployment continue to rise. Third, the switch from the Bundesbank to the European Central bank aggravated the German situation, since the ECB responds to European inflation and not German. Thus declining German inflation,

the consequence of both rising unemployment and union wage restraint, meets no direct ECB interest rate alleviation. The German version of the real interest trap is that a decline in German inflation, in so far as it does not reduce the ECB interest rate, automatically implies a higher *real* German interest rate.

### *Fiscal Policy*

Fiscal policy can be used, in principle, countercyclically. By contrast to the UK and the US, it has not been to any significant extent. A major reason is that this is seen as a challenge to monetary policy. In New Keynesian theory, central banks and monetary policy play a dominant role. Fiscal policy can put this at risk, since if it is expansionary it can counteract interest rate policy designed to stabilise inflation. The Bundesbank has thus been prepared to penalise a government which runs excessive deficits, and it did so in 1993–4 as a result in part of the deficit financing of reunification. The limits imposed by monetary on fiscal policy continued with the move to and into EMU. The requirements posed by the Maastricht conditions of entry into EMU—that the public sector deficit be reduced to 3%—were a major cause of the massive adverse demand shock motivating this contribution; and these requirements have been maintained under EMU as a result of the Stability and Growth Pact. The failure to meet the Pact testifies to the pressure put on German public accounts by low growth rather than to any countercyclical attempt to stimulate more rapid growth.

German governments have in any case been excessively cautious in their use of fiscal policy. This is an undertheorised area. But a case can be made that the logic is similar to that underlying monetary policy: namely that fiscal policy will be less accommodating the more powerful are wage and price setters. Until the ending of the fixed exchange rate period of Bretton Woods in 1972, most OECD economies saw discretionary fiscal policy as necessary in the absence of monetary policy. But it was also a period in which, until at least the late 1960s, unions were relatively acquiescent<sup>13</sup> Subsequently, in the UK and the US, where union power was sharply reduced in the 1980s, governments have been quite prepared to use discretionary fiscal policy—with *brio* in response to the 2001 recession.<sup>14</sup> In CMEs the picture is, on the surface, less clear but the same logic can be used: Where governments felt in control of inflationary pressures, because of completely centralised bargaining and employers with a strong commitment to low nominal wage growth (e.g. forestry products in Sweden, nationalised industries in Austria), fiscal policy was not problematic. But as most CMEs have become increasingly faced with more diffusely coordinated bargaining and with leading employers concerned to incentivise their skilled workforce, they have retrenched on cyclically corrected fiscal policy.

A final ironic thought on fiscal policy is this. The paper has argued that workers with company-specific skills have been at the root of the problem of underconsumption; these workers tend to be more skilled, to have longer tenure, and to be less likely to become unemployed than workers with more general occupational skills; but, employed and in higher-earning positions, and facing worse consequences

if unemployed, they have had the capacity to increase savings in response to a threatened cutback of welfare state provisions. The fiscal policy response of the German government to slow growth has been to subsidise (in one form or another) employment creation schemes for the unemployed, targeted on the least skilled. In Japan, the fiscal response has been job-creating local public goods, especially in the construction sector. In both cases, these responses were targeted on the wrong group from the point of view of stimulating consumer demand.

Why these fiscal responses? They may in part be due to the consensus nature of the political systems. The SPD is a 'representative' party, and has a powerful social wing (as does the CDU and the CSU); this represents lower income workers, and is strongly influenced by union views. It is tempting to argue that unions, whose income comes from maximising the number of members, are relatively more concerned about unemployment than are works councils whose median voter is relatively more highly skilled. By contrast to the consensus-based German system, in the US and UK, where the electoral system has been majoritarian, the focus on fiscal policy has been on the median voter, not on low-income workers. And in these economies the need to reassure better off workers has been less important.

#### *Fiscal Policy in Social Democratic Welfare States*

The Scandinavian economies have partially escaped from constrained fiscal policy. In a not wholly oversimplified description, Social Democratic welfare states offer women public sector employment in the social care sectors (health, education and social services) more or less on demand. One reason why Scandinavian households may be less nervous about economic shocks is that this provides an additional de facto 'social security' system: for it means that women can return to work or increase the number of hours they work if their partners lose their employment. And this may furnish one reason why the Scandinavian economies, which are also specific skill economies, have been less affected by the felt need to build up precautionary savings than have the continental.

