Politics *for* Markets

We argue that the welfare state operates very differently in the advanced sectors of modern economies and in the low skill sectors. Governments are concerned to promote the advanced sectors of their economies in which they have comparative advantage. This is a valence issue not a partisan one. Where companies and employees in advanced sectors co-invest heavily in company-specific skills, then governments will be concerned to maintain insurance infrastructures to underwrite these investments. Hence in advanced sectors, we see *politics for markets* in maintaining insurance-based welfare states. In low skill sectors, redistribution and active labor market policies are partisan issues for legislatures, so here our analysis is in line with *Politics Against Markets*. Effective welfare state policies depend on political coalitions in which the low skilled are represented. We suggest that those coalitions may be less available just as low-skilled workers are increasingly excluded from post-Fordist collective bargaining coverage.

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1. Introduction

In this paper we address two related propositions in Esping-Andersen's seminal 1990 book. One is the notion that distributive politics is multidimensional and can only be understood through coalitional politics. The other is the idea that the welfare state replaces the market, or "decommodifies". We will argue that former was ahead of its time, if theoretically underdeveloped, and helps us understand why governments respond differently to rising inequality, especially falling wages and rising unemployment among semi-skilled workers. The latter notion is more problematic, and we argue that it does not apply to the advanced sectors of modern economies. Instead of "politics against markets" (the title of Esping-Andersen's 1985 book) we argue that in fact a symbiotic relationship exists between the knowledge economy and the democratic welfare state.

To make our argument it is useful to distinguish between two "sectors" of advanced democracies that operate according to quite different political-economic logics: a "vulnerable" low-productivity, low-wage (mostly non-traded) sector, and an "advanced", high-productivity, high-wage, (mostly traded, or tradable, or high value-added input provider) goods and service-producing sector. Political parties and government represent different class interests and therefore have different incentives to respond to needs in the low-productivity sector. Policies towards this sector consequently reflect the composition of distributive coalitions. But governments also care about overall economic performance since a strong economy is a precondition for being returned to office. They therefore have an incentive to promote the advanced sectors using a variety of policies that expose business to competition and spur innovation and growth. These policies typically garner broad cross-class support, even as the government and the opposition will contest the record of the incumbent. Policies of decommodification play little or no role in this arena.

The two-sector distinction reflects some key insights from modern theories of economic agglomeration and trade (Krugman 1990; Fujita et al. 1999; Porter 1998; Glaeser et al. 1991; Melitz 2003). In these theories, knowledge-intensive, innovative firms depend critically on local or regional pools of highly skilled labor as well as technology transfers from other close-by, knowledge-carrying companies. This produces geographical clusters of high productivity industries, and these tend to be in the traded sector of the economy; frequently also engaging in foreign direct investment (Melitz 2003; Helpman et al. 2003). Jobs in this sector tend to be well-paid, in many advanced economies they are protected by unions or professional associations, and they are virtually all full-time. These are the clusters of firms, jobs, and workers that we refer to as the advanced sectors of the economy. At the other end are low-productivity firms relying heavily on un- and semi-skilled labor, and usually exhibiting no or little engagement with the international economy or technology transfers from other firms. They tend to be concentrated in retail and wholesale, food and other personal services, in addition to basic social services. Tradability in these industries is low and educational requirements are modest. In this sector we find a concentration of low-paid jobs, often part-time or temporary and with few job-related benefits or protections. These are the firms and workers that we refer to as the low-productivity or vulnerable sector.

Clearly the two-sector distinction is not completely cut-and-dry because some firms fall in-between, and because there will be some low-skilled workers in the advanced sectors (say, secretaries and cafeteria workers), and some high-skilled workers in the low-productivity sectors (especially managers). The extent to which this is true is largely a reflection of industrial organization and the extent to which low- and high-skill tasks have been subcontracted to firms in each sector (say, to food service companies in the low-productivity sector or to management consulting firms in the advanced sector). For our purposes, we can usually count all high-skilled workers as being part of the advanced sectors and all low-skilled workers as being part of the vulnerable sector. The exception is when skilled and semi-skilled workers are strong complements in production, which is a case we discuss below.

Most redistribution is to the vulnerable sector, and here there is still much to be learned from Esping-Andersen's coalitional perspective. Building on Esping-Andersen, as well as our own past work and that of Manow and van Kersbergen, we first show that the composition of government coalitions can be explained by political institutions that are closely correlated with Esping-Andersen's three worlds. Yet we also argue that the differences in these institutions, especially between continental Europe and Scandinavia, were muted or "concealed" for many years after World War II because of the nature of Fordist industrial production. With the end of Fordism and deindustrialization starting in the late 1970s, low-end workers grew increasingly dependent on transfers on the state and this exposed the importance of differences in government coalitions, confirming Esping-Andersen's insight.

The distributive conflicts that characterize the low-productivity sectors of the knowledge economy do not, however, extend to the advanced sectors. Contrary to Esping-Andersen's notion of "politics against markets", we see a symbiotic relationship between the two where governments of all stripes provide and/or underwrite an *institutional framework* which enables advanced sector companies to develop and carry forward their comparative advantages between successive democratic governments. This is not a reflection of business strength because a key component of the institutional framework is to expose companies to international competition, and if advanced capital was strong politically it would instead minimize such competition. Yet, in the right institutional environment firms in the advanced sectors will invest and thrive, and so will governments and overlapping generations of politicians. This relationship takes very different forms in different countries. But the political institutions that shape partisan coalitions today were set up a long time ago, we argue, not for primarily for partisan advantage but for bi-partisan gain.

This paper is thus written as a dialogue with Esping-Andersen in which we seek to make two contributions. First we provide an institutional explanation of coalitional politics that confirms the basic tenets of Esping-Andersen's welfare state typology, and which helps us understand differences in how governments relate to the low-skill sectors of the economy. This is largely a story about redistribution. Second, we propose that a symbiotic relationship exists between governments and the advanced sectors of the economy where policies are conducive to the competitiveness of firms, and such competitiveness in turn brings prosperity and electoral success. This is politics *for,* not *against* markets.

We build this argument with reference to the relationship between the welfare state and international competitiveness, as well as with a discussion of the origins of political institutions with redistributive consequences. The former speaks directly to, and against, a widespread view in the political economy literature, namely that global capitalism, footloose and increasingly powerful, has subverted democratic governance and rendered the welfare state obsolete. Capital, we argue, is increasingly tied down geographically, and it is politically weak because firms are forced to compete against each other by governments that thrive on such competition. The latter speaks to the relationship between distributive politics and economic growth. We argue that once democracy was seen as inevitable in the early 20th century, political institutions were designed to promote the interests of both (advanced) business and (skilled) labor, even as these institutions also had distributive consequences. These consequences are important for the welfare of the poor and low-skilled, but they do not explain the origins of the institutions, nor the symbiotic relationship that exists between business and governments, which is the foundation of prosperity.

