

*Program for the Study of Germany and Europe*  
*Working Paper Series #7.5*

**What Does Globalization Have to Do With the  
Erosion of Welfare States? Sorting Out the Issues\***

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Abstract

Is it really true that the economic processes described as globalization are eroding West European and North American welfare states (WS) ? This paper is a first step in a project aimed at answering the question. Focusing on conflicting arguments about the economic mechanisms which generate pressures on WS, it groups them into three answers to the title question: globalization has everything, nothing, or something to do with it. Tentatively concluding that the third answer, that domestic and international economic mechanisms do interact in specific ways to strain WS, it sets the stage for the second stage of the project. That is to analyze the political mechanisms shaping the policy responses to those strains and perhaps themselves contributing to those strains. To explore the issues to be addressed in this second step, a brief preliminary exploration of recent social policy patterns suggests that domestic political factors go a long way toward explaining them without much recourse to globalization, especially in the U.S. but also, if to a lesser extent, in Western Europe.

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\*This is a revised version of a paper presented at the GAAC-SSRC-Wissenschaftskolleg Summer Institute on Globalization, Social Policy, and the Semi-Sovereign Welfare States in Europe and North America, University of Bremen, July 25-August 5, 1995. An intermediate version was presented at a workshop of the Program on Advanced Research on the Europeanisation of the Nation-state (ARENA) at the University of Oslo, June 27, 1996. The financial support of both programs is gratefully acknowledged. I also wish to thank Andrew Glyn, Peter Hall, Ton Notermans, and George Ross for extensive comments on an earlier draft, as well as participants in the two workshops for their comments. Further comments are of course cordially invited.



## What Does Globalization Have to Do With the Erosion of Welfare States? Sorting Out the Issues

### Introduction

For a long time, I, along with many others, have been thinking about the relationships between changes in the international political economy and changes in those institutional arrangements within the advanced capitalist countries (ACCs), principally transfer payments and collective services, comprising what we refer to as the welfare state (WS).<sup>1</sup> Only recently, however, have I been thinking about how to design a study to explore those relationships systematically. This paper reports on what I have done so far in the hope that it will elicit criticisms and comments that will help me go further.

The study has two starting points. One is the observation that the WS is under strain, subject to political attack, and being rolled back in varying degrees in almost all of the ACCs. This is a matter of concern to me on the normative ground that the WS, whatever flaws particular variants may have, is a major historical achievement, rendering capitalism more compatible with a whole range of human values than it would otherwise be.<sup>2</sup> However, it is not the purpose of the study to elaborate the grounds for this view, important as it admittedly is to do so.<sup>3</sup> The second is the widely held belief that what is happening to WS is somehow the consequence of changes occurring in the international economic environment in which they operate. The term “globalization” is typically used to encompass those changes. The changes referred to are changes in the operation of capitalism. If capitalism is becoming globalized, the capacity of national institutions in the ACCs to condition its operations so as to protect the

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1. The abbreviation “WS” will normally be used for welfare states in the plural. When used for a welfare state or the welfare state in the singular, that will be made clear by preceding it with a singular article.

2. Karl Polanyi, The Great Transformation (Boston: Beacon Press, 1957) is an eloquent, though not philosophically systematic, statement of the human values at stake which is at the same time concerned with the international dimension of markets.

3. In lieu of referring to the large literature on ideology in social science, it may suffice here to mention the admonition to economists to acknowledge the values embedded in their analyses by Gunnar Myrdal in his The Political Element in the Development of Economic Theory (London: Routledge & Kegan Paul, 1953). See also his Value in Social Theory (London: Routledge & Kegan Paul, 1958).

values which WS have functioned to protect, the historical achievement embodied in the WS is in jeopardy.<sup>4</sup> The main purpose of the study is to probe this belief.

A lot of things have patently been happening in the extent and modalities of transborder economic activity; they look like pretty big things, so it seems hard to resist the impression that they have so changed the environment in which WS operate that WS are forced to change, possibly in ways that make it impossible for them to perform the distributive functions they came to perform in the earlier postwar era. Accordingly, the belief that economic globalization is eroding WS seems highly plausible. Many of the arguments to be found in the literature, both academic and polemic, lend support to it. But is it true? It may be that the changing international environment does not necessarily impose all the imperatives invoked as reasons why the welfare state has to be rolled back or changed in various ways to meet new economic imperatives, typically summed up as competitiveness, and that such claims about globalization and competitiveness are simply new ideological smokescreens behind which old inegalitarian goals are being pursued. Some skepticism definitely seems in order, for there are arguments to be found that provide some grounds for it.

So the first step is to try to sort out the issues raised by these conflicting arguments concerning the economic mechanisms by which pressures are put on WS, whether the pressures are exerted by globalization or not. This is what I try to do in this paper. However, the changes taking place in WS are obviously the result of political choices. If pressures exerted by globalization have anything to do with those changes, it is only through the political choices made in response to the pressures. Diverse responses, with diverse consequences for WS, may accordingly be possible. Thus, the changes taking place in WS are to be explained by the political mechanisms that determine the choices among the responses rather than by the economic mechanisms that exert the pressures, whatever the sources of those pressures. Indeed the political choices resulting in changes in WS may not be responses to pressures exerted by economic mechanisms at all. So in order to understand what is happening to WS it is necessary to analyze the political mechanisms that produce them, establishing whether they are in fact responses to pressures exerted by economic mechanisms, as well as whether those pressures are exerted by globalization or not. That political analysis is the second step in the study. I

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4. An aspect of what some argue is the more general obsolescence of national states in the face of globalization.

have come to some tentative conclusions about how to take the first step, but I have only begun to try to figure out how to take the second. So comments and criticisms concerning the first and suggestions about the second would be very welcome.

In order to sort out the issues dividing the various arguments concerning the economic mechanisms thought to exert pressures on WS, I have grouped the arguments into three different answers to the question posed in the title. The first is that globalization has everything to do with the erosion of WS -- that changes in the international economy are making it impossible to maintain WS. The second is that globalization has nothing to do with it -- that developments endogenous to the ACCs are undermining WS. The third is that globalization does have something to do with it, in partial agreement with the first, but that it does so specifically by amplifying the endogenous development to which the erosion of WS is ascribed in the second. Thus, the first and second are both partly right, but only partly, because neither the international nor domestic factors they respectively invoke are sufficient; it is rather the specific way the two sets of factors are linked that explains the erosion of WS. As may be suspected, the more complex third argument seems most plausible to me.

I proceed as follows. First, I briefly profile those changes in the international environment of WS to which the term "economic globalization" refers. The term is used in different ways. Here I simply present some data to establish that transborder economic activity has indeed increased sufficiently to render plausible the idea of increasing economic globalization. Then I raise the question of how globalization should be expected to have effects that could have something to do with the erosion of WS. I argue that such effects should operate primarily through any impact globalization might have on the operation of labor markets, particularly the levels of unemployment, inequality and poverty to which WS institutions are geared to respond. Such labor market effects strain the capacity of WS to meet their commitments, enlarging the political scope for responding to the strain by reducing and even abandoning those commitments. To the extent that policies which do so are implemented, the labor market effects are amplified. However, the observable trends toward increased unemployment, inequality and poverty, and policies which may contribute to them, are not necessarily the effects of globalization and policy responses to those effects. Whether they are or not, or if so how, are the issues dividing the three arguments to be considered. The stage is thereby set for comparing the arguments. I conclude the comparison by indicating tentatively

the conclusions I suspect should be drawn from it. I then turn to a brief discussion of how I think the second step in the study might proceed.

### Dimensions of Economic Globalization

As a first approximation, we can describe economic globalization in terms of trends along several distinct dimensions. One is international trade. Over the roughly three decades between 1960 and 1989, exports of the 24 OECD countries have grown at an average annual rate close to twice that of GDP, 6.3 per cent compared with 3.7 percent. The share of imports and exports in those countries' GDP correspondingly increased over the same period, more than doubling from the relatively low initial level of 9.6 percent to 20.6 percent in the U.S. and growing by under half from the much higher initial OECD average of 37.6 percent to 56.3 percent.<sup>5</sup> Clearly, trade has been increasingly linking national economies together.

While trade has grown faster than output, foreign direct investment (FDI) is now growing faster than trade. World outflows of FDI grew 3 times faster than output and 2.5 times faster than both exports and domestic investment between 1986 and 1990.<sup>6</sup> The annual rate of FDI more than quadrupled from \$39.8 billion in the late 1970s to \$167.2 billion in the 1986-92 period.<sup>7</sup> Correspondingly, the world stock of FDI nearly quadrupled between 1980 and 1991.<sup>8</sup> By 1990, total sales (domestic and export) of transnational corporations (TNCs)<sup>9</sup>

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5. Organization for Economic Co-operation and Development (OECD), Historical Statistics 1960-1989 (Paris: OECD, 1991), Tables 3.1 and 4.8.

6. World Investment Directory, Vol. 3 (New York: United Nations, 1992), p. v.

7 Bank for International Settlements, Sixty Third Annual Report (Basle: Bank for International Settlements, 1993), pp. 90-91.

<sup>8</sup>World Investment Directory, 1992, Vol. 3, p. v.

9. A variety of terms are used to refer to the organizational forms through which FDI takes place, such as multinational corporation, multinational enterprise, multidomestic corporation, global corporation or enterprise, and transnational corporation or enterprise. While the terms are often used interchangeably, the forms differ in various respects. I follow Peter Dicken in using transnational corporation (TNC) as a generic term covering a broad range of forms, but it should be noted that these include forms those not captured by statistics of FDI. The following definition, cited by Dicken, attempts to embrace this broad range of forms: "A transnational is the means of co-ordinating production from one centre of strategic decision making when this co-ordination

reached \$5.5 trillion, which was 2.5 times the \$2.2 trillion total value of exports of goods and services (excluding intra-firm trade, i.e., trade within TNCs).<sup>10</sup> These trends are the basis of the contention that TNCs “have become central organizers of economic activities in an increasingly integrated world economy.”<sup>11</sup>

Financial integration has been occurring even more rapidly than integration through trade and FDI. While there was a more than fourfold rise in average annual outflows of FDI from the late 1970s to 1986-92, portfolio outflows rose fourteen times, from \$15.0 billion to \$205.3 billion over the same period -- from a level substantially less than direct investment to a level considerably greater.<sup>12</sup> Rapid as this rise in portfolio capital movements has been, it has been dwarfed by the growth of transactions in foreign exchange markets, from a daily trading volume that was “negligible” in the late 1950s to about a \$trillion in the early 1990s. This was nearly “forty times the daily value of international trade.”<sup>13</sup> Another measure of how much it exceeded the financing needs of the “real economy” is that five days’ worth of foreign exchange transactions are equivalent to a “full year’s exports worldwide of goods and services,” while 24 days’ worth of those transactions are equivalent to a “full year’s output of world goods and services.”<sup>14</sup> Thus, financial markets have been even more thoroughly globalized than markets

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takes a firm across national boundaries.” Peter Dicken, Global Shift: The Internationalization of Economic Activity, sec. ed., (London: Paul Chapman Publishing Ltd, 1992), p. 48. See also the discussion by Paul Hirst and Grahame Thompson, “The Problem of ‘Globalization’: International Economic Relations, National Economic Management and the Formation of Trading Blocs,” Economy and Society 21, 4 (November 1992).

10. World Investment Directory, 1992, Vol. 3, p. v. According to Dicken, “these data massively understate the real level of TNC activity.” Dicken, Global Shift, p. 48.

11. World Investment Directory, 1992, Vol. 3, p. v.

12. Bank for International Settlements, Sixty Third Annual Report 1993, pp. 90-91.

13. Barry Eichengreen, International Monetary Arrangements for the 21st Century (Washington, D.C.: The Brookings Institution, 1994), p. 60. This figure refers to transactions on the 9 major national markets in April 1992. After making a number of adjustments to eliminate double-counting and allow for recording gaps, Eichengreen estimates the daily volume at the slightly lower amount of \$880 billion. *Ibid.*, p. 61.

14. Financial Times March 27, 1995.

for the production and sale of goods and non-financial services. In all these dimensions, then, economic globalization is apparently integrating national economies into what is increasingly a single world economy. If so, it is evidently one to which there is no corresponding political structure capable of regulating it, as states could once regulate national economies.<sup>15</sup>

This brings us back to the question in the title. For our purposes, the key difference among the three answers to that question concerns the explanations they offer for labor market developments in the ACCs over the past two decades or so. We turn to why this is so.

#### Labor Markets: The Linkage Between Globalization and Welfare States

If the effect of globalization is to undermine WS, it must operate through its impact on labor markets, particularly on levels of unemployment and the associated levels of labor market participation and earnings inequality. In the simplest terms, globalization undermines WS to the extent that it increases unemployment. The more unemployment there is, the greater the burden of expenditures to which WS are committed at the same time that it is more difficult to finance them (all of them, not just those on the unemployed), increasing the likelihood of fiscal crisis. Hence, full employment can be regarded as an essential condition for the viability of WS, as William Beveridge insisted in his design for a welfare state in Britain after the Second World War.<sup>16</sup> So whatever makes it more difficult, or ultimately impossible, to meet that condition, whether it is changes in the international economy or something else, undermines WS. The three arguments differ over whether, or if so how, it is changes in the international economy that do so.

The proposition that the viability of WS is contingent on full employment is familiar and presumably generally accepted -- it is hard to think of welfare states as anything but "full employment welfare states" or "Keynesian welfare states." But it is probably useful to spell out

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15. Many conclude from this that the capacity of national states to manage the economy within its borders, and hence a large part of national sovereignty, is disappearing. Charles Kindleberger, the reknown historian of the international economy, anticipated this as long ago as 1969 when he said that "the nation-state is just about through as an economic unit." Quoted in Nathan Kapstein, Governing the Global Economy: International Finance and the State (Cambridge, Mass.: Harvard University Press, 1994), p.3. For a broad discussion on the topic, "What Future for the State?", see Daedalus, Spring 1995, especially Vincent Cable, "The Diminished Nation-State: A Study in the Loss of Economic Power."

