How Many Varieties of Capitalism? Structural Reform and Inequality in Western Europe

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Introduction

Both scholarly and public debate over the future of West European welfare capitalism has tended to posit a simple choice between, on the one hand, Anglo-American style liberal market economies with small welfare states, and a continental European 'social model', in which markets are more constrained by state intervention and welfare provisions are generous (for instance Albert 1993, Hall and Soskice 2001). According to this schema, Western Europe has to choose between a coordinated and a liberal market economy, trading off the benefits and costs of these two models. The notion that one can obtain the 'best of both worlds' is implicitly rejected.

This dichotomous representation of the state-economy relationship builds on a long tradition, and finds its most recent expression in the much-cited Hall and Soskice project. However, the political economy and social policy literatures have also provided more nuanced categorizations of the institutional arrangements of modern capitalism (Esping-Andersen 1990, Garrett 1998, Kitschelt et al 1999, Schmidt 2002), and even a range of quite idiosyncratic national models, suggesting a wide range of possible combinations of economic institutions. However, the problem with more nuanced approaches is that what is gained in empirical nuance may be lost in analytic leverage. The more attention is paid to institutional specificities, the more difficult it becomes to establish any generalizable conclusions about the choices facing advanced political economies.

This paper seeks a middle way between the dichotomous approach and the more nuanced but less analytic accounts of advanced capitalism. Building on the suggestive empirical findings of Hicks and Kenworthy (2003), it suggests that advanced industrial nations can be usefully analyzed in terms of a simple two-dimensional matrix which points to four possible answers to the 'liberal-social' dilemma. Advanced industrial economies are assessed in terms of both their welfare effort (social outlays and income inequality) and their economic liberalism (microeconomic flexibility, degree of structural reform, and macroeconomic orthodoxy). The data show that there is no simple trade-off between liberalism and equality, and that different degrees of state intervention in the productive economy can co-exist with both high and low levels of welfare effort, and with varying degrees of success in combating inequality. This suggests that advanced industrial democracies are indeed constrained in their ability to fight inequality, but that the implications of institutional variation for social cohesion may differ from the conventional ‘liberalization -> inequality’ equation. This point is illustrated by short accounts of the ways in which three different examples of Western European welfare capitalism have responded to the pressure for reform.

Varieties of Capitalism, Worlds of Welfare and Policy Choice

Globalisation and the Welfare State

Recent work in comparative political economy has brought a much needed correction to some of the more sweeping claims about the sustainability of welfare states that characterized the debate in the early to mid-1990s. Many early contributions to this debate predicted dire consequences for welfare institutions as the internationalization of capital flows and the dismantling of trade barriers unleashed a ‘race to the bottom’ among Europe’s complacent and inflexible welfare states[1]. Social policies such as welfare entitlements, publicly funded services, and employment protection legislation would have to be rolled back if Western Europe was to ‘compete’ in the new global economy[2]. Such claims have been revealed to be over-blown however, and careful analyses of the realities of policy change under globalization depict a variety of responses dictated, in large part, by the different institutional arrangements governing politics and the economy in the advanced democracies[3].

Contrary to the convergence hypothesis, institutional constraints on welfare retrenchment appear decisive in determining the extent to which governments respond to globalization by cutting back social protection (see Kitschelt *et al* 1999, Pierson 2001). Countries with majoritarian electoral systems, decentralized wage bargaining, federal arrangements and limited welfare states have tended to reduce social provision, while those with inclusive electoral institutions, centralized wage bargaining, unitary structures, and more encompassing welfare institutions have tended not to (Swank 2002). In other words, the countries that have cut back social protection in recent years have for the most part been those that had less generous welfare arrangements in the first place. As such, globalization has not simply forced the abandonment of anti-inequality strategies in many countries in a race to the bottom.

Similarly, extensive research on wage bargaining has demonstrated that both decentralized and centralized labour market institutions can contribute to economic efficiency, although ‘intermediate’ models are likely to be penalized by globalization (Garrett 1998, Golden, Wallerstein and Lange 1999, Iverson 1999). Centralized wage bargaining can keep income inequality low without sacrificing economic performance. Other research stresses the complex interactions between institutions, interests and exogenous constraints, concluding that institutional divergence has actually increased in recent decades, in spite of, and in some ways because of, globalizing pressures (Franzese 2002). Finally, it has also been persuasively argued that many of the imperatives attributed to globalization are actually the result of other pressures, such as demographic and technological changes, and the shift in advanced democracies from a manufacturing-oriented economy to a services-oriented economy (Glyn 1998, Iverson 2001). In sum, dealing with these pressures does not have to mean the abandonment of attempts to maintain social cohesion (Esping-Andersen *et al* 2002).

Much of this work implicitly or explicitly draws on longstanding models or types of advanced welfare capitalism in order to make sense of the variety of responses to the problem of globalization and inequality. Most prominently, Hall and Soskice and their collaborators see these responses reflecting two broad types of institutional arrangements in advanced industrialized capitalism: liberal market economies (LMEs) and coordinated market economies (CMEs) (Hall and Soskice 2001). In LMEs markets and the price mechanism regulate most economic activity, whereas in CMEs markets coexist with various kinds of coordination and cooperation between economic actors. The crux of the ‘varieties of capitalism’ argument is that neither model is inherently more economically efficient, and both can harness their respective institutional comparative advantages to good effect in the unforgiving global economy. However, Hall and Soskice note that the coordinated market economy, with strong labour market institutions and generally more generous social provision, implies much lower levels of income inequality than is tolerated in the liberal market model.