2. The vulnerable sector and redistribution

The rise in inequality and labor market dualism have been subject of a rich literature in recent years, most notably Rueda (2005; 2008), Martin and Thelen (2008), Thelen (2012), Bradley et al. (2003), Emmenegger (2009), and Emmenegger et al. (2012). A key question in this literature, and indeed for our entire understanding of the role of democratic politics in redistribution, is the extent to which governments have stepped in to compensate and assist workers who have been adversely affected by deindustrialization and technological change; the people who make up the vulnerable sector of modern capitalism.

The decline of Fordist mass production since the 1970s and the shift towards knowledge-intensive production have severed complementarities in production between skilled and semi-skilled workers (Wallerstein 1990; Iversen 1999). Deindustrialization has contributed to this process by gradually segregating many low-skilled workers into insecure, often part-time or temporary, jobs. The combined effect of new production technology and deindustrialization has been a divergence in unemployment security and incomes between core and peripheral workers (Kalleberg 2003). The decline in the complementarities between skilled and semi-skilled workers has undermined solidarity in the industrial relations system as the bargaining power of low-skilled workers has declined. Such solidarity once produced broadly similar wage structures across different varieties of capitalism, but with its breakdown the redistributive role of the state has increased in salience.

It is important to note that redistribution towards the vulnerable sector does not involve the institutional framework that supports the advanced sector. This institutional framework covers a wide range of areas, including vocational training and higher education, technology transfer and innovation systems, regulation of skilled labor markets and industrial relations, corporate governance and markets for corporate control, those aspects of the welfare state relevant to advanced capitalism (its insurance but not redistributive functions), trade, competition and intellectual property policy, and the macroeconomic regime. As we argue in the next section, all governments have an interest in effective institutional frameworks: this is not an area of partisan division. But redistribution, and in general the protection of workers in the vulnerable sector, is not part of the institutional framework of advanced capitalism. Because these markets tend to be concentrated in non-traded, low-productivity services, globalization has affected them little.

This is therefore where Esping-Andersen's coalitional argument is most pertinent. Yet, the argument is incomplete because it does not explain why particular partisan coalitions are prevalent in one context but not another, and why they are stable. How, for example, is universalism in Esping-Andersen's social democratic model possible when one of the few robust results in models of coalition formation is that they will always exclude at least one group (to increase the gains of those inside the coalition)? Similar questions can be raised about Esping-Andersen's other welfare state types: Liberal welfare states provide means-tested benefits for the poor, but why are all benefits not concentrated on the middle classes? Conservative regimes favor insiders, but why do outsiders not offer a deal to a sub-set of insiders that would break up the original coalition? These are examples of what game theorists call the problem of a missing core in social choice.

Our solution builds on our 2006 coalition model (Iversen and Soskice 2006). In this model, like Esping-Andersen's, spending can be divided in multiple ways across low, middle and high income classes. The critical question for redistribution towards the vulnerable sector is whether there is an incentive to include this sector in the governing coalition. Our argument implies that this depends on the party and electoral systems. In a PR multi-party system where each class is represented by its own party there is an incentive for the middle-income party to ally with the low-income party because the size of the pie to be divided rises with the wealth of those excluded from the coalition. Majoritarian two-party systems are different because the middle might end up with fewer benefits and higher taxes under a center-left government where the left has taken over, whereas lower benefits are likely to be partially offset by lower taxes if the right takes over in a center-right government (under the reasonable assumption that redistribution cannot be regressive).

This model implies that redistribution to the vulnerable sector is only possible in PR multi-party systems. Yet there is an important differentiation within these systems that speaks to Esping-Andersen's distinction between social democratic and conservative welfare states. Following Manow (2009) and Manow and Van Kersbergen (2009), if parties under PR represent more than one class it opens the possibility for governing coalitions that excludes *both* the left and right. The historical example is Christian democratic parties because they represent multiple groups, including skilled workers, technicians, and upper-middle class professionals and managers. They are different from "cross-class" parties in majoritarian systems because they do not need win elections by appealing to the "median voter", and instead can allow group differences to be bargained out inside the party. Because these parties need to accommodate different interests, they tend to set aside divisive issues of redistribution and focus on their common interest in social insurance. But this "centrist" bias also means that they can often govern with other center parties without having to make compromises with the left. If we read Esping-Andersen through the lens of this coalition model, we would thus expect the interests of low-end workers to be far less well represented in *both* (liberal) majoritarian *and* PR electoral systems with strong Christian democratic parties.

We can illustrate this logic with some numbers from the OECD's Social Expenditure Dataset[1] for the post-1980 period (roughly the start of the rise in labor market inequality). If we assume that the vulnerable sectors are hit harder by adverse economic changes or "shocks", and if all countries have been exposed to the same structural shocks, then controlling for unexpected growth and "automatic" spending increases due to demographic shifts we can compare government spending across the three types of political systems: majoritarian countries (corresponding to Esping-Andersen's liberal welfare states), PR with strong Christian democratic parties (corresponding to Esping-Andersen's conservative welfare states), and PR with weak Christian democratic parties (corresponding to Esping-Andersen's social democratic welfare states).[2] The results are illustrated in Figure 1 using a "typical" shock, here defined as an exogenous change that causes governments to increase spending by one standard deviation of all spending changes (the detailed results and estimation procedure are described in Appendix A).

Consistent with the notion that inclusion in the governing coalition is critical, we find that PR countries with weak Christian democratic parties respond much more aggressively to shocks than other countries. For total social spending they increase outlays at twice the rate of majoritarian countries, and although other PR countries are also more responsive than majoritarian countries, this is true to a much lesser degree. In fact, the most striking finding is that PR countries with strong Christian democratic parties are not notably more responsive to shocks than majoritarian countries. When it comes to being attentive to the needs of lower-skilled and more risk-exposed workers it is clearly essential that parties representing these workers are regularly included in legislative bargains, and that is typically not the case when the center can govern on its own (with or without right party participation).

[Figure 1 about here]

Looking across policy areas, the differences between PR countries are somewhat muted for a social insurance type spending like unemployment, but it is more pronounced when we consider active labor market programs (ALMP) that are more targeted towards vulnerable workers. In the latter policy area governments in PR countries with weak Christian democracy increase spending almost three times more than governments in majoritarian countries. Of course, since spending on unemployment and APLPs are only a fraction of total spending, the effects of a typical shock on spending as a percent of GDP (measured on the y-axis) are also smaller.

