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Redistribution and the Power of the Advanced Nation State

Government Responses to Rising Inequality[1]

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During the past two decades advanced democracies have experienced a striking increase in wage inequality and a rise of dualism in the labor market. A key question for this paper is whether, and to what extent, the state has responded to these developments by providing compensation and new opportunities for those who have been most affected. Because the industrial relations and employment protection systems are no longer a guarantor for the welfare of low-end workers, equality increasingly depends on the capacity of the political system to forge inclusive alliances and counteract rising inequality through redistributive policies directed at the losers of change. Such capacity appears to have been absent or waning in most countries, although there is some notable variance.

A standard argument for this lack of government responsiveness is that politics are increasingly being subordinated to business interests. Hacker and Pierson (2011) suggest so in relation to the extraordinary inequalities of the US and the stagnant incomes of middle-class America. For Simon Johnson the great investment banks, with close links to successive administrations, caused the financial crash (Johnson and Kwak 2011). Streeck (2009, 2011), in an explicitly Marxist vein, attributes what he sees as the collapse of Durckheimian

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solidarity in the German political economy to advanced capitalism. Susan Strange predicted the hollowing-out of the nation state by the growth of huge multinationals (Strange 1996). For Rodrik globalization, especially low-wage competition and the ability of companies to locate wherever they want, now threatens the foundation of the welfare state (Rodrik 2011). Andrew Glyn (2006) argues that advanced capitalism has—with the continuing support of the state—had adverse economic consequences on distributional outcomes (the share of profits, income inequality, the welfare state) as well as unemployment and financial stability.

We disagree. A central feature of the organization of both capitalism and politics from the industrial revolution to the present day is that, despite ample opportunities to invest globally, advanced capitalist sectors are largely confined to the developed economies; both advanced capitalism and politics are largely nationally organized in these economies. Governments of all stripes have been concerned to promote the advanced sectors and have provided or underwritten the institutional frameworks seen as necessary to generate comparative advantages. Yet this does not imply that they are beholden to business interests. Critically for organizational and technological change, governments lean against the interest of capitalists to create protected and low-risk markets and have instead imposed competition, domestically or internationally, on their advanced sectors. A strong competition policy has been central both to stimulate innovation and efficiency, and also to limit monopoly profits.

Business in advanced capitalism is in fact politically weak. The leading knowledge-carrying firms cannot easily relocate beyond national borders in response to redistribution, and business cannot escape competitive pressure within national borders by buying off politicians because political parties and governments have to build a reputation for good economic governance in order to retain the trust of the middle class and lay claim to power in the future. Democratic politics is the main guarantor of prosperity in advanced countries, so if large numbers of people are excluded from sharing in this prosperity it is a problem with democracy, not with capitalism. Redistribution, and the protection of workers in low-skill sectors in general, is not part of the institutional framework of advanced capitalism. Because these markets tend to be concentrated in mostly sheltered low-productivity services globalization has affected them little, and governments are in no way constrained by the advanced sectors to compensate workers in these sectors. The lack of response to rising inequality is a political choice, and this choice is driven, we argue, by the incentives of governments to include representatives of low-skilled workers in policy-making.

Differences in these incentives are a function of both the electoral system and the party system, and this drives responses to rising inequality. The de facto exclusion of low-skilled workers from government in continental Europe accounts for why these countries have not responded as aggressively to skill-biased labor market shocks, despite large entrenched insurance-based welfare states. In fact, we will show that these countries do not differentiate themselves clearly from liberal market economies, and labor market stratification has risen notably as a consequence. Governments in the Nordic countries have been more responsive, not because they are less economically constrained, but because governments have often had to rely on support from the left.

If we are right, it raises the question of why studies have found that governments have become less responsive to demands for redistribution than in the past (e.g., Bradley et al. 2003), even as inequality and "needs" have risen. We suggest that this is a consequence of the same forces of change that caused inequality to rise: the end of Fordism, deindustrialization, and skill-biased technological change. All of this has the effect of undermining strong complementarities in production between skilled and semi-skilled workers, and this seriously undercuts the bargaining power of low-skilled workers in the industrial relations system. No longer needed to reach deals with employers, skilled workers stop pushing for policies that will also benefit low-end workers. Now, it is only by direct representation in government that low-skilled workers will get the attention of policy-makers.

The rest of this chapter is divided into four sections. In the first section we briefly make the case for why the advanced nation state is powerful and free to pursue policies that are contrary to the wishes of business. The second section develops the coalition argument and the idea that electoral and party systems determine whether governments are likely to be attentive to vulnerable workers. The third section tests the argument on spending data for OECD countries, and the final section concludes.

9.1 Location Co-specific Assets and the Autonomy of the Advanced Nation State

There are two main reasons why governments in advanced democracies have wide discretion in public policy-making, including over redistribution, despite claims that business interests have captured the state and that capital is so mobile that it is impossible to impose taxation significantly above the lowest international level.