#### *Real Wages in Small and Large Open Economies*

In finishing this section, let me return to economics proper with two points. The first concerns the effect on aggregate demand of real wage changes. A reduction in the real wage increases aggregate demand by depreciating the real exchange rate and hence increasing the balance of trade (assuming the Marshall-Lerner elasticity condition is satisfied). But a real wage reduction also reduces consumer demand. The bigger the economy, the more likely is the second economy-wide effect to outweigh the first traded-sector effect. Germany and Japan are two large open economies which have reacted to economic difficulty by substantial real wage restraint. This has reflected both the weakening of labour markets and the concern of unions in the exposed sectors to maintain employment. It seems likely that these large economies lost aggregate demand as a result of real wage restraint. Thus, this is probably a major



reason why Germany and Japan, but not the smaller CMEs, have had low demand growth—despite increased competitiveness.

### *Equilibrium in Open Economies*

The second point is this, and the failure to understand it has led to a misplaced analysis of the German case. In a closed economy, where there is a single unemployment equilibrium rate, it is straightforward to tell whether actual unemployment is above equilibrium. If it is, weak labour markets will be forcing money wages to rise less than the expected rate of inflation and, since price inflation is eventually brought down into line with nominal wage inflation, when unemployment is above equilibrium this will be associated with falling price inflation. Since in Germany inflation has been very low but stable, many observers have concluded that high unemployment in Germany simply means that the unique equilibrium unemployment rate has increased. This conclusion is incorrect in an open economy: This is because inflation is externally determined in equilibrium; a reduction in aggregate demand lowers the real wage until it is consistent with a weaker labour market; and inflation then restabilises at the world or EMU rate.<sup>15</sup>

### **Conclusion**

Using the Iversen tool-kit together with New Keynesian economics, I have sought to give an explanation of high and persistent unemployment in Germany in the last decade based on the failure of aggregate demand. Since German unemployment was lower than US unemployment right up to reunification, simple institutional theories do not explain much; moreover, the view that it resulted from a failure to meet changed international conditions fails, since on key indicators Germany is currently the most internationally competitive large advanced economy. Finally, the rise in unemployment since the early 1990s relates closely to the slowdown in aggregate demand. Three contrasts come out in the analysis: (1) Germany with specific skills, a strong welfare state, a consensus political system and non-accommodating monetary and fiscal policy contrasts with the UK and the US—with general skills, weak welfare states, majoritarian political systems and relatively accommodating monetary and fiscal policy; (2) large and persistent adverse shocks versus small adverse shocks, with the suggestion that the former lead to amplification, the latter to dampening, of the shocks in Germany; and (3) only lightly touched on in the last section, the differences between Germany and small CMEs. Again, to repeat the qualification at the start of this note, this should be taken as a sketch of where I believe research may be able profitably to go.

The aim of the contribution is to show how Iversen's ideas can be employed outside the areas of his own work. The insight which Iversen has developed in underlining the role of asset specificity in political science, and showing how it plays a foundational role in micro-agent behaviour and the movement between micro

and macro, provides a new approach for the discipline. His applications in the book are in the comparative political economy of advanced countries. They cover—and radically reinterpret—topics in particular relating to the welfare state. But the method he has developed has a wider—perhaps much wider—reach. I hope I have given a flavour of this in suggesting how the Iversen method in conjunction with the new macroeconomics can play a critical role in understanding the impact of aggregate demand on unemployment in economies in which specific skills are important and in the presence of serious shocks. It is a method which is likely to impact across the political science discipline.

