Labor Markets, Economic Policies, and European Economic Growth Since World War II

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[First draft, June 1999]
I. Introduction

Few facts have been highlighted more dramatically by recent events in the world economy than the need for supportive institutions for the operation of smoothly-functioning markets. Whether the events in question are transition in Russia or financial liberalization in Asia, we are reminded that markets do not operate in an institutional vacuum. An act of social and political agency is required to create the kind of institutional framework within which a market economy can develop and thrive.

Western Europe in the second half of the 20th century is a case in point. There, the economy that rose from the rubble in 1945 had been shattered by a quarter-century of depression and war. In response, a new set of socioeconomic arrangements was developed to create a context in which the market could be reconstituted. Those arrangements responded to the special problems that had marked or been bequeathed by Europe’s earlier history: the class conflict that had disrupted European labor relations, the political tensions that had riven the continent, and the needs of postwar economic reconstruction. They were attuned to the technological imperatives of the day. In the labor market, the aspect of the economy that is our focus here, this meant centralized bargaining, corporatist labor relations, strong wage compression, and all the social programs and interventions that fly under the banner of the European welfare state. It was in the context of these institutional arrangements that postwar unemployment fell to strikingly low levels and the European economy recovered at historically unprecedented rates.

This experience is also a reminder that acts of social and political agency can have unintended consequences and that socioeconomic institutions can develop a momentum of their own. Europe’s mixed economy, as a result of that momentum, overshot: the centralization of bargaining, the compression of wages, and the expansion of social programs went further than anyone anticipated, with unanticipated consequences like the spread of early retirement and permanent disability in the Netherlands, rising unemployment among the low-skilled, and lagging service-sector employment continent-wide. And when circumstances changed — when Fordist mass production gave way to a new generation of technologies emphasizing quality production and flexible specialization, in turn requiring more flexible labor markets — the continent found itself saddled with a set of institutions ill suited to the task at hand. The same institutional
arrangements once hailed as the foundation of the postwar growth miracle were now assailed as the causes of Eurosclerosis and high unemployment.

Observing that institutional developments acquire their own momentum is not to say that their development is unresponsive to changes in the environment or to the unintended consequences of their own operation. Thus, in response to the spread of new technologies, lagging international competitiveness, the persistence of double digit unemployment, and unsustainable fiscal positions, politicians and their constituents have begun to reform European labor relations to accommodate the economic and technological imperatives of the 21st century. But this is to get ahead of our story.

II. Labor-Market Governance and Economic Growth

Economic reconstruction in Europe after World War II took place against a backdrop of capital scarcity and labor militancy. Productive capacity had been devastated in the war, and many of the conservative political parties and organizations that were the traditional counterweights to organized labor had been discredited by their acquiescence to or even active participation in the Nazi war effort. This economic and social disarray was all the more alarming once the Soviet Union came to be seen as a threat to Western Europe. For U.S. officials and the European politicians with whom they allied, economic growth promised to solve all these problems at a stroke. It promised to give Western Europe the economic and military capacity to withstand the Soviet threat. It promised to give labor a stake in the market economy. It promised to restore the respectability of the capitalist class and of conservative political organizations.

But in order to initiate and sustain economic growth, three related problems had to be solved.

1) Short-termism. Given the destruction of plant, equipment and infrastructure, investment was key to postwar recovery. And even after the recovery phase was complete, investment remained central to the process of transferring to Europe the backlog of technologies and mass-production methods developed by American industry in the course of previous years. Given the disorganization of international financial markets, investment had to be financed at home. Faster growth and higher incomes in the future thus required sacrifices of consumption in
the present. Wages had to be moderated to free up the profits to finance capacity modernization and expansion. Those profits had to in fact be plowed back instead of being paid out to shareholders. A mechanism had to be created, in other words, to encourage labor and capital to trade current gratification for future gains and to thereby overcome the problem of short-termism.

(2) Collective-action problems. It is difficult to withhold the benefits of growth from those who refuse to support it. In the postwar setting this mean that individual unions inevitably were tempted to raise their own wages even while benefitting from the favorable market conditions created by the restraint of other unions. The profits freed up by their restraint did not remain in the same sector; rather, they passed through the national capital market, boosting investment, productivity and labor incomes economywide. Firms for their part were tempted to underinvest in R&D and technical training in the belief that these investments benefitted competing firms that did not help to defray costs. Collective-action problems had to be solved, in other words, to sustain the prerequisites for economic growth.

(3) Distributive conflict. One of the lessons of the interwar period, emphasized by Keynes, is that workers care about relative as well as absolute wages. Absent a consensus about distribution and a mechanism for bringing it about, disruptive social conflict can result. Like a messy divorce in which the family jewels are sold off to pay the lawyers’ fees, a society riven by distributioinal conflict will be prone to dissipate the resources needed to sustain prosperity and growth. In particular, different groups of workers will only be willing to restrain their wages if they are confident that they will get a fair share of the future benefits of that restraint. And an even distribution of the fruits of their labor today may be the only credible promise of an even distribution of those benefits tomorrow. Wage moderation, in other words, may presuppose wage solidarity.

Centralized and concertized bargaining of the form that emerged in Europe in the two decades following World War II addressed these three problems simultaneously. The coordination of bargaining across sectors encouraged individual unions to exercise wage restraint by convincing them that other unions would do likewise. The government provided unemployment, health and retirement programs -- the institutions of the welfare state, in other words -- which reduced workers’ uncertainty about their future welfare and therefore the
temptation of labor to engage in short-termism\(^2\). The insurance against loss of employment and income afforded by the welfare state, combined with a relatively flat wage structure, also made workers more inclined to acquire firm- and industry-specific skills that would otherwise have been risky investments. And tax policies penalizing dividends and conspicuous consumption reassured workers that wage restraint would translate into higher investment.

On the employer side, firms had to worry that the decision to invest would encourage their workers to raise their wage demands in order to appropriate the extra profits generated by that investment. But if wages were determined in economy-wide rather than enterprise-level negotiations, an individual firm's investment decision would no longer affect the wages it had to pay. In these circumstances, centralized wage negotiations led to a higher level of investment and, insofar as productivity was raised, to higher wages in equilibrium.\(^3\)

Interlocking directorships and the development of cohesive employers associations, operating under close government oversight, avoided the under-provision of technical training and R&D. Firms that would have otherwise been reluctant to provide training to their workers, for fear that they would be poached by competitors, were restrained by the threat of sanctions by both government and industry associations. In addition, the absence of high-powered incentives within the firm implied a preference for bank rather than securitized finance of the sort that Europe’s bank-based financial system was in a position to supply. This facilitated a focus on long-term profitability. Finally, institutionalizing union representation on corporate boards and government bureaucracies -- developing the institutions of “corporate governance” -- made it easier to monitor the parties’ compliance with the terms of these agreements. It facilitated “common knowledge” about the cooperative equilibrium.