16. William H. Beveridge, Full Employment in a Free Society (London: George Allen & Unwin, 1944).

a bit more precisely the view of the relationships between WS institutions and labor markets on which the proposition is predicated. In this view, labor market and WS institutions interact so as to jointly determine the distribution of access to resources or, as Richard Titmuss put it, “command-over-resources.”<sup>17</sup> Except to the extent that it is obtained through accumulated wealth, the vast bulk of people in the ACCs gain access to resources in two ways: income obtained through participation in the labor market -- earnings from work -- and the alternatives to it provided by WS institutions. Insofar as those institutions provide alternatives, they are conceived as diminishing dependence on participation in the labor market (or on persons who participate in the labor market) -- hence the notion that they are in varying degree “decommodifying.”<sup>18</sup> Because market pressures are thereby blunted, the bargaining power of parties to labor market transactions tends to be altered in favor of the sellers, i.e., labor, affecting the operation of labor markets and hence of the economy as a whole, including the possibilities for full employment. Precisely because of the effects of WS on labor markets, as is well known, critics of WS claim that they impair the functioning of labor markets and are thereby responsible for unemployment.<sup>19</sup>

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17. Richard M. Titmuss, Income Distribution and Social Change (London: George Allen & Unwin, 1962), p.198.

18. Drawing on the idea of decommodification developed by Polanyi, Gøsta Esping-Andersen uses it in distinguishing among patterns of social policy in The Three Worlds of Welfare Capitalism (Princeton: Princeton University Press, 1990). The idea is problematic as well as attractive. In any case, it points to the need to think of social policy as components of the whole range of institutions that structure the operation of labor markets, or in which labor markets can be said to be “embedded,” including trade unions and legislated labor standards, so that they should be conceived as jointly forming “labor regimes.” I discuss this briefly in Andrew Martin, “Labour, the Keynesian Welfare State, and the Changing International Economy,” in Richard Stubbs and Geoffrey R. D. Underhill, eds., Political Economy and the Changing Global Order (Toronto: McClelland & Stewart, Inc., 1994), p. 63.

19. There is, of course, a large literature on this. Recently, much of it has expressed or criticized the view that WS alternatives are excessively generous and cause unemployment to be higher than it would otherwise be, at least in continental Europe and Canada, so that scaling them back would improve the efficiency of labor markets and reduce unemployment. That view is put strongly with respect to Sweden in Assar Lindbeck et al., Turning Sweden Around (Cambridge, Mass.: MIT Press, 1994) and more circumspectly with respect to continental Europe in Commission of the European Communities, Growth, Competitiveness and Unemployment (Brussels: Commission of the European Communities, 1993) and OECD, The OECD Jobs Study (Paris: Organization for Economic Cooperation and Development, 1994). The view is subjected to

That is an issue to which we later return.<sup>20</sup> What is crucial for us at this point is that the provision of access to resources by WS institutions at the same time depends on earnings from work insofar as they comprise most of the income stream that is tapped to finance the provision. The viability of WS depends on the relationship between the magnitude of that income stream and the magnitude of the expenditures to be financed -- the larger the former is relative to the latter, the easier it is both economically and politically to maintain WS, and vice-versa. Clearly, a large part of what WS do is to channel a portion of the work earnings of those who are employed to those who are not for various reasons during the life course -- the young who are not yet participating in the labor force, those of working age who are participating but temporarily not working because they are unemployed, sick, taking care of family members, etc., and those who have permanently left the labor force. The result is a social distribution of access to resources different from -- typically more equal than -- the distribution of earnings from work.<sup>21</sup> But the categories of people whose earnings are tapped to provide the alternative forms of access to resources and the recipients of those forms are overlapping rather than separate groups, for employed people can also be current recipients, not only of income supplements (e.g., transfers or implicit transfers, via tax provisions, targeted to those with low

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scrutiny in Rebecca Blank, ed., Social Protection versus Economic Flexibility (Chicago: University of Chicago Press for NBER, 1994); Richard B. Freeman, ed., Working Under Different Rules (New York: Russell Sage Foundation, 1994); and Werner Sengenberger and Duncan Campbell, eds., Creating Economic Opportunities: The Role of Labour Standards in Industrial Restructuring (Geneva: International Institute for Labour Studies, 1994).

20. See below, p. 14.

21. Post-transfer inequality in family income rose less than inequality in earnings during the 1980s in all of seven countries covered by the Luxembourg study except the United States, in which post-transfer inequality rose more than earnings inequality. Peter Gottschalk, "Changes in Inequality of Family Income in Seven Industrialized Countries," American Economic Review 83, 2 (May 1993). See also Katherine McFate, Timothy Smeeding, and Lee Rainwater, "Markets and States: Poverty Trends and Transfer System Effectiveness in the 1980s," in Katherine McFate, Roger Lawson, and William Julius Wilson, eds., Poverty, Inequality and the Future of Social Policy (New York: Russell Sage Foundation, 1995).

work income) but also services such as health care insofar as they are universal.<sup>22</sup> Indeed the extent of the overlap is probably an important factor contributing to the political viability of WS, along with the extent to which those whose earnings comprise the tax base for WS expect to be future recipients.<sup>23</sup> Those whose work income is earned from employment in the WS service sector are of course simultaneously, though in different degrees, contributors and recipients.

Whatever the extent of the overlap, the larger the proportion of the population comprising the tax base, over which the tax burden of financing a given level of aggregate expenditures on transfers and services comprising WS is spread, the smaller the individual share of the burden, the easier it is to finance WS, and, presumably, the stronger the electoral support for it (a large WS is not necessarily less viable than a small one, providing the burden of financing it is sufficiently widely spread; it may even be more viable if stakes in it are as widely spread). In other words, the closer an economy is to full employment, not only in the sense of lower unemployment but also higher labor market participation rates, the greater the

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22. Thus, it is misleading to speak of the crucial ratio as one of contributors to recipients insofar as it implies that they constitute two mutually exclusive groups, except in particular cases such as those at work who contribute to pension schemes and the retired who receive pension benefits. Even then they are mutually exclusive groups only on a current basis and not over the life course. And even then it is not strictly accurate insofar as pension income is taxable.

23. Hence the common assumption that universal benefits have more robust electoral support than those targetted to the poor or some category of current recipients that can be rhetorically separated from current payers of taxes.

economic and, in turn, the political viability of WS.<sup>24</sup> This is why globalization undermines WS most fundamentally insofar as it makes full employment unattainable.

For whatever reasons, labor markets have increasingly fallen short of full employment throughout the ACCs, but especially in Europe, over the last couple of decades or so. This is dramatically illustrated by Chart 1, which shows total unemployment in the OECD area from 1950 to 1993.<sup>25</sup> There is a sharp turning point at the beginning of the 1970s. From 1950 until then, the total averaged under 10 million around a slightly declining trend. Since then, especially after the first OPEC oil shock, it rose abruptly, briefly reversing before the second oil shock only to rise even more precipitously to three times the level of the 1950s and 1960s in 1982. During the prolonged expansion in the rest of the decade the total declined but only to 25

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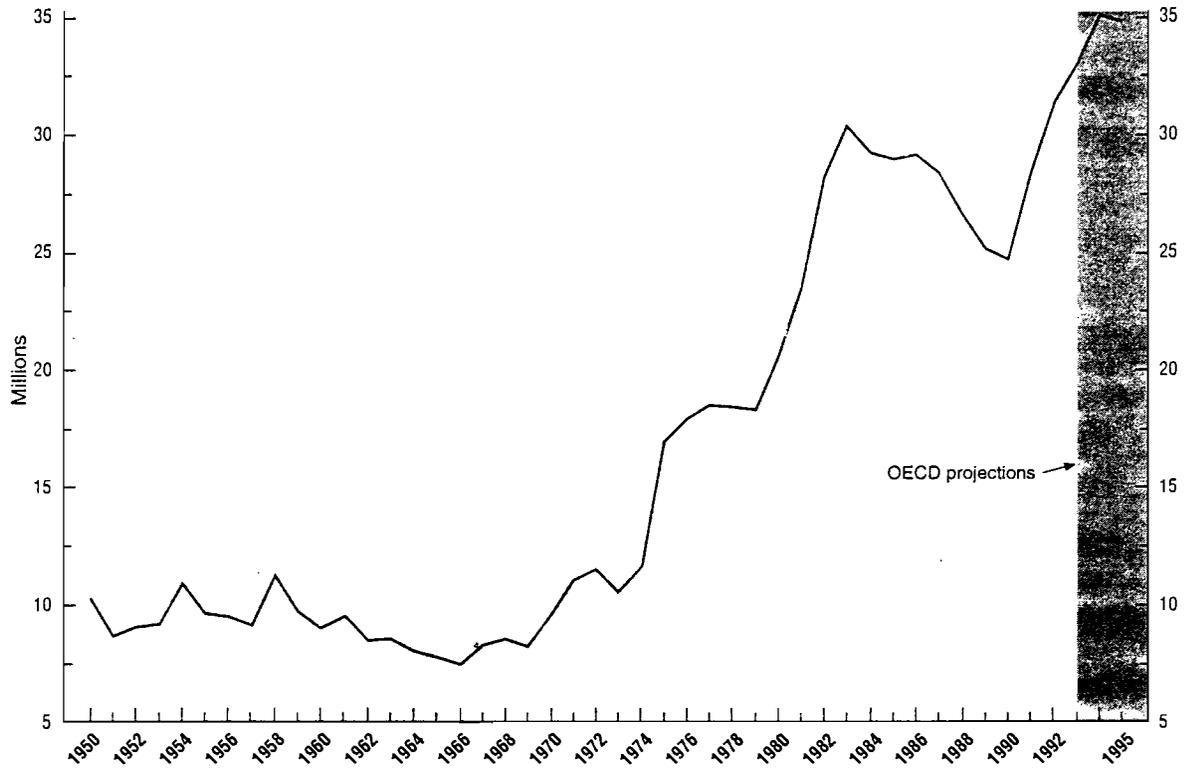
24. Note that labor market participation rates at different ages depends on the political definition of when “working age” begins and ends. This is obscured by much of the talk about demographic trends, namely the growing proportion of the population receiving pensions because they are living longer beyond retirement relative to those still in the workforce, for whom the “burden of supporting” retirees is increased, as a source of problems for WS. There are problems but they are the artifact of political definitions of retirement age and of economies apparently unable to provide full employment at constant rates of labor market participation for a population that is living longer -- i.e., generating sufficient jobs to employ both new entrants and workers who exit from the labor force at successively later ages.

Much more is involved in the economic viability of WS than such relationships between aggregate contributions and aggregate benefits. It has to do with the consistency of WS institutions and all the other institutions (including those that structure transborder transactions) which jointly determine an economy’s growth path, or “model of development.” The idea is nicely captured in the French “regulation” approach, in which all the institutions that structure labor markets form components of “mode of regulation” that make possible a specific “regime of accumulation.” In this view, probably familiar to most, the relationships between contributions and benefits is just one of the ways in which there has to be consistency between the various components with all the others in order for the regime of accumulation to have “coherence.” When coherence is impaired, the regime of accumulation falters, growth slows, crisis may ensue, and a new regime of accumulation may have to come into being for growth to be restored -- that it would come into being is in no way inevitable. Closely related is the American “social structure of accumulation” approach. The two are compared in David M. Kotz, Terence McDonough, and Michael Reich, eds., Social Structures of Accumulation: The Political Economy of Growth and Crisis (Cambridge: Cambridge University Press, 1994).

An accessible analysis of the mechanism of growth in the ACCs during the “golden age” and how the coherence among its components eroded built on a loose synthesis of the two approaches is provided by Andrew Glyn *et al.*, in Stephen Marglin and Juliet Schor, eds., The Golden Age of Capitalism: Reinterpreting the Post-war Experience (Oxford: Oxford University Press, 1990). In a fuller discussion of the issues addressed in this paper, it would be necessary to show the linkages between WS institutions and the whole regime of accumulation and its internal strains along similar lines.

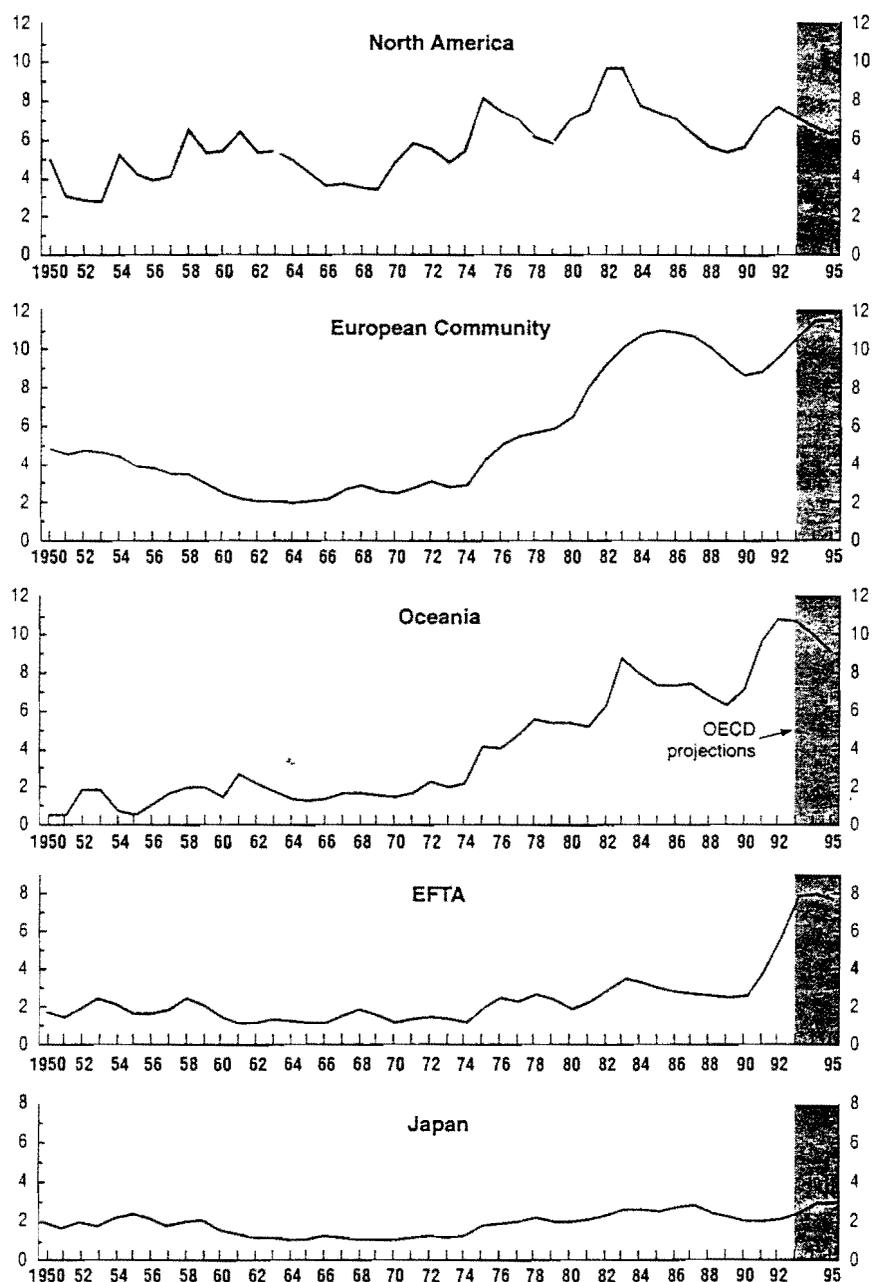
25. OECD, The OECD Jobs Study, p. 9.