All in all these results confirm the continued relevance of Esping-Andersen's typology – even in a period when governments are widely thought to have little discretion -- and they highlight the importance of coalitional politics for distributive outcomes. During the "golden age" of welfare state development these differences were hidden behind high levels of wage compression, shared job protections, and employment-related social insurance. When production technologies bind together skilled and semi-skilled workers, as was broadly the case under Fordist production methods, semi-skilled workers can "free-ride" on the bargaining strength of skilled workers. This is still true to some extent – labor markets in all coordinated market economies are more integrated and equal than in liberal countries – but the contrast to the Nordic countries in terms of deliberate government policies of compensation has now become very striking.

3. The advanced sector and the symbiotic relationship

The results presented in the previous section are consistent with Esping-Andersen's position that the democratic welfare state is an arena of political power, which needs not conform to market forces or to the interests of employers or the wealthy. But Esping-Andersen goes a step further and implies that the welfare state also undermines markets and the interests of business in general, including the advanced sectors of the economy. The welfare state is fundamentally the result of the class struggle (Korpi 1983; Stephens 1979); it is "politics against markets" as succinctly captured by the tittle of Esping-Andersen's first book (Esping-Andersen 1985). Here we disagree. We see the core institutions of social protection found in both the conservative and social democratic welfare states as complementary to the functioning of the advanced sectors of the economy, and we would go so far as to argue that the political institutions that have promoted redistribution are also conducive to both business and union interests. We argue below that it is for precisely this reason that institutions conducive to redistribution encountered little opposition when they were adopted in the early 20th century. Policies towards the advanced sectors are non-partisan, and these policies include key aspects of the welfare state.

Our claim is that there exists a symbiotic relationship between business and democratic governments where the latter set up or sponsor an institutional framework which enables firms in the advanced sector to develop and carry forward their comparative advantages. We see the provision of the conditions in which advanced capitalism can flourish as a central function of governments in these countries. Again, this institutional framework covers a wide range of areas, such vocational training and higher education, technology transfer and innovation systems, industrial relations, corporate governance, trade, competition and intellectual property policy, and the macroeconomic regime. Most importantly, it also includes those aspects of the welfare state relevant to advanced capitalism; viz. its insurance rather than redistributive functions.

In relationship to the welfare state, our argument builds on the welfare production regime theory set out in Estevez-Abe et al. (2001); which is itself based on a varieties of capitalism (VoC) approach (Hall and Soskice 2001). As argued by Williamson (1985), North (1990), and others, when an economy is characterized by heavy investment in co-specific assets, economic agents are exposed to risks that make market exchanges problematic.[3] A precondition for such an economy to work efficiently is therefore a dense network of institutions that provide information, offer insurance against risk, and permit continuous bargaining and impartial enforcement of agreements. These non-market institutions are not designed to "decommodify" as in Esping-Andersen's account, but to protect and enhance the value of the critical assets that economic agents, including skilled workers, sink into production.[4]

Another central feature of the VoC approach is the idea of institutional complementarities, where the effectiveness of one institution depends on the design of another. This idea implies that all major institutions of advanced capitalism are complementary to each other: the industrial relations system, the financial and corporate governance system, the training system, and the innovation system. This points to a very different understanding of the welfare state and its relationship to production and employer interests. Specifically, in Estevez-Abe et al. (2001) we argue that social protection (including job protection, unemployment benefits, income protection, and a host of related policies such as active labor market programs and industry subsidies) encourages workers to acquire skills that are co-specific with employers, which in turn enhances the ability of firms to compete in international markets. Central features of the welfare state are thus linked to the economy in a manner that creates beneficial complementarities.

This view runs up again the common claim that taxes to fund the welfare state are simply a cost on production. "Social institutions", writes Dani Rodrik, "can be treated 'just like' any other determinant of comparative advantage" and "more generous social welfare systems will be associated with lower competitiveness" (1998, p. 45). While Esping-Andersen does not use this language, it is in fact very consistent with the notion of de-commodification and the idea of "politics against markets".

Figure 2 lends some modest empirical support to this "social spending as a cost" conjecture. It shows that domestic price levels measured by the real exchange rate (U.S. dollar is reference currency) after subtracting the impact of GDP/capita (the Balassa-Samuelson effect) as a function of social spending (as a share of GDP). While there is no tight relationship, Esping-Andersen's three clusters are broadly speaking visible, with the liberal countries in the bottom left-hand corner, the social democratic countries in the top right-hand corner and the "conservative" welfare states somewhere in-between. Large welfare states are expensive and Rogowski and Kayser (2002), among others, have argued that the high price levels in many European countries reflect the costs of a bloated welfare state (see also Wren and Rehm 2013). Rogowsky and Kayser (2002) even conjecture that this could lead to reform of institutions such as PR, which, quite consistent with our argument in the previous section, facilitate a big welfare state (2002, p. 538).

[Figure 2 about here]

Yet anyone looking for a negative relationship between domestic price levels and international competitiveness will be disappointed. The correlation is in fact the reverse, and it is quite strong (see Figure 3). Competitiveness is measured here as a country's share of OECD exports divided by its share of OECD output. To adjust for the fact that small countries trade more than large ones, for reasons unrelated to competitiveness, we subtracted the effect of country gross domestic product (GDP) on performance by first regressing relative export shares on real exchange rates and country GDPs.[5] The result presents a major puzzle: large welfare states with high price levels are world beaters when it comes to selling goods and services in international markets.

[Figure 3 about here]

Our explanation for this puzzle focuses on the mutually reinforcing effects of social protection, investment in skills, and coordinated wage bargaining. The latter is a good starting point because coordinated wage bargaining is closely associated with wage compression, which keeps down costs of highly skilled labor in the export sector while raising it on low-skilled labor in the non-traded sector. This has the simultaneous effect of improving competitiveness while raising the domestic price level; a key to solving the puzzle (see Iversen and Soskice 2010 for details). Even though inter-sectoral wage coordination has declined, it continues to be far higher in the generous welfare states of northern Europe than in liberal countries.

Holding down skilled wages, while giving an advantage to export-oriented firms, also means that the demand for skilled workers will rise while the supply will decline. This brings up two important issues. One is that compression of wages reduces the returns on skills, and hence the incentive to invest in these skills. For coordinated systems to produce high levels of competitiveness, therefore, there has to be an effective training system in place that is subsidized by the state. One may see such subsidization as a complement to the welfare system (Iversen and Stephens 2008), and despite differences in the organization and content of training, all the export-oriented countries of northern Europe feature strong, publicly subsidized vocational training systems**.** Political support for these systems in turn relies on groups with an interest in training being represented in the legislature and in governing coalitions.