Together, then, these institutions and policies overcame all three obstacles to growth: short-termism, the difficulty of collective action, and distributional conflict. But the viability of this solution depended critically on the presence of a set of historically-specific supporting

\(^2\) On the relationship between uncertainty, short-termism, and wage militancy, see Pzreworski and Wallerstein (1982).

\(^3\) These possibilities are modeled by Hoel (1990).
conditions and policies. First, cooperation was facilitated by the exceptional scope for rapid growth after the war. The European economy was functioning below capacity. A massive influx of labor from Eastern Europe and internal migration from low-productivity agriculture to high-productivity industry reduced upward pressures on wages and supported the modern sector’s growth. Above all, there was a backlog of unexploited technologies left over from the years of war and depression, ready to be imported from the United States. For all these reasons, the return on investment was high. Restraint supporting that investment was generously rewarded.

Second, centralization was facilitated by the homogeneity of the labor force, which made it easier for workers to reach understandings about wage relativities and for employers to live with wage compression. Highly-skilled scientists and professionals were not the mainstays of postwar European manufacturing. The then-dominant Fordist mode of production, which relied high-speed-throughput technologies, an extensive division of labor, and semi-skilled workers, was not hindered by wage compression that pushed up the cost of unskilled labor and depressed the wages of the most highly skilled, since European industry made heavy use of workers in neither tail of the skill distribution. To the contrary, insofar as centralized and solidaristic bargaining delivered wage restraint, it enhanced the cost competitiveness of the continent’s largest, most dynamic firms.

Third, government policies supported cooperative centralized bargaining by alleviating economic insecurity, addressing distributive concerns, and sanctioning noncooperative behavior. Tax policies rewarded investment and punished consumption, as noted. Subsidies and low-interest loans were channeled to sectors where unions displayed wage restraint and to firms willing to support apprenticeship training and finance R&D. Countercyclical monetary policies and automatic fiscal stabilizers limited uncertainty about the future. The rapid expansion of the welfare state also encouraged workers to make risky investments in skills, and, above all, it addressed the problem of distributional conflict by supporting the maintenance of a “social wage” that satisfied egalitarian norms.

An important question, not often asked, is how the state could be relied upon to perform these functions. While this issue needs further study, a few observations are in order. For one, the mainstream parties that emerged from Europe’s experience with left- and right-wing
extremism before and during the war were more inclined to pursue a common interest in economic growth than to engage in polarizing distributive politics. The Cold War reinforced their pragmatism and moderation, and, with the notable exception of Britain, PR electoral systems gave party elites a strong incentive to seek compromise in order to form governing coalitions. In turn, elites’ emphasis on growth and consensus-building encouraged voters to judge government performance on precisely those dimensions, and a “frozen” party system with relatively stable voting blocks reduced the incentives of parties to try to buy off each others constituencies through policy overbidding and fiscal largess. Moreover, parties owed their electoral success as much to the mobilizational efforts of highly centralized organizations of capital and labor (the latter in particular) as to their own efforts. This gave these organizations the power to “punish” parties if they misbehaved by withdrawing their support at the polls. Governments therefore had an incentive to consult and involve the main labor market organizations in preparation of new legislation and to seek their consent in its implementation. In effect, the existence of these disciplined mass organizations enabled the mainstream parties to credibly commit to the consensus policies of postwar Social Democracy.

The story up through the end of the 1960s is one of institutional complementaries and self-reinforcing dynamics. In other words, the way the pieces fit together worked to stabilize the operation of the European mixed economy and to propel the high-growth process forward. Governments supported centralized bargaining because strong unions and employers organizations and rapid growth favored the electoral fortunes of the mainstream parties. Politicians nurtured the institutions of centralized bargaining by granting representational monopolies to the peak associations of capital and labor, rewarding unions for their restraint and attending to their distributional interests. In turn, those strong unions and employers associations supported incumbent governments at the polls and lent their policies credibility by providing them with a “punishment technology” that alleviated potential time-inconsistency problems.

To be sure, the degree of centralization and its ancillary features were not the same in all

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4 The notion of a frozen party system is due to Lipset and Rokkan (1967).
European countries. As we elaborate in the next section, this characterization applies more readily to Northern and Central Europe than to either the U.K. and Ireland, where bargaining remained fragmented along craft lines, or to France and Southern Europe, where the union movement suffered from chronic ideological divisions. Even within Northern and Central Europe, there was a good deal of variation in national arrangements. In Austria, there was less pressure than elsewhere for redistribution. In Germany, peak level coordination never really got off the ground; rather, unions and employers associations learned to play a tacit game of follow the leader under the watchful eyes of an inflation-adverse central bank with a credible punishment technology of its own. But the spread of centralized wage bargaining and corporatist governance was, to a greater or lesser degree, evident over much of Western Europe after World War II.

II. Postwar Variations

As an ideal type, the postwar settlement featured three core elements: i) centralized wage bargaining, ii) commitment to full employment, and iii) policies to promote wage equality and insurance against labor market risks. The Scandinavian countries, notably Sweden, came closest to this ideal type. During the 1950s a booming Swedish economy and a strong Social Democratic government committed to full employment convinced employers that peak level wage bargaining was their best bet to contain wage pressures. On the union side, centralization and wage restraint were coupled with demands for redistribution, and the Rehn-Meidner model of solidaristic wage policies, adopted at the Swedish LO’s congress in 1951, institutionalized the principle of "equal wages for equal work" across industries and sectors. Such policies inherently favored the most dynamic sectors of the economy and forced inefficient firms to either modernize or perish; a process that was facilitated by active labor market policies. Though peak-level bargaining emerged later in Denmark and Norway, partly because labor markets were not as tight during the 1950s as in Sweden, this move towards centralization was likewise accompanied by wage solidarism.