Chart 1. Unemployment in the OECD area  
1950-95



Source: Organization for Economic Cooperation and Development, OECD Jobs Study: Facts, Analysis, Strategies (Paris: OECD, 1994), p. 9.

Chart 2. Unemployment rates in OECD regions, 1950-95  
Per cent



Source: Organization for Economic Cooperation and Development, *OECD Jobs Study: Facts, Analysis, Strategies* (Paris: OECD, 1994), p. 10.

million, and following the deep recession at the beginning of this decade it rose by what is projected to be another 10 million by 1995. Of course, the total labor force has increased so unemployment rates have not increased as much as the absolute numbers, but it is sobering to recognize that the equivalent of the entire working age population of a medium sized or several small European countries is now jobless.

This picture of increasing unemployment in the ACCs has to be nuanced by the fact that its geographic distribution has been uneven and changing. Among the five areas into which the OECD is divided in Chart 2, North America had higher average unemployment rates than the rest until the late 1970s, when European Community (EC) rates caught up and surpassed them. The EFTA countries and Oceania have currently joined the EC in experiencing higher rates, ranging between 8 and 11 percent, than in North America, where they have declined from a peak of 9.5 percent in 1982 and a lower peak of 7.5 percent in 1992 to a current level of 7 percent. Only Japan is shown as having lower rates than the others throughout, although its labor market is sufficiently different from those of the others that adjustments aimed at achieving comparability are even more problematical than in the other cases.<sup>26</sup> It is difficult to determine how much of the current levels reflect continuing trends or short term fluctuations but the long term trends are quite clear: since the early 1970s, unemployment has increased throughout the ACCs, with the increase continuing in Europe and partially reversing in North America.

The rather striking reversal in relative unemployment rates of Europe and North America between the early postwar decades and the more recent decades is partially paralleled by similar trends in earnings inequality. Generalizing loosely, there has been an increase in earnings inequality almost everywhere in the OECD, reversing earlier trends toward decreasing inequality, but the increase in inequality has been considerably greater in the U.S. than in all other countries except Britain. Greater differentiation among the other countries is indicated by an analysis of changes in educational and occupational differentials in ten ACCs between the 1970s and 1980s by Richard B. Freeman and Lawrence F. Katz.<sup>27</sup> According to the data they summarize, inequality continued to decline only in the Netherlands. It stopped declining but did

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26. Ibid., p. 10.

27. Richard B. Freeman and Lawrence F. Katz, "Rising Wage Inequality: The United States vs. Other Advanced Countries," in Freeman, ed., Working Under Different Rules.

not increase in France, Germany and Italy, rose moderately in four other countries, and rose a lot in the U.K. and U.S.<sup>28</sup> However, the U.S. still stands alone in the form which the increased earnings inequality has taken and the extent to which it has been passed on into inequality in living standards without any mitigation by WS institutions. Although inequality rose in both the U.S. and U.K. more than anywhere else (even more in the U.K. than the U.S. by some measures), in Britain “real earnings for all workers rose rapidly, so that despite greater inequality, the real pay of those at the bottom of the distribution grew. . . . By contrast, in the United States real earnings at the bottom of the earnings distribution fell sharply. From 1979 to 1989 the real earnings of lower-decile Americans dropped by 11 to 17 percent (depending on the survey used) compared to an increase in the real earnings of lower-decile British workers of 12 percent.”<sup>29</sup>

At the same time, inequality in earnings as well as total family income (standardized for family size) was at least partially offset by social policy, in the form of tax provisions and transfers, so that inequality in total family income was lower than inequality in earnings, in most of seven ACCs included in a study based on LIS data for the 1980s, with the exception of the U.S. and Netherlands. But post-transfer family income was still much greater and increased more in the U.S. than in any of the other countries.<sup>30</sup> In another study based on LIS data, the

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28. It should be emphasized that different measures produce different results, such as a slight decline rather than slight increase in Germany, a slight increase rather than slight decrease in the Netherlands, and an increase in Canada as large as in the U.S., but the broad pattern of variation, especially the contrast between the U.S. and continental Europe, is not appreciably altered.

29. Freeman and Katz, “Rising Wage Inequality,” p. 40. Emphasis in the original.

30. Peter Gottschalk, “Changes in Inequality of Family Income in Seven Industrialized Countries” *American Economic Review* 83, 2 (May 1993). This study includes Australia and omits Germany. The measure of inequality used is the ratio of 90th to the 10th decile person or family in the respective distribution.

The Luxembourg Income Study (LIS) data on which the study is based, while probably the most comprehensive and comparable available, is not very satisfactory for analyzing changes over time because they cover two years, around the beginning of the 1980s and around the middle of the decade, depending on the country, which span a rather brief period. The data are better for cross-national comparisons in the years which they cover.

The Netherlands case seems anomalous. Part of the explanation may lie in the fact that the Netherlands had the lowest or next lowest (after Spain in 1983) labor force participation rate in the OECD, 59 percent compared with an OECD Europe average of 66 percent and a U.S. rate of 73

U.S. was again the outlier in the extent to which households headed by non-elderly poor are lifted out of poverty by income-support programs in seven ACCs, defining poverty line as 50 percent of median income. Virtually no such households were lifted out of poverty by U.S. social policy (0.3 percent in 1979 and 0.5 percent in 1986), while the incomes of from one-fifth (Canada) to three-fifths (Netherlands) of the households that were below the-poverty line before taxes and transfers in the other six countries were brought above the line after taxes and transfers.<sup>31</sup> Generally, increased unemployment was accompanied by increased inequality and poverty, but the relationship varied greatly.<sup>32</sup> In the U.S., however, increased inequality in earnings and retrenchment in social policy contributed to increased poverty despite decreased unemployment.

Thus, there appears to have been a trade-off, with the U.S. experiencing higher employment (higher participation as well as lower unemployment) at the cost of greater inequality and poverty than in Europe (and to some extent Canada), while Europe experienced less increase in inequality in both earnings and post-tax and transfer incomes and in poverty at the apparent cost of less employment. This is often explained as reflecting differences in labor market and WS institutions through which common economic forces are refracted (what those forces are is at the center of the differences among the three arguments we have to compare).<sup>33</sup>

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percent in 1983. The Netherlands also had the next highest (again after Spain) unemployment rates in the 1980s. If the low participation rate reflected exit from the labor market primarily by unemployed low-paid workers, given relatively generous unemployment and social assistance benefits, this could account for the small change (increase or decrease, depending on the data used) and relatively low level of earnings inequality in the Netherlands -- i.e., the low paid dropped out of the earnings distribution. At the same time, a higher proportion of households that were poor before taxes and transfers were lifted out of poverty by taxes and transfers in the Netherlands than any other country covered by LIS data. Labor force data from OECD Economic Outlook, July 1994, pp. 202-03. For source on poverty, see the next footnote.

31. Katherine McFate, Timothy Smeeding, and Lee Rainwater, "Markets and States: Poverty Trends and Transfer System Effectiveness in the 1980s," in Katherine McFate, Roger Lawson, and William Julius Wilson, eds., Poverty, Inequality, and the Future of Social Policy: Western States in the New World Order (New York: Russell Sage Foundation, 1995), especially pp. 38-39. This study differs from the one cited in the preceding footnote in that it includes the former West Germany and excludes Australia.

32. *Ibid.*, pp. 33-38.

33. For example, Gottschalk, "Changes in Inequality of Family Income," p. 136.

The lesson drawn from this by many European economists and politicians, as is well known, is that the employment performance of the “great American jobs machine,” can only be matched by reducing the “rigidities” with which excessive union power, excessively restrictive labor legislation, and an excessively generous WS allegedly afflict European labor markets so as to achieve the “flexibility” of the U.S. labor market.<sup>34</sup> This may be the wrong lesson to be learned, as suggested by Freeman when he points out that the “sizable reductions in pay for the less skilled in the US have not been sufficient to maintain their employment; have impoverished them and their families; and arguably contributed to the decision of many of them to engage in crime.”<sup>35</sup> Lower aggregate wage growth rather than a greater increase in inequality may have contributed to lower U.S. unemployment, according to Freeman, while others point to deficient demand, due to more restrictive macroeconomic policies in Europe, to account for higher unemployment in Europe.<sup>36</sup> Whatever economic forces or policies have been causing the varying levels of unemployment (whether they are common or not), it seems to be associated with a deterioration in the capacity of WS institutions to bring about lower poverty and inequality than market forces would otherwise produce. Understanding the links between variations in unemployment and these socio-economic outcomes obviously requires analysis of variations in the labor market and WS institutions that still structure the operation of the different labor markets and how they have been changed by political responses to economic forces. Our immediate task is not to offer such an analysis but to consider the conflicting arguments concerning the nature of those forces, around which the discussion that follows is organized.

#### Globalization Has Everything to do With It

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34. The alleged economic costs of WS are of course an old story but its recent development can be traced back to Herbert Giersch’s diagnosis of “Eurosclerosis” [reference to be supplied]. For literature on the debate over this issue, see footnote 20.

35. Richard B. Freeman, “The Limits of Wage Flexibility to Curing Unemployment,” Oxford Review of Economic Policy 11, 1 (Spring 1994), p.72.

36. Ibid., p. 70; Stephen Nickell and Brian Bell, “The Collapse in Demand for the Unskilled and Unemployment Across the OECD,” Oxford Review of Economic Policy 11, 1 (Spring 1994).

The arguments that attribute the erosion of WS to increasing internationalization or globalization of the economy run along two lines. One concentrates on production -- the "real economy" -- and the other on finance.

#### 1. The Globalization of Production.

According to the first, a spatial redistribution and reorganization of production, initially of manufactured goods and increasingly of services as well, is taking place. The growth in FDI whose overall dimensions were summarized above is viewed as the main mechanism through which it has been occurring. Some distinguish two variants of the argument.<sup>37</sup> One focuses primarily on the redistribution of production from the "North," consisting of the already industrialized or "developed" countries of Europe, North America and (in most discussions) Japan, to the "South," consisting of the newly industrializing or "less developed" countries of Asia and Latin America. The other focuses more broadly on the relocation and restructuring of production throughout the world, within the North and South as well as from North to South. The first is referred to as the "new international division of labor" (NIDL) argument while the term "globalization" is reserved for the second. The discussion here is initially confined to the first.

Folker Fröbel and his colleagues, who gave this line of argument its classic formulation, argue that the production of manufactured goods (to which their analysis is limited) is being redistributed from the old industrialized countries of the North, in which such production was virtually entirely confined until recently, to the newly industrializing countries of the South, in which such production is rapidly increasing.<sup>38</sup> From their "world systems" perspective, this is fundamentally transforming the structure of the "world capitalist system." This is being brought about through investment in new production sites in the South by TNCs based in the Northern

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38. David M. Gordon, "The Global Economy: New Edifice or Crumbling Foundations?" New Left Review 168 (March-April 1988). This is an important summary and critique of the argument that the international redistribution of production is the source of the economic troubles -- slow growth, unemployment, etc. -- in the ACCs, to which we shall refer later on. The core of Gordon's argument has also been published in David M. Kotz, Terence McDonough, and Michael Reich, eds., Social Structures of Accumulation: The Political Economy of Growth and Crisis (Cambridge: Cambridge University Press, 1994).

38. Folker Fröbel, Jürgen Heinrichs, and Otto Kreile, The New International Division of Labor (Cambridge: Cambridge University Press, 1980).

“core” of the world capitalist system . They are doing so in response to possibilities for profitable production opened up in the “periphery” by three conditions: 1) a flow of migrants from the countryside into the cities of the developing countries that has created “a practically inexhaustible reservoir” of “extremely cheap” labor;” 2) a “division and subdivision of the production process” that fragments it into operations that “can be carried out with minimal levels of skill easily learnt;” and 3) the development of transportation and communication technologies that makes it possible to produce the fragmented parts of “goods at any site in the world.”<sup>39</sup> These conditions are reinforced by others, notably institutional arrangements that assure profitable exploitation of cheap labor such as repression of unions and freedom from any labor health and safety and other requirements, particularly through the establishment of export processing zones.<sup>40</sup>

The result has been a proliferation of sites for profitable production of manufactured goods for export in the South. Once Northern companies started investing in these sites in order to take advantage of the possibilities for profitable production they offer, the terms of competition among them were irrevocably altered, making such investment an imperative of survival for all companies, which is why the process amounts to a fundamental structural change in the world economy, described as a “new international division of labor” (NIDL). In contrast with the old division of labor in which the North exported manufactured goods while the South exported raw materials, the South now also exports manufactured goods, which compete with the goods produced in the North not only for export but for domestic markets as well. This shift in the pattern of trade reflects not only a relocation of manufactured goods production but also its reorganization. The different components or stages into which the production of final goods is fragmented are produced in subsidiaries of TNCs all over the globe, in the North as well as the South, depending on where it can be done most profitably, and combined in centrally controlled production chains. Companies that fail to organize such global production chains, shifting to the South production of all fragments that can be

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39. Ibid., 13, 5.

40. Fröbel et al ascribe the growth of industrial production for export (as opposed to earlier import substitution industrialization, virtually entirely to multinational companies based in the North, and describe it as taking place largely in export processing zones. Pp.

manufactured with the cheap unskilled labor in unlimited supply there, or to become parts of such chains organized by TNCs, will ultimately be unable to survive.<sup>41</sup>

The WS of the North are undermined by the NIDL as a direct result of its basis in the “vast industrial reserve army of extremely cheap labor.” Because the production that draws on that reserve army utilizes such a small proportion of it and at such low wages, it generates too little demand to be absorbed where it takes place. “The markets supplied by the industrialization of the developing countries are therefore predominantly overseas, primarily in the traditional industrial countries.”<sup>42</sup> There, of course, workers who formerly produced the goods (or components of them) now imported from the new sites become unemployed, adding to growing levels of unemployment which cannot be reduced precisely because it results from the fundamental structural transformation of the world capitalist system. Persistent high unemployment produces “long-term fiscal crisis” so that “outlays on social services are being cut, while . . . higher social security contributions and taxes threaten employees with a decrease in real incomes.”<sup>43</sup> In short, by creating a “world market for production sites and for labor,” the NIDL renders impossible the full employment on which WS are predicated.<sup>44</sup>

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41. Ibid., p. 44.

