Democratic politics is about distributive conflict tempered by a common interest in economic growth. This lecture is about rethinking the trade-off between growth and equality. We do this through an examination of income distribution, labour markets, wage bargaining and employment growth in liberal market economies (Ireland, UK, USA, Canada and Australia), social market economies (Sweden, Norway, Finland and Denmark), corporatist market economies (Germany, Netherlands, Austria), and Mediterranean market economies (Italy, Spain and France). The lecture concludes with a discussion on the fiscal crisis facing the nation-state, welfare state retrenchment and directions for progressive reform.

Modern industrial societies have generated a conflict between the egalitarian logic of democracy versus the inegalitarian logic of the market. The attempt to reconcile these tensions has given birth to democratic capitalism: popular elections among competing political parties whereby citizens across the income distribution can make their political demands on the state. This democratic process rules any notion that the economy can be separated from politics. On the one hand, employers and employees, are free to organise themselves into peak organisations and engage in collective bargaining. On the other, political parties are free to organise and seek direct election to the state. The latter is, constitutionally speaking, more embedded and prioritised in liberal representative democracy. The complex institutional relationship between the two is central to the evolution of post-war welfare states. This connects social policy with labour market policy in the social economies of Europe.

This lecture builds upon Jonas Pontusson's study into the political and policy trade-offs facing the USA and Western Europe in their pursuit of equality, economic and employment performance. It begins from the assumption that those across the income distribution have different material interests that either do or do not get reflected in the public policies of the state. In terms of outcomes these 16 countries vary significantly. Some have kept inequality low, but unemployment high, equality low and employment high. Like most comparative political economists, this study traces the divergence to politics and the construction of institutions: political parties, the welfare state and collective bargaining. As argued last week by Esping Anderson, underpinning these institutions are political-class coalitions. It is the variation in these political-class coalitions that generated liberal, social and corporatist economies.

Pontusson emerges from this welfare state research tradition, but engages with the new varieties of capitalism literature, outlined in last week’s lecture, that emphasises the importance of employers, skills, and productivity regimes. This research projects puts significantly more emphasis on the coordinating capacities of multi-national corporations. Therefore it challenges the power resource theories that trace differences in the welfare state to the strength and weakness of labour. What this VoC revisionist theory missed was the mechanisms through which these institutions evolve under the pressure of Europeanisation and globalisation, both of which can be considered processes of international capitalist integration. VoC illustrated that it was the incentives facing employers and business interests that underpinned the core distinction between liberal and coordinated market economies, reflected in the
archetypical difference between the USA and Germany. This lecture integrates the two theories but seriously calls into question whether VoC can explain the politics of egalitarian capitalism.

All comparative political economists maintain that employer and business interests matter. Where they differ is the extent to which they view employers and corporate interests as benign or malevolent. Pontusson maintains a lot of the traditional welfare state arguments on political-class coalitions. This is a direct outcome from his study into distribution and equality. VoC scholars were more interested in sectoral developments in the productive economy, and institutions of industrial relations and labour market coordination. Recently both traditions have come under critique for missing the internationalisation of global market capitalism, particularly the role and expansion of finance markets in driving economic growth, and subsequent boom bust cycles, and European integration.

Even if one accepts that there has been general neoliberal convergences in terms of the global market paradigm within which democratic state operate, it would be empirically wrong to suggest that cross-national variation either does not exist or do not matter. We are interested in the equality enhancing effects of institutions. So let's examine the core arguments, empirical findings and theoretical contribution of Pontusson for our study into the political and policy of the European Union, a topic that has been underplayed in the American comparative political economy research tradition. Europeanisation, as we will argue throughout the course, and illustrated by the Scharpf reading in week one, has had a significant impact on the shape of macro-economic, social, wage and labour market policy in member-states. This was a direct response to the employment sluggishness of European labour markets that Pontusson illustrates in chapter 1: rethinking the trade-off between growth and equality.