Fiscal policies in Norway and Sweden were mildly counter-cyclical, but both countries ran

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5 In fact, there were important international differences, as we have emphasized elsewhere. See Eichengreen (1996) and Iversen (1999).
surpluses most of the time, and the savings were ploughed back into the economy through an investment policy based on low interest rates. Keeping interest rates below the international level enabled governments to target industrial policies through credit rationing, and investment policies were also used to counteract swings in the business cycle by hoarding business surpluses during economic upswings and releasing them during downturns. Furthermore, the future welfare of workers was assured by a rapid expansion of pension and other social rights, as well as by a government firmly committed to full employment. In part this commitment was made credible by an expansion of employment opportunities in the public sector where more and more social services were being provided. Correspondingly, government spending increased considerably during the 1960s (see Figure 1), but as long as unions did not demand compensation for higher taxes, such spending did not necessarily undermine profitability and investment in the economy. In turn, cooperation was ensured through centralized bargaining, and by drawing representatives of the main labor market organizations into the preparation and implementation of literally every new piece of social or economic legislation.

As we move south and west from Scandinavia, one or more elements of the postwar model are weakened, but in no case are all three missing entirely. Thus, Germany, Austria and Switzerland all developed highly coordinated and ordered systems of industrial relations in the 1950s, but in neither case did wage bargaining get centralized to the national peak level as in Scandinavia. Even in Austria, often portrayed as the archetype of centralized corporatism, actual wage bargaining was conducted at the industry and firm levels, albeit with the labor confederation in a strong coordinating role. In Germany and Switzerland there was little peak-level steering of bargaining, although Germany experimented with peak-level coordination.

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6 Supply-side credit policies were not as developed in Denmark, and the government often ran deficits.
Figure 1. Public spending as percent of GDP, 1950-1990.

During the Concerted Action program initiated in 1967 (abandoned again in 1978). Even without centralized intervention, however, industry bargaining in all three countries developed into a highly coordinated system with the exposed engineering sector in the role as the wage leader. This meant that wages were always set with an eye to international competitive conditions, something that in the Scandinavian countries was accomplished only through a negotiated consensus.

In the first decade after World War II the success of industry bargaining in these countries can in part be explained by the large influx of labor from eastern and southern Europe, which placed downward pressures on wages; an element was missing from the more insulated
Scandinavian labor markets. However, as immigration slowed down and labor markets tightened, continued coordination came to depend more on the capacity and willingness of politically independent central banks to punish unions and employers for militant wage-price behavior. As long as bargainers could rationally expect inflationary settlements to be met by higher interest rates and a fall in demand and unemployment, they had an incentive to act with restraint. Monetarism also functioned as deterrence against governments engaging in expansionary fiscal policies, and firm commitments to full employment along Scandinavian lines were never made. Partly for this reason, and partly probably also because of the political influence of Christian Democratic parties, the public sector was also never used as an instrument in the government’s employment policy as in Scandinavia. Thus, in 1960 between 4.5 and 4.8 percent of the working age population was employed in the civilian public sector in Switzerland and Germany, whereas the comparable figures for Denmark and Sweden were 6.8 and 7.5; a gap of about 2.5 percent. By the end of the 1960s this gap had widened to over 4 percent, and it grew considerably larger during the 1970s (as discussed below).

But while the Germanic countries differed from the Scandinavian in their level of public service provision and employment, the former passed generous entitlement legislation, such as Adenauer’s 1957 pension reform, which greatly increased social spending. Likewise, governments in both groups of countries instituted extensive legal and regulatory protection of the employment relation, and they supported or mandated the creation of employee workplace representation. Such measures, combined with the social commitments, reassured unions that the future welfare of their members was relatively secure and that wage sacrifices would be put to productive use. Politically, stability was guaranteed by federalist institutions and by PR electoral

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7 See Eichengreen (1999).

8 For example, even when a moderate Keynesian economics minister in Germany sought to respond to a recession in the 1965-66, the public works program was timid and probably unrelated to the recovery. See Scharpf (1991), p. 119.

9 Austria was a partial exception because of a large nationalized firm sector.

10 The laggard here is Denmark, partly because its industrial structure is so dominated by small firms.
systems that necessitated government power sharing. Epitomizing this principle of power sharing, Switzerland was constitutionally wedded to a proportional distribution of government portfolios between the main parties.

The Belgian and Dutch experiences are positioned somewhere between the Scandinavian and Germanic. In both countries wage-setting was coordinated at the peak-level through tripartite negotiations, but unions in both countries were divided between confederations of socialist, catholic, and protestant (in the Netherlands) or liberal (in Belgium) orientations. This posed difficulties in organizing peak-level coordination, but also increased the need for such coordination in order to prevent damaging wage competition. What contributed to the success of governments in fostering cooperation was that neither unions, nor their political party counterparts, were competing for each others members (Flanagan et al. 1983, 102). Coming out of the war, both societies were highly segmented, or “pillarized,” and no pillar could reasonably hope to become hegemonic. Coupled with a PR electoral system, this meant that parties were forced to compromise and could only advance their own interest by advancing the interest of each other.

The result was an unusually complex system of multi-level bargaining between the government, the three union federations, and employers, as well as within the union federations between the peak level and individual unions. Compared to the Scandinavian countries, the government took a more proactive role, with the government appointed Board of Mediators approving all collective agreements in the Netherlands, and frequent interventions of Belgian governments in bilateral negotiations. But these interventions typically involved some exchange of wage restraint for an increase in the social wage, and they therefore bound the government as much as the social partners. In Belgium, for example, the first postwar government adopted a social security scheme in return for labor’s adherence to the Social Pact limiting wage increases, and the Dutch social security system embraced by the social partners was second to none in Europe. Like their German neighbor, however, Christian Democratic parties vetoed increases in state provision of services traditionally handled by church organizations or by the family.

France, Italy and the United Kingdom clearly represent the cases most deviant from the ideal type. All suffered difficult coordination problems because of fragmented labor movements
and weakly organized employers. In France and Italy, unions were weak and divided by ideological and confessional cleavages, many of which allied with strong but politically marginalized communist political parties. The latter saw the unions not simply as vehicles for workers’ material progress, but also as an important organization resource in the parties’ effort to mobilize and expand a mass base. Partly for this reason, governments in both countries were reluctant to pursue policies that could strengthen the communist unions. It was precisely the absence of such a competition for the “hearts and minds” of workers in the Belgian and Dutch cases, which made compromise and coordination possible in spite of multiple cleavages.

During a brief period after World War II, circumstances in Italy hinted at what could be accomplished through compromise. The main unions had agreed to form a single confederation (CGIL), and the country was governed by a broad coalition of Christian Democrats, Socialists, and Communists. This constellation produced one of the most important and enduring postwar policy legacies, the scala mobile, which indexed wages to inflation based on a flat rate payment principle. In effect, this was the first step towards a solidaristic wage policy. But from 1947 onwards the Communists were eliminated from government participation, and the labor confederation subsequently broke into its three main parts. Christian Democratic hegemony over government power was subsequently used to undermine the organizational strength of unions, while employing deflationary policies and migration from the rural Mezzogiorno to subdue the unions appetite for wage militancy.