42. Ibid., pp. 5, 45.

43. Ibid., pp. 2-5.

44. The idea that production is being reorganized into global chains, with different links in different parts of the world including the North, and the concomitant development of a world market for production sites and labor, seems to blur the distinction between the NIDL and globalization variants made by Gordon and others referred to earlier. The distinction holds only insofar as the NIDL view is formulated in terms of a division between core and periphery that corresponds to a division between the North and South. From a globalization perspective, the core-periphery division no longer corresponds to the North-South division as TNCs seek sites for different links in their production chains wherever advantages may be found throughout the world. Thus, labor processes associated with Southern labor regimes, typically using immigrants from the South, can be found within such “global cities” of the North such as London, New York, Tokyo, and Los Angeles. See Saskia Sassen, *The Global City* (Princeton: Princeton University Press, 1991). TNCs from Korea invest in Britain and TNCs from Germany invest in the former Communist countries of Eastern Europe to take advantage of lower wages in those sites than at home. *Financial Times*, June 29, 1995 and July 11, 1995. However, the issue which the NIDL argument raises concerning the huge supplies of labor in Asia -- especially in China, India, and Indonesia -- and how they are utilized in production for the world market remains a highly challenging one as those countries press their integration into the world economy.

Many others have since presented a basically similar view of the impact which the spread of manufacturing from the old industrialized countries to the newly industrializing countries has had on WS while criticizing and modifying various specific aspects of the version of the NIDL model formulated by Fröbel et al.. The flaws ascribed to the latter include generalizations resting too narrowly on evidence from a few sectors with special characteristics (textiles, garments, electronic consumer goods), and even an insufficient differentiation among them, an exclusive focus on enclave industrialization through export processing zones to the neglect of broader patterns of industrialization, and too heavy an emphasis on TNCs as the agent of industrialization in the South to the neglect of domestic capital and the diverse roles played by different states.<sup>45</sup>

However nuanced and qualified, arguments attributing the erosion of WS to growing competition from production shifted to new sites in the South continue to emphasize the impact of low labor costs there, in terms of working conditions and other labor standards as well as wages, and their slow growth relative to productivity growth. This, according to the “global Keynesian” version of the argument produces a vicious circle of worldwide demand deficiency. The whole strategy of securing competitive advantage by producing manufactured goods for world markets in the South where wage growth can be kept behind productivity growth -- by repressive labor regimes as well as large labor surpluses -- assures that demand there will be insufficient to absorb output, which can therefore be profitable only insofar as it is absorbed in the old sites of manufacturing production in the North. There, the competitive advantage that lower labor costs gives goods imported from the new sites erodes the market shares of goods produced in the old sites where wage growth had been kept up with productivity growth -- by democratic labor regimes as well as demographically and institutionally limited labor supplies. The result is deficient demand in the North, either through the loss of high-wage manufacturing jobs which are not replaced with others at similarly high wages or with sufficiently high alternative incomes, or through reductions in wage growth brought about by weakening unions and lowering labor standards. Deficient demand in the North adds to the unemployment created by the loss of market shares to imports from the South, which in turn reduces demand for those

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45. No review of the literature is offered here. For a useful summary of the critiques by a writer who takes the NIDL model as the point of departure, see Jeffrey Henderson, The Globalisation of High Technology Production (London: Routledge, 1989), chap. 8.

imports, thereby adding to deficient demand in the South. Aggregate global demand consequently falls increasingly short of that needed to close the circuit between investment and consumption in the global capitalist system as a whole, steadily increasing worldwide unemployment.<sup>46</sup> WS in the North are consequently undermined at the same time as poverty and inequality are perpetuated in the South.

## 2. The Globalization of Finance

In the argument focused on the globalization of finance, the most fundamental way in which it undermines WS is also by increasing unemployment, just as in the the argument focused on the globalization of production. However, it does so by a different mechanism, operating through the constraints it imposes on the macroeconomic policy autonomy of national governments. According to a standard formulation of the argument by Michael Stewart, these constraints are systematically asymmetrical in their effects: they frustrate macroeconomic policies of governments that put higher priority on minimizing unemployment than on minimizing inflation relative to other governments. Thus, the globalization of finance has created a “deflationary bias” in the world economy. Stewart sums it up as follows.

A country which unilaterally pursues deflationary policies, trying for example to reduce the growth of the money supply regardless of the implications for output and employment, is likely to be relatively successful in achieving its deflationary objectives. . . . A country which unilaterally pursues an expansionary policy, on the other hand, is much less likely to do so successfully. Forces at work in the international economy . . . will tend to limit the extent of any such unilateral expansion. . . . The net effect of this asymmetry -- of the greater staying power of deflationary than of expansionary policies -- is a bias towards deflation in the world economy as a whole.<sup>47</sup>

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46. Variants of the global Keynesian argument can be found in Hartmut Elsenhans, “Rising Mass Incomes as a Condition of Capitalist Growth: Implications for Today’s World Economy,” *International Organization* 37, 1 (Winter 1983), and “Absorbing Global Surplus Labor,” *Annals of the American Academy of Political and Social Science* 492 (July 1987); *North-South: A Program for Survival* (Brandt Report), (Cambridge, Mass.: MIT Press, 1980); Walter Russell Mead, *The Low-Wage Challenge to Global Growth: The Labor-Cost Productivity Imbalance in Newly Industrialized Countries* (Washington, D.C.: Economic Policy Institute, 1990); and Collingworth, Terry, J., William Goold and Pharis J. Harvey, “Time for a Global New Deal,” *Foreign Affairs*, January/February 1994.

47. Michael Stewart, *The Age of Interdependence: Economic Policy in a Shrinking World* (Cambridge, Mass.: MIT Press, 1984), p. 48.

The “forces at work” are the pressures exerted by actors on foreign exchange markets (the international “financial community”) who are able to shift enormous amounts of short-term capital almost instantaneously from the currency of a country to that of others.<sup>48</sup> As described earlier, the gross volume of daily transactions on foreign exchange markets approached a \$trillion in 1992. This exceeds “the total official reserves of all International Monetary Fund (IMF) member countries combined.” It is estimated at twice to three times as much during “periods of intense speculation.”<sup>49</sup> There is thus a huge discrepancy between the amount of capital that can be deployed against any currency and the official reserves with which central banks and the IMF can try to defend it. “In a market that trades \$1 trillion worth of currency daily, the few billions that central bankers can buy and sell are peanuts.” According to a “European central banker, ‘central banks have realized that they cannot manipulate the markets - that any battle of strength they would lose.’”<sup>50</sup>

The volume of transactions on private international exchange markets rose rapidly to such massive proportions only recently, as the data cited earlier indicate. During much of the Bretton Woods era of essentially fixed exchange rates, adjustable in principle only when “fundamental disequilibria” occurred and subject to international agreement, national capital markets were effectively insulated from each other, private international financial markets were minuscule, and most foreign exchange transactions were official, conducted by central banks and finance ministries. Moreover, these transactions primarily served trade, financing it and settling payments imbalances among trading partners, as well as international transfers instrumental to foreign policy.

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48. The actors consist of “government and central bank officials of countries [like] some of the OPEC countries. . . with large international reserves; key figures in the twenty or so largest international private banks; treasurers of multinational corporations -- particularly of the giant oil, car, and chemical concerns -- and other private sector financial institutions such as pension funds and insurance companies” plus “a few particularly influential stockbrokers and journalists.” Stewart, The Age of Interdependence, p. 48.

49. The total official reserves were estimated at “\$750 billion in September 1992, the last episode of intense one-way speculation.” Eichengreen, International Monetary Arrangements, pp. 62, 64.

30. Business Week, July 17, 1995, p. 80.

The subsequent growth of private international finance, from the small beginnings of the Euromarket in the 1960s to the global financial market in its current magnitude, is explained in different ways. The conventional wisdom, incorporated in the argument about the globalization of finance in question here, explains it by the development of the electronic technology that makes instantaneous shifts of unlimited amounts possible and by the increasing interest in utilizing it generated by the growth of international economic activity, in both the real economy in the form of trade and FDI and, more recently, portfolio investment as the insulation of national capital markets was broken down by deregulation and liberalization. But deregulation and liberalization are actions by governments, and an alternative explanation of the globalization of finance ascribes it primarily to those actions, and the domestic political dilemmas to which they were responses, rather than technology.<sup>51</sup> This alternative view is important for us, but here it is the consequences attributed to the globalization of finance, whatever its causes that concern us.

The shift from fixed to floating exchange rates following the collapse of the Bretton Woods regime was followed by much greater volatility in exchange rates.<sup>52</sup> For those holding the growing amount of assets denominated in various currencies, this intensified the need for strategies to safeguard their holdings against losses from exchange rate changes. It also enlarged the opportunities for gains from speculation on anticipated exchange rate changes. Volatility and adaptations to it reinforced volatility, increasing its amplitude. Continuous adjustment of portfolios to maximize the risk-adjusted rate of return on them, financial innovation that provides new ways of doing so, such as various kinds of derivatives (and new business opportunities for the financial services offering them), and speculative movements that turn into self-fulfilling prophecies by generating runs on particular currencies all contribute

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51. Stewart, The Age of Interdependence; Michael C. Webb, "International Economic Structures, Government Interests, and International Coordination of Macroeconomic Adjustment Policies," International Organization 45, 3 (Summer 1991). For what is probably the most sophisticated formulation of essentially the conventional view, see Eichengreen, International Monetary Arrangements, chap. 4. The best elaboration of the state-centered alternative, as well as an excellent survey of the conventional explanations, is provided by Eric Helleiner, States and the Reemergence of Global Finance: From Bretton Woods to the 1990s (Ithaca: Cornell University Press, 1994).

52. Eichengreen, International Monetary Arrangements, p. 12, Figure 2.2.

to the hyperactivity on currency markets. The result is not just a tendency to make exchange rate changes overshoot the changes required for adjustment to changes in the “fundamentals” of macroeconomic relationships between countries but to overshooting in directions that confer a deflationary bias to the system as a whole.<sup>53</sup>

The effects of the operation of the system on an individual state’s macroeconomic policy autonomy can be expected to vary with a lot of factors, including the policy instruments used, the size of its markets (and hence its bargaining power) and whether its currency floats or is pegged in relation to others, unilaterally or by some international agreement (like the European Monetary System). Nonetheless, according to Stewart, the overall effects will be characterized by a deflationary bias. Thus,

the response of the world financial community to policies . . . expected to reduce [the relative] rate of inflation and strengthen its balance of payments and currency is likely, on balance, to validate and reinforce these policies. . . . Money will flow in, raising the exchange rate and thus putting further downward pressure on inflation, while at the same time enhancing the deflationary impact on output and employment of the original measures.<sup>54</sup>

In contrast, policies that are more expansionary than those of other states “tend to be invalidated and aborted.”<sup>55</sup> Money will flow out in the expectation of a higher relative rate of inflation, unless offset by interest rate increases, which would defeat the purpose of the expansionary policies. If, to continue the expansionary policies, interest rates are not raised or raised insufficiently, money would continue to flow out, depreciating the currency if it floats or depleting reserves if the currency is pegged. Depreciation tends to accelerate inflation by increasing import prices and generating pressures for compensatory wage increases, so as to

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53. In addition to works already cited, see also Kurt Hübner, “Flexibilization and Autonomization of World Money Markets: Obstacles to a New Long Expansion?” in Bob Jessop, Hans Kastendiek, Klaus Nielsen, and Ove K. Pedersen, eds., The Politics of Flexibility: Restructuring State and Industry in Britain, Germany and Scandinavia (London: Edward Elgar, 1992); and Andrew D. Cosh, Alan Hughes, and Ajit Singh, “Openness, Financial Innovation, Changing Patterns of Ownership, and the Structure of Financial Markets,” in Tariq Banuri and Juliet B. Schor, eds., Financial Openness and National Autonomy: Opportunities and Constraints (Oxford: Oxford University Press, 1992).

54. Stewart, The Age of Interdependence, p. 51. Emphasis in the original.

55. *Ibid.*, p. 52. Emphasis added.

produce an inflationary wage-price spiral that would require successively higher interest rates in order for the rate of return to foreign holders of assets denominated in the state's currency to be preserved. In the absence of such interest rate increases, the outflow of money, depreciation, and inflation, and yet more outflow continues. If the currency is pegged, the credibility of the state's commitment to the peg erodes as long as its expansionary policies continue, since its reserves continue to decline, approaching the point at which there are no more reserves with which the exchange rate can be defended, so that a devaluation is to be expected. The closer the state comes to the point at which it is forced to choose between devaluation or abandonment of its expansionary policy, the more likely the approach to that point will be accelerated by a speculative attack on the currency. In such a situation, speculators are in a position to make a "one-way bet." If the devaluation, which their actions make more likely, occurs, they have not merely avoided losses but made gains through the repurchase of the currency for less foreign currency than they earned when they sold it. In the unlikely event that the devaluation does not occur (e.g., if the state does abandon its expansionary policies or, perhaps on condition that it does so, other states choose to support the currency), they have not lost anything. Whether through depreciation or devaluation, the decline in the exchange rate will spur inflation by raising import prices, which may well fuel a vicious circle of declining exchange rates and inflation. To break the circle, the state will have to replace its expansionary policies with restrictive ones, increasing interest rates, as well as tightening fiscal policies, to dampen demand and stem the outflow of money, which means that it will have to deliberately increase unemployment. Thus, the "pressures on the government to modify or even abandon its expansionary policies will mount, and soon become irresistible."<sup>56</sup>

There is an additional aspect to the threat to full employment attributed to the operation of global financial markets stressed by others. That is that the enhanced possibilities for maximizing the rate of return on financial investments by continuously redistributing them among assets denominated in different currencies, and the pressure this puts on states to meet expectations for returns on those investments by competitively raising interest rates, tends to make returns on financial investment higher than returns on productive investment. Combined with a decline in the rate of profit from industrial capital, according to Kurt Hübner, this has

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56. Ibid., pp. 51-2. The account of the argument draws as well on Eichengreen, International Monetary Arrangements and Webb, "International Economic Structures."

“speeded up the separation of the monetary sphere from the real economic sphere of the world market.” Thus, “[m]oney and credit transactions no longer solely serve for investment purposes in the productive realm.”

[The world] money market itself has become a genuine realm for the valorization of capital. This indicates a drastic increase in liquidity preference of industrial capital as well as money capital holders, releasing a massive switch from productive to financial assets. . . [T]he monetary sphere can offer more favorable valorization opportunities as soon as the profit rates on productive capital and profit expectations of firms decrease.<sup>57</sup>

However, financial investments continued to offer more favorable returns even when profit rates on productive capital rose again from the mid-1980s, reflecting the extent to which the monetary and real spheres had been separated, with “negative effects on real economic accumulation processes.” While writing from a neo-Marxist perspective, Hübner is able to cite the Bank for International Settlements in support of this view.