This school of thought has emerged as a powerful counter to the convergence theorists’ insistence that social goals will have to be sacrificed if advanced industrial democracies are to adapt successfully to globalization[4]. These critiques of the ‘globalization as convergence’ thesis offer some reassurance and encouragement for supporters of Western

European welfare states. However, in the public debate, the welfare state remains under heavy pressure. Part of the reason is the poor economic performance of the largest CMEs - Germany, France and Italy - over the past decade. These countries' slow growth contrasts with the relatively stronger growth of Western Europe's LMEs.[5] International economic institutions and the financial press frequently draw on comparisons of ideal-typical LMEs (the US and UK) and CMEs (usually Germany) to argue the case for the increased marketization of economic and social life.

This discourse, however, rests on a potentially misleading dichotomization of economic models. Although there is relatively little controversy over membership of the market-friendly group of English-speaking democracies, the 'social Europe' alternative is more diverse. In much of the policy debate, the non-English speaking advanced industrial countries tend to be lumped together as market-averse welfare states, with sluggish growth and high unemployment brought about by well-meaning but wrongheaded systems of social protection. Sweden's generous social benefits, Italy's state pension liabilities, Germany's restricted shopping hours, and France's insistence on 'national champions' are mixed together in the same Eurosclerotic bag. This 'continental corporatist' model is then contrasted with the 'Anglo-American' market-based model: a 'capitalist culture-clash' in which the latter is usually tipped as the winner.[6]

Much of the debate surrounding globalization and structural reform has revolved around this choice, with proponents of structural reform arguing that the European social model is unsustainable, and many on the left denying the need for any fundamental reform. Given continental Europe's recent poor economic record, framing the debate in such terms places supporters of the welfare state in an unpromising position. However, this dichotomy conflates the degree of liberalization of economies with their approach to tackling inequalities, which are two analytically separate issues. The following account suggests the choice is far less stark than the rhetoric might suggest.

Variation Within Varieties: LMEs, CMEs and Structural Reform

The distinction made by the 'varieties of capitalism' school between liberal market capitalism and coordinated market capitalism lumps together political economies that other typologies have perhaps more usefully separated out. For instance the CME group contains countries that Esping-Andersen divided into social democratic and conservative/Christian democratic welfare state types, whilst more recently Schmidt has revived a further distinction, between 'statist' and 'managed' CMEs (Esping-Andersen 1990, Schmidt 2002). Of course, any comparative effort will tend to elide some differences whilst emphasizing others, and the LME/CME dichotomy does indeed capture important features of the economic dilemmas facing advanced industrial democracies. However there are patterns of differentiation within the CME group which have important implications for the range of policy choices available to combat inequality.

Analyses of what is broadly termed 'structural reform' – the adoption of supply-side measures that favour investment and enhance the efficiency of markets – suggests a wide range of responses within the group of CMEs. Table One shows a 'league table' of structural reform recently produced by Lehman Brothers (Llewellyn *et al* 2003). Predictably, the Anglo-Saxon liberal political economies come out on top of this ranking, which measures country performance on a range of variables tapping the efficiency of labour, financial and product markets and the quality of education and technological development. What is less obvious is that the high-spending social democratic welfare states of Northern Europe come close behind, with Sweden out-scoring Ireland. The conservative/Christian democratic welfare states perform poorly in this ranking, with the Southernmost European countries faring worst.

(Table One About Here)

(Figure One About Here)

This ranking suggests that openness to structural reform does not correspond neatly to standard understandings of the role of state intervention in the economy. Figure One, which looks at structural reform and public sector size, illustrates this point quite clearly. LMEs such as the United Kingdom and Ireland are to be found, predictably, in the bottom right quadrant combining a good record on structural reform and a low level of government spending. However, the CMEs spread over a wide area, with Italy combining a relatively high level of spending with little structural reform, and Denmark and Sweden combining even higher government spending with significant structural reform. In short, the LME/CME distinction does not seem to tap the ability of advanced industrial economies to adopt market-friendly reforms. Some CMEs succeed and others fail, irrespectively of the size of their public sectors. In fact, there is surprisingly little correspondence between the degree of market-friendliness of economic institutions and the extent to which governments intervene to tackle inequalities (see Esping-Andersen 1999, Esping-Andersen *et al* 2002). Northern European social democracies, such as Sweden and Denmark, have more extensive welfare arrangements and lower levels of social inequality than both the LMEs (the UK and Ireland) and the other CMEs. The next section will take a closer look at the data in order to make sense of these variations.

Worlds of Welfare and Structural Reform: Does Liberalization Mean the End of Equality?