The first reason is that advanced capital is in fact tied, to a significant extent, to particular locations. Knowledge-carrying companies are largely domestically rooted because their core knowledge is embedded in their workforces and they typically need to locate in relevant agglomerations of skills and other knowledge-carrying companies. This is true across advanced economies, and it is true for national as well as multinational companies. As the Cambridge economist and specialist on multinationals, Ha-Joon Chang, puts it (2011: 8):

> [C]ompetences are usually embodied in people (e.g. managers, engineers, skilled workers), organisations (e.g. internal company rules, organisational routines, institutional memory) and networks of related firms (e.g. suppliers, financiers, industrial associations . . .), all of which cannot easily be transported to another country. . . . However powerful a company may be it cannot transport its institutional surroundings to another country. . . . the most sophisticated activities that require high levels of human and organisational competences and a supportive institutional environment tend to stay at home.

Assets owned by the leading knowledge-carrying companies, which are typically heavily engaged in international trade, are thus in fact location-specific. They are also co-specific in the sense that they depend on the inputs from other companies, and in particular from their skilled labor force, which represent much of the firm- and industry-specific knowledge that firms build their competitive advantages around. The critical importance of such "location co-specific assets" makes the "footloose" metaphor profoundly misleading as a description of advanced capitalism. And if exit is not an easy option, nor is collective pressure on the government.

In addition, advanced capitalist companies are profit-driven, independent, and competitive. Hence they are not set up for collective political action: they cannot easily coordinate politically in order to pressure governments. Even in coordinated economies, and in politically decentralized liberal systems such as the US, their ability to coordinate politically outside negotiations over particular aspects of institutional frameworks is limited. Indeed, one of the key institutional preconditions for advanced capitalism is that firms are forced to compete with one another, both in international and domestic markets. Firms would like to limit competition in their markets, and a strong competition policy has been central to stimulating innovation and efficiency, and also to limiting monopoly profits. Political parties in advanced countries can be seen as overlapping generations of politicians who impose competition on business because they care about the future and need to build a reputation for good economic governance in order to retain the trust of the middle class and lay claim to power.

These features of advanced companies and their skilled labor forces have been *reinforced* by globalization and the IT revolution, and the positive feedback between them. Most subsidiaries of multinationals are in the Triad, the advanced economies of North America, Western Europe, and the advanced East Asian world (Rugman 2012). Much of this investment reflects the concern of multinational corporations (MNCs) to exploit their core technological capabilities by tapping into complementary technological competences in skill agglomerations elsewhere in the advanced world (Cantwell and Zhang 2011); alternatively, it consists of the setting up of subsidiaries needed to customize goods and services for the specificities of foreign markets. In both cases the effect is to tie MNCs down geographically, as opposed to increasing their ability to "shop around": multinationals are tied down by the co-specificity of skilled workforces and subcontractors in skill clusters and agglomerations.

It is also the case that the positive feedback between globalization and the IT revolution has increased product market competition, with a massive increase in the variety of products (goods and services, often intertwined), in their quality and sophistication, and in their speed of responsiveness to changing market conditions. The more competitive large companies become with each other, the less credible is any attempt to organize collective action (such as an investment strike, or a withdrawal from R&D or training) to pressure governments of advanced economies to change policies. This increase in the competitive environment in which modern companies operate is as true of Germany or Sweden as of the UK and the US.

In our view, then, the IT revolution and globalization have weakened the political capacity of advanced capitalist companies to change the policies of the governments of advanced economies. This does not apply to the governments of less-advanced nations, where major agglomerations of location co-specific assets are missing, and where multinationals are instead taking advantage of cheap low-skilled labor. This puts additional pressure on poorly skilled workers in the advanced nations, but it does not in any way limit the capacity of governments to redistribute or pursue active labor market policies.

This is not inconsistent with governments being deeply concerned to ensure that the institutional frameworks of the advanced sectors in which they have comparative advantages promote those sectors as effectively as possible. An important distinction as far as partisan preferences are concerned is between the politics of institutional frameworks and those of redistribution. All advanced governments have an interest in effective institutional frameworks: this is not an area of partisan division. But this is not the same as promoting the interests of advanced companies. Increasingly, it is a necessary condition of a party's electability that it is seen as effective in promoting the competitiveness of its advanced economic sectors, and often governments enforce increased competition (as Thatcher did) which leading companies deeply oppose. But redistribution, and the protection of workers in low-skill sectors in general, is not part of the institutional framework of advanced capitalism. Because labor markets for low- and semi-skilled workers in the post-Fordist world tend to be concentrated mostly in sheltered low-productivity services, globalization affects them little.[2] In general, most redistribution is from high- income to low-income groups, not from capital to labor, and most skilled labor is immobile across international borders.

Low skilled labor mobility is not only a result of language barriers and differences in educational standards and occupational regulations—medical, law, and other professional degrees are not easily transferable—but also because skilled workers from top to bottom are part of location co-specific investments that by definition are not the same elsewhere. Even within national borders, the occupational and social networks that characterize, say, Silicon Valley are very different than those that characterize Route 128, despite all the similarities (Saxenian 1994). We surmise that very few national policies to fund redistributive transfers in advanced democracies have been abandoned because of fear of skilled labor out-migration.