Considerable high real earnings on short-term investments can be detrimental to production in that acquisition of liquid financial assets in place of consumer expenditures or stock-pile investments by private enterprises is promoted. In actuality these high real earnings offer an explanation for the fact that . . . real income growth within the Group of 10 . . . did not fully transfer into higher expenditures.<sup>58</sup>

Thus, the “process of real accumulation is . . . blocked by the monetary side of the valorization process.”<sup>59</sup> Summing up, the deflationary bias resulting from the globalization of finances undermines WS by increasing unemployment not only through its inhibiting effects on short-term expansionary macroeconomic policy but also through its inhibiting effects on long-term growth.

The arguments that national economic policy autonomy and with it the viability of WS are undermined by the globalization of production and finance are of course not necessarily mutually exclusive, although some argue that one, typically financial globalization, is more

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58. Hübner, “Flexibilization and Autonomization;” and Cosh et al., “Openness, Financial Innovation,”

58. Bank for International Settlements, Annual Report 1987, p. 71, quoted in Hübner, “Flexibilization and Autonomization,” p. 63.

59. Ibid.

decisive than the other. We cannot review the entire literature here, but much of it argues that internationalization generally, including the mobility of both real and financial capital, constrains the governments of the ACCs in ways that prevent them from restoring full employment and forces them to roll back WS. All of these lines of argument are rejected by those that find the explanation for tendencies that threaten WS in developments within the ACCs, individually or as a group.

#### Globalization Has Nothing to Do With It

There are several lines along which it is argued that domestic factors, more or less common to the ACCs, far outweigh the effects of external constraints in accounting for the labor market trends that are threatening the viability of WS. I review three of them. One focuses on the relationship between technological change and the composition of demand for labor. The second focuses on the relationship between the distribution of power between labor and capital and profits. The third focuses on the relationship between macroeconomic policy regimes and cumulative price movements. Strickly speaking, neither the first nor second hold that international factors have nothing whatsoever to do with labor market developments; each of them ascribes some impact to those factors while holding that the domestic factors are the decisive ones. Only the third makes the strong claim that domestic factors are entirely sufficient to account for the trends without any recourse to changes in the international economy. I concentrate on the third and treat the other two more briefly.<sup>60</sup>

##### 1. Technological Change

As formulated most forcefully by Robert Z. Lawrence, this argument is applied primarily to the United States although its causal analysis is applicable to all of the ACCs, and indeed to manufacturing throughout the world.<sup>61</sup> It offers an explanation of changing labor market outcomes in the U.S., especially the growing inequality in real earnings of American workers. It focuses on the declining real wages of less educated U.S. workers most affected by

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60. We treat the first two so briefly only because time is running out. They will be treated more fully in the next revision of this paper.

61. Robert Z. Lawrence, "Trade, Multinationals, & Labor," Faculty Research Working Paper Series, John F. Kennedy School of Government, Harvard University, July 1994.

the decline of employment in manufacturing relative to that of other sectors. While the deindustrialization that has deprived so many of them of their jobs is typically blamed on increasing competition from low wage producers in the NICs and elsewhere in the South, the argument is that international trade has had little net effect on the size of the manufacturing sector -- and even less on employment throughout the economy because of the sector's small size relative to the rest of the economy.

Instead the proximate cause of the decline in employment of less-skilled workers in manufacturing is identified as technological change. This has increased productivity in that sector, while slower productivity growth in the rest of the economy has retarded sufficient growth in jobs with comparably high wages to compensate. Moreover, the technological change in manufacturing is biased "towards the more intensive use of skilled labor."<sup>62</sup> Such technological change is found not only in home plants of American NCs but also in their foreign subsidiaries, including those in the developing countries.<sup>63</sup> The decline in manufacturing employment in the U.S. is thereby concentrated on less-skilled workers, for whom there is no offsetting demand at equivalent wages in others sectors, so that real wages of those remaining in the sector decline not only relatively but also absolutely.<sup>64</sup>

Note that the argument is addressed to the impact of the globalization of production as it affects trade in manufactures, taking into account the effects of FDI, but not to the impact of the globalization of finance and the destabilizing and deflationary consequences attributed to it.

## 2. Labor-Capital Conflict

This argument, along lines elaborated by Andrew Glyn, ascribes the higher levels of unemployment over the past two decades primarily to efforts by capital and governments in the ACCs to reverse the increases in the power of labor resulting from the extended period of full

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62. Ibid., p. 16. See also Jeffrey D. Sachs and Howard J. Schatz, "Trade and Jobs in U.S. Manufacturing," Brookings Papers on Economic Activity, 1:1994.

63. Lawrence, "Trade, Multinationals, & Labor," espec. p. 26.

65. The real wage decline for these workers was facilitated by the weakness of American unions, which were further weakened by the process as well as by hostile employers and government. Freeman and Katz, "Rising Wage Inequality," p. 48.

employment in the preceding decades of the “golden age” of rapid growth.<sup>65</sup> Sustained full employment increased the bargaining power of workers, unorganized as well as organized, contributing to increased trade union membership and with it the labor movement’s political influence. The result was increased distributive conflict, between different groups of workers as well as between labor and capital. In the political arena, there was conflict over distribution of taxes to finance the increased social wage labor was able to win, which fed back into wage demands to the extent that the taxes fell on labor. In the labor market, labor-capital conflict was manifested by an increased strike rate, including the surge of wildcat strikes in the late 1960s and early 1970s. Such distributive conflict generated upward pressures on prices. To the extent that full employment levels of demand enabled employers to pass wage increases on in prices, the consequence was inflation; to the extent that they could not, the consequence was a squeeze on profits. The latter tended to occur as increasing international trade subjected firms to competition that limited their ability to pass increased wage costs on in prices. The squeeze on profits was reinforced by the ability of workers to prevent a reduction in the rate of nominal wage increases despite a decline in the rate of growth of productivity, which was itself partly due to the increasing power of labor to resist managerial controls and changes in the labor process designed to maintain productivity growth. By reducing industrial investment, the profit

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65. Andrew Glyn, “Social Democracy and Full Employment,” Unpublished paper, May 1995. Keynes anticipated, in 1943, “that a serious problem will arise as to how wages are to be restrained when we have a combination of collective bargaining and full employment. Quoted by Glyn, “Social Democracy,” p. 3.

Michal Kalecki, who developed independently an approach to full employment similar to the one of Keynes, argued that the problem posed a fundamental challenge to capitalism. In his view, “under a regime of full employment, the ‘sack’ would cease to play its role as a disciplinary measure. The social position of the boss would be undermined, and the self-assurance and class consciousness of the working class would grow. Strikes for wage increases and improvements in conditions of work would create political tensions.” While he believed that “the rise in wages resulting from the stronger bargaining power of the workers is less likely to reduce profits than to increase prices,” he thought business leaders’ concerns for workplace discipline and political stability would lead them to regard “lasting full employment [as] unsound from their point of view.” As to inflation, whether it could be prevented “would depend on the institutional arrangements of the regime of full employment.” In a famous passage, he concluded that “‘Full employment capitalism’ will of course have to develop new social and political institutions which will reflect the increased power of the working class. If capitalism can adjust to full employment a fundamental reform will have been incorporated in it.” Quoted by Glyn, “Social Democracy,” p. 3. See also Andrew Martin, “The Dynamics of Change in a Keynesian Political Economy: The Swedish Case and its Implications,” in Colin Crouch, ed., State and Economy in Contemporary Capitalism (London: Croom Helm, 1979).

squeeze reinforced the decline in productivity, thereby reducing the rate of output growth, intensifying distributive conflict, and exacerbating inflationary pressures or the profits squeeze, creating a vicious circle that replaced the golden age virtuous circle of full employment, growing demand, investment, output, and full employment.

The “response from employers was to try, through economic policy and legislation, to restore their power in the factories, discipline at the wage bargaining table and control over the level of state spending.”<sup>66</sup> Although governments attempted to resist the vicious circle, sooner or later, depending on their political composition, the response from all of them has been to make a fundamental shift in economic policy, abandoning full employment in favor of restrictive macroeconomic policies that have resulted in increased unemployment and kept growth rates low. Thus the only way that has been found to reduce the distributive conflict that destabilized the economies of the ACCs has been to eliminate the full employment on which labor’s power to engage in that conflict rested. The shift in macroeconomic policy, relying mainly on tightened monetary policy, has been accompanied by the erosion of institutional features of the golden age mode of regulation which reinforced labor’s power, such as employment security legislation, collective bargaining rights, and rights to income support at high replacement rates. Hence, WS have been undermined directly and through the elimination of the full employment on which it depends in order to reverse the shift of power in favor of labor resulting from full employment. Stability has been restored by this pattern of policy, accompanied by a restoration of profits. But this has been accomplished in a way that precludes any restoration of the rate of growth that characterized the golden age because governments are committed to preventing expansion at a rate that would restore full employment, bringing with it a restoration of labor’s power.

Note that while this argument ascribes increased unemployment primarily to domestic factors within the ACCs, it leaves some room for the impact of international factors. The spillover of macroeconomic policies among the ACCs, which are linked to each other by trade much more than they are with economies of the South, and especially the international financial

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66. Andrew Glyn, “Stability, Inegalitarianism and Stagnation: an overview of the advanced capitalist countries in the 1980s,” paper prepared for the WIDER project on Savings, Investment and Finance, July 1993, p. 1.

instability to which the globalization of finance contributed, are cited as making it more difficult to maintain full employment, but not impossible. Commenting on the abandonment of full employment even by the social democracies most committed to it, Glyn contends that

. . . conditions in the world economy and their influence on national economies do not constitute the fundamental block to full employment policies. . . . [They have] not ruled out policies for expanding employment where the costs for the rest of society are explicitly counted and willingly shouldered by the mass of wage and salary earners. But until social democracy can formulate and gain support for such an alternative, mass unemployment is liable to continue as the mechanism by which distributional conflict and other challenges to capital are contained.<sup>67</sup>

### 3. Price Instability

This argument, stated most strongly by Ton Notermans, is similar to the preceding one in that it finds the proximate cause of increased unemployment in the turn to restrictive macroeconomic policies in response to the operation of labor markets.<sup>68</sup> However, the explanation of why governments have responded that way is grounded not in an analysis of conflict between capital and labor but in a view of the fundamental dynamics of monetary economies. According to this view, all such economies (i.e., all modern market economies) are inherently vulnerable to cumulative, self-reinforcing price movements, downward as well as upward, depending on whether economic actors perceive governments to be implementing deflationary or inflationary policy regimes.<sup>69</sup> Once such movements get beyond a certain point, governments can only stop them by credibly replacing the prevailing policy regime by one that supports price movements in the opposite direction. Governments must do so because in a “decentralized economy coordinated by the medium of money economic policies must necessarily

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67. Glyn, “Social Democracy,” pp. 13-14.

68. Ton Notermans, “The Abdication from National Policy Autonomy: Why the Macroeconomic Policy Regime Has Become So Unfavorable to Labor,” *Politics and Society* 21, 2 (June 1993).

69. See Peter Temin, *Lessons from the Great Depression* (Cambridge, Mass.: MIT Press, 1990), for a discussion of the concept of macroeconomic policy regimes.

accord priority to maintaining relative price stability in order to ensure the coherence of the system.”<sup>70</sup>

From this perspective, the recent shift away from a full employment to an anti-inflationary policy regime constitutes an epochal change, comparable to the opposite shift from the anti-inflationary policy regime embodied in the Gold Standard to the full employment policy regime on which postwar WS depend. In each case, all the ACCs made the policy regime change, although they did so at different times and in different ways, cataclysmic in the case of Germany, depending on the dynamics of their individual political economies. While the recent policy regime change is common to all the ACCs, however, this argument rejects the view that it is a response to changes in the international environment that is common to all of them. Instead, it is a response to a common problem that has its sources within the domestic political economies of each of them: the problem of inflation. But the theory of monetary economies invoked to explain the more recent policy regime shift is a general one applicable as well to the Great Depression shift to the policy regime that has now been reversed. According to the theory, monetary economies depend for their functioning on relatively stable and predictable values of money, that is prices. This condition is vulnerable to breakdown by expectations of price changes, either downward or upward. Such expectations tend to become self-fulfilling prophecies, given specific assumptions about the policy regimes to which governments are committed, producing self-reinforcing cumulative price movements that can be extremely disruptive to real economic activity. Markets cannot function unless states provide the institutional conditions necessary for them. The money through which market economies are coordinated is as, if not more, essential an institutional condition as property rights. Providing money is thus a generic function of states in market economies, and how they perform that function is decisive in shaping expectations about stability or instability of prices and the direction in which cumulative price movements occur.<sup>71</sup>

The Great Depression was a case in which expectations of a cumulative downward spiral of prices were based on governments' implementation of a policy regime, the Gold

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70. Ton Notermans, “Social Democracy and External Constraints,” Unpublished paper, January 1995, p. 13.

71. *Ibid.*

Standard regime, that in fact assured that the deflationary spiral would continue. The results were everywhere so destructive that governments everywhere abandoned that policy regime, although it typically took changes in the composition of governments, sometimes drastic, for it to happen. But the alternative that replaced it proved vulnerable to upward price spirals, and postwar governments ultimately proved unable to pursue a policy regime aimed at maintaining full employment while curbing such inflationary spirals. This sustained expectations that the inflationary spiral would continue as long as governments remained committed to that regime, even if they intermittently pursued restrictive policies that temporarily curbed inflation until the policies were reversed to restore full employment, thereby reinforcing the conviction that governments were committed to implementing the full employment policy regime. This simply reinforced inflationary pressures, making inflation increasingly intractable.

What made the full employment policy regime vulnerable to such upward cumulative price movements was the fact that there were no institutional arrangements capable of successfully combining full employment with price stability in any of the ACCs (with the possible exception of Japan), even the small open economies with neo-corporatist wage-determination systems.<sup>72</sup> Thus, none had been able to solve the problem inherent in a full employment economy that both Keynes and Kalecki already identified, in different form, back in the 1940s.<sup>73</sup> Consequently, one after the other, governments abandoned that regime in favor of a restrictive monetary policy regime that increased unemployment, signalling their willingness to do what had to be done to restore price stability. The order in which governments successively made the policy regime shift depended on the specificities of their political economies, including the relative robustness of the institutions for reconciling full employment and price stability and the balance of political forces with different preferences for full employment relative to price stability, but all eventually succumbed. Thus, the common policy regime shift that has undermined WS was a common response to a common domestic economic problem, and no recourse to changes in the international political economy is needed to account for it.