Esping-Andersen's 'three worlds of welfare' and Hall and Soskice's distinction between LMEs and CMEs dominate scholarly discussion of the dilemmas of welfare capitalism. However, the way these typologies have been employed have tended to oversimplify the range of choices available to national governments. Hall and Soskice's work, as we have seen, somewhat elides important variations in institutional arrangements amongst CMEs. Esping-Andersen's work, on the other hand, has tended to be interpreted in terms of a 'league table' of welfare state development, with social democracies having the best record in achieving social equality and decommodification, liberal welfare states having the poorest, and Christian democracies being placed somewhere in between. However, viewing this typology as a ranking is misleading since it does not correspond to political economies' ability to adapt to changing world economic conditions. Instead, as we shall see below, the best and worst performers in terms of inequality have proved equally adaptable to the pressures of globalization and marketization, whilst the middle-ranking Christian democratic welfare states have faced most difficulties.

Moreover, both of these typologies tend to adopt a linear understanding of variation which does not seem to capture the range of outcomes that can actually be observed. Recent research has sought to move beyond this. Edwards (2003) uses cluster analysis to generate distinct welfare state groupings on the basis of Esping-Andersen's data, and finds a partial confirmation of the ‘three worlds’ typology, with some data to suggest a ‘fourth’ world amongst Southern European states (also Ferrera 1998). Hicks and Kenworthy (2003) use principal components analysis to tease out the different dimensions along which welfare regimes can be distinguished, finding two orthogonal factors: one which they call ‘Socialist-Liberal’ which taps the extent to which welfare entitlements are universalistic and favourable to female labour force participation as opposed to means-tested and of limited scope; another they call ‘conservative’, which taps the extent to which welfare benefits are occupationally based and reflective of status differentials. One of the most interesting findings in their work is that, rather than two different ‘types’, social democratic and liberal welfare states seem to be opposite ends of a single dimension, whilst there to be found at the same end of the second ‘conservatism’ dimension. This finding helps make sense of the otherwise perhaps counterintuitive point we made above, that both of these ostensibly radically different welfare regime types have adapted equally quickly and in similar ways to global economic change, leaving the conservative/Christian democratic regimes behind.

Hicks and Kenworthy’s insight, based solely on variables relating to welfare provision, can be taken further with the help of a range newly available data on the regulation of economic activity produced by international institutions such as the World Bank and OECD, as well as economically liberal think tanks such as the Fraser Institute. These data provide a number of measures of the extent to which advanced industrial states intervene in markets by regulating, channeling and constraining economic activity. The previous section suggested that apparently liberal policies can coexist with extensive welfare arrangements which curb inequalities. We therefore subjected indicators of welfare effort, and indicators of economic regulation, to closer scrutiny to examine the ways in which they interact. A principal components analysis was carried out on a range of variables tapping economic liberalism and statism (see appendix). This analysis yielded a regression factor score which we deployed as an ‘index’ of economic liberalism/statism (see Figure Two).

The index resembles the picture found in the Lehman Brothers ‘structural reform’ rankings. Whilst it is no surprise to find the UK well ahead in terms of the degree to which it has deregulated its economy, it is noteworthy that Denmark, the Netherlands and Finland are all placed towards the ‘economically liberal’ end of the spectrum, whilst Sweden is also in the liberal half. At the other end of the scale, the Catholic/Orthodox

European countries have scores reflecting ‘economically illiberal’ or ‘statist’ institutions. These results show that the dimension Hicks and Kenworthy identified in welfare institutions extends to much broader institutional arrangements of the political economy. In short, in English-speaking Europe and in the small Northernmost states of Europe (with the exception of oil-rich Norway), business activity is mostly lightly regulated, with the state interfering relatively little in the economic decision-making of private actors.

(Figure Two About Here)

It is worth taking a look at the disaggregated data to get a feel for what this means in practice. Analysis of financial markets, product markets, business conditions, and labour markets confirms that in many policy areas the CME group is divided between ‘liberal’ and ‘statist’ political economies, with the former often more similar to the LMEs than to the latter. For example, as Figure Three below shows, standard measures of financial market liberalization group some of the highest spending welfare states (the Northern European social democracies) close to the finance-friendly UK, whilst the conservative/Christian democratic welfare states tend to cluster towards the bottom of the scale.

(Figure Three About Here)

A similar picture emerges regarding product market regulation and business conditions. In Figure Four, the UK – the poster child of economic reform in Western Europe – fails to outperform the Northern European social democracies in providing a lightly regulated environment for business, with Finland and the Netherlands scoring higher for a broad measure of business conditions, while Denmark and Norway enjoy lower start-up barriers.

(Figure Four About Here)

Finally, even in the controversial area of labour market flexibility (Figure Five), there is a striking degree of variation amongst CMEs. Although the UK stands out here for its combination of low employment protection and decentralized wage bargaining, there are again some surprises. According to World Bank data, Denmark and Austria have less restrictive employment laws than the UK and Ireland, and Sweden is more or less tied with the LMEs.[7]

(Figure Five About Here)

What does this mean for inequality? There are a number of difficulties involved in drawing firm conclusions on this point. First, many of the liberalizing reforms measured in this data are relatively recent, and may bring about changes in levels of inequality which have not yet been detected in the available research. Thus, we could be seeing convergence but with an equality lag. Second, the strong impact of encompassing labour market institutions on inequality is well documented however (Wallerstein 1999). Countries lacking such institutions may find that liberalizing reforms have stronger effects on levels of inequality than on countries with such institutions. Third, inequality can have an independent causal effect on welfare arrangements; there is for instance some evidence that high levels of inequality make it less likely that income support programmes will be established (Moene and Wallerstein 2002). However, a preliminary look at the data does suggest at least that there is not a linear relationship between levels of inequality and the position of political economies on the 'liberalism-statism' spectrum.