The second issue is that heavy focus on exports entails a high degree of specialization. The firms that are most successful in export market rely on specialized knowledge and workers with very specific skills. Investment in these skills is risky because changing international market conditions and unpredictable technological change, both largely outside the control of national governments, can render these investments worthless. Social protection, broadly construed, serves as an insurance against such risks. Skilled workers usually enjoy relatively high employment protection, but if they *do* lose their job they can typically fall back on a range of protections that help maintain their income. Unemployment insurance is only one. Even more important are health and pension benefits that follow the worker and are underwritten by the state and/or the collective bargaining system. The welfare system redistributes, but it also insures, and such insurance is a precondition for high competitiveness and hence for the profits of the most successful firms. Key aspects of the social protection system are politics *for* markets.

Figure 4 lends some support to these propositions. It shows the relationship between export performance and two of the variables we have emphasized: wage bargaining coordination and social spending. Countries that combine coordination with high protection tend to do well in international competition. Switzerland appears to fall out of this pattern, but only because the OECD social protection data strongly underestimates the generosity of the Swiss welfare state. In particular, it doesn't capture large parts of old age and health care spending because it is "mandatory private" (see Adema et al 2011).[1] Switzerland also has very strong unemployment protection system, and collective bargaining often includes aspects of social insurance[2]. Italy has relatively high spending, but is not a star export performer. This picture would change, however, if we excluded the south, which is a backward and corrupt economy that accounts for many social transfers in Italy. Ireland stands out as an exception in terms of export performance, but its success is largely due to multinationals using Ireland as a distribution and marketing beachhead into the much larger European market, as opposed to specialized production taking place in Ireland. It should also be noted that all of the high export performers, minus Ireland, have well-developed vocational training systems.

[Figure 4 about here]

4. The origins of the three worlds

In section 3 we argued that redistribution is associated with multi-party PR systems, and the division into PR and majoritarian electoral systems is almost perfectly collinear with the distinction between liberal and coordinated market economies. This raises the question of the role of distributive politics and efficiency in the emergence of political and economic institutions, including the social protection system. For Esping-Andersen, the origins of the modern welfare state are the democratic struggle for "de-commodification", conditioned by the power of the left and coalitional politics. Our understanding of the role of governments in modern economies suggests a rather different interpretation that emphasizes the importance of common interests and the creation of an institutional framework for the leading sectors of the economy. Political institutions that were conducive to the economic success of northern Europe had striking distributive

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[1] We thank Patrick Emmenegger for pointing this out to us. "Mandatory private" old-age pensions was 7.2% of GDP in 2007 (Adema et al. 2011); and health care insurance is mandatory, with those who cannot afford to pay subsidized by the state. Coverage is virtually 100 percent, and taking all forms of spending into account Switzerland has the second most expensive health care system in the world. More details on the "unexceptional" Swiss welfare state can be found in Kriesi (1999).

[2] According to the European Trade Union Institute, collective agreements include, besides working conditions proper, such as wages, working time and so on, items such as additional pension fund regulations, early retirement, conflict resolution procedures, joint social funds, funding of training and further training, joint bodies for implementation and control, participation rights, financial participation, and procedures related to collective redundancies and takeovers. Collective agreements cover 51 percent of the workforce, including most skilled workers in the export sector.

consequences; but apart from democracy itself they were for the most part not created with partisan objectives in mind.

Building on Katzenstein (1985), Crouch (1993) and Thelen (2004) we have argued elsewhere (Cusack et al. 2007, 2010) that the explanation for the linkage between economic and political systems, and hence also types of welfare states, is likely to be that PR promotes the legislative representation of economic agents who have made significant investments in each other; in co-specific assets. Such representation facilitates compromise over regulatory policies in which there is a strong element of common interest, especially through a specialized committee system. Since co-specific investments are less prevalent in liberal market economies, the need for such representation is less pressing and the right has an interest in preventing the redistribution that is associated with PR. Majoritarian systems instead encourage parties to elect strong leaders to convince the median voter that they are not beholden to special interests or to "excessive" redistribution.

This suggests an alternative to standard historical explanations of the origins of electoral and party systems, and hence also a different perspective on the partisan coalitions that underpin the modern welfare state. Like Esping-Andersen we pay close attention to economic interests, but unlike Esping-Andersen we do not see a deep partisan struggle over the core economic and political institutions of modern capitalism, once the shift to democracy was seen as inevitable (that shift itself was intensely contentious as we have argued elsewhere; see Iversen and Soskice 2010).

If the welfare state is seen as contrary to markets and the interests of employers, as argued by Esping-Andersen, and if large welfare states are furthered under PR electoral institutions, we would expect the left to favor PR and the right to oppose (as do Alesina and Glaeser 2004). But while it is true that the left in most countries at the turn of the century favored a transition to PR (all had inherited variants of single member district, SMD, systems), practically all center and right parties also ended up supporting PR in the countries that adopted PR. Conversely, all the major parties in the non-adopters favored the retention of majoritarianism. The choice of electoral systems appears not to have been a deeply partisan issue. Blais et al. (2005) show that there were no great divisive political debates on these issues (again, once democracy had taken hold).

The critical variable, we submit, was the organization of production and labor on the eve of the industrial revolution. Where guilds and agricultural cooperatives were strong, and where employers were coordinated and unions organized along industry lines, both right and left parties ended up supporting PR as a political mechanism to protect their mutual investments in co-specific assets. Where guilds and agricultural cooperatives were weak, where employers were poorly organized and poorly coordinated, and where unions were divided by crafts, large parties catering to the middle class saw no interest in a PR electoral system that would have given direct representation to low-paid, unskilled workers (as opposed to parties catering to the middle classes)

Countries which chose proportional representation in the early twentieth century were also those which had historically had relatively negotiated forms of political decision-making. These include all of Katzenstein's small states (Katzenstein 1985), thus also Lehmbruch and Lijphart's consociational countries (Lehmbruch, 1967, Lijphart, 1968), as well as Germany (west of the Elbe) and North and Central Italy. We refer to these as proto-corporatist countries. In these societies, as Crouch's seminal *Industrial Relations Systems and State Traditions* (1993) shows, the nineteenth century state and policy-making systems had emerged out of Ständestaat traditions. They comprised densely institutionalized local and regional economies. Within these sub-national communities – rural Gemeinde, small and larger towns with their formal or informal guild structures, sometimes defined confessionally, linguistically and/or ethnically – local decision-making involved consensus-based negotiation and bargaining so that different group interests (except those without possessions) could be effectively represented. This allowed the solution of collective action problems and the safe creation of co-specific assets within local and regional economic networks.