By the 1960s, however, rapid economic growth had greatly reduced the ranks of the unemployed, thereby strengthening the unions, and the Christian Democratic Party (DC) had lost much of its electoral support to the Socialists and the Communists, thereby unlocking its monopoly on government power. On this background the DC shifted strategy and decided to form a coalition with the Socialists and to embark on policies that endorsed the goals of full employment and (moderate) redistribution of income and wealth (Flanagan et al., 1983, 514-5). These policies, however, were not accompanied by institutional reforms that could overcome collective action problems in the labor market, an omission that would haunt the Italian economy long after the labor upheavals of the “hot autumn” in 1969 subsided.

As in Italy, French unions were divided and weak after the war, but wage bargaining was
relatively well organized at the industry level, and extension procedures ensured that collective agreements within a particular industry would apply to all workers in that industry. Unlike the Italian situation, the French state could also rely on extensive administrative levers to pursue aggressive investment and industrial restructuring policies. Using its control over banks and credit, the government sought to overcome problems of under-capitalization and under-investment in R&D in the small firm dominated industrial structure by nationalizing key industries and facilitating the creation of “national champions.” The policy was guided by economic Plans that empowered bureaucrats to monitor and reward firms for compliance with the growth-oriented goals. Large industrialists, and to lesser extent trade unionists, were consulted in the planning process, but neither had the power to jeopardize implementation of the Plans. To the extent heavy investment and demand stimulation created bottlenecks and inflationary pressures, it was dealt with through devaluations. But the strategy did not accord much attention to reducing inequalities, except as was needed for the government to retain legitimacy in the eyes of voters. Yet, despite lack of extensive redistribution, and the weakness of organizations of labor and capital, France exhibited some resemblance to the postwar ideal type by promoting investment and full employment.

By contrast, Britain never developed institutions and policies that enabled an effective solution to the three problems of growth. Following the war, a reform-minded Labour government had nationalized several industries, but otherwise industrial policies were arm’s-length, in part as a result of a market-based financial system that did not lend itself easily to French-style *dirigisme*. The financial system was also an important impediment to the government’s full employment policies. Because British banks were heavily oriented towards international banking, they opposed devaluations, and this meant that expansionary policies would always run up against a balance of payment constraint. Consequently, when the government tried to address internal imbalances through demand stimulation, it would often find itself reversing policies so as to not cause a politically unacceptable depreciation of the pound (Hall 1985, ch. 4). The resulting “stop-go” pattern was clearly not conducive to far-sighted investment and wage strategies.

Instead, the only component of the postwar model that was pursued with vigor was the
expansion of the welfare state, a notably example being the creation of the National Health Service. But although representatives of employers and unions were consulted extensively on economic policy matters, legislation designed to diffuse distributive conflict did little to induce union wage restraint for the simple reason that no individual union had any incentive to cooperate with the government’s incomes policy. British unionization rates were high, and since membership was divided on a very large number of mainly craft-based unions, collective action problems were rampant. Even attempts under the Conservative Heath government to use statutory incomes policies largely failed and merely got the government mired down in a bitter struggle with the miners union. Commensurate with the incapacity of British institutions to solve problems of collective action and short-termism, investment faltered, and the British economy fared much worse than the rest of Europe.

III. The End of the Postwar Growth Miracle

In most European countries the postwar model continued operating smoothly through much of the 1960s as corporatist institutions were elaborated and extended. The rate of growth of output per employed person accelerated from an already impressive 3.6 per cent per annum in the ‘fifties to 4.2 per cent in the ‘sixties (see Table 1). Investment was maintained at high levels, and inflation was subdued. This, however, was the calm before the storm. Starting with the hot summer of 1968, wage moderation collapsed and inflation exploded. The wage increases won by strikers in 1968-69 were about twice those of the preceding three years.\footnote{Allsopp (1983), Table 3.4.} And with the Vietnam War-related acceleration of inflation in the United States, the collapse of the Bretton Woods System and the first OPEC oil shock, Europe’s institutions of economic governance, already under stress, were confronted with a series of unprecedented challenges.

What were the sources of this inflationary pressure? Most obviously, unemployment continent wide had fallen to strikingly, perhaps unsustainably, low levels. With the share of employment in agriculture having declined to less than 15 per cent, elastic supplies of underemployed labor from the agricultural sector no longer served to cap industrial wage

\footnote{Allsopp (1983), Table 3.4.}
demands. Johansen’s (1987, pp.148-9) description of the situation in Denmark is representative. “In the mid-1960s,” he writes, “the registered unemployed were either workers who were in the process of changing from one job to another and had a few idle days in between, or older people staying in isolated municipalities in Northern Jutland or the smaller islands from where they did not want to move.” Under such conditions, the threat of unemployment no longer disciplined wage demands. Memories of high unemployment faded as the postwar generation of workers aged and retired. The Soviet threat was perceived as less immediate, removing one immediate incentive for labor and capital to pull together. And with the weakening of the Bretton Woods System in the late 1960s and its breakdown in the early ‘seventies, inflationary expectations lost their anchor.

The broader context was the gradual exhaustion of the scope for catch-up growth. Although high levels of demand sustained rapid growth in the 1960s, the technological backlog supporting Europe’s catch up was progressively depleted. With slower growth on the horizon, the rate of return on current sacrifices came to look less attractive. Why sacrifice higher incomes now in return for higher incomes later if the payoff on investment and growth would be less? Lower growth also complicated the efficient solution to distributive conflicts. Since solidaristic wage policies depended on centrally bargained pay increases, whereas local wage “drift” was more responsive to market conditions, such policies presupposed bargained increases and were therefore prone to generate wage hikes in excess of the scope for real wage growth.