## Notes

- [1] Hall, 'Central Bank Independence;' Hall and Franzese, 'Mixed Signals;' Iversen, *Contested Economic Institutions*; Soskice and Iversen, 'Non-Neutrality of Monetary Policy.'
- [2] Mares, *Taxation*.
- [3] An introduction to the more general relation between political science and the new macroeconomics is in Iversen and Soskice, 'Political Science and the New Macroeconomics.'
- [4] Soskice, 'Reinterpreting Corporatism;' Hall and Soskice, 'Introduction to Varieties of Capitalism.'
- [5] Esping-Andersen, *The Three Worlds*.
- [6] For a historical analysis of the co-evolution of coordination, specificity and consensus-based or representative political systems see Iversen and Soskice, 'Distribution and Redistribution.'
- [7] As I said at the start of this note, several points in the argument need much more detailed empirical work. In particular the savings data needs to be examined at micro panel data level.
- [8] From a Keynesian perspective, the idea of specific skills as constraining consumption because (of the fear that) alternative employment is difficult to find ties neatly into the concept that consumers are demand-constrained: they have to take their income as given rather than have the capacity—micro foundational in the New Classical world—of supplying as much labour as they choose at the going real wage rate for their skills.
- [9] These arguments are explained in Carlin and Soskice, *Macroeconomics*. It also explains how and why New Keynesianism has replaced the New Classical approach of the late 1970s and 1980s which assumed that there would never be disequilibrium unemployment.
- [10] Iversen, *Contested Economic Institutions*.
- [11] This is formally shown in Soskice and Iversen, 'Non-Neutrality of Monetary Policy.'
- [12] Estavez-Abe et al., 'Social Protection.'
- [13] Christian Democratic Germany remained reluctant to use discretionary fiscal policy until the grand coalition in the late 1960s and Schiller's Law on Promoting Stability and Growth. Perhaps this should be related to the shift of IG Metall from a *relatively* militant union in the early 1950s to a moderate union by the 1960s.
- [14] In the UK between 2000 and 2004 total private sector employment rose by around 300,000, direct public sector employment rose by 450,000, and employment contracted out to the private sector from the public sector including construction rose by 550,000 (Glyn, *Financial Times*, 29/06/05).
- [15] Carlin and Soskice, *Macroeconomics*.

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## Responses and Some Agenda Items for the Future Study of Democratic Capitalism

A symposium on your book by some of the premier scholars in comparative political economy is both flattering and exciting (and a little frightening!). I have learned much from the comments, and I welcome the opportunity to clarify and elaborate on some of the key propositions in the book. Most importantly, because the essays probe in new directions, they suggest a range of questions and puzzles that will help set the agenda of the field for years to come. I cannot possibly address all of these but will focus on five issues that strike me as particularly important for future research.

### Preferences for Social Protection

As Stephens points out, I concur with power resource theory in its emphasis on electoral politics. The difference is my attempt to unpack the rather generic concept of labor in much of the welfare state literature, and to shift the focus away from the idea that the politics of the welfare state is equal to the struggle of labor against capital. In my mind, class in political economy explanations of mass politics should be rooted in asset ownership, and for the vast majority of people, human capital is their most important asset. As argued in the book, and in a paper with David Soskice,<sup>1</sup> this boils down to an argument that the level of human capital ( $\sim$  income) explains the demand for redistribution, while its degree of specificity explains demand for social insurance (although the two are closely linked in practice—more on this below). So Stephens is quite right to say that there is class conflict in my story, though not in the usual sense of capital against labor.

Kitschelt makes two objections to the asset model. One is that the skill logic mostly applies to blue-collar workers who are trapped in jobs that are disappearing (what I discuss as deindustrialization). Much of the effect of skill specificity on preferences, he says, disappears when controlling for a blue collar dummy variable. I tried to include such a variable in my regressions, using the same definition as in Kitschelt and Rehm's 2004 study.<sup>2</sup> But I could find neither a significant direct effect of the variable nor any effect on the estimated parameter for skill specificity. The blue collar variable is positively related to skill specificity, which means that the mechanism by which this variable affects preferences is precisely as modeled. But the blue collar variables explain less than half the variance in skill specificity, and if I exclude all blue-collar workers from the regression, the effect of skills actually slightly *increases*. So this is definitely not just a story about blue-collar workers, or manufacturing, as Kitschelt would have it.