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72. In this respect, Glyn and Notermans are in agreement.

73. See footnote 66.

The very strong claim made by this argument is underlined when it is distinguished from another which offers an alternative explanation for the succession of regime shifts in different states stretched out over a decade and a half, between Germany in 1974 and Sweden and Norway at the end of the 1980s. It attaches different relative weight to domestic and international factors in accounting for the shift in the cases at different points in the sequence. In the earliest cases, domestic factors are decisive but international factors become increasingly compelling in the later cases, precisely because of the shifts already made in the earlier cases. Thus, Germany shifted first because its response to the first OPEC oil crisis was shaped by political factors that gave price stability higher priority than full employment, Britain shifted soon thereafter because its particularly weak institutions for reconciling full employment and price stability made it especially vulnerable to the disruptive effects of the oil crisis and consequential recession, as was also the case in the U.S., particularly after the second oil crisis, and so on.<sup>74</sup> As successive states shifted from anti-unemployment to anti-inflation policy regimes, they progressively changed the international economic environment for the remaining countries. Those that tried to hold out against making the shift found it increasingly difficult to do so -- that is, the argument goes, it is harder to maintain full employment in some countries the more the other countries with which they trade increase unemployment so as to fight inflation. The hold-outs experience higher inflation than their trading partners, so their domestic producers find themselves at a competitive disadvantage. The hold-outs experience deficits in their current balance of payments, international financial markets put their currencies under

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74. Note that, in this analysis, while the OPEC oil price rises are obviously events in the international political economy, reflecting the loss of America's power to maintain the postwar energy regime it had put in place, they do not constitute decisive changes in the IPE exogenous to the domestic economies of the ACCs. On the contrary, the oil price rises are part of, and were made possible by, an international commodity price boom generated by inflationary pressures in the ACCs, triggered initially by the Vietnam boom in the U.S. which resulted from the fiscal policy stalemate during the Johnson administration, and which fatally disrupted the Bretton Woods monetary regime. Thus, economic impulses were transmitted among the ACCs, affecting their domestic policy options, but it was the dynamics of the domestic political economy of the U.S. that was the main source of the impulses and of the political economies of the other ACCs that determined how much the inflationary impulses would be amplified or dampened in the process. The prevailing effect was to amplify them until the first OPEC price rise and, initially, to dampen them afterwards. The dampening effect was, in turn, attenuated in response to the high unemployment that resulted, unleashing new inflationary pressures that were more sharply reduced by the turn to drastically restrictive monetary policy -- the "monetarist shock" that accompanied the second oil price shock -- again first in the U.S.

pressure, devaluations in response to the pressure and in an effort to restore competitiveness merely intensify inflationary pressures, to which those domestic producers who produce for foreign markets respond by increasingly shifting their investment to their foreign markets. So the holdouts are eventually forced to give up on full employment as well and do what the others do to fight inflation. Thus, external pressures, created by the changes in the international economic environment resulting from the accumulating, mutually reinforcing joint effects of individual states' policy choices, eventually force all states to make the same shift in policy regime.<sup>75</sup>

However, according to Notermans, this misidentifies the cause of policy regime change in the holdouts. From his point of view, the cause lies in the fact that the holdouts are no more able to solve the problem of maintaining non-inflationary full employment than the others -- i.e., all are victims of a common problem. Any that could solve it would be able to continue full employment even if the others could not. Thus, if a country had the institutional arrangements that could achieve a better trade-off between inflation and unemployment than others, it could have lower unemployment than others without having higher inflation rates, so there would be no loss of competitiveness as far as prices were concerned. Under those circumstances, the internationalization of financial markets would pose no threat. As long as inflation rates were no higher, there would be no reason for financial market operators to put pressure on the currency. Moreover, even if inflation rates were moderately higher though not accelerating, there need be no loss of competitiveness as long as a flexible exchange rate policy could be pursued, permitting moderate depreciation just sufficient to offset the higher inflation rate.<sup>76</sup> This should be possible for a country endowed with institutions capable of preventing the effects of depreciation from accelerating inflation. It is precisely because no countries have such

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75. Stewart, The Age of Interdependence, makes an argument along these lines, based on the spillover effects of different countries policies on each other, in addition to the argument about the deflationary bias of the international financial system summarized above.

76. It is argued that moderate inflation is necessary for systems of coordinated multi-level wage bargaining, like those in the Nordic countries, to work, because it allows unions at all levels to deliver some nominal increases to all their members, thereby permitting some adjustment of wage relativities without requiring the wages of any workers to fall. Juhana Vartiainen, "Can Nordic Social Corporatism Survive," Trade Union Institute for Economic Research, Stockholm, 1994, cited by Glyn, "Social Democracy and Full Employment," p.12.

institutions that they have repeatedly tried to implement hard currency policies in order to provide an external anchor for resistance to inflation which domestic institutions cannot provide.<sup>77</sup>

Likewise, the internationalization of production would not pose a problem. Since domestic producers for foreign markets suffer no price disadvantage from producing at home for export, there is no pressure to invest abroad, other things being equal. Other things are not entirely equal because there is, for example, a need for investment in foreign markets in order to be sure of access and to be close to customers. But such outward FDI does not necessarily undermine domestic employment, since it can also increase demand for exports, and there can be offsetting inward investment. This conclusion is only implicit in the price stability argument as elaborated by Notermans, since he does not address the globalization of production. But it follows from his argument that the relationship between the domestic economy and its external environment only becomes a problem because of the domestic sources of inflation with which governments cannot cope. So the root cause remains the absence of institutions capable of achieving that comparatively better trade-off, either through inability to create or maintain such institutions, rather than either the globalization of finance or production. Thus, the holdouts share the problem of inflation common to the other ACCs and ultimately make the same policy regime shift in order to cope with it.

In many respects, then, the labor-capital conflict and price stability arguments are similar. They both challenge the belief that globalization is the source of the strains that are eroding WS. They do so more exhaustively than the technological change argument because they both address globalization of finance, which the technological change argument does not, at least as formulated in the American literature. All three arguments share the position that increased unemployment can be entirely accounted for by factors operating within the ACCs. The price stability argument goes furthest in insisting that it can be accounted for by factors operating within each of the ACCs individually. The technological change argument leaves this open because it does not take up the internationalization of finance. That does enter into the

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77. Ton Notermans, personal communication, July 18, 1995. When the commitment to a hard currency policy exacts politically intolerable costs in unemployment, the governments pursuing it are evidently forced to abandon it, as Sweden and Britain did during the recent currency turmoil in Europe.

labor-capital conflict argument as a factor that has made the pursuit of full employment more difficult, but not impossible, providing that the institutional conditions for avoiding inflation and a squeeze on profits can be met. Under those circumstances, the problem which lies at the core of the technological change argument would also be tractable. Thus, both the labor-capital conflict and price stability arguments locate the source of the threat to WS in the operation of the political economies of which WS are themselves a part.<sup>78</sup> In particular, they both locate the source in the labor market institutions through which wages are determined.

In doing so, both arguments depend on an explanation of why the problems rooted in the labor market institutions through which wages are determined get worse over time, so that they reach a point where the change in policy regime occurs. In the price stability argument, the explanation ultimately rests on the postulated tendency of all market actors (regardless of class) to act on the basis of expectations about price movements in one direction or another, depending on the policy regimes to which they perceive governments to be committed. This then produces cumulative price movements in one direction, to which governments are sooner or later compelled to stop by adopting a contrary policy regime. In the labor-capital conflict argument, it is the postulated tendency of labor's power to increase in the context of a full employment policy regime, broadly conceived to include institutional underpinnings of labor's power, leading to an increasing squeeze on profits, which precipitates the replacement of the full employment policy regime by one that maintains enough unemployment to weaken labor's power. However, there is an alternative explanation of why the problems rooted in the labor market institutions through which wages are determined get worse over time which is consistent with both the inflation and profits squeeze arguments but which rests ultimately on changes in the international political economy. That argument offers the third of the three answers to the question in the title.

#### Globalization Has Something to do With It

This argument, presented by Adrian Wood, links changes in the composition of demand for labor attributed to the globalization of production with the shift to restrictive macroeconomic

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78. There are obviously parallels between this argument and the neo-liberal critiques of the welfare state which allege that it impairs competitiveness, but the analysis and political judgments are of course different.

policies in the the ACCs through the responses of labor market institutions in the ACCs to the changes in the composition of demand for labor.<sup>79</sup> It is thus consistent both with arguments that locate the sources of strain on WS in international factors and those that locate them in domestic factors. In the process, however, it denies the claims that might be advanced on behalf of either to provide adequate answers to our question: globalization does not have everything to do with the erosion of WS, nor does it have nothing to do with it; it does have something to do with it, but so do factors within the ACCs. However, the decisive factors are not technology, as in the technological change argument, but the institutions that structure the operation of labor markets under conditions changed by the globalization of production, as in the labor-capital conflict and price stability arguments. Because of this, and because it is built around a particular view of how labor markets in the North and South are linked by trade, our brief designation for it will be the labor markets argument.

The heart of the argument lies in the global distribution of the production of manufactured goods utilizing labor with different levels of skill. Three levels or categories of skill are distinguished. One consists of workers with education, training or experience which gives them skills beyond literacy -- "professional and technical workers, managers, and craftsmen."<sup>80</sup> The second consists of workers with only a basic education which gives them literacy but no skills beyond that. The third consists of workers with little or no education so that they lack literacy as well as other skills. The second and third categories are both unskilled by comparison with the first but the fact that the former possesses literacy and the latter does not is a crucial distinction between them. What is crucial about it is that the unskilled but literate workers have the level of skills that modern labor intensive manufacturing by and large requires, while the unskilled illiterate by and large do not.

What has happened over the past four decades is that there has been a change in the global distribution of the production of manufactured goods that utilizes unskilled but literate labor. At the beginning of the period, almost all of the production of such goods for world markets was confined to the industrialized countries of the North. Since then, and at an

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79. Adrian Wood, North-South Trade, Employment and Inequality: Changing Fortunes in a Skill-Driven World (Oxford: Oxford University Press, 1994).

80. *Ibid.*, pp. 6, 41-56.

accelerating pace, an increasing proportion of the production of such goods has been taking place in those countries of the South in which there has been a sufficient spread of basic education to provide a growing supply of unskilled but literate labor. This has been reflected in a dramatic change in the composition of North-South trade.<sup>81</sup> Whereas manufactured goods accounted for only about 5 percent of the South's exports to the North in 1955, they accounted for over half by 1990. This tenfold increase in the share of manufactured goods in the South's exports to the North corresponds to an increase in value from less than \$1 billion to about \$250 billion, amounting to an annual average growth of 15 percent in real (price adjusted) terms. This has enabled the South to finance increased imports of manufactured goods from the North. The big increase in the North's export of manufactured goods to the South has meant that the share of manufactured goods in the North's exports to the South has more than held steady, increasing from 73 to 79 percent. But the composition of manufactured goods in North-South trade has changed. The increased share of manufactured goods in the South's exports to the North is accounted for almost entirely by goods produced with labor that is literate but unskilled. Such unskilled labor intensive goods have "vanished" from Northern exports of manufactured goods, while the increase in Northern exports has been concentrated in skill-intensive goods.<sup>82</sup> In other words, there has been a decisive shift in the global distribution of exports of manufactured goods produced by literate unskilled labor from the North to the South.

This redistribution in the production of such goods has resulted in contrasting changes in the demand for literate unskilled labor relative to the demand for skilled labor in the North and South. In the North, the demand for unskilled labor has declined relative to that for skilled labor, while in the South the change in relative demand for the two categories has been the reverse. We focus for the time being on the change in relative demand in the North, for its

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81. The countries Wood includes in the North are usually those defined by the World Bank as "high income OECD members" or, previously, "industrial market economies," or the UN's "developed market economies," and sometimes all of the OECD, but always excluding the former Soviet Union and Eastern European countries (i.e., includes only the former West Germany. He usually includes in the South the UN's "developing market economies," plus China, Hong Kong and Singapore. *Ibid.*, pp. 65-66.

Most of Southern exports of manufactures concentrated in the four Asian tigers (Korea, Taiwan, Hong Kong and Singapore but exports from others, including China, India, Malaysia, Indonesia and the Philippines are increasing.

82. *Ibid.*, pp. 1-2.

consequences for the WS of the North is what we have to understand. There the change in relative demand has generated pressures for increased wage differentials and therefore increased income inequality. As we saw, there is evidence of such a reversal of earlier trends toward decreased differentials and inequality throughout the North -- that is part of the whole pattern of erosion of the WS that we observe and seek to explain. However, the extent of the pattern varies -- broadly, there is more of it in the U.S. than Western Europe.<sup>83</sup> Wood agrees with those who attribute these variations to the extent to which existing institutions make it possible to resist the pressures for increased differentials generated by the change in relative demand. The institutions through which the pressures are resisted are all those comprising the labor regimes that structure labor markets in WS, including trade unions and the transfer payments that put a floor on wages. To the extent that the pressures are thereby resisted -- i.e., to the extent that relative wages are "rigid" -- there is a mismatch between the demand and supply for the two categories of labor: there are shortages of skilled and surpluses of unskilled labor. This tends to add to the upward pressure on wages for skilled labor while increasing unemployment of unskilled labor. But precisely insofar as the institutions make it possible to resist this pressure for increased differentials, wage increases for skilled labor tend to be followed by wage increases for the unskilled labor that remains employed (the "insiders"). The joint effect is to accelerate inflation.<sup>84</sup> This dynamic is summarized as follows:

Skill shortages speed up inflation, since they cause money wages to rise faster, not only for skilled workers but also for unskilled workers (whose wage rises follow those of skilled workers because of the institutional pressure for relative wage rigidity).

This aggravates the macroeconomic problem of reconciling low inflation with low unemployment. In technical language, it raises the equilibrium rate of unemployment or the NAIRU (the rate of unemployment that would be needed to prevent inflation from accelerating). . . . What happens to the actual rate of unemployment depends on government policy towards inflation. . . . [I]f the government wants to stop inflation accelerating, it must deflate the economy to eliminate the shortages of skilled labour. This deflation amplifies the increase in unemployment among unskilled workers.<sup>85</sup>

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83. See above, pp. 13ff.

84. Woods, North-South Trade, pp. 290-323.

85. *Ibid.*, pp. 17.