(Figure Six About Here)

Figure Six plots European countries against their levels of income inequality (measured by Gini coefficients) and their position on the liberalism/statism spectrum. A curious pattern emerges from this analysis. The highest levels of inequality are found in the United Kingdom, the clearest example of an LME in Western Europe. However, the other examples of high inequality are to be found in LMEs such as Ireland and (with some qualifications) Switzerland, and in the 'statist' CMEs France, Italy and Spain (one would expect Portugal and Greece, for which inequality data are unavailable, to be located in a similar position). The remaining CMEs are to be found in the bottom left quadrant, combining low levels of inequality with relatively high scores for economic liberalism.

This suggests a three-fold typology which has some resemblance to Esping-Andersen's 'three worlds': a statist form of CME found in most of Catholic/Orthodox Europe with high inequality, a more liberal form of CME found mostly in Northern Europe which creates low inequality, and economically liberal LMEs with limited welfare and high inequality. Further understanding of these relationships requires a careful statistical treatment which is outside the scope of this paper. The next section simply provides brief accounts of the dilemmas facing, and the adaptations made, or not made, to globalizing pressures, by representative examples of each of the three 'types' identified above, followed by some tentative conclusions.

Three Worlds of Income Inequality: The Dilemma of Structural Reform

The (Still) Equitable Market Economy? The Scandinavian Social Democratic Model

Coming on the heels of a precipitous economic collapse in the early 1990s were real GDP declined by 5 percent between 1990 and 1993, and total unemployment (registered unemployed plus ALMP training places) reached 12 percent, the social democrats (SAP) returned to power in 1994. However, far from repudiating the 'market conforming' policy stances that may have in fact engendered the crisis of the period[8], the SAP sought to further structural reform in the areas of pensions, labor markets, and social welfare provision, while adhering to a market-conforming macroeconomic framework. The wheels, it seemed, were finally coming off the Swedish Welfare Wagon.

Weakened public finances led to reductions in public as well as private employment, and in response to such pressures, the government began a program of deregulation that eventually encompassed postal services, telecommunications, domestic aviation, electricity, and the rail network. Further microeconomic reforms, such as the 1993 competition law that restricted anti-competitive behavior, and incremental changes to labor market regulation to encourage flexibility and part-time work, were made throughout the decade.

Macroeconomically, the objective of price stability was enshrined as the number one goal of macro-economic policy, and the Riksbank acted throughout the decade as an autonomous guardian of the currency without regard to domestic economic conditions.

Similary, the state ‘shackled’ itself along neoliberal lines by adopting, in the 1996 state budget, a target of a two percent budget surplus to be achieved over the business cycle tied to a three year nominal expenditure ceiling (where overruns in one budget area must be met with reallocation of existing revenues). At the same time, marginal tax rates were slashed. The fact of these reforms suggests a profound transformation of the Swedish political economy, while the results of these reforms on Swedish business, and the overall marcoeconomy, have been dramatic.

From 1993 to 2000 “industrial production rose by about 60 percent, equivalent to annual growth of about seven percent.”[9] Similary, the services sector grew from 48 to 60 percent of the economy from 1990-2000, a significant part of which is growth in the IT sector where Sweden has emerged as world leader and investment hub for global business. Given this new pro-business environment, Sweden performs well in international comparison of enterprise demographics. Though enterprise birth rates are marginally higher in the UK than in Sweden, other large welfare states, such as Norway and Denmark, have higher enterprise birthrates than all other LMEs. Once established however, Swedish enterprises survival rates “are consistently higher than those recorded in other countries.”[10] In fact, the death rate of enterprises in LME’s such as the UK is almost double that of Sweden. Given this, it is hard to make the claim that such an environment is bad for business.

This picture is further enhanced by international comparison of labor productivity and unit labor costs. Looking at output per employed person in manufacturing, and taking 1992 as the baseline year (index value 100), LME’s such as the US and the UK racked up impressive gains in productivity (index values of 154.6 and 128.4 respectively). However, this same BLS time series shows Sweden having nearly doubled its labor productivity in constant dollar terms over the decade to an index value of 196.4.[11] Similarly, unit labor costs in manufacturing over the same period, again taking 1992 as the baseline, show that while the US and UK made some gains in reducing unit labor costs (from 100 to 74.8 and a from 100 to 99.4 respectively), Sweden’s unit labor costs plummeted by over fifty percent in real terms over the same decade (from 100 to 48.2).