The reason for the difference in our results, I suspect, is that Kitschelt and Rehm also include a measure of formal education as well as five separate occupational variables (of which the blue collar dummy is one). Considering that formal education is a measure of general skills, used in the denominator of the skill specificity index, and that the occupational variables are based on the same ISCO classes that make up the numerator of that index, it is hardly surprising that the effect of the skill specificity variable goes down. This is the same issue, I surmise, in the analysis by Mehtens that Stephens refers to. Classifying occupations into what Kitschelt and Rehm call 'socio-economic groups' is essentially a way to parse out the effect of the skill variable, and in some cases render the results meaningless.<sup>3</sup> In my view this is an unattractive alternative to deriving the measure from an explicit theoretical model where the assumptions are clear and where the causal agent is directly measured. But it *does* suggest the need for a conceptual and empirical analysis of the relationship between the conception of class in the asset model and more sociological conceptions of class such as Kitschelt's.

Kitschelt's other argument is that skill specificity matters only for preferences over employment and unemployment protection, not for other forms of social protection

such as pensions and health insurance. Are specific skills workers more prone to illness or old age, Kitschelt asks rhetorically? No, but my argument also says something quite different, namely that public benefits of all sorts reduce the variability of expected future income. If pensions and health insurance help reduce the riskiness of future income, demand should be rising in skill specificity (which is what I find). Surely this is true for public health insurance when compared to private. The ability to maintain a certain level of private insurance depends on the bargaining power of individual workers as they move from one job to another, and the bargaining power of those with highly portable skills will be more invariant than those with specific skills. The same is true for pensions, although I agree that the case is weaker here because many public pensions are earnings-related (still, most schemes contain some risk pooling).

The point I take from Kitschelt's critique is that it would be desirable to (a) differentiate between types of benefits according to their effects on income and risk redistribution, and (b) endogenize the design of benefit systems. My argument has two testable implications here. The first is that general skills countries should have more private insurance with little pooling across firms and industries, while specific skills countries should have more public insurance with higher levels of risk pooling (though this is not true if all skills are firm-specific—Japan may be a case in point). The second implication is that the effect of skill specificity on demand for public insurance at the individual level should vary with the structure of the national insurance system (the effect is stronger the greater the level of risk redistribution). This can be tested using multilevel regression techniques.

### **Efficiency Versus Distribution**

Several comments imply that I only consider efficiency aspects of social spending; in particular the complementarity that such spending provides for an economy relying on specific skills. Stephens is concerned that I do not accord the class struggle enough attention, and Kitschelt questions whether the story is historically accurate given the importance of unskilled labor for the political left and their demands for redistribution (although he concedes that skilled labor probably everywhere is the core of organized labor).

I may be guilty of blurring the line between efficiency and redistribution to the point of making all redistribution look like a form of efficiency. Phelan's observation that I regard the welfare state 'first and foremost' as a means to alleviate risks, and Stephens' that I overplay the importance of skill specificity for redistribution, suggest this. My aim, however, has been to underscore that much redistribution serves insurance purposes (and vice versa) and to move beyond the common 'politics against markets' image of the welfare state. As succinctly captured by both Phelan and Stephens, the reason that massive redistribution survives in a competitive international economy is that it also facilitates investment in human capital and produces comparative advantages for firms. Were that not true we would surely see

globalization linked to large cutbacks in high-spending countries. Yet such cutbacks seem to happen only in liberal market economies, which rely much more on markets and self-insurance (Phelan calls this logic disheartening, and it is).

The book underscores that demand for insurance is also critical for explaining redistribution. The reason relates to Rawls' theory of justice: Behind the veil of ignorance—that is, if people do not know where they will end up in the income distribution—risk aversion results in demand for more equality. Consequently, exposure to risk, which depends critically on the portability of the assets people own, will lead to preferences for less inequality. Yet Stephens points out that vocational training, a measure of specificity, is only moderately related to redistribution (0.47—see Table 3). It turns out, however, that this depends quite a bit on the measure of redistribution. If, instead of the percentage reduction in the gini (which is the measure used by Stephens), one uses the percentage reduction in the poverty rate, the correlation increases to 0.75.

Be that as it may, I *do not* want to claim that all redistribution is a function of the demand for insurance or, for that matter, that every aspect of the welfare state was built by employers in alliance with skilled workers. People are not completely ignorant about their future market income, so political coalitions are surely also about redistribution. The reason that relatively high levels of redistribution are nevertheless tolerable for employers is that they *also* serve insurance purposes that can be conducive to the product market strategies of leading companies. Phelan does a nice job in outlining my position on this issue and to explain the importance of distributive politics for overcoming commitment problems: it is easier to commit to current than to future redistribution (where the latter serves insurance purposes). For more details on my approach to the relationship between efficiency, distribution and commitment, I urge the reader to consult the introductory chapter, which can be found on my website (then read the rest of the book!). That chapter makes clear, I think, that I do not intend quite such a uni-causal story as Kitschelt's Figure 1 suggests.