Inequality is the enduring legacy of the past quarter of a century in western capitalist societies. Pontusson wants to argue that despite general trends there is still a viable European model of welfare capitalism. He does this through a detailed examination of income, skills, employment and macro-economic choices. What he overlooks is the powerful effect of European economic integration (particularly the single currency) on the European social model. The market liberal view not dominates the EU Commission, the ECJ, the ECB and the politics of European economic integration. Mario Draghi, the new ECB president stated explicitly in an interview with the Wall Street Journal last week that the old contract of ‘Social Europe’ needed to come to an end up radical structural reform of the welfare state and labour market.

But there has been no difference in economic growth rates between LME and SME countries over the past two decades. In the aftermath of the crisis we can see that SME countries have actually weathered the storm better. These countries have shown that egalitarian institutions enhance competitiveness:

1. Wage setting institutions that coordinate wage restraint in the interest of full employment and low inflation.
2. Wage compression constrains the low-wage sector and enhances productivity through incentivising employers to invest in skills
3. Large public sectors provide more training and education for their citizens and enable their market economies to move up the value chain

Varieties of capitalism

The core question is whether LME have a comparative employment performance over countries with high taxes and regulated labour markets. Economists usually take the average unemployment rate in the EU and compare this to the USA. But this masks significant variation within European countries. The EU’s employment problem can be traced to Spain, France and Italy.
The EU certainly needs to be concerned about the sluggishness of employment growth in some member-states. But there is competing evidence that labour market flexibilisation, reduced social benefits and lower income taxes are the answer to this problem.

It could be argued, as Pontusson does, that weak employment performance is a result of external shocks, growth models, and poor macro-economic management rather than any of the intrinsic features of social market economies themselves.

In this regard, comparative political economists, who analyse the precise institutional configurations between the political-societal and economic, are in a better position to design public policy responses than economists working from ahistorical and a priori market models. If there is a trade-off between equality and efficiency it cannot be answered in the abstract.

Pontusson classifies Germany, Austria, Switzerland, Belgium, the Netherlands, Sweden, Denmark, Finland and Norway as social market economies (SME), and the USA, UK, Ireland, and Canada as liberal market economies (LME). Unlike Esping-Andersen he builds upon Soskice (2002) and identifies three core characteristics that distinguish these regimes:

1. Densely organised business communities who coordinate outside the market
2. Strong unions and highly institutionalised collective bargaining systems
3. Public provision of social welfare and employment protection

I agree with Pontusson that non-market forms of business coordination constitute an important feature of the social market model. But unlike VoC scholars I would argue that it is one feature among many, and therefore the entire SME model cannot be reduced to the benevolent interest of firms in skill formation. The role of organised labour remains crucial to collective bargaining and political party competition for the level of social protection provided by the state.

Institutional underpinnings of business coordination

A core feature that distinguishes LMEs from SMEs is the extent to which corporations rely upon bank credit or the stock market in financing industrialisation. It is certainly true that the corporate financing arrangements of German firms implied closer relationships with domestic financial interests. But the recent financial crisis has called into question the role of ‘patient capital’ in SME countries. Financial liberalisation, and the shared currency has radicalised the process of raising capital across all countries. In fact, Hall and Soskice (2002), in a footnote, admitted that financialisation of global capitalism could bring to an end the major difference between LME and CME countries. See ICTWSS database.

Labour market institutions and welfare states

Collective bargaining constrains the ability of individual employers to set the wages and working conditions of employment in social market economies. This is a crucial difference between LME and CME economies, and was central to the comparative dimension of my PhD work. If one examines long term trends in union and employer density rates, and collective bargaining coverage (see the ICTWSS database) Nordic social democratic countries diverge from both corporatist and liberal economies. In some instances government legislation provides for the sector extension of collective agreements, but in general it is their high trade union density rates, which turn unions into macro-economic managers rather than the assumption of rent seekers, as implied in economics.
In terms of welfare state or social protection expenditure, the core difference here is how welfare is organised not how much individual countries spend. In SMEs, labour protection falls under departments of social policy. Nordic and corporatist states, as we discussed last week, can be distinguished by the expenditure on social insurance and universal public payment, and the commitment to female employment participation. Italy is distinguished by the absence of public provision of welfare.

Policy choices flow from institutional arrangements but not in a deterministic way.