In-migration of low-skilled workers poses a different challenge because these workers compete directly with low- and semi-skilled resident workers. This contributes to dualist tendencies and makes active labor market policies, in addition to passive transfers, even more important. Yet, low-skilled labor mobility hardly presents a major constraint on redistribution because immigration from outside the European Union can and has been curtailed. In spite of the growing migration of low-skilled labor within the EU/EEA, only a tiny fraction of total social spending goes to migrant workers. This could change, however, and immigration has emerged as a central issue across Europe, potentially undermining support for the left. This is why unions in many countries (Denmark and Sweden excepted) have lobbied governments to adopt statutory wage floors through extension laws and mandated minimum wages, especially since the 2004 and 2007 EU enlargements (Dølvik et al. 2014).

Another constraint on policy is the European Monetary Union (EMU), which has led to tight fiscal and monetary policies that have undoubtedly contributed to unemployment. Yet, only in southern Europe has EMU undermined the capacity of the state to tax and spend on low-skilled sectors (our empirical analysis excludes southern Europe with the exception of Italy). Nor does EMU explain differences in policies between the Nordic and continental European countries: Finland is an EMU member, Denmark is pegged to the Euro, and the other Nordic countries have pursued conservative fiscal and

[2] The collapse of Fordism and the IT revolution of course eliminated huge swathes of low and semi-skilled employment, and the move to greater trade openness increased job losses for the less-skilled. Over recent decades the children of such workers have benefitted from increased years of education as the proportion of upper secondary graduation has risen from less than half of relevant age cohorts in the early 1960s to around 85–90 percent in most advanced economies, with corresponding increases in tertiary education. But those with low skills today are seldom employable in advanced sectors given the social and coordination skills needed to work with highly skilled workers in contemporaneous organizational technologies.

monetary policies over the past two decades (with the partial exception of Norway because of oil wealth).[3] The liberal countries are all outside EMU, but they have not responded aggressively to rising inequality.

The constraints on spending are instead political, but these constraints are broad rather than narrow. While capitalists and top managers are clearly opposed to high taxes and redistribution, partisan majorities in national legislatures are decisive. Looking across advanced countries, the available historical data suggest wide scope for governments to redistribute, ranging from a little over 10 percent in the US to over 60 percent in many small European countries, if measured as the percentage reduction in the poverty rate. Of course, some of this spending is for insurance purposes, but partisan majorities in national legislatures are decisive for redistribution. These majorities often oppose significant redistribution, and this opposition may have been deepened by low-skill immigration. One may well view this as a failure of democracy. But rarely does redistribution interfere in any major way with the interest of governments in maintaining effective institutional frameworks. This is not a story about capital subverting the popular will; this is a story about the lack of popular will.

9.2 A Model of Redistribution

Meltzer and Richard's (1981) influential model of redistribution implies that more inequality leads to more redistribution. But while the notion of democratic governments "leaning against" the market is intuitively and normatively attractive, it has met with little empirical support (see Lindert 1996; Moene and Wallerstein 2001; Iversen and Soskice 2009). Indeed, the cross-national pattern among democracies appears to be precisely the opposite, and rising inequality has not produced more redistribution, especially not to the low end (see also Barth and Moene, Chapter 10 of this volume).

A key weakness in standard models of redistribution, such as Meltzer and Richard's, is that policies are assumed to be unidimensional because this binds together groups that may have conflicting interests. Flat-rate benefits make the poor an automatic beneficiary of the political influence of the middle class, for example. We cannot assume that this is the case, and our 2006 model of coalition formation (Iversen and Soskice 2006) allows transfers to be divided in multiple ways across different economic classes.

Specifically, we assume that there are three classes—low, middle, and high—and that they are represented politically by political parties. The party system, however, takes different forms in different electoral systems. In *majoritarian*

[3] Norway and Sweden may have benefited from exchange-rate flexibility, with salutary effects on employment, but we control for unemployment in the empirical analysis.

systems there are strong incentives to form parties that are coalitions of classes in order to capture a majority. We assume that there are two parties: one center-left that is an alliance of low- and middle-income voters, and one center-right that is an alliance of middle- and high-income voters. Since low- and high-income voters can do no better than vote for the center-left and center-right party, respectively, the party controlling the government is decided by a majority of middle-class voters.

Proportional representation (PR) systems are different because here it is possible for each class to be represented by their own party. In the base-line model we therefore assume that there are three parties: a left, a center, and a right party, each representing a different class. Assuming that no party has an absolute majority, the parties controlling government are decided through post-election bargaining between two parties at a time. The outcome is a split-the-difference compromise, conforming to a Rubinstein bargaining with equally patient agents. A party chooses the coalition with the highest payoff for its own class, and payoffs are proportional to the taxable resources represented by the excluded party, which are rising in income.