### **Electoral Systems and Coalitional Politics**

One of the messages of the book is that we need to understand redistributive politics as a multi-class coalition game. This implies abandoning simple unidimensional conceptions of redistribution such as the well-known median voter model by Meltzer and Richard.<sup>4</sup> Once we do, the importance of political institutions (especially electoral systems) and political parties (especially whether they are leadership- or constituency-oriented) becomes evident.

The electoral system argument in the book and in a related paper with David Soskice<sup>5</sup> says that the composition of coalitions is different under proportional representation (PR) and majoritarian rules, and that there will be more center-left governments, and redistribution, under the former than under the latter. Stephens' data in Table 4 captures this partisan bias very nicely. It shows a 25% edge for the left in terms of cabinet shares under PR systems, and a 36% edge for the right in

majoritarian systems. Stephens is right to point out that part of this difference is due to differences in voter preferences, and here we are back to the preference argument. But a significant portion of the difference, I would maintain, is a result of coalitional dynamics. As Stephens points out, this is most evident in the PR systems because one can immediately see that the center-left on average has more seats in the cabinet than in the legislature, which can only be due to the center and left allying more of the time. In the majoritarian cases the bias is harder to spot because coalitions are internal to parties, and the effect of these will only show up in the form of strategic voting by the middle class. It is striking, however, that the right wins significantly more of the time in systems where a standard Downsian logic would predict that either side will win half the time. I do not know of a convincing alternative explanation of this phenomenon.

Is the linkage between electoral systems, left-right coalitions, and redistribution 'merely' a postwar story, as Kitschelt contends? I do not think so. Countries that transitioned to PR did so between 1910 and 1930 so this is when we should begin to see the effect on spending. Based on data on social transfers assembled by Thomas Cusack for 14 countries that could reasonably be considered democracies in most of the period (using a fairly relaxed definition of democracy), and for which data are available, average spending in the eight countries that transitioned to PR rose 1.6% as a share of GDP while the figure for the countries that remained majoritarian is 0.5%. Belgium, Britain, and the Netherlands are the only countries that do not fully conform, although they fall into line later. I do not disagree, of course, that most of the expansion in welfare spending came during the 1930s and especially after World War II. But the institutional seeds for this later expansion were planted earlier in the century.

That said, I agree with Kitschelt, as well as Martin, that new cleavages and policy considerations are likely to become increasingly salient over time. Because my book emphasizes the role of coalitional politics it should be conducive to the study of this 'new partisan politics.' This also partially addresses Phelan's concern about agency since there *are* choices to be made. Very briefly, I see at least three important new lines of conflicts, all of which pose difficult challenges for the political left.

One is over investment in higher education, which is the one Kitschelt emphasizes. All parties understand the importance of such investments for growth, but because access to higher education continues to be class-biased it may be easier for the middle class to agree with the right to expand funding. Still, public education has traditionally been an issue for the left and it could remain so if educational reform is linked to aggressive efforts at reducing the class bias (something that has happened in Britain and Scandinavia but not in most continental European countries). It may be modeled as a modified version of the coalition game in the book, with the qualification that targeting of subsidies to low-income groups has a smaller effect on take-up rates than for the middle class.

A second conflict is over the deregulation of labor (and product) markets. Professionals with portable skills would like to see such reforms, while skilled workers (mostly males in manufacturing) would want to restrict any such reforms to

temporary and part-time employment. A critical question is whether skilled workers can forge alliances with low-skilled workers to ‘flexibilize’ temporary and part-time employment while compensating for lower wages and job security through transfers (this is what I call ‘selective and shielded deregulation’ in the book). The danger here is the emergence of a coalition between professionals and low-skilled in favor of across-the-board deregulation. A related possibility, as Martin and Stephens both point out, is deliberate activation policies where the state subsidizes the training and employment of the least employable. An important question here is whether the middle class will try to shun the costs of these programs through alliances with the right.