Thus, the argument offers an explanation not only of why the problem of inflation has been a common one but also why it has become progressively more intractable over time, making it increasingly difficult to reconcile full employment and price stability through whatever institutions for doing so there may be, leading governments to respond, sooner or later, by shifting to an anti-inflation policy regime. From this point of view, the factors on which the price stability and labor-capital conflict arguments rest -- a tendency for price movements to be cumulative and self-reinforcing and a tendency for profits to be squeezed -- may be present, but they are not the decisive reason why the common problem of inflation confronting the ACCs becomes increasingly difficult, marked by a worsening trade-off between inflation and unemployment. Instead, the decisive reason is the change in the relative demand for unskilled and skilled labor resulting from the accelerating change in the composition of North South trade in manufactured goods (and probably services as well).

As an explanation of the worsening trade-off between unemployment and inflation, Wood's argument is evidently more applicable to Europe, and to a lesser extent Canada perhaps, than to the U.S. In the latter, it was possible for the shift in relative demand to work its way through relatively unhindered to increased earnings (and ultimately household) inequality, as we have seen, because of weakened unions and highly decentralized bargaining even where unions remain, as well as a meagre welfare state which does not support much of a "reservation wage." With labor's capacity to engage in distributive conflict so diminished in the U.S., the need for restrictive policy to undermine it, as postulated in the labor-capital conflict argument, is correspondingly diminished, accounting for the lower unemployment and greater inequality in the U.S. than elsewhere. Thus, the different apparent trade-offs between unemployment and inequality in Europe and the U.S. seem quite plausibly explained as different institutionally conditioned responses to the same basic pattern of change in the composition of demand for labor that Wood attributes to the change in the composition of North-South trade. I therefore refer to this as the labor skills argument.

While Wood's argument can be reconciled with both the labor-capital conflict and price stability arguments, it is challenged by those who advance the technology argument, which he regards as the most plausible alternative explanation. The technology and labor skills arguments agree that the composition of demand for labor in the North has been changing, increasing

demand for skilled and decreasing demand for unskilled labor. Insofar as this is the case, it can probably explain much of the pressures on WS operating through labor markets, in the form of increasing unemployment, resulting mainly from policy responses to the increasing difficulty of reconciling low inflation and low unemployment, as suggested by both versions of the labor market argument. However, those who advance the technology argument disagree with Wood over the extent to which North-South trade is a factor: the technology argument says that technological change is independent of such trade and accounts for all or almost all of the change in the composition of demand for labor, while trade can account for very little if any because there is too little of it relative the size of the North's economies. Wood contests the methodology of the technology explanation, concluding that the impact of trade is underestimated because it fails to take into account the effect of trade in inducing the very technological change that is presented as an alternative explanation.<sup>86</sup> He argues that technological change in the North is itself a response to competition from increasing production using literate low-skilled labor in the South. The high (relative) price of such labor in the North makes production using it unprofitable, leading to the substitution of new technology for such labor, and increased demand for skilled labor to use the new technology, which makes production profitable even though the price of such labor is higher than for the displaced low skilled literate labor. This disagreement is one of the central issues in the wide discussion provoked by Wood's work and deserves further consideration in the light of recent or pending new analyses.

#### Economic Pressures on Welfare States: A Tentative Conclusion

As intimated earlier, I think a version of the third argument, that globalization has something to do with erosion of the WS but that it is not a sufficient explanation, is the most plausible. In this version, most weight would be put on sources of economic pressure on WS from within the ACCs, as in the second argument, but would incorporate the globalization of finance, which Wood does not take into account, as well as of production, on which his argument focuses. The globalization of both would be included as factors which have aggravated the economic pressures from within, making it increasingly difficult to cope with

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86. Ibid., espec. pp. 277-289.

those sources of pressure consistently with the maintenance of WS. I will suggest what this argument might look like by sketching out the causal chain it postulates between economic mechanisms and policy outcomes. I'll try to construct this causal chain in such a way as to show where the international and domestic dimensions of the economic mechanisms, respectively, may enter into it, and where the political factors enter into it. This version of the third argument is not offered as an answer to the question but as a plausible hypothesis on the basis of which to organize research -- i.e. as a heuristic device.

We start with the change in the global distribution of production of traded goods and services that use labor of different skills. This lowers demand for low skilled and increases demand for high skilled labor in the North. Goods previously produced with low skilled labor in the North are either no longer produced in the North or are produced with new technologies that replace large numbers of low skilled labor with small numbers of high skilled labor, and that makes the production profitable despite the higher wages of the high skilled labor because it lowers the unit labor cost of the production. Thus, the changing composition of demand for labor of different skills in the North is the combined effect of the changing global distribution of production using those skills and of the development and application of new skill-biased technology at least partially in response to the changing global distribution of production.

We go on to the way this change in the composition of demand works through to labor market outcomes. Two sets of factors determine how it works through. The first are those that define labor regimes: the institutions that structure employment transactions, particularly unions and job security law; and the social policy institutions that determine alternatives to employment income, and hence the reservation wage. These variations in labor regimes produce outcomes that tend in two contrasting directions. They differ in the relative tendencies toward increased inequality and poverty and increased unemployment. There is a greater increase in inequality and poverty but less increase in unemployment in one than in the other. The higher inequality and poverty but lower unemployment outcomes are characteristic of the U.S., whereas the lower inequality and poverty but higher unemployment outcomes are characteristic of Europe.

The second set of factors are macroeconomic policies. The levels of labor market outcomes are a function of differences in aggregate demand produced by variations in macroeconomic policies. Those policies are not independent of labor regimes. Insofar as variations in labor regimes refract the changing composition of demand for labor in different

ways, they are believed to determine the level of unemployment that is consistent with a non-accelerating rate of inflation (the NAIRU). So labor regimes combine with policy objectives concerning price stability to shape macroeconomic policies, and those policies interact with labor regimes to produce the observed labor market outcomes.

Both of these sets of factors that determine how the changing composition of demand for labor resulting from the global redistribution of production works through to labor market outcomes are functions of domestic politics as they have defined labor regimes and macroeconomic policies historically, however much domestic politics may have been conditioned by international factors. This is also true of the next links in the chain concerning the budgetary consequences of the labor market outcomes.

Although the labor market outcomes fall into the contrasting patterns indicated before, both patterns put pressure on the budgets of WS by generating claims for transfer payments defined by social policy, even though the kinds of claims they generate are different. The high poverty and inequality pattern tends to generate relatively more claims for social assistance, whereas the high unemployment pattern tends to generate relatively greater claims for unemployment benefits. Each is also associated with other pressures for government expenditures, related to the demographic distribution of the outcomes and particular societal factors. The high poverty and inequality pattern in the U.S. is associated with high expenditures on prisons, whereas the high unemployment pattern in Europe is associated with high expenditures on early retirement.

The extent of the resulting pressure on budgets of WS depends not only on the levels of claims for transfer payments defined by social policy but also the way tax policy defines the financing of transfer payments. Even an increase in relatively low levels of payments can precipitate a fiscal crisis of the WS if taxation levels are relatively low, as in the U.S., just as an increase in relatively high levels of payments can do so even if taxation levels are relatively high, as in Western Europe. Thus, it is the whole tax-transfer structure that determines the vulnerability of a WS to fiscal crisis. The variations in tax-transfer structures are of course also functions of the domestic politics by which labor regimes have been historically defined.

Macroeconomic policy is an important determinant of the extent to which there is a fiscal crisis, since macroeconomic policy affects the volume of claims on the WS by influencing rates of growth, and hence the amount of revenues from employment income relative to the volume

of claims, with a given tax-transfer structure. The consequences for WS obviously depend on how governments respond to the fiscal crisis. The old Keynesian response was to accept budget deficits resulting from the fall of employment income relative to rising transfers. Governments would enter the bond markets to finance the deficits by borrowing, in the expectation that it would increase economic growth, thereby increasing employment and reducing unemployment, eventually eliminating the gap between revenues from employment income and expenditures on transfers. Indeed, the increase in transfer payments thereby financed are expected to contribute to that by keeping aggregate demand from falling as much as it would as a result of decreased employment income in the absence of the transfers -- i.e., the idea that transfers function as automatic stabilizers.

However, powerful constraints now operate against such a response according to both of the first two arguments concerning the economic mechanism by which WS are eroded. The difference between them is that the first attributes the constraint to the globalization of finance whereas the second attributes it to the inefficacy of domestic institutions for reconciling full employment and price stability. Thus, the first tells us that governments can't finance increased deficits by borrowing because international financial markets won't lend to them, except at interest rates that will defeat the expansionary intentions of the budget deficits. The second tells us that governments won't increase deficits to increase growth and decrease unemployment because they believe reduced unemployment will result in a renewed acceleration of inflation in the absence of domestic institutions capable of preventing it.

Accordingly, as long as either mechanism is at work, and governments retain the respective beliefs about the behavior of bond and labor markets, governments will not respond to the increased aggregate volume of claims to transfer payments resulting from the labor market outcomes of the changing composition of demand for labor, whichever way the latter works through to the outcomes, by pursuing an expansionary fiscal policy. The consequence must be a persistence of those labor market outcomes which generate the increased claims. There are various alternatives to expansionary fiscal policies that governments might pursue. The choice among the alternatives may depend in part on which mechanisms governments believe are at work. In any case, this is another point in the chain of causality in which political factors are decisive. To illustrate, I first list some alternatives.

One alternative is to counteract whatever increase in deficits may be produced by redefining the tax-transfer structure. Governments now do so mainly by redefining the claims so as to lower the level of payments rather than by increasing the level of taxes -- in other words, by rolling back the WS. This leaves the economic mechanism producing the labor market outcomes unaffected but alters their budgetary consequences.

A second alternative is to make changes in the institutions for determining the terms of employment so as to increase the attractiveness of employing unskilled labor. Governments do so by reducing statutory minimum wages, reducing the power of trade unions to prevent the wage of low wage workers from falling relative to those of other workers, or by offering wage subsidies to employers who hire unemployed unskilled workers. This intervenes in the economic mechanism so as to alter labor market market outcomes in ways that may reduce budgetary pressures from claims generated by unemployment (unless subsidized workers simply replace unsubsidized workers) though not necessarily from claims generated by poverty or wage subsidies.

A third is to do whatever can be done to change the skill composition of the supply of labor to conform more rapidly than it otherwise would to change in the skill composition of demand for labor. Governments now do that by various forms of change in education and training institutions, including formal education, active labor market programs for retraining, lifelong education, and so forth. This intervenes in the economic mechanism so as to alter the labor market outcomes, although this in turn can only ease the budgetary pressures over the long-run.

A fourth is to do whatever it can to lower the level of unemployment at which inflation accelerates -- i.e., lowering the NAIRU -- so as to permit macroeconomic policies to be more expansionary. While the difficulties governments encountered in their attempts to do this through incomes policies in the past contributed to their turn to a macroeconomic policy regime relying on restrictive policies to prevent inflation, there are indications that some governments now may be renewing such attempts. This intervenes in the economic mechanism so as to alter labor market outcomes in ways that may ease budgetary pressures by decreasing the level of unemployment at a given level of demand and inflation rate, thereby increasing the ratio of revenues from employment relative to expenditures on transfers. While changes in the skill composition of supply as in the third alternative can also contribute to this, their effectiveness in

this respect depends on macroeconomic policies creating enough demand to match but not exceed the increased supply of skilled labor.

Governments might pursue any of these alternatives regardless of whether globalization or domestic factors are believed to be the sources of budgetary pressures. However, there are other alternatives that might be pursued if globalization were viewed as a major source of the pressures. Some alternatives would be addressed to the globalization of production. Protectionism, unilateral or multilateral on a regional basis, would intervene at an early stage in the economic mechanism postulated by the globalization argument, so as to limit the competition from producers using lower cost literate unskilled labor, thereby preventing the labor market outcomes generating budgetary pressures. Another alternative, which free traders sometimes identify as protectionism but which should be distinguished, is to make imports contingent on the observation of labor standards enabling workers in low wage countries to keep their wages from lagging behind productivity growth. Thus, the international trade regime would be modified to make labor standards part of the rules. According to the global Keynesian argument, and contrary to the orthodox free-traders' objections, this would increase demand in the South, thereby increasing demand for imports from high wage countries and hence employment income and revenues in the latter, so that the combined effect in North and South would be increased global aggregate demand and employment.

Other alternatives would be addressed to the globalization of finance in an effort to counteract the tendency for large, rapid capital movements to overshoot and cause very large fluctuations in exchange rates and to produce the postulated deflationary bias. The analog to protectionism would be the reimposition of capital controls, again unilaterally or multilaterally on a regional basis. A less drastic alternative would be to "throw sand in the wheels of international finance," as some economists have recommended. This would include such measures as the "Tobin tax," deposit requirements on foreign exchange transactions and dual exchange rates. Yet another, more comprehensive alternative would be to recreate an international monetary regime through which international public authorities would perform the functions of a central bank, either for a regional common currency area like the proposed EMU or the international economy of multiple currencies.

Strategies for coping with the different sources of pressure on WS from globalization are obviously not mutually exclusive, and if they are believed to be the globalization of both

production and finance the strategies may be regarded as mutually reinforcing. Similarly, if the sources of pressure are believed to be both international and domestic, strategies for coping with both may be mutually reinforcing rather than mutually exclusive, although it is conceivable that pursuing either might accomplish more than pursuing neither.

Whatever conclusions one reaches about the economic mechanisms that put pressures on WS and the possible responses to those pressures, the policies governments actually adopt in response to the pressures will obviously depend on the political mechanisms that shape the choice of policies. Understanding those political mechanisms is the next major task that has to be carried out in order to analyze what links, if any, there are between globalization and what is happening to WS. Anticipating that analysis, I do not expect that it would show causality running in one direction, from the economic mechanism to policy outcomes, with the political mechanism acting as a set of intervening variables, filtering and refracting the pressures generated by the economic mechanism to produce policy responses to those pressures. On the contrary, I would expect it to show causality running both ways, so that political choices themselves also have consequences for the economic mechanism and the pressures it produces, in its international as well as domestic dimensions. Not surprisingly, I would expect economics and politics to interact, but equally unsurprisingly, I would expect the interaction to take place over time, so that it can only be demonstrated through an historical account or a dynamic model. Since I don't know how to do dynamic systems modelling, my analysis will have to take the form of an historical account. And since the interaction of the economic and political mechanisms will be analyzed in terms of how actions are shaped by distinctive economic and political institutions which change over time, the analysis will have a strong resemblance to what people these days are calling historical institutionalism.

Pending more work on how to analyze the political mechanisms that link the economic mechanisms that generate pressures on WS to the policy outcomes that are to be explained, I'll just illustrate very sketchily some of the lines along which I think the analysis would run.

#### The Politics of Pressures on Welfare States: A Trial Run

Given the striking differences in labor market outcomes and social policy responses to the consequent pressures on WS in the U.S. and Western Europe, an obvious way to frame the whole effort is to analyze those differences and try to understand how political mechanisms

interact with economic mechanisms to produce those differences and associated WS policies. Here, in very preliminary and reckless fashion, is where I expect such an effort to lead.