These problems were exacerbated as the postwar wave of Fordist mass-production methods gave way to more skill-intensive science-based technologies and flexible specialization (what European observers refer to as diversified quality production), resulting in increasing demand for skilled workers. This made policies of solidaristic wage bargaining designed to compress the wages of more- and less-skilled workers more difficult to sustain. Skilled workers attempted to “liberate” themselves from centralized bargaining and wage directives and pushed for higher wages. But given the expectation of wage equalization, the resulting “wage drift” filtered down to the ranks of unskilled, who used the leverage they possessed as a result of the operation of multi-layered bargaining and solidaristic wage norms to push up their earnings as well. Inflation was unavoidable in this setting.
This shift in the composition of labor demand in manufacturing, combined with the failure of relative wages to adjust, caused less-skilled workers to be pushed off onto the service sector. But since productivity growth in manufacturing outstripped productivity growth in services, the less skilled workers who now comprised the bulk of the labor force in services found themselves priced out of work. In this manner, what had previously been an effective means to overcome distributive conflict and create a broad base of support for wage restraint now generated wage pressures and problems of unemployment.

Governments responded to the consequent unemployment by increasing their spending in the effort to sustain demand. They responded to breakdown of wage moderation by encouraging further centralization of negotiations. Unions were promised increased health and unemployment payments and larger social security stipends as the quid pro quo for restraint. Public spending as a share of gross domestic product rose from 24 per cent in 1967-69 to 30 per cent in 1974-76. In fact, although growth in spending as a percentage of GDP had been spectacular during the 1960s, the expansion was even faster during the 1970s (see Figure 1). Its growth was particularly rapid in the Netherlands, Denmark, and Sweden, where public spending was directly tied to the expansion of transfer payments and social programs.

This strategy worked best where the institutions of corporatism and centralized wage bargaining were most advanced. Fiscal expansion and accommodating monetary policy stimulated employment rather than inflation, given agreements by the unions to restrain their wage demands. Where private-sector employment growth lagged, governments supplemented it with increases in public employment or early retirement schemes. In Austria and Sweden, these policies combined to keep unemployment at a remarkably low 1.7 and 2.0 per cent of the labor force in 1973-79. In Germany, where the unions similarly restrained wages but macroeconomic stimulus was less (due to the strong anti-inflationary predisposition of the Bundesbank and deficit

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12 Total factor productivity growth in private services OECD wide was about 2.5 percentage points per annum lower than total factor productivity growth in manufacturing between 1970 and 1994. Based on data in OECD (1996).

13 This is an unweighted average for the 13 European countries in Figure 1.

reductions by capital-market-constrained state and local governments), unemployment still averaged less than 3 per cent. By comparison, in countries like Britain, Italy and France, where corporatist institutions were less well developed and more difficult to reinforce, demand stimulus tended to produce inflation instead of additional employment. Unemployment rates were consistently higher in this second set of countries (as shown in Table 2).

While outcomes differed across countries, the intensification of inflationary pressures and the deterioration of labor market outcomes were evident continent wide. Hence, when the economy was exposed to the second OPEC oil-price shock, it became more difficult to apply the same shopworn formula. Additional demand stimulus now threatened to aggravate an already serious inflation problem. Having already held wages below inflation for some years, unions were loath to continue doing so. Public employment having been expanded significantly in the previous recession, budgetary burdens were now heavier, leaving less room for increases in public spending. As can be seen from Figure 1, public spending stagnated in most countries during the 1980s, and in some it actually declined. Considering that the dependent population -- retired people, unemployed, and disabled -- grew everywhere, the decade of the 1980s clearly marked the end to, and in some cases the reversal of, the postwar trend. It also marked the end to the “social democratic-Keynesian cooperation” that had contained European unemployment in the 1970s. Adjustment to the second oil shock consequently proved more difficult than adjustment to the first. Between 1973-79 and 1979-85, unemployment rates Europe-wide rose by half again and in some countries, like Germany and the Netherlands, more than doubled.

The constraints on policy responses at the national level were further tightened by rising capital mobility. Capital mobility had been trending upward since the early 1960s. The restoration of current-account convertibility in 1959 made it possible to evade capital controls by exploiting invoicing “leads and lags.” Moreover, as governments moved away from the harsh financial control of the immediate postwar years and restored more market-friendly forms of financial regulation, it became more difficult to stop capital flows at the border. And inflation which eroded real interest rates gave finance an even stronger incentive to seek more

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15 The phrase is from Scharpf (1991).
remunerative opportunities abroad. An unintended consequence of the policies with which governments met the first oil shock was thus a rise in capital mobility which constrained the policy independence of national central banks and limited the scope for using interest rates to encourage investment. The experience of the first Mitterrand Government in 1981-82 is only the most dramatic instance of a more general phenomenon.

The late 1970s and early 1980s was also the period when the European welfare state overshot. The intention was to alleviate distributive conflict and induce wage restraint by expanding the government’s commitment to future welfare spending. But this “deferred wage” strategy reflected and reinforced, rather than solved, mounting problems of short-termism and distributive conflict in the labor market. It served only to borrow time before these problems, in an aggravated form, had to be confronted head-on. Nonwage labor costs soared as governments shifted the burden of financing social benefits onto employers. These costs rendered firms reluctant to hire and undermined their international competitive position. Generous unemployment benefits and disability pay insulated the unemployed from pressure to search for work. These factors combined to render Europe’s labor markets less flexible. And the recipients of governments’ largess soon became formidable opponents to those who sought reform.

There is a sense, in other words, in which the continent’s subsequent difficulties were created or at least significantly aggravated by these efforts to use the welfare state to reinforce the social contract. Public employment soared as governments expanded public-sector payrolls in response to rising unemployment. Tax rates and public debts soared as governments sought to finance the consequent wage bill and to expand solidaristic social transfers.

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16 For an analysis along these lines, see Esping-Andersen (1990, ch. 7).

17 Nonwage costs as a share of total labor costs rose between 1965 and 1975 in each of the nine countries considered by Flanagan, Soskice and Ulman (1983).
IV. More National Variations

Once again, our broad brush has painted over important national variations. In countries where the institutional capacity for wage self-restraint was limited, especially the UK and Italy, governments sought to centralize wage bargaining and induce restraint through accommodating monetary and fiscal policies. Thus, the “social contract” between unions and the British Labour Party created the basis for a series of reforms -- including legislation to improve union rights, increases in old-age pensions, food subsidies and rent control – that were expected to lead to social peace and wage restraint. Adding to the redistributive dimension of the policy, the TUC (the trade union confederation) pursued a solidaristic wage policy of equal wage increases for all groups. Likewise, in Italy the Center-Left government sought to trade a pension reform and industrial restructuring for wage moderation. The scala mobile was also strengthened, and in the inflationary context of the post oil shock, the egalitarian effects were very substantial.