Given these institutional, policy, and performance transformations, one must conclude that the Swedish model, and the equality associated with it has gone out the window. Yet this would be a mistake. First of all, as noted above, in comparison with LME's, Sweden's Gini coefficient has hardly moved in the past three decades. Whereas the US's Gini increased from 0.301 in 1979 to 0.368 in 2000, and in the UK the Gini moved from 0.270 in 1979 to 0.345 in 1999, Sweden's Gini went from 0.215 in 1975 to 0.252 in 2000; a smaller increase in inequality over a longer period of time from an already low baseline. In fact, Sweden today is still far more equal than the UK was thirty years ago.

Second, the picture of wholesale structural reform painted above is in fact much more complicated than the simple 'liberalization -> inequality' equation would allow. Reforms, as noted above, have certainly occurred. Indeed, in the core areas of welfare transfers, public pensions have put more emphasis on the link between contributions and benefits; private spending on pensions is up; hospitals can and have been privatized; a voucher system has been introduced into the secondary education system, and private school subsidies have been passed by the Riksdag. Yet having said all this, it is less impressive than it sounds.

By 1995 only 1 in 10 local authorities had implemented an educational voucher system. Meanwhile, private school pupils accounted for only seven percent of the eligible school population.[12] On pensions and unemployment benefits, while changes were made to replacement rates, overall "the generosity of Swedish social security was on average the same in 1998 as in 1980."[13] In fact "the unemployment benefit was [even] more generous [than formerly]."[14] Spending on private health and retirement certainly has increased, as has means tested benefits, which implies more markets and less equality. However, this too is misleading since the proportion of the population covered by such benefits has actually increased, in large part due to immigration. As Lindbom argues, increased expenditure on social assistance is not the result of less universalism and more liberalism. Rather, it is the opposite case where benefits cover more people who need more assistance and who were not part of the older, narrower, regime.[15]

Furthermore, while taxes were cut in the early 1990's, they were raised again in the latter half of the decade when the regressive nature of the 1990 reforms became apparent.[16] Once Sweden recovered from the collapse of the early 1990s and began to run a surplus in 1998, as well as paying down the national debt, the government increased spending on child support and other benefits. As Prime Minister Persson said to the SAP Congress in Sundsvall the previous year “healthcare, social services and schooling come before tax cuts,”[17] and indeed they did, consistently.

In sum, while there has been structural transformation in the Swedish welfare state, it is simply not the case that such transformations are inevitably inequality increasing. Despite marketizing measures being implemented from early 1990s on, Sweden remains a social democracy with a large public sector, generous social benefits and public services, and low levels of inequality. As Steinmo puts it “The Swedish model (which comprises corporatist decision-making institutions, solidaristic wage policies, and perhaps even the ‘politics of compromise’) may well be dead. But the ambition and political support for a largely egalitarian polity with a very large welfare state and the taxes to support it live on quite healthily today.”[18] In sum, and contrary to expectations, marketization and liberalization, which undeniably has occurred in Sweden, does necessarily lead to greater inequality.

The Free Economy and Weak Society: The Anglo-Saxon Liberal Model

In contrast, the United Kingdom is the clearest example in Western Europe of a political economy that has embraced liberalizing structural reforms without managing to (or bothering to) cushion the effects of marketization on the social fabric. The Thatcher and Major governments of the 1980s and 1990s carried out important liberalizing reforms in financial, product and labour markets. In the financial sector, an already lightly regulated banking and investment industry was deregulated further, fuelling a significant expansion of financial services, which became the motor of the British economy. In product markets, reforms to the retail sector and the Thatcher governments’ enthusiastic championing of the European single market contributed to further liberalization. In labour markets, significant reforms had a direct and lasting effect on social cohesion. A series of legislative measures to undermine the position of trade unions, in combination with a rapid and extensive restructuring of the British industrial sector, skewed industrial relations in favor of employers and reduced the role of collective bargaining in the determination of wages. Reforms to the welfare system moved in a restrictive direction, reducing the real value of welfare benefits, limiting entitlement, and de-indexing the state pension system from inflation.

The consequences of these changes have been far-reaching. On the one hand, proponents of structural reform can point to the United Kingdom's comparatively good growth performance in the 1990s and early 2000s as evidence of the effectiveness of market-friendly liberalizing measures. In particular, the higher than average percentage of the active population in employment is often attributed to the increased labour market flexibility resulting from the Thatcher reforms. On the other hand, these changes have been accompanied by an extraordinarily rapid increase in income inequality. In 1979, the UK had a Gini coefficient of 0.27, lower than France and only slightly higher than Germany. By 1995 the UK Gini coefficient had reached 0.34, a level matched only by the United States and Italy amongst advanced industrialized nations.