In these countries a majoritarian electoral system worked adequately at the national level through much of the nineteenth century. Constituencies were represented in national politics by local notables elected by plurality and often unopposed (in the case of Denmark, for example, by a show of hands in the town square). With economic interests generally geographically defined, these provided for their more or less proportional representation. And, with dominant local and regional economic networks, the national level was in any case less important in regulating economic activities. With economic activity concentrated at the local level, local governments were paramount and a constituency-centered political system worked well to represent economic interests at the national level.

By the end of the nineteenth century, however, industrialization, urbanization and the growth of the working class had made the old SMD system of national representation increasingly disproportional. Industry and industrial workers were more and more concentrated in the growing cities, while the system of representation favored the countryside.

At the same time economic networks and regulatory legislation were becoming increasingly national to reflect the accelerating process of industrialization. We draw attention to the growth of legislation and rule-making on vocational training and collective bargaining during the period from the late nineteenth century through the early part of the twentieth, gradually complemented by policies of social protection, from workplace injury insurance and unemployment compensation to pensions. Partially in parallel are the huge growth of industry associations and unions at national level, and also the development of parties from parties of notables, weakly professionalized and lacking discipline, to mass parties, professionalized and with very close relations to economic interest associations.

As regulatory politics and economic networks moved to the national level, parties in proto-corporatist societies thus became increasingly professionally organized to represent these local, regional and now sometimes national interests. They were "representative" parties of economic interests. Confessional parties were no exception: while Christian Democratic parties defended (within limits) the interests of the Church (though by no means always Rome) they were also, in the words of Manow and Van Kersbergen (2009) "negotiating communities" for the many different economic groups that defined early industrialization – handwork and the Mittelstand, small-holding peasants, larger peasants, Catholic unions, as well as landlords and sometimes business (see also Kalyvas (1996) and Blackbourn (1980)). This reflected the fact that economic life was partially organized on confessional lines in the relevant countries.

The professionalized parties that emerged in the wake of the industrial revolution represented distinct class interests and they wanted to preserve their distinct identities. This was increasingly hampered by existing SMD institutions, as manifested in increasing disproportionalities of representation, and the adoption of PR was the solution. This did not require exceptionally rational forecasting: once the move to the national level of industry and politics made it apparent that the preexisting majoritarian institutions of representation were producing stark disproportionalities, PR was the natural choice to restore representivity: Interest-carrying parties needed to preserve their identity to be able to continue to represent their interest or interests at the national level. The transition to PR was a means to restore a negotiation-based political system in which different economic interests were effectively represented by parties. To do this there was no obvious alternative to PR, and it was supported across the party spectrum (again, unlike democratization).

Scandinavian and continental countries had much in common in their Ständestaat and guild backgrounds, and both ended up with PR. But their party systems diverged, and this had consequences for government coalitions and redistributive policies, as we argued above. The origins of this difference is clearly related to religion as both argued by Esping-Andersen and Manow. But we also discern a key difference in the organization of production that helped create and sustain differences in the party system. Although the evidence is tentative, in the continental countries the peasant-dominated countryside was *more closely integrated* into the urban economies than was the case in Scandinavia, and this had consequences for political representation (Herrigel 1995; Hechter and Brustein 1980; Katzenstein 1985).

If the formerly strongly feudalized areas (East Prussia and the Mezzogiorno, as well as the Ruhr region in West Prussia) are excluded, something like these patterns seem to be traceable a long way back in history. Hechter and Brustein use the term "petty commodity production" areas to describe the continental pattern and "sedentary pastoral" to describe the Scandinavian pattern, and they begin their account in the twelfth century (Hechter and Brustein 1980). While a great deal more work is needed to pin down the connections, the petty commodity production areas seem clearly related to the decentralized production regions identified by Herrigel in South and West Germany (Herrigel 1995). These urban-rural networks were in fact complex cospecific asset groups where producers were "absolutely dependent upon one another" and "engage[d] in highly asset-specific exchanges" complemented by institutions that "constitute important fora to engage in negotiation and to establish understanding regarding . . . their individual and collective interests" (Herrigel 1995, 29).

It is not hard to see that the urban-rural networks of the continental coordinated economies created political coalitions in the Catholic Christian democratic parties that connected some lower-income groups (largely peasant) with higher income artisan and small producer groups. The reason that groups with different economic interests remain with a party that is Catholic only in name is explained, we submit, by the interdependencies of these economic interests. The rural-urban, peasant-artisan-small employer-merchant co-specific asset network acted, if our hypothesis is correct, to create a peasant-Mittelstand constituency that had an incentive to remain within the Catholic party.

The incentive structures for unions and business in Scandinavia developed in a similar way to those in the continental economies, but a major difference with the continental economies lay in the nature of the agricultural sector. While Scandinavian peasants owned their own land and coordinated activities as in the continental countries, Scandinavian agriculture did not have the same tight links and dependency upon urban economies. Instead, the agricultural communities were tightly knit and heavily invested in co-specific asset relationships within autonomous rural cooperative frameworks. There was thus not the same logic in Scandinavia to support a peasant-Mittelstand party. Instead the logic of co-specificity led to agrarian parties from which the occasional large landowner was excluded.

The point of this brief, and necessarily very incomplete, historical account is to highlight what we see as the key role of economic interests in the formation of modern welfare production regimes. Such interests cannot be reduced to redistributive politics because the key institutions that affect such redistribution – especially the electoral and party systems -- were fundamentally shaped, and motivated by, a desire to represent distinct interests but also to advance common interests in managing and promoting major investments in co-specific assets. These assets bind groups together, and the accumulation of such assets is the foundation on which the advanced sectors of the economy are built. The system of representation is a complement to the framework institutions of modern capitalism -- including the social protection system -- and it is the political guarantor of capital accumulation. In Esping-Andersen's account the private nature of such accumulation is instead the source of distributive conflict, and growth happens in spite of, not because of, democratic politics. Again, it is politics against markets. We do agree that distributive coalitions matter, especially in the non-advanced sectors of the economy, but these coalitions are largely a byproduct of political institutions that were set up with very different goals in mind.