With these assumptions, it follows that in multiparty PR systems left and center parties have an incentive to ally with each in order to tax the rich (as opposed to the middle and the rich taxing the poor). This leads to a center-left partisan bias. In two-party majoritarian systems, on the other hand, parties are themselves coalitions, and while both will appeal to the middle class, the middle class (the "median" voter) will worry about post-election deviations from this platform. Assuming that the right cannot engage in regressive redistribution, incomplete platform commitment puts the middle-class voter at risk, and with equal capacity for commitment this risk is greatest under center-left governments where a party controlled by the left will simultaneously cut middle-class benefits and raise taxes. Right-controlled center-right governments will also cut benefits for the middle class, but this loss will be partially offset by lower taxes. This gives the center-right an electoral advantage, and while the left can compensate by committing more firmly to a centrist platform, usually by delegating strong powers to a moderate leader, redistribution will tend to be lower in majoritarian systems.

So, at least in part, the difference in government coalitions may be a function of the electoral system. Unlike power resource theory, which treats partisanship as an exogenous variable, in our model redistribution is a function of partisan coalitions induced by the electoral system. And unlike the Meltzer–Richard model, the possibility of partisanship emerges because spending can be targeted, which makes it multidimensional.

An important qualification to this base-line model is that parties under PR may represent more than one class. PR does not force parties to "suppress" particular groups in the party in order to remain politically viable, unlike

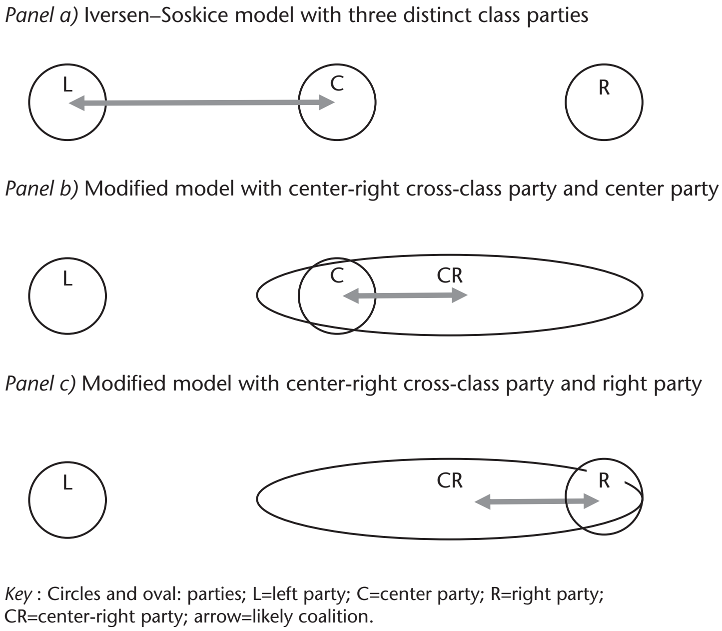

Figure 9.1 A simple model of three-party bargaining

parties in majoritarian systems, so a party can allow differences in group preferences to be bargained out inside the party. Parties in PR systems are "representative parties" in this sense, whereas in majoritarian systems parties have to favor the middle group in order to win elections, typically by concentrating power in a moderate leader ("leadership parties"). Having representative coalition parties in a PR system makes an important difference to the analysis, as illustrated in Figure 9.1.

The base-line "pure" class party model is illustrated in panel a of Figure 9.1. Since the composition of the coalition depends on the choice of the center party, and since the bargaining game is defined by a single contract line between the ideal points of two parties, we can capture the party coalition dynamic in a single dimension, even though the underlying policy space is multidimensional. In the case of representative class parties (panel a) we get the center-left coalition outcome as described above. Basically, it pays to keep out the right party because the pie to be distributed among those in the coalition depends on the taxable wealth and income represented by the party left out of the coalition.

However, there are consequences for the analysis if a party represents multiple groups. This is illustrated in panel b. In this example parties on the right have shed their independent liberal or conservative identity to incorporate constituencies in the center or even to the left of the center. Reflecting a compromise between different constituencies, these cross-class parties are in effect closer to the center and therefore more attractive as coalition partners for center parties than traditional right parties. What is assumed here is that the cross-class party will negotiate an inner-party compromise on its "aggregate" position and will bargain with potential coalition partners from that unified position; thus, the cross-class party will not break up during coalition bargaining, with its centrist members forming a de facto coalition with the center party. Parties may change over time for structural reasons, but we assume that they do not change in the short-term for strategic reasons.

This logic allows for different possible coalitions. One variation is illustrated in panel c, where the center is incorporated into a center-right party, but where a (smaller) independent right party survives. Here the eventual coalition may be between the center-right and right parties: a (CR, R) coalition. The existence of cross-class parties on the center-right thus open up the possibility of government coalitions leaning to the right under PR, and it has the counterintuitive implication that when independent right parties are weaker under PR, and the center (or center-right) stronger, right-leaning governments become more likely.

