PART I

Welfare Production Regimes

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A Political Economy Approach to the Welfare State

Printing is one of the world's oldest industries, and typography is one of the oldest occupations in the industrial economy. Typographers essentially transformed stacks of typed and handwritten manuscripts into a form that permitted the mass production of books, newspapers, and journals. Half technicians and half craftsmen, typographers were highly skilled, well paid, and proud harbingers of Gutenberg's revolutionary invention. However, the craft was radically transformed over time: first from "hot-metal" typesetting to "analog" typesetting and then to digital CRT (cathode ray tube) and laser image-setting. In the process of change, previous typesetting skills were swept aside in a matter of a decade or two, and large numbers of typesetters and other printing production workers lost their jobs – many by an invention that the printed word helped set in motion: the computer. Lead molds, printing plates, and all the other paraphernalia that went into the original printing processes were retired to the dusty shelves of industry museums. But retirement was not an option for the majority of typographers whose livelihood depended on using the skills they had acquired through long apprenticeships and years of learning by doing.

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

The point of this story is to highlight a central theme of this book: the importance of political and economic institutions for protecting the human capital in which people have invested. Job protection, unemployment benefits, income protection, and a host of related policies such as public retraining programs and industry subsidies, all help to insure workers against the loss in asset values when external shocks in technology and labor market conditions shift the demand for skills. Indeed, having in place some form of protection is a precondition for people making investments in specific skills in the first place. High job security, wage protection backed by union power, and guaranteed health and pension benefits have encouraged generations of young people to follow in their parents footsteps and choose typography as their trade. And, needless to say, the health of the printing industry depended on people willing to invest in specific skills. Likewise, the acquisition of specialized knowledge in academia, including that represented by Kremlinologists, would be very risky without some form of job security, and specialized knowledge is the lifeblood of any major research institution. Even if the institution of tenure was invented as a response to the Red Scare in the 1920s, its persistence owes much to the fact that it is functional to the production of new knowledge.

But social protection is clearly not only about insurance, it is also about redistribution and political conflict. By this I mean that whereas insurance is an institutional device for workers to consensually pool their risks and reimburse each other for potential future losses, redistribution is a device wherein money is taken from some workers and given to others in the present, without prior consent to do so. When printers' unions went on strike across the industrialized world in the 1970s, it was to seek subsidization of their own jobs and income, not to collect an already agreed upon insurance or to guarantee the future reproduction of old typographical skills. Everyone understood that traditional typesetting as a trade was doomed and that protection of current workers served largely distributive purposes. For the unions, it was a matter of survival, and they fought bitter battles, sometimes violent, to delay the introduction of new technology and to force employers to retain their old typographical workers. It is no accident that the first publishing houses to introduce new technology, such as *LA Times* and *Oklahoma City Times*, were ones with the weakest unions.

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

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

Even traditional distributive politics, I submit, is not well understood in the existing literature. Though there is considerable evidence that class politics matters, why is distributive politics played out so differently in different countries? The fact that partisan politics is systematically biased to the left in some countries but to the right in others is not in any straightforward way related to the power of unions or the size of the traditional working class. For example, it is striking that the decline of the industrial working class and their unions has been associated with a rise, not a collapse, in the political support for the welfare state. Also, countries with the most skewed distribution of income, where standard class arguments would predict the most radical redistribution, are in fact the least redistributive. The solution to these puzzles, I argue later, is to be found in the interplay of insurance and redistributive incentives to support the welfare state, as well as in the political institutions that translate these motives into policy. In turn, preferences for social protection are explained by the key assets, especially skills, that economic agents have invested in.