By the end of the 1970s it was clear that the social pacts in Britain and Italy were far more effective in achieving their egalitarian objectives than in solving the collective action problems besieging the industrial relations systems. From the perspective of their beneficiaries, social reforms and solidaristic wage policies were collective goods, and they did not necessarily make unions more prone exercise restraint. By contrast, better paid workers in more secure labor market positions had an incentive to circumvent wage solidarism by asking for additional raises at the local level, and to oppose higher taxation. This contributed substantially to rising inflation and a growing balance of payment deficit, all while the government accumulated more and more debt (see Table 3). Despite flexible exchange rates, international competitiveness was jeopardized as indicated in Table 3 by the appreciation of the real effective exchange rate. By the end of the 1970s the experimentation with concertation had broken down in both Britain and Italy, setting the stage for a decade of neo-liberal reform and monetarism.

But inflationary pressures from egalitarian policies were also evident in some of the northern European countries where the institutional capacity for wage restraint was greater. Committed to solidaristic wage policies, and operating in a low growth environment, labor

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18 In 1976, Britain had to petition the International Monetary Fund to help it deal with its balance of payment crisis.
confederations found it difficult to offer nominal wage restraint at a level that was consistent with price stability. The problem was aggravated by changes in technology that made many employers eager to pay trained workers higher wages, thereby setting off wage drift and compensatory demands from lower-paid groups. Yet in order to understand the broader macroeconomic implications of this problem, we have to also consider the monetary policy response of the government.

In countries such as Belgium, Denmark, and the Netherlands where centralization of bargaining was high, but exchange rate policies relatively restrictive and constrained by participation in the European currency arrangements, somewhat better inflation performance came at the expense of a deteriorating real exchange rate (see Table 3). The incapacity to combine centralized and solidaristic wage bargaining with low nominal wage increases undermined international competitiveness and resulted in a rise in employment. In Finland, Norway, and Sweden this problem was dealt with by adopting more flexible exchange rate policies, permitting occasional devaluations coupled with negotiated wage restraint. At least temporarily this form of centralized accommodation therefore helped to preserve low levels of unemployment. But as other countries embarked on deflationary policies in the 1980s, in the context of increasingly integrated financial markets, the policy was harder to sustain. Only in countries such as Austria, Germany, and Switzerland, where wage bargaining was less centralized yet highly coordinated, was it possible to combine real wage adjustment with low inflation. At least partly for this reason, bargaining institutions and economic policies in these countries appeared more resilient to change than in the rest of Europe.

Another important source of divergence was the government’s response to the loss of employment in industry and agriculture. Between 1965 and 1990 about 9 million jobs were lost in the European manufacturing sector, and an equal number in agriculture, amounting to more than 21 percent of the (growing) labor force.19 Ironically, the main reason for this loss was rapid productivity gains in manufacturing, which was made possible precisely by the success of the

19 Based on OECD data for Austria, Belgium, Denmark, Finland, France, Germany, Italy, Netherlands, Norway, Sweden, Switzerland, and United Kingdom.
Rowthorn and Ramaswamy (1998) provide a comprehensive analysis of the causes of deindustrialization and show that productivity growth was by far the most important factor. Of course, many new jobs were simultaneously created in private services, but in many countries these jobs were insufficient to offset the losses in manufacturing and agriculture; a problem that was aggravated by increased labor force participation among women. For governments committed to full employment the response was substantially to increase the number of public employees. As shown in the right panel of Figure 2, Scandinavian governments managed in this way to not only compensate for sluggish private service employment growth, but also to absorb a substantial number of women entering into the labor market (as implied by the difference between employment gains in services and losses in the traditional sectors). In other European countries, however, notably Germany and the Netherlands, the growth in public sector jobs was too small to compensate for those lost in agriculture and manufacturing.

Figure 2 also shows that the relative success in creating employment in private services was related to the level of wage equality. This trade-off between jobs and equality was clearly a new and troublesome development. The postwar model had been based on the assumption that wage compression would facilitate job creation in the most dynamic sectors of the economy, matching or even outpacing those lost in the least dynamic sectors. This assumption was reasonably satisfied in the expanding industrial economy, but since the mid-1960s the bulk of new jobs had come in services where productivity growth was sluggish. Particularly in those services using low-skilled labor intensely, high and rising wages at the bottom reduced the rate at which new jobs could be created. Thus it is only in three non-European OECD countries, Canada, Japan, and the US, with above average wage inequality that job creation in private services outpaced job destruction in manufacturing and agriculture.

Underpinning this trade-off was a deeper institutional problem that struck at the heart of the postwar model. As illustrated in the left panel of Figure 2, the centralization of the wage bargaining system was closely linked to wage compression. To overcome collective action problems, centralized bargaining institutions had been constructed to ensure that wages in all sectors would move in tandem, and that distributive conflict would be reduced through

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Rowthorn and Ramaswamy (1998) provide a comprehensive analysis of the causes of deindustrialization and show that productivity growth was by far the most important factor.
solidaristic wage policies. This worked well in an industrializing economy with massive productivity gains in the sectors with the greatest hiring needs, but in the context of deindustrialization centralized bargaining linked to productivity performance in the exposed sector did not necessarily produce overall wage restraint. Equally important, while wage solidarity was designed to overcome one type of distributive conflict it now created new and equally troublesome ones. In Scandinavia, where public sector expansion was used as a remedy to the employment problem, divisions developed between the private and public sectors over the coordination of wages and level of taxation. In the Germanic countries, where the government refused to raise public employment, the tension was between insiders unwilling to give up high
wages and job security, and outsiders unable to price themselves into employment.  

V. Decentralization and Reform

By the 1980s, then, it was clear that the postwar growth model urgently required updating. Public debts had exploded, rising to more than 100 per cent of GDP in Belgium and Ireland and approaching that level in Italy, in all these countries raising troubling questions of sustainability (see Table 3). Unemployment rates, having shot up, showed no sign of coming down, for their part creating worries about social stability (Table 4).

Greater labor-market decentralization was the obvious cure to these ills. By allowing wage differentials to develop, it promised to accommodate the industrial demand for skilled labor consequent on the spread of new post-Fordist technologies and to stimulate service-sector employment growth. Employment growth in turn promised to boost payroll tax revenues and cut government outlays on unemployment compensation and disability payments, helping to solve the fiscal problem. Not surprisingly, therefore, the pressure for decentralization and flexibilization of wages was greatest in countries where centralization has historically been the highest, and not surprisingly decentralization came first in those countries most committed to price and exchange rate stability, and featuring internationally integrated capital markets. Belgium and the Netherlands shifted to industry-based bargaining systems in the 1970s, followed by Denmark in the 1980s and Sweden in the 1990s.