**Income distribution and labour markets**

Rising income inequality is a general trend across all advanced industrial societies. But in the US it has become particularly pronounced. This is directly related to fiscal tax and spends policies over the past twenty years, and the impact this has had on the top 1 percent of the distribution. Most of the inequality across the OECD is related to a growth in earnings related inequality. The egalitarian logic of democracy has not kept pace with the inegalitarian logic of market forces.

But there is significant cross-national variation in the extent to which wage inequality has grown in the OECD. Pontusson argues, and I agree, that this can be traced to political and institutional factors. The decline in union density rates and public sector retrenchment are two examples. These are less the outcome of natural market forces but political dynamics. The real process of institutional change can be observed in changes in the distribution of employment. Some countries have experienced wage inequality rise but a rapid growth in employment. More jobs and full employment lifted everyone’s standard of living even if it widened intra-wage differentials.

**Employment performance**

Unemployment is the principal source of economic insecurity in capitalist societies. For social democrats the employment rate (the percentage of the labour force in jobs) is a better measure than the unemployment rate. The employment rate, a concept that I will use throughout this course, is related to three variables:

1. The number and size of the working-age population (i.e. not children or the retired)
2. The number of people in the labour force who want jobs
3. The number of jobs available

The question for public policy is what institutions and government policies affect these in the process of job creation. Or whether they affect them at all? It would appear that LME countries are better at creating jobs than SMEs. This, according to some, can be traced to egalitarian wage structures. Is this the main obstacle to employment growth?

**Macroeconomic management and wage bargaining**

One of the defining institutional characteristics of social market economies, and crucially overlooked in the economics profession, is the role of macro-economic institutions and co-determination in facilitating wage restraint, and how this interacts with monetary policy. The construction of the Eurozone has increased the restrictive nature of macro-economic, whereas it is looser in the UK and USA.

Those countries with encompassing and coordinated wage bargaining, namely social democratic economies, have managed the constraints more effectively than liberal and southern European countries. Coordinated wage bargaining, it must be emphasised, however, does not mean egalitarian outcomes.
**Welfare States, Redistribution and Economic Growth**

In the context of international economic growth, competitiveness constraints and increased cross-border capital mobility the market-liberals have argued that there is a fundamental conflict between public welfare provision and economic growth. This argument, ironically, has been strengthened in the aftermath of the financial crisis. Despite its origins in liberalisation of finance policies, it is the welfare state that has come under greatest attack for reform.

The post-war expansion of the welfare state in Europe had a major impact on the distribution of income in advanced capitalist societies. A larger public sector usually coincides with lower levels of absolute and relative poverty. Cuts to the public sector can be intuitively associated with the reverse. This can clearly be observed in Ireland where the post 2000 gains in reducing household poverty have been reversed with the 2008-2013 IMF-ECB led austerity program.

The poverty reducing effects of encompassing welfare states primarily occurs through the provision of social services and cash benefits. There is minimal evidence to suggest that an expansion in the welfare state inhibits economic growth and therefore reduces average aggregate living standards in the 60’s and 70’s and mixed evidence for the 80’s and 90’s. There is no evidence for the 2000’s.

The associated efficiency gains and disincentives effect on the unemployment, captured in many OECD, IMF and EC policy documents usually says more about the models they use than actually existing capitalist societies. Abstract market competition models, by definition, make large welfare states look inefficient, as resources are being taken out of the assumed competitive economy. These models do not account for the main objectives of social policy: redistribution and equality.

The size of social spending, as argued last week, is secondary to the actual effects of social policy. That is, it matters more what welfare states actually do than how much they spend. Nordic countries have championed the model of flexicurity, and not discussed by Pontusson. This is premised on securing the person not the job – to ensure that economic growth translates into job growth.

**Welfare states in retrenchment – discussion**

There are two dominant arguments to explain welfare state retrenchment since the 1990s:

1. Ideology and neoliberal politics
2. Functional response to the pressures of globalisation and Europeanisation

Discuss using cross-national empirical evidence on welfare state reform. Is there convergence or divergence? Do historical distinctions remain valid in Europe?

Next week we will examine the trajectory of institutional change in welfare state regimes since the 2000’s, the politics of liberalisation and the Europeanisation of social and employment policy.