The major historical example of this logical possibility is Christian democracy. Even if Christian democratic parties have long shed their religious heritage, they retain their multi-class character and are best understood as *coalitions* of economic interests, including skilled workers, technicians, and upper-middle-class professionals and managers. Manow (2009) and Manow and van Kersbergen (2009) aptly refer to these parties as "negotiating communities," and because they need to accommodate different interests they tend to set aside divisive issues of redistribution and focus on their common interest in social insurance. Compared to traditional liberal and conservative parties, Christian democratic parties are much more favorably disposed toward the welfare state, even as redistribution to the poor and low-skilled is downplayed. As long as Christian democratic parties can garner a majority with center parties, there is consequently little reason to expect governments to lean against inegalitarian tendencies in the labor market.

The paradoxical implication of this argument is that strong independent right parties tend to produce more center-left governments. The Nordic countries exhibit strong electoral support for secular right parties, measured by vote shares, but relatively left-leaning governments and weak center parties. Continental and southern European countries exhibit weak electoral support for liberal and conservative parties, but relatively right-leaning governments with strong center parties. In other words, the stronger the right is electorally, the more left-leaning are governments! This pattern, implied by the coalition model, is not implied by any existing theory to our knowledge.

We believe that these distinctions capture long-standing differences between political systems that have shaped government responses to rising inequality.

Even occasional center-left governments in the continental countries and center-right governments in the Nordic countries have not prompted fundamental policy changes precisely because such changes are known to be unsustainable. At the same time, we acknowledge that party systems are themselves slowly being transformed. One force of change is secularization, which has undermined support for Christian democratic parties. Yet this does not necessarily change the dynamic we have described. Indeed, with the decline of Catholic faith and the Church, the negotiating power of "social wings" representing the poor may well have declined within Christian democratic parties. This would spell more exclusion, as long as these parties can govern without the left.

In the Nordic countries, the forces that transformed the economic system have caused changes in the electoral base of political parties. The interests of increasingly skilled and well-paid workers are diverging from those of semi-skilled workers, with the former moving toward the center and the latter often shifting to populist anti-immigrant parties on the right. Deindustrialization has also caused divergent preferences among employers and their top employees, resulting in more independent right parties that are seeking broader electoral support at the center of the political space. In combination, these changes appear to have facilitated the rise of center-right governments in the post-2000 period, and, to the extent that this is a lasting shift, we may see policies directed toward "outsiders" being abandoned. This may well already be happening in Sweden (Lindvall and Rueda 2012). We discuss these changes, with some additional caveats, in the conclusion.

9.3 Government Responses to Rising Inequality

The effect of the de facto exclusion of low-skilled workers from governing coalitions in Christian democratic welfare states—or PR countries with weak independent right parties—was muted during the first three postwar decades because semi-skilled workers were included in encompassing and solidaristic wage-bargaining systems, as well as in related employment and social protection arrangements in the labor market. In the new knowledge economy, industrial relations systems no longer fulfill this function. Instead, the political system has replaced the industrial relations system as a potential guarantor of equality, with compensation for the low-skilled depending on active government intervention to redistribute resources, provide training and job opportunities, or set wage floors or extend collective wage agreements through legislation (although we do not consider the latter here).

The relatively high level of solidarism experienced in most labor markets before the 1980s can be explained by the extensive complementarities that existed between skilled and semi-skilled workers in the Fordist industrial economy. Because Fordist mass production relied on both skilled and semi-skilled workers in a continuous production process where interruptions are costly (as exemplified by the continuous assembly line), different skill groups made up complementary factors in the production function. Following the logic developed by Wallerstein (1990), such complementarities empowered semi-skilled unions, or semi-skilled workers within industry unions, to bargain for higher wages relative to skilled workers. They also enabled semi-skilled workers to benefit from the bargaining power and political clout of skilled unions over employment and social protection. While semi-skilled workers were rarely politically pivotal, their position in the production and industrial relation systems ensured that their interests were well-aligned, and well-attended to, by skilled workers and their unions.

By the same token, the sharp rise in wage inequality in the 1980s and 1990s is at least in part a result of the complementarities between skilled and unskilled workers being undone by new technology in manufacturing and because of the segmentation of the occupational structure caused by deindustrialization. The end of Fordism has caused a disintegration of semi-skilled and skilled work, and deindustrialization (including outsourcing of services that were previously provided in-house) has had a similar effect by creating a segregated tier of low-skilled service-sector jobs, reinforced by partial deregulation of especially temporary employment markets (Dølvik and Martin, Chapter 11 of this volume). In both fragmented and industry-based bargaining systems this has meant a severe loss in power for semi-skilled workers. Union membership among the semi-skilled, as well as bargaining coordination, have declined rapidly in both liberal and continental European countries as a consequence (Lange and Scruggs 2002; Visser 2006; 2013).