But greater labor-market decentralization could work only if governments also succeeded in putting in place a range of supportive institutional arrangements. For one thing, new monetary institutions had to be installed. Where centralized bargaining and continuous consultation between the peak associations and government could no longer be relied upon for wage restraint, it became necessary to anchor inflationary expectations — to signal the unions that monetary policy would be non-accommodating, implying that excessive wage demands would mean additional unemployment and not just inflation — by adopting an exchange-rate commitment and

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21 For a more thorough analysis of new distributive divisions, see Esping-Andersen (1999).
generally speaking, the exchange-rate commitment came first, in the 1980s, while the central-bank independence followed only in the 1990s, but the two developments were part of the same larger process. In addition, a credible commitment to exchange-rate stabilization and monetary non-accommodation presupposed a solution to the fiscal problem; otherwise, central banks might come under irresistible pressure to inflate as a way of rescuing governments from their debt difficulties. Pegging the exchange rate would only bring down interest rates toward German level, and thereby reducing debt-service costs, if fiscal excesses were also eliminated. But this had to be done in a way that did not fray the social safety net so badly as to create insurmountable resistance to the policies designed to deliver greater labor market flexibility, or to undermine the insurance aspects of spending which were important in encouraging workers to invest in non-general skills. The only European example of a radically confrontational strategy designed to undermine the power of the unions is Britain, and here it was made possible only by a majoritarian political system with a divided opposition.

While each country had to solve these problems in its own way, the European Monetary System, the Single Market and the Maastricht Treaty contributed to the process. Obviously, no discussion of the institutions of economic governance in the second half of the 20th century can reasonably omit mention of European integration. To be sure, European integration has been a complex — even contradictory — process. For some it has been a way of introducing the chill winds of competition into the European economy and intensifying the pressure to deregulate and eliminate the excesses of the welfare state, while for others it has been designed to halt the race to the bottom and to create an alternative to cutthroat competition. Be that as it may, the integration process has clearly supported labor market decentralization. By eliminating capital controls and making realignments more difficult, the Single Market solidified the exchange-rate commitment and the credibility of the non-accommodating monetary policies needed to restrain wage demands in more decentralized labor markets. By making central bank independence and fiscal retrenchment conditions for qualifying for monetary union, the Maastricht Treaty reinforced the

\(^{22}\) This argument is developed more fully in Soskice and Iversen (forthcoming).
credibility of that macro-policy stance. And the advent of monetary union itself, which hands over the reins of monetary policy to a European Central Bank with unparalleled independence and an unprecedentedly narrow mandate, has removed any residual doubts about the new orientation of monetary policy.

VI. Adaptation and Political Will

The success stories of the 1980s and 1990s have received much attention. Denmark eliminated unsustainable deficits and at the same time ignited rapid economic growth. The Netherlands reformed its welfare state and dramatically reduced the rate of unemployment. Sweden and (to a lesser extent) Germany decentralized wage bargaining, although dramatic improvements in economic performance have yet to materialize. We will now consider these experiences in more detail. But the unspoken question that lurks behind them is how these countries developed the political will to overcome resistance to greater labor-market decentralization, and why the same has not been uniformly true elsewhere in Europe.

In Denmark, bargaining was significantly decentralized starting in 1981 in response — revealingly — to pressure from engineering firms and skilled workers. Peak-level bargaining was superseded by negotiations between sectoral associations and their union counterparts. Ancillary reforms were pushed through by a center-right coalition government that came to power in 1982. Capital markets were liberalized, requiring the krone to be more firmly pegged to the Deutschmark, which helped to reconcile greater-labor market decentralization with wage moderation. The budget deficit was eliminated, reinforcing the authorities’ anti-inflationary credibility; the turnaround in the full-employment primary budget amounted to 10 per cent of GDP, of which 3 per cent was accounted for by reduced government consumption and the bulk of the rest by increases in taxes (net of transfers). While consumption grew rapidly in the aftermath of these policy innovations, driven in large measure by massive wealth gains in securities and one-family houses, the most impressive response was the investment boom: business investment rose

at an average annual rate of 13 per cent between 1983 and 1986.\(^{24}\) That so much of the response took the form of investment plausibly reflects the attractions of a more decentralized and flexible labor market.

The Netherlands is a broadly similar story. There, authority over wage setting shifted gradually starting in the early 1980s from peak to industry and local levels, although the government and national unions continued to play a role. Labor market reforms, which were endorsed by the main unions, deregulated many aspects of the employment relationship and resulted in a very substantial rise in part-time and temporary jobs. These jobs often do not carry the same benefits and protection as full time employment, and the dispersion of wages and earnings have increased significantly. Greater labor-market decentralization and wage dispersion was reconciled with the need for continued wage restraint by fiscal consolidation, made possible in part by the elimination of excessively expensive unemployment, disability and early retirement support, and by the country’s early and firm commitment to the European Monetary System (and, in the 1990s, to the EMU process). The result has been a halving of Dutch unemployment and, in the 1990s, relatively robust economic growth.

In Sweden, in contrast, there was a significant lag between labor market decentralization and the adoption of complementary macroeconomic policies. Metal-workers and their employers -- again the obvious opponents of wage compression -- began to negotiate separate agreements in 1983, and other sectors followed. A significant increase in wage dispersion soon became evident. But notwithstanding the government’s continued efforts to orchestrate these negotiations and moderate the rate of wage increase, there was a tendency as the labor market became more decentralized for wage restraint to break down — for sectoral unions to “leapfrog” one another. The Riksbank’s traditional policy of accommodating negotiated wage increases did not deter this behavior -- to the contrary. A first attempt to institute a hard currency policy, by linking the exchange rate to the EMS, lacked credibility owing to Sweden’s high unemployment, large budget deficit, and weak banking system and came apart in the European currency crisis of 1992. A second attempt, initiated once Sweden had put its banking crisis behind it, was more successful.

\(^{24}\)For details, see Giavazzi and Pagano (1990).
The authorities cut the budget deficit, strengthened the independence of the central bank, and authorized it to adopt an explicit policy of inflation targeting.