I proceed on the assumption that some form of the third argument about the economic mechanism will prove most applicable: globalization, and more narrowly, internationalization, has something to do with the erosion of the WS in both the U.S. and Europe, but it is limited and specific in different ways. As far as the globalization of production is concerned, trade is a smaller part of U.S. GDP than of the European countries, but most trade on both sides of the Atlantic is with other countries in the same region, so competition from cheap labor producers is not a large factor in either -- as argued by the proponents of the technology argument who hold that trade is much too small to account for more than a small portion of the observable labor market outcomes. For the U.S., regional trade has a larger component of trade with less developed, low wage economies, e.g., Mexico. There is less diversity in levels of development within the EU, to which a very large portion of trade is confined. Trade with the rest of the world accounts for under 10 percent of aggregate European GDP. Moreover, since there is currently a surplus in Europe's trade with the rest of the world, the argument that there is a problem with Europe's competitiveness, and that the European WS is somehow to blame for it, is suspect. To be sure, the trade balance might be turned negative in a European economy which was booming enough for unemployment to be significantly lowered. But it is not clear that this would translate into a current account deficit that would necessarily constrain growth, particularly insofar as European currencies continue to float against the rest of the world (i.e., primarily the dollar). If there are issues of competitiveness, they are largely issues concerning the competition of European companies in each others' markets -- although this might have to be qualified in view of the opening of Eastern Europe.

Financial internationalization has different consequences for the U.S. and Europe. While the U.S. may no longer be the hegemon that organizes the international financial regime, U.S. economic policy does not seem to be much constrained by international financial markets, while the heavy weight the dollar continues to have in international financial markets means that fluctuations in its exchange rates still have a large impact on the currencies of other ACCs. On the other hand, the economic policies of the individual EU member states seem to have been much more constrained by movements in and out of their currencies in the foreign exchange markets. That at least is one of the main arguments advanced in favor of a single currency. But

a coordinated expansion which left relative “fundamentals” roughly the same, while exchange rates were left free to adapt to unavoidable unevenness in expansion, could conceivably minimize the vulnerability of European expansionary policies to frustration by the markets nearly as well as the adoption of a single currency. It would undoubtedly permit a greater decrease in unemployment than possible under the strategy for moving to a single currency that was adopted in the Maastricht Treaty on European Union (TEU). Why that strategy was adopted and what it has to do with pressures on European WS therefore become the crucial questions, to which I will return.

Whatever the relative importance of pressures generated by international and domestic economic mechanisms on WS now, internationalization probably contributes very little to explaining the differences in the patterns of social policy that have been historically established in the U.S. and Europe. Explaining those differences has of course been a major industry whose work it is not necessary to duplicate. The main point is that the domestic political dynamics that have shaped the distinctive variants of the WS in the U.S. and Europe continue to operate. My hunch is that they probably have much more to do with what is happening to WS on both sides of the Atlantic than globalization and internationalization.

While the international exposure of the U.S. economy has undoubtedly increased, including outward foreign direct investment as well as trade, it is hard to see how that contributes to explaining the course of WS erosion in the U.S., which has most recently witnessed the all-out attack on Federal social policy mounted by the conservative Republicans in Congress led by Gingrich and powerfully supported by the Christian Right, culminating in President Clinton’s signature of the legislation ending the Federal government’s guarantee of social assistance. To be sure, there is a large business component to the coalition for rolling back what there is of an American WS. Small business evidently perceives a stake in low wages as well as low taxes, while the financial sector sees lots of money to be made from private medical services and privatizing pensions.<sup>87</sup> While there are multiple sources of political pressure to roll back the American WS, it is a rollback from the low level of what

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87. It turns out that even erosion of social assistance offers opportunities for making money. Large information systems and management consulting corporations now see multibillion dollar business opportunities in contracting with states to operate the new “welfare to work” programs for which they have been given responsibility by the new legislation. The New York Times, September 15, 1996.

Skocpol describes as a bifurcated WS, which is highly vulnerable because of the division between entitlements (social security pensions and health insurance for retirees) and means-tested transfers (social assistance).<sup>88</sup> What is especially important about this is how the establishment of this structure and the current attacks on it tap the politics of race that has so profoundly shaped American political development.<sup>89</sup> So what is happening to the American WS can probably be explained almost entirely in terms of domestic political mechanisms, without any resort to international economic mechanisms.

In the European case (cases, really, since the individual country situations vary as well as interact within the process of European integration), the political choices producing the pervasive and persistent pattern of restrictive macroeconomic policy, and the high, long-term unemployment it has sustained, are central to the pressures on WS. The epochal shift from a macroeconomic policy regime geared to maintaining full employment to one geared to curbing inflation has evidently been more far-reaching in Europe than in the U.S., as reflected in the fact that unemployment levels which were lower in Europe than in the U.S. in the earlier postwar period have been higher in Europe than in the U.S. since the early 1980s. In the U.S. the shift was most clearly marked by the turn to extremely restrictive monetary policy by the central bank

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88. While the separation of the wide, relatively advantaged and mobilized constituency for pensions by right (“entitlements” in American parlance) and the narrow, relatively disadvantaged and unmobilized constituency for means-tested social assistance renders the latter more vulnerable to attack, the former may not be secure over the long run. The bifurcated WS may be vulnerable to a sequential divide-and-conquer process, in which entitlements are attacked once there is little left to social assistance. As noted above, the mass of money flowing through the public pension system is a highly attractive target for financial business, and hence for a government attuned (ideologically or/and financially) to the latter’s interests. Paul Pierson makes a similar point more generally: “Universal programs do tend to be stronger, but because of this they also are much larger and generous. Because they are often directly in competition with private alternatives, they also present a much more serious challenge to the market-oriented preferences of conservative government. Means-tested programs tend to remain small, stingy, and restricted to groups unable to afford private provision. The result of these differences is that a government committed to radical change finds its attention naturally drawn to universal programs.” Dismantling the Welfare State? Reagan, Thatcher, and the Politics of Retrenchment (Cambridge: Cambridge University Press, 1994), p. 170.

89. The literature is vast, but a long view of the political legacy of slavery can be gained from Barrington Moore, Jr., Social Origins of Dictatorship and Democracy (Boston: Beacon Press, 1966), Chapter III; C. Vann Woodward, The Strange Career of Jim Crow, Sec. ed. (New York: Oxford University Press, 1966; Jill Quadagno, The Color of Welfare (New York: Oxford University Press, 1994); and Thomas Byrne Edsall and Mary D. Edsall, Chain Reaction: The Impact of Race, Rights, and Taxes on American Politics (New York: W. W. Norton, 1991).

in 1979 (the Volcker shock) but the overall macroeconomic policy stance was fairly quickly made less restrictive by the Reagan administration's fiscal policy. In Europe, the macroeconomic regime shift occurred successively in different countries, ranging from Germany in 1974 to Sweden in 1991. The party composition of governments evidently affected the timing and to some extent the intensity (i.e. degree of restrictiveness) of the shift but it ultimately occurred in all countries. However, governments succeeding those which had initiated the shift typically increased its intensity, suggesting the weakening of electorates' low unemployment expectations as a parameter of party competition.

While individual European governments made the shift at different times, it was incorporated into the strategy for further European integration through the design for transition to and operation of EMU. The latter, insofar as it is implemented, would amount to a step toward political union in institutionalizing European monetary but not fiscal policy capability -- i.e., equipping the EU with instruments for implementing the restrictive macroeconomic policy regime but not with those that can generally more effectively serve an expansionary macroeconomic policy regime. Tying themselves to the convergence criteria (on inflation, budget deficits, and public debt) to which they committed themselves in the TEU, European governments (even those that do not necessarily anticipate entering EMU initially or possibly ever) are perpetuating the restrictive regime despite extremely low levels of inflation and in the face of Depression era levels of unemployment. With expansionary macroeconomic policy thereby ruled out, microeconomic, or "supply-side," measures, designed to increase labor market "flexibility," are widely urged as the only way to reduce unemployment. This serves as the rationale for erosion of the WS in various ways, particularly by lowering the replacement rates of transfers, and hence the "reservation wage," as well as by decreasing job security and increasing wage dispersion. Initiatives in this direction have had varied success, with conflict over them frequently dominating politics, as in Germany at the time of writing.

For some, as noted earlier, the ultimate objective of such changes in European labor regimes is to make them more closely approximate the one prevailing in U.S., to which they attribute lower unemployment and higher employment growth in the U.S. -- the so-called "great

American jobs machine.”<sup>90</sup> It is plausible to argue, as Wood does,<sup>91</sup> that labor regimes in Europe resisted market pressures toward greater inequality (resulting from the changing composition of demand for labor with different skills) more effectively than in the U.S., resulting in a higher NAIRU and hence the need for higher levels of unemployment to reduce inflation and prevent its renewed acceleration. But the different institutions that refract the impact of change in the international economy differently are the legacies of differences in the past politics of distributive conflict. Insofar as change in the international economy is the source of new strains on those institutions, suggesting the need for change in the institutions, opportunities for undoing the past settlements of distributive conflict are opened up. However, there are alternative ways of adapting to the changing composition of demand for labor, as indicated above (and Wood himself points out), as there are to other developments (e.g., demographic trends) which point to needs for change. These alternative ways have diverse distributive consequences, defining some of the issues in renewed distributive conflict, as expressed in muted form in terms of “positive” as opposed to “negative” flexibilization. At the same time, the shift toward a restrictive macroeconomic policy regime itself undoes the past settlements of distributive conflict, while altering the interests at stake in renewed distributive conflict and the resources with which to press those interests (e.g., the relative bargaining power of labor and capital in the market arena). Thus, if the economic mechanisms putting pressure on WS operate roughly as suggested by the variant of the third argument sketched above, the explanation for the variations in policy responses to those pressures is probably to be found largely in the systematic differences between the domestic politics of distribution in the U.S. and Europe (and within Europe).

In the European case, however, it is not just the domestic politics of distribution within the individual countries that shapes policies toward WS, for they are decisively conditioned by the politics of European integration. Above all those policies, as well as the economic mechanisms generating the pressures to which the policies respond, are conditioned by the incorporation of the restrictive macroeconomic regime into the design for monetary union. Hence, the political choices thereby embodied in the TEU have to be explained in order to

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90. See above, pp. 15-16.

91. See above, p. 40.

understand what is happening to WS in Europe. As suggested above, the idea that EMU was designed to free European economic policy to pursue lower unemployment by eliminating the vulnerability of the separate national currencies to speculative whipsawing is not very persuasive, since other alternatives could conceivably achieve the same or better results in terms of employment than the particular strategy adopted for EMU. The one mentioned earlier is a coordinated expansion which left relative "fundamentals" roughly the same, while exchange rates were left free to adapt to unavoidable unevenness in expansion. Another is the rapid introduction of a single currency and European central bank in advance of any convergence of economic fundamentals instead of the other way around, as agreed in the TEU, along with the establishment of substantial capacity for fiscal redistribution in order to ease adjustment. In one form or another, these alternatives were proposed, but they were defeated. This suggests that if an economic objective was decisive, it was not lower unemployment but rather the continued prevention of inflation -- i.e., the deliberate institutionalization of the restrictive macroeconomic regime at the European level, where it would presumably be less easily threatened by domestic political reactions against the consequent continuation of high unemployment.

However, even if such an economic objective was widely shared (by governments coping with higher inflation which sought an "external anchor" for monetary policy as well as governments enjoying lower inflation which sought assurance that a common currency would be managed in such a way as to preserve low inflation), it might not have been decisive. An alternative explanation is that the further political integration of Europe was the decisive objective, and that the particular formula for EMU that emerged from the bargaining process was what was necessary to secure the main goal. In this view, the geopolitical objective of tying Germany to the rest of Europe so as to avert yet another disastrous intra-European war was what set the process of European integration in motion. However, this rationale for a united Europe did not suffice to secure the political support on which integration depended. Accordingly, reliance was placed on what Jacques Delors described as the "economic approach" to political integration, consisting of successive increments of economic integration, in the expectation that the requirements of economic integration would lead to increased "pooling of sovereignty" in European institutions. This is essentially how European integration has in fact proceeded, from the European Coal and Steel Community through the Common Market, the European Monetary System, and the Single Market, to the Economic and Monetary Union. For

this strategy to work, however, the forms of economic integration had to be consistent with the interests of those whose political support was decisive, principally business and economic policy elites. Hence, the dominant thrust has been market opening rather than market regulation, emphasizing the removal of barriers to transborder transactions rather than common rules governing social policy and industrial relations. Once the single market increment was on course, a single currency was looked upon as offering the best prospect of the next increment, not least because it would strengthen the European institutional structure by entailing the transfer of monetary policy authority to a European central bank. As envisaged by some, notably Delors, the transfer of macroeconomic policy capability would not be confined to monetary policy but would include increased, if still modest, fiscal policy capability. But what emerged from the bargaining was not this broader vision of economic and monetary but one much more narrowly confined to monetary union. Moreover, it was one framed very much in terms of the restrictive macroeconomic policy regime to which most European central bankers were generally committed and on which the German central bank especially insisted. Thus, a strategy for monetary union consistent with this commitment, including the stringent requirements for deflationary convergence, was a condition for securing agreement on the next increment of economic integration through which the further political integration of Europe was to be achieved -- a fundamental goal which was given renewed urgency by the unification of Germany.<sup>92</sup>

Whether this view of the political sources of the particular strategy for EMU that was adopted is supported by the evidence remains to be seen. However, if something like this view is confirmed, it suggests that what is happening to European WS can be largely explained on the basis of the interaction between the domestic politics of European states and the politics of European integration. While the latter is certainly in part a response to changes in the international political economy, those changes probably contribute little to explaining the political choices entering into the shift to a restrictive macroeconomic policy regime which most

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92. This view is suggested by (though not entirely attributable to) accounts presented in George Ross, Jacques Delors and European Integration (Oxford: Blackwell Publishers, 1995); David Cameron, "Transnational relations and the development of European economic and monetary union," in Thomas Riss-Kappen, Bringing Transnational Relations Back In: Non-state Actors, Domestic Structures and International Institutions (Cambridge, UK: Cambridge University Press, 1995); and Dorothee Heisenberg, The Mark of the Bundesbank: Germany's Role in European Monetary Cooperation (Dissertation, Yale University, 1996).

fundamentally undermines European WS, and the strategy for European integration through which that shift has been generalized and institutionalized. Thus, in both the U.S. and Europe, my expectation is that what has been happening to WS is to be explained largely by the distinctive dynamics of politics within each rather than the common pressures exerted by globalization.





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