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

1.1. Toward a New Approach to the Study of the Welfare State

As the printing industry example suggests, the ability of management to introduce radical new technology is undermined by strong unions and labor market regulation. Indeed, the notion that these institutions, and the welfare state more generally, erode the market is a central theme among neoclassical economists and political sociologists alike. According to those who take this view, labor is an anonymous commodity, easily aggregated into a single factor *L*, where each constituent unit (worker) is "replaceable, easily redundant, and atomized" (Esping-Andersen 1990, p. 37). Logically, the opposite of market (or "commodification") is state (or "decommodification"). It means that "a person can maintain a livelihood without reliance on the market" (Esping-Andersen 1990, p. 22). The welfare state transforms *L* into not-*L*, and thereby set the worker free: free to organize, free to oppose capital, free to be an individual rather than a commodity. Again in the words of Esping-Andersen: "Decommodification strengthens the worker and weakens the absolute authority of the employer. It is for exactly this reason that employers have always opposed decommodification" (1990, p. 22). The welfare state is "politics against markets" (Esping-Andersen 1985), and the historical strength of the political left, mediated by alliances with the middle classes, determine how much welfare state and how much market you end up with (Korpi 1983, 1989; Esping-Andersen 1990; Huber and Stephens 2001).

The power resources model of the welfare state as it is known is the dominant approach to the study of the welfare state. It suggests that the welfare state is built on the shoulders of an unwilling capitalist class, who will be looking for any opportunities to unburden itself. This is also a central theme in the burgeoning literature on globalization where the "exit option" for capital presents precisely such an opportunity. As Wolfgang Streeck explains in the case of Germany: "Globalization, by increasing the mobility of capital and labour across national borders, extricates the labour supply from national control and enables the financial sector to refuse doing service as a national utility" (Streeck 1997). In a similar vein, Dani Rodrik concludes that "integration into the world economy reduces the ability of governments to undertake redistributive taxation or implement generous social programs" (Rodrik 1997).

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

In recent years, an alternative approach to the welfare state has emerged, which emphasizes the role of employers. Contrary to the power resources model, Peter Swenson (2002) shows through careful archival research that employers played a proactive role in the early formation of social policy. Swenson argues that in tight labor markets employers will seek to take social benefits out of competition by creating a uniform, national social insurance system. When labor markets are slack, on the other hand, high-cost producers may feel compelled to impose costs on low-cost producers through mandatory social insurance arrangements. Swenson argues that the first logic helps explain early welfare reforms in Sweden, while the latter helps explain salient features of the New Deal legislation in the United States.

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

In a recent dissertation on the German welfare state, Philip Manow (2002) has likewise advanced the thesis that the German system of social protection, through a process of institutional coevolution, emerged as an important complement to the collective bargaining system, which in turn underwrote union wage restraint and international competitiveness. By delegating much of the responsibility for social policy to the social partners, the institutional incapacity of the German state to guarantee full employment (as a result of federalism, an independent central bank, etc.) was compensated for by a social system that provided very high levels of insurance in the event of unemployment and other shocks to income. In earlier work, Peter Baldwin (1990) also challenges the notion that the welfare state was erected by the industrial working class alone, against the will of the middle classes. Much universalism in the "social democratic" welfare states of Scandinavia, for example, was the result of pressure by farmers and other nonworkers at the turn of the century to be included in social programs that served as instruments of insurance as much as tools of redistribution.

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

At the heart of the difficulties in the standard view of the welfare state is a neoclassical conception of markets that largely ignores differentiated skills. Although unskilled day workers can sensibly be analyzed as an undifferentiated factor L, and although such labor can be exchanged efficiently in something that approximates spot markets, in Becker's (1964) seminal work and in new institutional economics, these conditions are considered the extreme of a continuum. At the other extreme, you find workers with highly asset-specific investments in skills – L_s, where $s = (1, 2, 3, \ldots, n)$ refers to differentiated skills – coupled with nonmarket institutions that protect and manage these investments.