Indeed, under the New Labor administration of Blair, the picture has actually worsened, despite the much lauded 'redistribution by stealth' and welfare reforms the party has undertaken. As Andrew Shephard puts it, "Since Labor came to power the Gini coefficient has increased once more… Income inequality over the past two years [2000-2002] has been higher than in any other period covered by our data [1979-2002]."[19] Secondly, Labour's tax increases, which have been largely concentrated on fuel, cigarettes, alcohol etc. are disproportionately paid for by the very people who are being redistributed to, which is probably why the government's own recent surveys of inequality find at best, "no consistent trend since the start of the 1990s" in income inequality.[20]

The United Kingdom therefore stands out particularly for the dramatic rate of increase in inequality, since both Italy and the United States had higher levels of inequality at the beginning of the data series. The UK also shows starkly the potential costs in terms of social inequality and cohesion of an aggressive and uncompromising approach to structural reform. Without the kinds of buffers to social inequality present in the Northern European CMEs, such as generous public services and pensions, social benefits with high replacement rates, and centralized wage bargaining, liberalizing reforms can cause a rapid deterioration of social cohesion. Despite the UK's relatively good recent performance in terms of employment and growth, its level of income inequality remains stubbornly high and exceptionally so by the standards of Western Europe. In sum, one can have market reforms that do indeed lead to greater inequality, but this tends to occur most in societies that were highly unequal to begin with.

Shackling the Economy Without Combating Inequality: The Catholic/Statist Model

The countries where the ‘statist’ model of heavy and often cumbersome regulation of financial, product and labour markets is strongest are France, Greece, Italy, Spain and Portugal (for an assessment of the effects of this type of regulation on employment see Esping-Andersen 1996). The Luxembourg Income Study data does not include Greece and Portugal, but the remaining three all have relatively high income inequality by Western European standards. Italy is the most extreme case in this regard. In terms of regulation, the Italian economy remains, despite some privatization and supply-side reforms since the early 1990s, very heavily constrained by legalistic state intervention.

In financial markets, Italy has a limited stock market and a highly fragmented and politicized banking sector, although the 1990s have seen a process of consolidation amongst the larger actors in the financial sector. In product markets, Italy has the most restrictive regulation of entry in Western Europe, with complex and bureaucratic procedures for starting new business (see Djankov *et al* 2002). A range of rules, regulations and backdoor protectionism restrict free competition in a range of sectors, including key areas affecting everyday life such as city-center retail, travel and transport, public utilities and housing, for example. Italy also retains a significant state presence in industrial production and services through state-owned or part-owned companies. These features make Italy one of the least ‘marketized’ economies in the advanced industrialized world.

This tradition of state interventionism, however, has made little contribution to addressing social inequalities. Indeed, after a deterioration of inequalities in the 1990s, Italy is second only to the UK in Europe. Part of the reason for this is the relatively restricted coverage of collective bargaining, in part because of the very large small and medium-sized business sector, and the large numbers of workers employed in the ‘underground’ economy. Another is the peculiar structure of welfare spending in Italy. In part, Italy reflects the patterns of welfare provision of Esping-Andersen's 'continental/corporatist' regime, with social insurance-based benefits heavily skewed towards tenured male workers and the retired, and very little income support for other groups. Status differentials are strongly maintained, and the resulting inequalities exacerbated by the clientelistic mechanisms through which welfare and retirement programmes have been developed in Italy. The outcome is that welfare spending is not very redistributive, and fails to provide much help to the most at-risk groups. Low levels of employment, and the general lack of available work in the South of Italy, also contribute to inequalities. Italy is the most dramatic case of the failings of the 'statist' model, and it has performed comparative poorly in terms of growth and employment even compared to the other 'statist' cases.

France, as another large mature industrialized economy, is the most similar case, and whilst it shares some of the same problems, its performance in terms both of macroeconomic indicators and in terms of inequalities has been better. The Southern European new democracies are in a different position, with lower levels of productivity but other lower wage costs, which have helped them to take advantage of the opportunities provided by the single European market and the dramatic monetary easing resulting from the entry into the single currency. However, all these economies to some extent share the problems of weak job growth and low overall levels of employment, patchy and excessively selective welfare provision, and regulatory measures which have the effect of shielding inefficient producers of goods and services from competition. In the Italian case in particular, statist policies and institutions appear to combine the 'worst of both worlds' by acting as a drag on economic growth whilst doing little to deal with social inequalities and poverty.

Conclusion

This paper has attempted to show two things…and tentatively suggest one more. First, and empirically, it has confirmed the finders of other scholars that that globalization does not necessarily create more problems for generous welfare states than for more limited welfare states. Instead, we have argued that significant market-conforming reforms can be undertaken in advanced political economies without necessarily giving up on equality. In order to demonstrate this we examined the degree of structural reform, financial liberalization, labor market flexibility, the regulation of entry, and the degree of legalistic intervention relative to existing levels of inequality in the set of European advanced industrial states. We found that, in contrast to much of the conventional wisdom, significant ‘business friendly’ structural (and other) reforms can be undertaken without surrendering equality. In fact, those states that were most unequal to begin with were precisely those that became comparatively *more unequal* under conditions of globalization. This applied for both LMEs, and what might be termed the Southern European or Mediterranean ‘variety of capitalism’. In contrast, the ‘most likely victim of globalization’, the Scandinavian welfare state, has shown itself to be quite adaptive and able to undertake a variety of reforms, that while changing the form of the model, do not (thus far) significantly alter its content. In sum, while there is a tendency in the literature to conflate liberalization and welfare state retrenchment, the two are distinct concepts, and distinct outcomes, which need to be measured separately. Inequality in not an inevitable price to be paid for growth in the global economy.