The final conflict is across genders. For reasons elaborated by Estevez-Abe<sup>6</sup> and briefly discussed in the book, because it is harder for women to commit to continuous careers they are at a disadvantage in specific skill economies where such commitment is particularly important to employers. This creates divisions over the role of the state in providing jobs and services that benefit women,<sup>7</sup> although the size of the gender gap will be conditioned by the stability of the family in which income pooling occurs.<sup>8</sup> The gender division intersects the other two because women are disproportionately in low-skilled part-time jobs, at the same time as they have a greater stake in spending on higher education (since they can compete better with men in general skills jobs).

### **The Employment Puzzle**

One of the most striking differences between the economics of continental Europe and the US is the decline since the early 1970s in work volume in the former and the stability in the latter. Though this growing gap may in part reflect differences in work–leisure preferences, it is implausible that these preferences suddenly started to diverge. The standard explanation that rising taxation is to blame requires implausible assumptions about the elasticity of labor supply to account for more than a small portion of the difference.<sup>9</sup> The book instead attributes much of the gap to the difficulty of generating jobs in low-skilled social and personal services when wages are compressed, and when taxes and job protection are high. But there is an intriguing alternative macroeconomic explanation suggested by Soskice.

Soskice roots his logic in two structural-institutional features that are emphasized in the book: skill specificity and political systems that make cutting social programs difficult. The latter has macroeconomic implications because any welfare cutbacks, or labor market reform, will require politicians to whip up an atmosphere of crisis in order to get all the necessary political actors on board. By doing so, workers with specific skills get nervous about future income security and start saving as a precaution (unless there is an option for women to work more, as in Scandinavia, because this serves an insurance via income pooling in the family). This depresses demand and employment, causing even more anxiety and precautionary saving. The government is constrained in making up for the shortfall in demand because industry- or sector-based bargaining systems require governments to stay committed



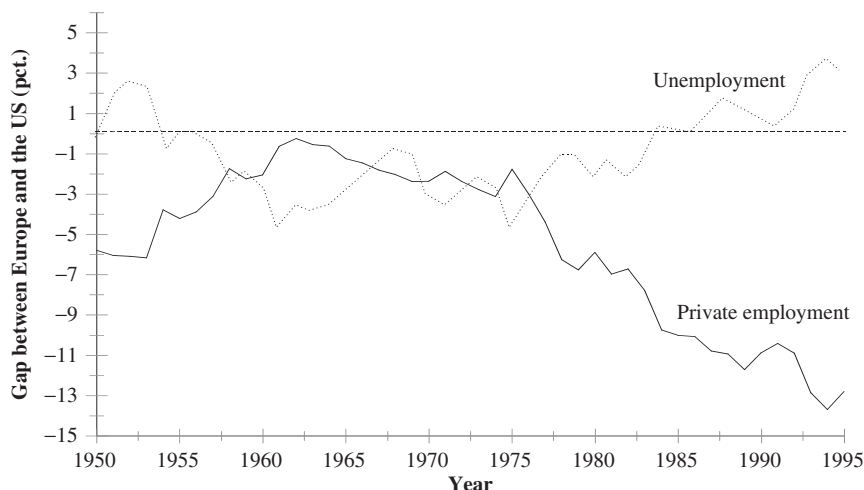
to a non-accommodating macroeconomic policy as a way of inducing unions to exercise wage restraint.

Soskice's story is remarkable because it suggests that the macroeconomy works according to different logics in LMEs and in CMEs with and without a large female-dominated public sector. Existing macroeconomic theory does not take account of these differences, and because the argument prominently emphasizes the role of political institutions and unions, it is one to which political scientists are particularly well positioned to contribute. The story strikes me as particularly convincing in explaining the Japanese situation where the central bank is unable to make up for the demand shortfall because of deflationary expectations. It may well prove to be one of the most important innovations in macroeconomic theory in recent years.