Of course, workers are not the only ones who invest in specific assets; firms, merchants, and virtually any agent involved in economic exchange do also. And because economic agents are engaged in exchange, and because they sometimes own the assets jointly, most assets are cospecific in the sense that they tie together the welfare of people and make them dependent on one another. For every worker whose livelihood is tied to a specific skill, there is an employer who depends on the worker with those skills. As argued by Polanyi (1944), Williamson (1985), North (1990), and others, when an economy is characterized by heavy investment in such cospecific assets, economic agents are exposed to risks that make efficient market exchange problematic. A precondition for such an economy to work efficiently is a dense network of institutions that provide information, offer insurance against risk, and permit continuous and impartial enforcement of complex contracts. In the absence of such institutions, exchange is possible only at a small scale in local trading communities where people know each other well and engage in repeated face-to-face interactions.[1] At a larger scale, markets left to their own devices either will fail to produce much exchange, will be accompanied by costly and continuous haggling, or will involve only very homogeneous types of assets (L as opposed to L_s).

Nowhere is the importance of institutions more evident than in the labor market where the welfare state plays a key mediating role. Social protection is particularly important in solving market failures in the formation of skills. Without implicit agreements for long-term employment and real wage stability, investment in skills that are specific to particular jobs, firms, or

[1] Marshall's concept of industrial districts likewise emphasizes repeated interactions in localized settings as a precondition for efficient outcomes (Marshall 1922).

industries will be suboptimal. In the absence of insurance, workers shun such investments because unanticipated shocks to the economy, whether as a result of recessions or technological change, can prevent workers from reaping the returns on their investments. Employers will also be reluctant to invest in their employees' skills, or in equipment that requires those skills, unless they believe that institutions that prevent poaching and discourage unions from exploiting the potential holdup power that specific skills confer are in place.

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

A similar logic applies to human capital. When skills are specific to a particular firm, industry, or occupation, their owners are exposed to risks for which they will seek nonmarket protection such as protection of jobs, standardization of wages, or state-guaranteed benefits. Skills that are portable, by contrast, do not require extensive nonmarket protection, and when there is little protection, investing in such skills is the best insurance against adverse market conditions and technological change. Yet, despite its intuitive appeal, asset specificity plays virtually no role in existing explanations of the welfare state. Labor is *L*, and workers are "replacable, easily redundant, and atomized." Correspondingly, politics is labor against capital, *L* against *C*. By contrast, the approach offered in this book emphasizes the critical

[2] Alt et al. (1999) shows empirical evidence that lobbying rises with the asset specificity of industries. See also Alt et al. (1996) for a more theoretical treatment of this and related arguments concerning the importance of asset specificity.

importance of the *level* and *composition* of human capital (L_s) for explaining the character of the welfare state – the *level* because it determines income and hence workers' demand for redistribution; the *composition* because it determines workers' exposure to risk and hence their demand for insurance. It is natural to label this an asset theory of the welfare state, although political institutions are also important as we will see in a moment.

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

Do ordinary people also worry about protecting the value of these assets? The answer obviously varies from individual to individual according to the level and mobility of her skills, but there is no question that many workers face a substantial risk that their training can be made partially or entirely redundant by new technology or other forces of change (as in the example of typographers). Taken as a whole, manufacturing employment in the OECD has been cut in half since the 1960s, and a large portion of the jobs that remain require substantially different skills. There is every reason for workers and their unions to concern themselves with insurance against income losses as a result of redundant skills, although it is hard to quantify.[4] And such insurance cannot be provided exclusively through the market as a result of well-known problems of moral hazard, adverse selection, and other market

[3] These are 1995 numbers expressed in 1999 dollars.

[4] One of the difficulties of quantifying the specificity of skills is that wage and social protection systems are set up to reduce the riskiness of specific skills. Skill certification and wage standardization by skill categories, for example, are ways for unions to prevent individual workers from experiencing large drops in income. Variability of wages is therefore not an indicator of asset specificity. Chapter 3 goes to considerable length in developing alternative measures of skill specificity and to tie such specificity to social policy preferences.