Second, and analytically, to the extent that typologies remain useful, we argue that the over picture of welfare state demography is still better captured by Esping-Andersen’s ‘three worlds of welfare capitalism’, in which LMEs (liberal welfare states) are contrasted with two kinds of CME: the Scandinavian social democratic welfare state, and a varient of the continental European Christian democratic welfare state. This outcome pertains since economic reform, often portrayed as a one-way street towards free market capitalism, is actually far more compatible with the institutions of the social democratic welfare state than is generally acknowledged. The Northern European social democracies have managed to combine market-friendly regulation of key areas of the economy with high levels of state spending, which permit generous welfare provision and public services[21]. As we have seen, despite significant reforms being undertaken in such states, the relatively good economic performance of this group of economies through the difficult period of the 1990s has not been achieved at the expense of social solidarity. Economic reform does seem to improve economic performance, but nations can choose whether or not to accompany a liberal market regime with a decommodificatory welfare state. One choice does not negate the other.

This analysis, we feel, has important lessons for Social Democratic parties in the rest of Western Europe. Social Democratic parties in Christian democratic welfare states can, in principle, liberalize their economies and maintain high standards of welfare provision, which should be good news to the politically paralyzed and hugely unpopular German SPD, for example. Similarly, Social Democratic parties in liberal welfare states such as the UK can aim to expand social provision without necessarily undermining the functioning of markets. Inequality need not remain 'the unmentionable word' – as Peter Hain found out - for Third Way politicians. Hopefully then, European Social Democrats can both defend left values and respond to the challenges of a changed economic situation without simply denying that change has taken place, or accepting wholesale the dogmas of anti-welfare liberals.

Notes

[1] This view has been adopted both by opponents and proponents of social democracy: for the former, Ohmae 1995, for the latter Scharpf 1991, 1997, Kitschelt 1994, Rhodes 1998, Stephens, Huber and Ray 1999.
[2] Often these arguments are built on a fundamental misunderstanding of the nature of international trade; see Krugman 1996.
[3] The literature emphasizing these institutional arrangements is often labelled the 'varieties of capitalism' approach, after Hall and Soskice 2001.
[4] For a recent example of the standard view on structural reform in Western democracies, see Llewellyn *et al* 2003.
[5] Ireland has posted the fastest growth in the EU, whilst the UK has outperformed the other large EU economies.
[6] See 'Britain and Europe: Business and Finance: Slump Intervenes in Capitalist Culture-Clash', *Financial Times*, 6 November 2002.
[7] Moreover, the well-documented efforts of the Northern European social democracies in the area of active labour market policies make an important contribution to allocative efficiency which is not reflected in this data.
[8] Those being badly timed credit market deregulation and tax reform plus and incredible currency peg.
[9] Swedish Institute, Fact Sheets on Sweden, FS 1 ab Qad (May 2001) p. 2
[10] Schror, p. 3.
[11] U.S. Department of Labor, Bureau of Labor Statistics, March 2004. http://www.bls.org. Accessed August 16th 2004.
[12] Svennsson p. 214
[13] Lindbom p. 178
[14] Ibid.
[15] Lindbom p. 182
[16] Steinmo p. 40
[17] Quoted in Keesings Record of World Events on line edition. http://keesings.gvpi.net/keesings/lpext.dll/KRWE/krwe-23594/krwe-24472/krwe-24706/krwe-24798/krwe-24799. Accessed August 17th 2004.

[18] Steinmo p. 42
[19] Shepard p. 4
[20] Lakin p. 2.
[21] Indeed, the World Economic Forum's 'Competitiveness Report' for 2004 found that Finland, Denmark and Sweden – all high-spending social democratic welfare states – were more 'competitive' than even the United States ('US Still More Competitive than EU', *Financial Times*, 27 April 2004, p.2.).

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Appendix

Principal Components Analysis:

Seven variables included. Extraction method: principal axis factoring. Factor scores method: regression. Full results available on request.

Variables:

Restrictiveness of Employment Law – data for 1997 generated by World Bank *Doing Business* project, cited from Botero *et al* 2003 which provides a full description. High scores imply more restrictive employment laws.

Regulation of Entry – data for 1999 generated by World Bank *Doing Business* project, cited from Djankov *et al* 2002 which provides a full description. High scores imply more regulation.

Government Enterprise – data for 2000 generated by Fraser Institute, (http://www.fraserinstitute.ca/). See Gwartney and Lawson *et al* 2001 (p.25) for a full description. Fraser Institute's index of government enterprises and investment as a percentage of GDP in 1999 (Area I, c). The Fraser Institute regards awards higher scores to countries with lower level of public ownership of enterprises and lower public investment. We invert the index so that high scores imply higher levels of intervention. Fraser Institute score inverted so that higher scores imply more state-controlled companies.

Liberal Financial Regulation - data for 2000 generated by Fraser Institute, (http://www.fraserinstitute.ca/). See Gwartney and Lawson *et al* 2001 for a full description. Higher scores imply more liberal financial sector regulation.

Industrial Relations Law - data for 1997 generated by World Bank *Doing Business* project, cited from Botero *et al* 2003 which provides a full description. High scores imply more requirements for business to consult with social actors.