5. Conclusion

In this paper we have argued that Esping-Andersen's coalitional perspective on the welfare state -- brilliantly outlined in his 1990 book -- stands up to scrutiny and helps make sense of distributive politics even in an era of globalization. Yet, to understand the nature and persistence of coalitional patterns we need to pay attention to political institutions and the organization of production, and we also need to draw a clear distinction between advanced and peripheral sectors of modern capitalism. The low-skill sectors are not essential to the knowledge economy, and governments are not constrained by any "structural dependence" on capital to refrain from redistribution. When governments fail to do so, it is a failure of democracy, not of capitalism. The core knowledge-carrying sectors of the economy are different. They are essential for economic growth and therefore for the long-term political support of governing parties, but they are also dependent on democratic governments to provide the institutional infrastructure on which they depend. This is what we have referred to as a symbiotic relationship, and we have argued that generous social protection in some cases is part of this relationship because it can facilitate investment in specialized knowledge, which in turn makes it possible to take advantage of opportunities for specialization in the global economy.

This symbiotic relationship between the advanced sectors and democratic governments is clearly on display when we consider the spectacular success of northern European countries as exporters. Here wage coordination promoted though the wage bargaining system goes hand in hand with social insurance and government investment in training to propel the expansion of the advanced sectors into world markets. This is not politics *against* markets; this is politics *for* markets.

Yet not all benefit from this symbiotic relationship. The end of Fordism and the rise in low-skill services have undermined solidaristic wage policies and inclusive coalitions in the industrial relations system. This has led to a decline in unions and cross-sector coordinated wage bargaining, and an associated increase in inequality and labor market dualism. We have suggested that the policy responses to these problems reflect long-standing cross-national differences in economic and political institutions and the differences in political coalitions that they give rise to. This part of our story is consistent with Esping-Andersen's focus on distributive politics. Indeed, it suggests that class politics through the state is more important than ever for distributive outcomes, even as political institutions in most countries are not conducive to the interests of the poor.

When we look back in time to the origins of current democratic institutions we see both distributive conflict and the promotion of common interests. Democracy was intensely contested in countries where unions and the left were strong and unified, and in liberal-majoritarian system there was no taste for PR systems that would have given the left greater say over public policies. Yet once democracy was a reality, PR was adopted by countries that inherited co-specific investment systems as industrialization pushed the center of gravity of economic networks from the local and regional levels to the national level; it reflected the need for national representation as standard setting increasingly took place at the national level. At the deepest level, the endorsement of PR by both the left and right in the early 20th century is a testament to the particular form the symbiotic relationship took in countries which we now admire for their generous welfare states.

Appendix A: Estimation and detailed regression results for Figure 1

We use a modified version of a method pioneered by Blanchard and Wolfers (2000). The core idea is to use year-dummies to estimate the effects of unobserved common shocks on policy variables, while at the same time differentiating the direction and strengths of these effects by distinguishing countries on key political-institutional variables. The original model requires nonlinear regression, but it turns out that it is complicated to produce the correct standard errors using Stata's non-linear procedure (as in Blanchard and Wolfers). We have done this in a separate paper (Iversen and Soskice 2014), and the results are consistent with the ones reported here. They are available from the authors.

Here we use a simpler two-stage procedure that can be estimated using linear OLS. In the first stage we regress changes in government spending against a complete set of year and country dummies, plus controls, in order to identify the average effects of shocks in each year on spending. We use these results to construct a "shock" variable (for each of the dependent variables), which is simply the magnitude of the estimated time effects in each year. In other words, we use average policy changes as a proxy for the extent of the shock in each year. These shocks can be both positive and negative.

In the second stage we regress spending against the shock variable and its interaction with our political-institutional measures (PR with weak and strong Christian democratic parties). The comparison group is majoritarian countries. Only two cases in our sample exhibit change on the institutional variables. Italy introduced a majoritarian system in 1994 before switching back to PR in 2006, and New Zealand went from a SMD majoritarian system to a PR-dominant system in 1994 (with the first election under the new system in 1996). Because there is a possibility of heteroskedasticity and serial correlation in the errors, we use panel-corrected standard errors with correction for first-order serial correlation as recommended by Beck and Katz (1995). The specific procedure in Stata is xtpcse, using AR-1 correlated errors.

To take account of unobserved heterogeneity across countries we use country fixed effects, and we also include a set of controls designed to remove non-discretionary components of spending decisions. One is unexpected growth, which is defined by the difference between the rate of GDP per capita growth in a particular year minus the average rate of growth in the previous three years. The logic is that governments make budgetary decisions using GDP projections that are based on recent growth trends, so when growth is unexpected high or low it affects the denominator of the spending as share of GDP measure. In addition we control for the "automatic" effects of demographic changes by including variables for (the first difference in) the share of the population who are under 15 or who are over 65.[6] Like the growth data, these data are from the OECD.stat online database. Finally, we include a control for "automatic unemployment disbursements," which are the benefits unemployed receive "automatically" because of the income replacement rates that are "on the books" at the time they are laid off. By including a control for spending "mandated" by replacement rates that were in place in the year before the shock, we focus attention on the discretionary elements of the budget.

The replacement data are from Vliet and Caminada's (2012) updated version of Scruggs (2004) widely used dataset. [7]

We also tried to include measures for economic openness (imports plus exports as a percent of GDP), female labor force participation (as a percent of the working age population), and voter turnout. None of these register a significant effect and leave our substantive results unaltered. They have been omitted in the regression results reported below.

Finally, there are two technical issues that we need to address. Since the shock variable is estimated rather than observed directly, the estimate of the effect of shocks will contain measurement error. Such error, however, will always bias the results downwards, never upwards. So using the estimated shock variable will give us a conservative (or lower bound) estimate of the true effect. More precisely, in the simplest form the true model is

$$\Delta y_{it} = \alpha_{PR} \cdot s_t + u_{it}$$

where s_t is the true shock and α_{PR} is the parameter on either of the PR dummies. But we estimate s_t by $\hat{s}_t$; then we estimate

$$\Delta y_{it} = \alpha_{PR} \cdot \hat{s}_t + \alpha_{PR}\left(s_t - \hat{s}_t\right) + u_{it}$$

with the error term now augmented by the measurement error.
Assume $\hat{s}_t = s_t + \varepsilon_t$ (which we can in principle derive from the Stage 1 regression as the unbiased difference between the estimated and true value of the parameter s_t). Then:

$$\Delta y_{it} = \alpha_{PR}\hat{s}_t d_{PR} + \alpha_{PR}\left(s_t - \hat{s}_t\right) d_{PR} + u_{it}$$

$$E\hat{\alpha}_{PR} = \alpha_{PR}\left(1 - \frac{\sum \hat{s}_t (s_t - \hat{s}_t)}{\sum \hat{s}_t^2}\right) = \alpha_{PR} E\left(1 - \frac{\sum_i (s_t + \varepsilon_t)\varepsilon_t}{\sum \hat{s}_t^2}\right) \to \alpha_{PR}\left(1 - \frac{\sigma_\varepsilon^2}{\operatorname{var} s}\right)$$

So the estimated effect of PR (with or without a strong CD) underestimates asymptotically the true effect. The same proportionate (asymptotic) bias is true for the other PR effect.