Austria and Germany offer another interesting duo of paired case studies. In Austria the process determining the distribution of wage increases was decentralized even earlier. Negotiations determining the distribution of wage increases never became as centralized as in other small European countries, although some coordination of plant- and sectoral-level negotiations was carried out by the Trade Union Federation. While exceptional wage increases for particular groups of employees still had to be approved by the Parity Commission (representatives of the Trade Union Federation, the Chambers of Agriculture, Commerce and Labor, and the government), this was regularly authorized on grounds of strong demand or short supply. Evidence of rising wage dispersion over time suggests that even this modest efforts at labor-market-wide coordination have come to exercise less influence over time.\(^{25}\) Wage dispersion in Austria is now strikingly high, as high as in the United States by some measures.\(^{26}\) But Austria’s close economic ties to Germany meant that its monetary policy was closely keyed to that of the Bundesbank from that same early stage, avoiding any erosion of wage and budgetary restraint.

In Germany, union resistance to decentralization was stronger. Reunification led the 16 sectoral unions, seeking to prevent the emergence of a low-wage Mezzogiorno in the east, to push for the incorporation of workers in the five new \textit{länder} into their national wage rounds. Limited wage differentials between east and west were permitted, but with these expectation that these would be closed in a few years. However, the reality of low relative labor productivity in the former German Democratic Republic translated this policy into very high rates of unemployment in the east. Under the pressure of this unemployment, workers and employers developed a variety of ways of circumventing national agreements. But the problems in the German economy have also been manifested by a lack of wage restraint in the west, and this must be understood in part by a breakdown of macroeconomic coordination. Thus, unification was


\(^{26}\) OECD (1996), Figure ??
followed by a politically popular, economically unsustainable, fiscal expansion that prompted the Bundesbank to drive up interest rates and causing unemployment to rise. By adopting an unsustainable fiscal stance the government in effect jeopardized the virtuous interplay between wage and monetary policies, thereby decoupling unions’ wage demands from economic outcomes. The experience underscores the importance of having a macroeconomic regime that supports the smooth functioning of the wage bargaining system.

An essential question that we alluded to above is what makes some governments seemingly do “the right thing” while other do not. We do not believe that this question has been satisfactorily answered in the literature. Although there is some evidence that fragmentation of government power is linked to deficit spending and debt accumulation, two of the most successful cases of reform in the 1980s, Denmark and the Netherlands, were governed by multiparty minority governments.\(^{27}\) Conversely, one of the worst failures of macroeconomic management in the 1970s, Britain, epitomizes the majoritarian form of government. Another institutional variable that is often highlighted as conducive to responsible government policies, federalism, does little to account for the contrasting experiences of Austria and Germany or the similarities in between British and US economic policies during the 1980s.\(^{28}\) Like theories of government “capture” these arguments also have difficulties accounting for the timing of difficulties.\(^{29}\)

We believe that a potentially fruitful approach is to allow for the existence of multiple equilibria between economic policies and labor market institutions, and then model changes from one equilibrium to another as a political contest between governments and organized interests with opposing institutional preferences. In the context of uncertainty, different actors can have incompatible expectations about their ability to secure a preferred outcome, and this sometimes can lead to a “war of attrition,” where agents are producing economically inefficient outcomes.\(^{30}\)

\(^{27}\) See, for example, Alesina and Perotti (1995).

\(^{28}\) For an often cited statement on the role of federalism for economic performance, see Weingast (1995).

\(^{29}\) See Eichengreen (1996).

\(^{30}\) See Alesina and Drazen (1991) for an example of how to model this logic.
One may think of this as a coordination game where the ability credibly to commit to a course of action is an essential, but not directly observable, resource that can produce common knowledge about a particular outcome. Indeed it may be the case that commitment “technologies” have become more important for government policies as the party system has fragmented and competition for swing voters has increased.

Applying this logic, if we broadly think of the 1980s as a shift from a “Keynesian centralization” equilibrium to a “monetarist decentralization” equilibrium, implying both changes in government policies and in wage bargaining institutions, it is not hard to imagine that this transition took different forms in different countries depending on the relative strength of actors with conflicting preferences. Entrenched interests seeking to preserve existing institutions and policies may have deterred some governments from adopting the necessary reforms. Belgium may be a case in point. In other cases the government may have genuinely believed that it could rekindle the postwar compromise, and breathe new life into old institutions. Sweden during the 1980s fit this scenario, with a government committed to full employment and organized interests in the export sector committed to decentralization.

VII. Conclusions and Implications

In this paper we have provided a bird’s-eye view of European economic growth in the second half of the 20th century, using labor-market governance as our perch. We have emphasized the importance of institutional arrangements -- in particular, arrangements affecting labor markets, although the point is more general -- for the operation of a market economy. Europe in the aftermath of World War II illustrates the point. Postwar economic growth was based on what we have referred to as Fordist technologies. To grow, European manufacturing merely had to import technologies of mass production from the United States and to apply to them substantial inputs of capital and semi-skilled labor. The institutions of solidaristic wage bargaining developed after World War II were ideally suited to these tasks. They eased potentially divisive distributive conflict and delivered wage moderation, which in turn supported high investment. The wage compression that was a corollary of their operation was of little practical consequence for production so long as the dominant industrial technologies remained
such that European firms relied on a relatively homogenous labor force.

But as the backlog of technologies was exhausted and developing countries emerged as new competitors in many of Europe’s old industries, Fordist mass production inevitably gave way to diversified quality production which relied more on highly-skilled workers and less on brute-force inputs of capital and labor. Increasingly the centralization of bargaining and the compression of wages became obstacles rather than aids to growth. Downward pressure on the relative wages of highly-trained workers made it difficult for manufacturing firms to attract and retain the skilled labor they required, while upward pressure on the wages of the less skilled gave rise to widespread unemployment. The employment problems were exacerbated by the difficulty of generating a sufficient number of jobs in low-skilled and labor-intensive services where productivity growth lagged that of manufacturing. In response, European labor relations shifted in the direction of greater decentralization, but only haltingly and in the face of considerable political resistance.

If our first message, then, is the importance of institutions, our second is the need for institutional adaptation to the changing context for economic growth. Assuming as we do that growth will rely even more heavily in the future than in the past on rapidly-changing, science-based, skilled-labor-intensive technologies, Europe to compete will have to continue to move in the direction of greater labor-market decentralization, albeit only to a point where the gains in flexibility are not outweighed by an exacerbation of collective action problems. For a non-accommodating macroeconomic strategy to be successful in the context of strong unions, some measure of coordination in wage-setting is required. Yet, to capitalize fully on new technologies and changes in the types of labor they require, Europe will have to accept wider and more variable wage differentials. Whether its polities can accommodate these demands, given their egalitarian norms and communitarian values, will help to determine whether Europe is able to capitalize on the technological opportunities of the 21st century and re-establish a full employment economy.
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