Yet, I do not think it is an *alternative* to my explanation (and Soskice only implicitly implies that it is). First, while I am quite prepared to accept that a portion of the unemployment in many European countries is due to depressed macroeconomic demand (I say so explicitly in chapter 6), macroeconomic conditions can hardly explain the entire gap. Soskice<sup>10</sup> suggests that, as a rule of thumb, a 1% change in the trade balance (as a percentage of GDP) is equivalent to about a 1% change in the rate of unemployment. In 2005 the trade surplus for Germany (his main example) was about 0.7% of GDP, so eliminating it would only make a small dent in unemployment (though maybe there would be multiplier effects of this occurring across Europe and in Japan).

Secondly, it cannot explain the sector-specific nature of the European employment experience. Continental European employment in manufacturing and agriculture converged almost completely to US levels in the postwar period, but the same is not true for labor-intensive private services. The reason is not that European countries have chosen to employ more people in the public sector. Although some, like France and Scandinavia, do, this is a deliberate strategy to provide services and employment that are under-supplied in the private sector (as Stephens also points out). In the past one could perhaps argue that the low participation rates among women in countries like Germany and Italy were due to a desire by women to stay at home, but few would argue that this is true today.

Finally, I think Soskice needs my diagnosis of structural problems to get his vicious macroeconomic cycle to spin. Economic shocks of the ordinary *cyclical* variety are what social and political institutions in CMEs have been designed to cope with. There are no reasons such disturbances should be a cause for alarm precisely because governments can be relied upon to respond with counter-cyclical social spending. This is the institutionally mediated effect that I find in my 'shock analysis' in chapter 5. Soskice's logic arises when there is a widely perceived need for *structural* reform, and while he can point to German unification and the Maastricht conditions for EMU entry Figure 2 (taken from the book) shows that the divergence in employment performance between the US and continental Europe started earlier, and much of the divergence is due to labor-intensive services. This is where I think my story becomes complementary to his: I have



**Figure 2** The (Un)employment Gap Between Continental Europe and the United States. *Note:* The gap is defined as average continental European (un-)employment minus US (un)employment. Above the zero line, absolute (un-)employment is higher in Europe. Employment is measured as a percentage of the working age population in private sector employment. Unemployment is measured as standardized unemployment rates. Continental Europe refers the following countries: Austria, Belgium, Denmark, Finland, France, Germany, Italy, Netherlands, Norway, and Sweden

an explanation for why politicians feel a need for labor market reform, and it is this perceived need that causes workers, especially full-time skilled workers, to feel insecure.

Soskice's and my own story, especially in combination, point to pathological aspects of specific skills, high protection, economies. But I believe institutions in these countries are more efficient for employment in another respect: unions help to ensure that worker preferences over work and leisure are implemented in employment contracts. Since the 1970s technological change has put a premium on shop-floor autonomy and teamwork, which in turn makes it hard for managers to monitor individual work performance. In Europe and Japan this is a function that in large measure has been assumed by 'internal' unions. In the UK and the US, by contrast, employers have to try to solve the problem by hiring workers who are likely to work hard in the interest of the company. But employers do not know the 'type' of potential workers, especially younger ones. Workers therefore have an incentive to signal their commitment by agreeing to work longer hours and having shorter vacations than they would optimally prefer. There is thus a collective action problem for workers in liberal market economies that unions solve in Europe. I believe this, and the other explanations for the European employment puzzle, are extremely fruitful areas for future research.

## **Institutional Origins**

Cathie Jo Martin asks a fundamental question that has not been adequately addressed in the book: What are the origins of the institutions that I discuss? Martin makes a bold conjecture that strikes me as plausible: majoritarian political institutions undermined coordinated capitalism in the US. The reasons relate to the effect of two-party competition. When parties must compete for the median voter to win, they cannot be seen as beholden to the specific interests of any particular group. These interests instead have to turn themselves into political advocacy groups, which is not conducive to class compromise and collaboration. A case in point is the National Association of Manufacturers (NAM). While American manufactures were prepared to support a coordinated and consensual form of capitalism in the late nineteenth century, the structure of the political system forced NAM to become just another special interest.