The second issue is that in estimating the first stage against a full battery of country and time dummies, the procedure consumes N + T, or 45 (in average) degrees of freedom. In principle these need to be subtracted from the actual number of observations (393) in estimating the standard errors for the second stage. This gives us 439 instead of 483 degrees of freedom and introduces a small error. Specifically, if the reported standard error of any reported coefficient, α is $se_\alpha = \widehat{se_\alpha}\big/\sqrt{484}$, the "true" standard error is $se_\alpha^* = \widehat{se_\alpha}\big/\sqrt{439}$ so that each reported standard error should be multiplied by $se_\alpha^* / se_\alpha = 1.05$. Since this does not affect any of the reported significance levels, and since the two-stage procedure biases the coefficients downwards, we report only unadjusted results.

Table A1 shows the regression results from the second stage of the estimation, which are the basis for Figure 1 in the main text.

[Table A1 about here]

We might add that the general results presented in table 1 are confirmed if we use a nationally specific shock variable in a nonlinear setup. The shock variable in this analysis is deindustrialization, defined as the annual drop in industrial employment as a share of the working age population, incorporated into a non-linear model. The results are reported in Iversen and Soskice (2014). This analysis also shows that our common shock variable, as defined about, is fairly highly correlated with the deindustrialization variable, measured as annual means (.64).

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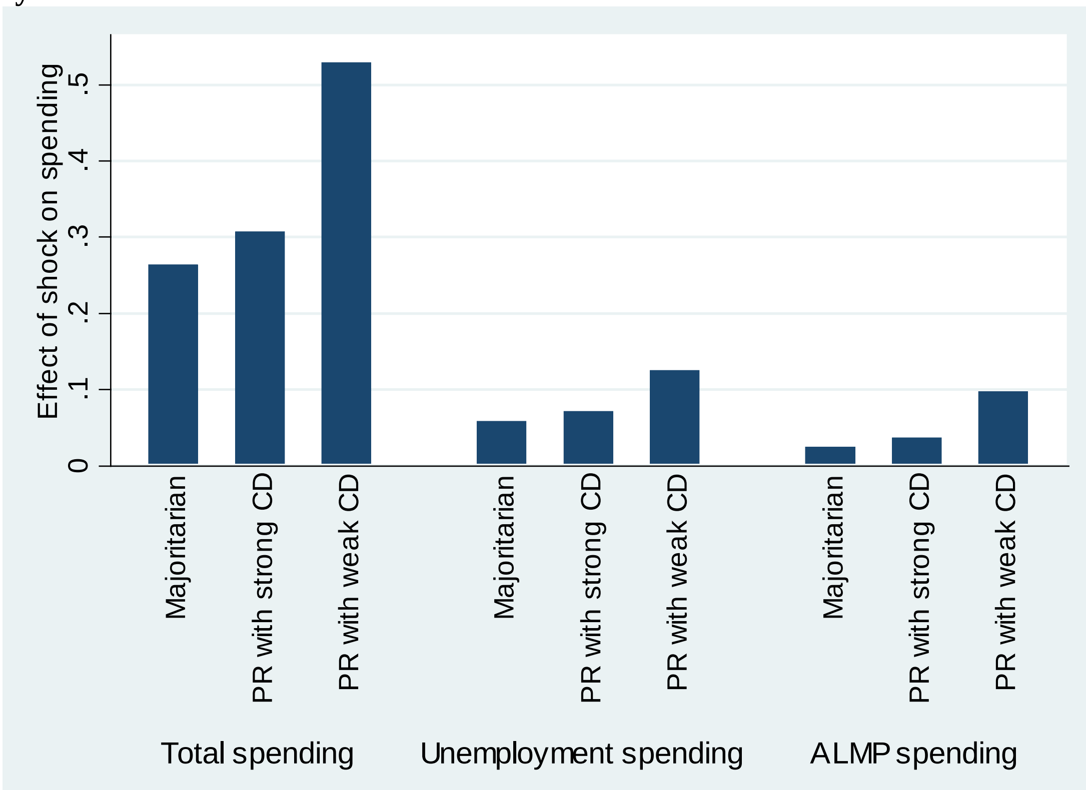
Figures and tables

Figure 1. The responsiveness of governments to adverse shocks in different political systems

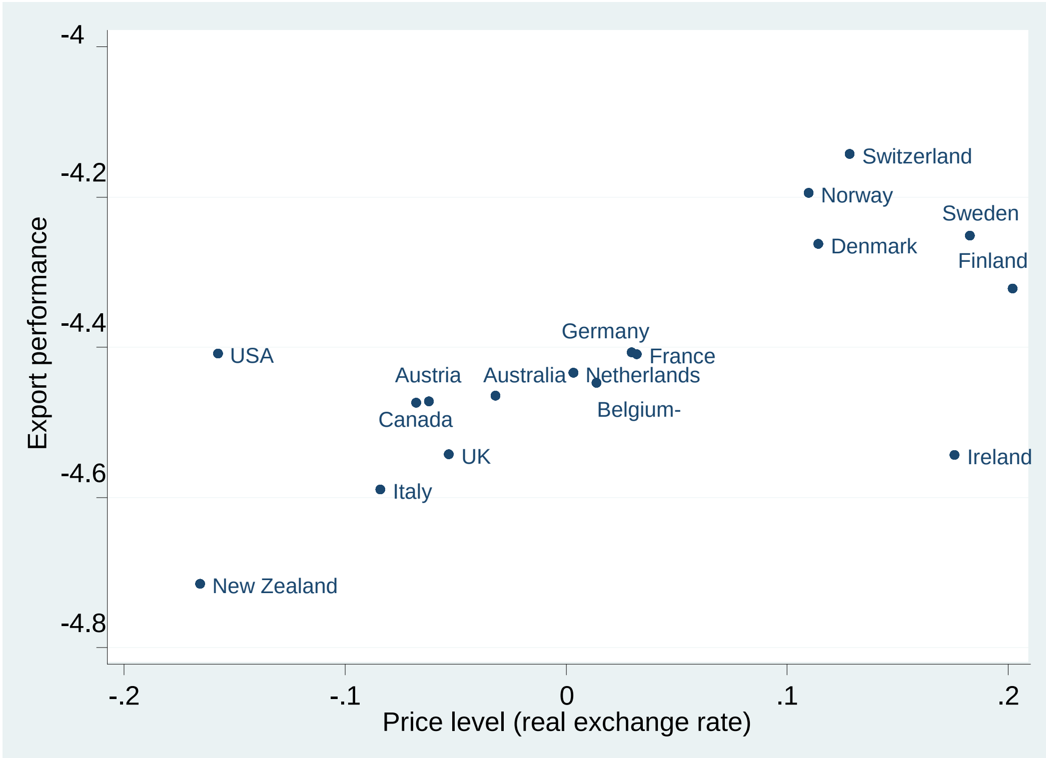


Notes: Figures are based on results in Table A1 in Appendix A and show the estimated change in government spending as a percent of GDP resulting from a "typical" exogenous shock, which is defined as a change that causes governments to increase spending by the equivalent of one standard deviation of all spending changes. Data are from OECD *Social Expenditure Statistics*. Online Database Edition.