The key question in this section is the extent to which governments have stepped in to compensate and assist workers who have been adversely affected by the decline of labor market protections and the rise in employment and wage inequality. Unable to depend on the industrial relations system to protect them, would-be outsiders are increasingly reliant on state assistance. Such assistance comes in a range of different forms, from guaranteed health care, early retirement, and unemployment compensation to active labor market policies, retraining, and state-guaranteed job offers. Government involvement in setting wage floors and regulating work conditions in low-skilled labor markets with many immigrant workers is also an increasingly contested policy area (Dølvik et al. 2014). Rueda (2005; 2007) rightly argues that insiders have little interest in many of these policies, but the extent to which this is true, we argue, depends on the political incentives of parties to include the interests of low-end workers in governing coalitions.

We rely on OECD's Social Expenditure (Soc) Dataset to explore this question.[4] In addition to total social spending, these data include information on specific spending areas that are more or less targeted to weak groups in the labor market—specifically, spending on unemployment benefits and active labor market programs. Yet all social spending tends to benefit those with the lowest incomes and the most exposure to risk, so we also use total social spending as a dependent variable. All variables are as a percentage share of GDP.

We focus on the period from 1980 to our most recent observation in 2009, which is roughly the time-frame for the dynamics we have outlined above. The difficulty is to measure the magnitudes of "shocks" to the economy, mainly because they are likely to be affected by policies that are intended to counter them. Active labor market programs, for example, are designed to improve the employment opportunities of those at the greatest risk of unemployment. If so, unemployment would not be a good "shock" indicator.

Instead, we use a modified version of a method pioneered by Blanchard and Wolfers (2000). The core idea is to use year-dummies to estimate the effects of unobserved common shocks on policy variables, while at the same time differentiating the direction and strengths of these effects by distinguishing countries on key political-institutional variables. The original model requires nonlinear regression, but here we use a simpler two-stage procedure that can be estimated by simple linear OLS. In the first stage we regress changes in government spending against a complete set of year and country dummies, plus some controls, in order to identify the average effects of shocks in each year on spending across our 17 countries. We use these results to construct a "shock" variable (for each of the dependent variables), which is simply the magnitude of the estimated time effects in each year. In other words, we use average policy changes as a proxy for the magnitude of the shock in each year. These shocks can be both positive and negative.

In the second stage we regress spending against the shock variable and its interaction with two institutional measures. One is PR systems with strong independent right parties (or weak center or Christian democratic parties); the other is PR systems with weak independent right parties (or strong Christian democratic parties). The comparison group is majoritarian countries, corresponding to Esping-Andersen's (1990) liberal welfare states. Only two cases in our sample exhibit change. Italy introduced a majoritarian system in 1994 before switching back to PR in 2006, and New Zealand went from a Single Member District majoritarian system to a PR-dominant system in 1994 (with the first election under the new system in 1996).

[4] OECD, Social Expenditure Statistics. Online Database Edition.

The classification of strong and weak right parties (alternatively, weak and strong Christian democratic and center parties) in the PR cases is based on the combined vote share of liberal and conservative parties using the Armingeon et al. dataset (Armingeon et al. 2012). This separates the Nordic countries from the continental and southern European countries. We excluded Switzerland because it has a collective executive that does not allow the coalitional logic we are interested in to work.[5]

The two interaction variables capture the extent to which PR systems with and without strong independent (secular) right parties respond differently to shocks compared to majoritarian (liberal) systems. To take account of unobserved heterogeneity across countries we use country fixed effects, and we also include a set of controls designed to remove non-discretionary components of spending decisions. One is unexpected growth, which is defined by the difference between the rate of GDP per capita growth in a particular year minus the average rate of growth in the previous three years. The logic is that governments make budgetary decisions using GDP projections that are based on recent growth trends, so when growth is unexpectedly high or low it affects the denominator of the spending as share of GDP measure.

Another control removes "automatic" effects of demographic changes by including variables for (the first difference in) the share of the population who are under 15 or who are over 65.[6] Like the growth data, these data are from the OECD.stat online database. Finally, we include a control for "automatic unemployment disbursements." When workers become unemployed they usually receive unemployment benefits based on the income replacement rates that are "on the books" at the time they are laid off. These replacement rates are based on past legislation and take time to change, so not all government spending on unemployment benefits is discretionary in the usual sense. By including a control for spending "mandated" by replacement rates that were in place in the year before the shock, we focus attention on the discretionary elements of the budget. These include current changes to replacement rates themselves, but also more administrative changes in the application of rules, as well as in the eligibility and duration of benefits. The replacement data are from Vliet and Caminada's (2012) updated version of Scruggs' (2004) widely used dataset.[7]

[5] In the case of New Zealand, after the switch to PR we classified the Nationalist Party as a liberal-conservative party. New Zealand after 1994 is therefore counted as a PR case with a strong secular right.

[6] These controls are only relevant for total spending because unemployment and ALMPs only apply to the working-age population.

[7] Automatic unemployment disbursement is defined as the first difference in unemployment as a percent of the working-age population times the net replacement rate in the previous year, which is the ratio of net unemployment insurance benefits to net income for an unmarried single person earning the average production worker's wage.