The argument breaks new ground in a literature that has had little to say about historical origins. Hall and Soskice,<sup>11</sup> in their seminal volume on varieties of capitalism, briefly acknowledge the importance on understanding historical origins and then move on. Swenson, Mares, and Thelen<sup>12</sup> have all made key contributions in explaining aspects of the historical organization of capitalist institutions, but none has attempted to explain the relationship between types of capitalism and political institutions. Martin is starting to fill this gap, and I highly recommend the paper in which she spells out the logic in greater detail.<sup>13</sup>

But instead of using the electoral (and party) system as a cause, as Martin does, one can also look at it from the perspective of economic actors trying to manipulate the political system. I do that in a paper with Tom Cusack and David Soskice.<sup>14</sup> There we argue that in countries where economic agents had made large investments in co-specific assets (not the least specific human capital) at the eve of the national industrial revolution, securing representation of those interests in the national legislature became necessary to protect those investments and to facilitate cross-class cooperation. Once local economies were broken up by the nationalization of production, and national regulation and standard-setting became important, PR electoral systems emerged as the political solution to the problem of representation. For reasons that Martin explains well, leadership-oriented median voter parties were not conducive to such representation, and they would have posed a threat to organized capitalism. This suggests the origin of PR electoral systems in Europe.

More specifically, the countries that developed highly coordinated industrial relations and vocational training systems in the early twentieth century emerged out of modes of production that were characterized by a strong guild tradition, coordinated employers, agricultural cooperatives, and industrial (as opposed to craft) unions (Denmark is an exception to the latter, but strong employers forced unions into a coordinated framework by the turn of the century). As illustrated in Table 5, these countries are also the ones adopting PR in the 1920s. Countries where guilds and employer coordination were weak, and where defensive craft unions were pitted against the interests of employers seeking to maintain managerial control and expand

**Table 5** The Organization of Production and the Adoption of PR

		Adoption of PR electoral system by the end of the 1920s?	
		NO	YES
<b>Organization of production and labor, c. 1900</b>	<i>No guilds/cooperatives, weak employer coordination, and craft unions</i>	Australia, Canada, New Zealand, United Kingdom, United States	
	<b><i>Guilds/cooperatives, employer coordination, and industrial unions</i></b>		Belgium, Denmark, Germany, Norway, Sweden, Switzerland, Netherlands
	Ambiguous cases	France, Japan	Italy

*Sources:* Classification of production based on Crouch, *Industrial Relations*; Katzenstein, *Small States*; Thelen, *How Institutions Evolve*; Mares, *The Politics of Social Risk*; Swenson, *Employers against Markets*. Electoral systems are classified in Powell, *Elections as Instruments of Democracy*.

the supply of skilled workers, the right remained committed to majoritarian institutions. The reason was suggested above: Majoritarian systems are more conducive than PR to the protection of the right's distributive class interests. Hence, if it were not for the desire to protect specific assets and facilitate cross-class cooperation, it is hard to imagine the right would ever have abandoned majoritarian institutions. In the US, maybe it was also not possible to do so because democracy (and majoritarian institutions) emerged before the industrial revolution and the constitution made subsequent changes difficult (unlike European countries where PR emerged in the course of democratization and industrialization). At any rate, as Kitschelt points out, the linkage between electoral institutions and production systems in Table 5 suggests a completely different explanation of PR than the standard one in political science literature.<sup>15</sup>

## Notes

- [1] Iversen and Soskice, 'An Asset Theory.'
- [2] Kitschelt and Rehm, 'Socio-economic Group Preferences.'
- [3] For details see 'A Note on the Relationship between Skills and Class,' at <http://www.people.fas.harvard.edu/~iverson/SkillSpecificity.htm>
- [4] Meltzer and Richard, 'A Rational Theory.'
- [5] Iversen and Soskice, 'Electoral Institutions.'
- [6] Estevez-Abe, 'Gendering Varieties.'
- [7] See Huber and Stephens, 'Partisan Governance.'
- [8] See Iversen and Rosenbluth, 'The Political Economy of Gender' for details.
- [9] See Alesina et al., 'Work and Leisure.'
- [10] Soskice, 'Macroeconomic Analysis.'
- [11] Hall and Soskice, *Varieties of Capitalism*.

- [12] Swenson, *Employers against Markets*; Mares, *The Politics of Social Risk* and Thelen, *How Institutions Evolve*.
- [13] Martin, 'Sectional Parties.'
- [14] Cusack et al., 'Specific Interests.'
- [15] See Rokkan, *Citizens, Elections, Parties* and Boix, 'Setting the Rules of the Game.'

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