Figure 2. Social protection and domestic price levels (adjusted real exchange rates), 1980-2000

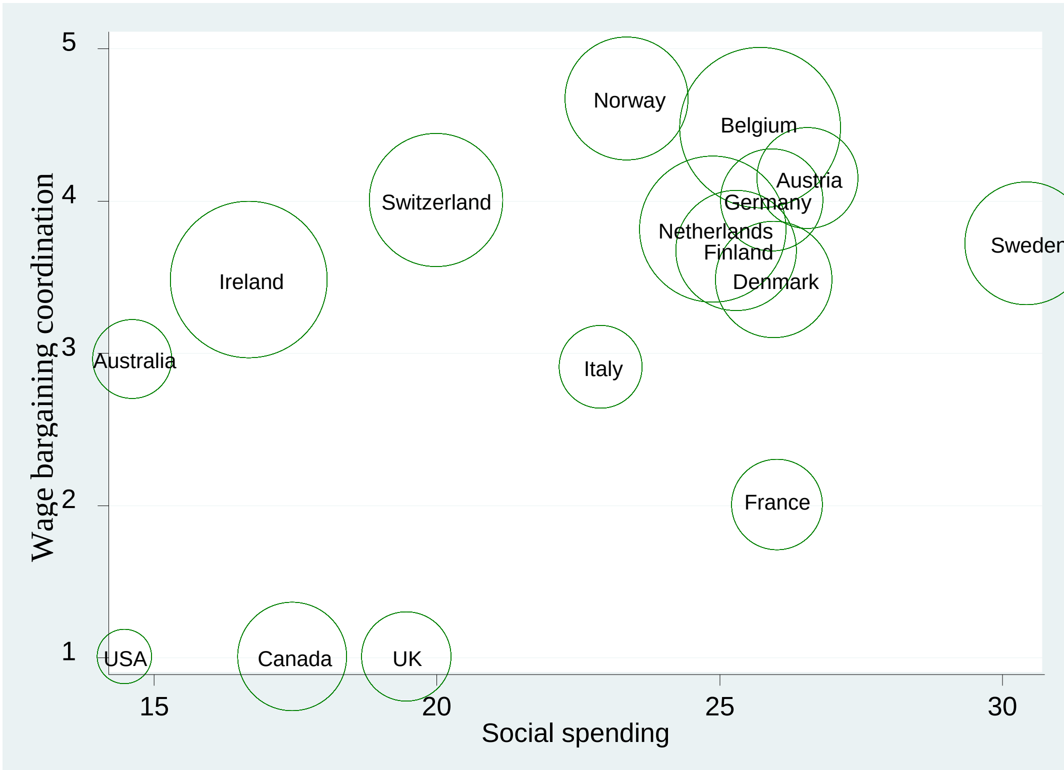
Notes: The price level is defined as the (log of) consumer price level in any country relative to the U.S. consumer price level, deflated by the nominal dollar exchange rate (so as to express it in a common currency). Unity (0 after logging) means purchasing power parity with the United States so that a dollar buys the same goods and services in a particular country as in the United States; higher values mean that a dollar will buy less than in the United States (indicating an "overvalued" exchange rate). Social spending data are from OECD *Social Expenditure Statistics*. Online Database Edition. Real exchange rate data are from the Penn World Table (PWT), Mark 6.3.

Figure 3. Price Levels and Export Performance in 18 OECD Countries, 1980–2000



Notes: Competitiveness is measured here as a country's share of OECD exports divided by its share of OECD output. To adjust for the fact that small countries trade more than large ones, for reasons unrelated to competitiveness, we subtracted the effect of country gross domestic product (GDP) on performance by first regressing relative export shares on real exchange rates and country GDPs. Data are from the OECD Stan Data Base. Online Database Edition. For the definition and data source for price level see Figure 2.

Figure 4. Social protection, coordinated wage bargaining, and competitiveness, 1980-2000.



Notes: size of circles indicates export performance, as defined in text. The wage bargaining coordination index is from Kenworthy (2001); the social spending variable is from the OECD.

Table A1. Regression results for the effect of shocks on government policies

	Total social spending	Spending on unemployment	Spending on ALMP
Shock	0.78***	0.68***	0.51***
	(0.12)	(0.12)	(0.12)
PR with weak CD * shock	0.74***	1.24***	1.53***
	(0.26)	(0.32)	(0.27)
PR with strong CD * shock	0.12	0.24	0.25
	(0.16)	(0.24)	(0.27)
Unexpected growth	-0.15***	-0.24***	-0.44
	(0.01)	(0.03)	(0.19)
Share of population under 15	0.52***	-	-
	(0.17)		
Share of population over 65	0.30	-	-
	(0.17)		
Automatic disbursements	0.69***	0.43***	-
	(0.11)	(0.02)	
N	493	483	397
Adj. R-squared	0.59	0.64	0.27

Key: *: p<.10; **: p<.05; ***: p<.01 (two-tailed tests)

Note: These are the results from the second stage estimation described in the text. Country fixed effects have been omitted.

Endnotes

[1] OECD *Social Expenditure Statistics*. Online Database Edition.

[2] Since Switzerland has an collective executive that is not the result of coalition bargaining we exclude it from the analysis. It has no effect on the substantive results.

[3] Polanyi (1944) is an important precursor for many of these arguments.

[4] "De-commodification" is central to Esping-Andersen's understanding of the welfare state and it means that "citizens can freely, and without potential loss of job, income, or general welfare, opt out of work when they themselves consider it necessary" (1990, p. 23). Further, "[d]e-commodification strengthens the worker and weakens the absolute authority of the employer. It is for exactly this reason that employers have always opposed de-commodification" (p. 22).

[5] We regressed export performance on *both* GDP and the real exchange rate (price level) to avoid that the former picks up an omitted variable bias that would bias the relationship between the price level and export performance in Figure 3.

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

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