We also tried to include measures for economic openness (imports plus exports as a percent of GDP), capital mobility (from Chinn and Ito 2008) female labor-force participation (as a percent of the working-age population), and voter turnout. None of these, notably those meant to capture exposure to the international economy, register a significant effect and leave our substantive results unaltered. They have been omitted in the regression results reported below.

Table 9.1 shows the regression results from the second stage of the estimation, and Figure 9.2 is a graphical representation of the effects. We find that PR countries with strong right parties, paradoxically, respond much more aggressively to shocks than other countries. This is because strong independent right parties push the center to ally with the left, whereas strong cross-class, and center-oriented, Christian democratic parties are often able to govern without the left. For total social spending they increase outlays at twice the rate of majoritarian countries, and although other PR countries are also more responsive than majoritarian countries, this is true to a much lesser degree. In fact, the most striking finding is that PR countries with weak right parties and strong center or Christian democratic parties are not notably more responsive to shocks than majoritarian countries. When it comes to being attentive to the needs of lower-skilled and more risk-exposed workers it is clearly essential that parties representing these workers are regularly included in legislative bargains, and that is typically not the case when the center can govern on its own (with or without right party participation).

Table 9.1 Regression results for the effect of shocks on government policies

	Total social spending	Spending on unemployment	Spending on ALMP
Shock	0.74***	0.60***	0.50***
	(0.18)	(0.19)	(0.16)
PR with strong right * shock	0.65***	1.23***	1.61***
	(0.25)	(0.37)	(0.41)
PR with weak right * shock	0.17	0.34	0.25
	(0.21)	(0.40)	(0.30)
Unexpected growth	–0.14***	–0.02***	–0.43
	(0.02)	(0.004)	(0.28)
Share of population under 15	0.56***	–	–
	(0.17)		
Share of population over 65	0.43**	–	–
	(0.21)		
Automatic disbursements	0.81***	0.47***	–
	(0.15)	(0.05)	
N	503	483	397
Adj R-squared	0.62	0.66	0.24

Key: *:p<0.10; **:p<0.05; ***: p<0.01 (two-tailed tests)
Note: These are the results from the second stage estimation described in the text. Country fixed effects have been omitted.

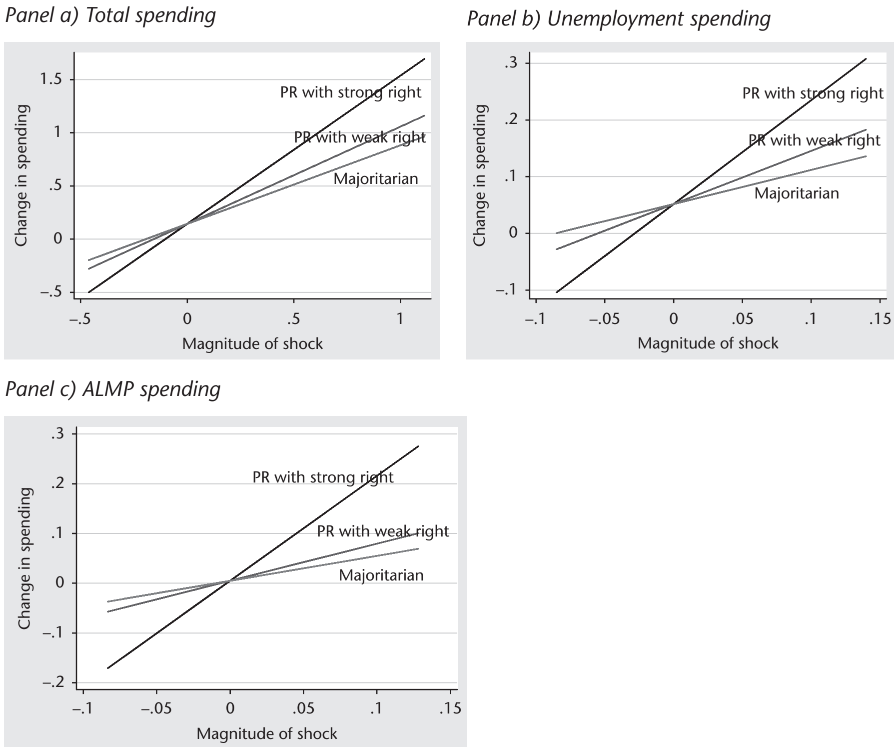

Figure 9.2 Government responsiveness to shocks depending on political system, 1980–2009

Looking across policy areas, the differences become notably larger as we consider policies that are more targeted toward vulnerable workers. A "shock" that causes a 1 percent increase in overall spending in a majoritarian country is estimated to cause a 1.85 percent increase in spending in a PR country with strong secular right parties, which corresponds to Esping-Andersen's social democratic welfare states despite having large right parties. In the case of unemployment benefits the corresponding ratio is 3, while in the case of ALMPs it is over 4.

Equally remarkable is the fact that PR countries with strong cross-class "center" parties but weak secular right parties—the "conservative" or "Christian democratic" welfare states in Esping-Andersen's terminology—are virtually indistinguishable from majoritarian countries. This may seem surprising considering the long-standing generosity of the welfare state in these countries (Huber and Stephens 2001). But this generosity does not translate into policies that lean strongly against the inegalitarian effects of the breakdown of Fordism and deindustrialization. Our results are unambiguous and consistent across policy areas, and they strongly suggest that continental European and liberal economies have failed to attend to the needs of an increasing number of lower-level, insecure workers. The reason, we submit, is that ruling coalitions systematically exclude the interests of "outsiders."

9.4. Conclusion

The end of Fordism and the rise in low-skill services have undermined solidaristic wage policies and inclusive coalitions in the industrial relations system. This is associated with a decline in unions and coordinated wage-bargaining, as well as with a notable rise in inequality and dualism in the labor market. Broadly speaking, the alliance that used to exist between low- and high-skilled workers in the industrial relations system, which was heavily dependent on complementarities in the production system, has collapsed. Much of the difference in outcomes across countries, in terms of income inequality, insider–outsider divisions, and economic performance, can now be accounted for by differences in the (institutionally induced) patterns of political coalitions.

Governments in most advanced countries have not been responsive to these changes. The explanation for the lack of "compensation," we have argued, is not that governments are beholden to business interests or that capital is footloose. It is that the main political parties, and the constituencies they represent, have no reason to respond to the needs of low-skilled workers. In the already deregulated liberal market economies, majoritarian political systems provide little incentive for political parties to redistribute. The British "New Labour" government is a case in point. While marginally more resources were allocated to active labor market programs, targeted transfers, and in-work benefits, LIS data indicates that there was no overall rise in redistribution from the previous Conservative government. Instead, the political incentive for both the left and right in these systems is to concentrate benefits on the middle class. This creates high levels of inequality, both before and after taxes, but because labor markets are flexible there are no pervasive insider–outsider divisions in the economy.

The continental European and Nordic countries all have extensive social protection for the middle classes, but only the Nordic countries have engaged proactively in compensatory transfers and in policies designed to activate the unemployed and offer them training and new job opportunities. Beneath this contrast are important differences in political coalitions. In countries with proportional representation and strong conventional right parties, center-left coalitions that include potential outsiders are much more prevalent than in PR countries with strong Christian democratic, but weak conventional right parties.

We have made a point of underscoring the political-institutional differences between the Nordic and continental European countries and the divergence in outcomes that these differences have given rise to. Yet, there are several future scenarios that suggest the possibility for more convergent policy changes.

One is that a coalition centered on "core" workers in the continental European countries simply becomes too small to be electorally viable. This possibility is closely tied to the transformation of the traditional family and the possibility that women will vote against Christian democratic parties. Because it is much harder for women to commit to continuous careers, they are over-represented among outsiders and many would potentially benefit from public policies that emphasize employment, general education, and retraining—as well as more accommodating family policies. Yet, they face competing incentives to support policies that protect the jobs and incomes of the core skilled male labor force insofar as they are married to male insiders. A great deal therefore depends on the stability of the traditional male-breadwinner family in these countries. If women become seriously worried about their options outside the marriage, due to rising divorce rates, then the continental insider coalition may be hard to sustain.

This is not entirely a story about outsiders because (in recently educated cohorts in many countries) women have increasingly longer periods of education than men. But these workers also move in and out of the workforce to a greater extent, and this may reflect an equilibrium in which they work in occupations where group- or unit-specific skills and long tenure are less important. It may be that employment protection is less important to such a workforce, and that unemployment insurance and ease of employment re-entry is more important. On the other hand, if these high-educated women increasingly partner with high-educated men, policies specifically targeted to the low-skill sector may garner low support. Such "assortative mating" would also potentially remove better educated women from "outsider coalitions" in the Nordic countries.

A very different, and potentially gloomier, prospect is the break-up of inclusive coalitions in the Nordic countries because of the conflict over immigration. There is an uneasy balance between a liberal immigration policy, free movement of labor, and a generous welfare system for those who are in low paying jobs, unemployed, or in otherwise precarious labor market positions. Since immigrants are disproportionately represented in this vulnerable group they easily become the target of new right appeals to limit immigration and concentrate benefits on natives, a mechanism that has been reinforced by the rising inflows of EU labor migrants who qualify for social benefits. Such attacks draw low-income voters away from the left and have provided the right with a de facto coalition partner.

Yet, it is not clear that this will necessarily result in major cuts in spending on "outsiders" because new right parties may take up their cause. For example, it is very clear that the Danish People's Party have championed basic social programs like public pensions and healthcare. As conventional right parties are moving to the center to capture middle-class votes, the new right may have moved to the left. An alliance between the two may not be so different in terms of redistributive policies as one might fear. This poses unresolved questions in relation to low-skill EU immigrants, however, because excluding them from social benefits violates current EU law. Raising the wage floor and imposing strict labor market regulations may turn out to be a solution for which new right parties may be strange but not implausible supporters.