Stock Market Capitalization – as a percentage of GDP for 2001. Data from World Bank www.worldbank.org

Freedom to Operate in Business - a Fraser Institute measure of the capacity of economic actors to conduct business without interference for the year 1999. Here we take the ‘Area VII’ scores which specifically measure ‘Freedom to Operate and Compete in Business’. Area VII includes administrative conditions and new businesses, time spent in dealing with government bureaucracy, the requirements involved in starting a new business, the extent of local competition, the magnitude of irregular payments to public officials and bank credit for business (for more detail on how these measures were gathered, see Gwartney and Lawson 2001: Ch.2). Countries where economic actors are deemed to be able to pursue business without interference have higher scores.

Other variables used in this paper:

Government Outlays – total government spending as a percentage of GDP for 2000, OECD Historical Statistics, www.oecd.org

Lehman Brothers Structural Reform Rating 2002 – scores given to countries for success in achieving liberalizing supply-side reforms and promoting high quality education and technological development. Cited in Llewellyn *et al* 2003, which also provides a full description.

2002).

Union Centralization Dataset – measure of coverage of collective bargaining as a percentage of the workforce for 1996. Cited in Golden, Wallerstein and Lange 1999, which also provides a full description of how the data was generated.

Income Inequality – household income inequality measured in terms of a Gini coefficient. Data generated from Luxembourg Income Study, a survey-based analysis of household incomes. See www.lisproject.org for full description.

Table One

Rankings from Lehman Structural Reform Database

1.United States	8.Ireland	15.Germany
2.Canada	9.Finland	16.Belgium
3.New Zealand	10.Netherlands	17.Spain
4.United Kingdom	11.Denmark	18.Austria
5.Australia	12.Japan	19.Portugal
6.Sweden	13.France	20.Italy
7.Switzerland	14.Norway	21.Greece

Source: Llewellyn *et al* 2003: 76.

Table Two

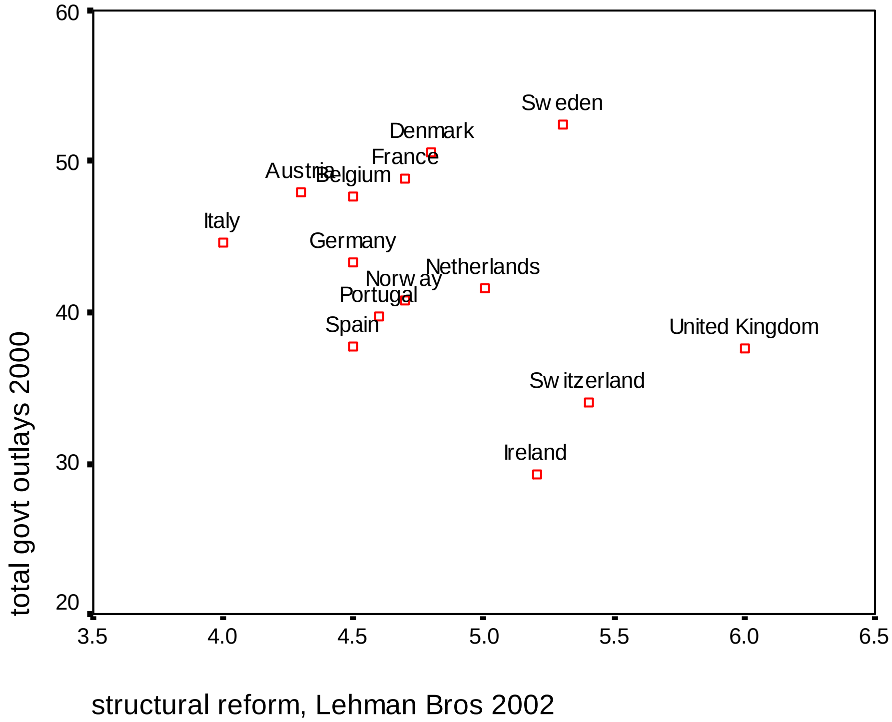
Indicators Used for Income Inequality and Economic Statism/Liberalism

Country	Econ.Statism /Liberalism Factor Score	Income Inequality (Gini c.)	Financial Sector Regulation	Regulation of Entry	Labour Law
Austria	.03874	0.27	8.1	9.0	0.80
Belgium	-.04660	0.25	8.2	8.0	1.77
Denmark	-.99671	0.26	8.9	3.0	0.95
Finland	-.90460	0.25	8.4	5.0	1.73
France	1.26813	0.29	7.6	15.0	1.59
Germany	.04084	0.25	8.4	10.0	1.57
Greece	1.31681	-	7.0	15.0	1.89
Ireland	-.74977	0.32	8.1	3.0	1.04
Italy	1.61032	0.33	7.4	16.0	1.51
Netherlands	-.98090	0.25	9.0	8.0	1.68
Norway	.13198	0.24	8.0	4.0	1.29
Portugal	1.01910	-	7.9	12.0	2.36
Spain	.76170	0.30	7.7	11.0	2.18
Sweden	-.26248	0.25	8.0	6.0	1.05
Switzerland	-.79903	0.31	8.6	7.0	1.28
UK	-1.44752	0.35	9.0	5.0	1.02

For sources and descriptions, see appendix.

Figure One

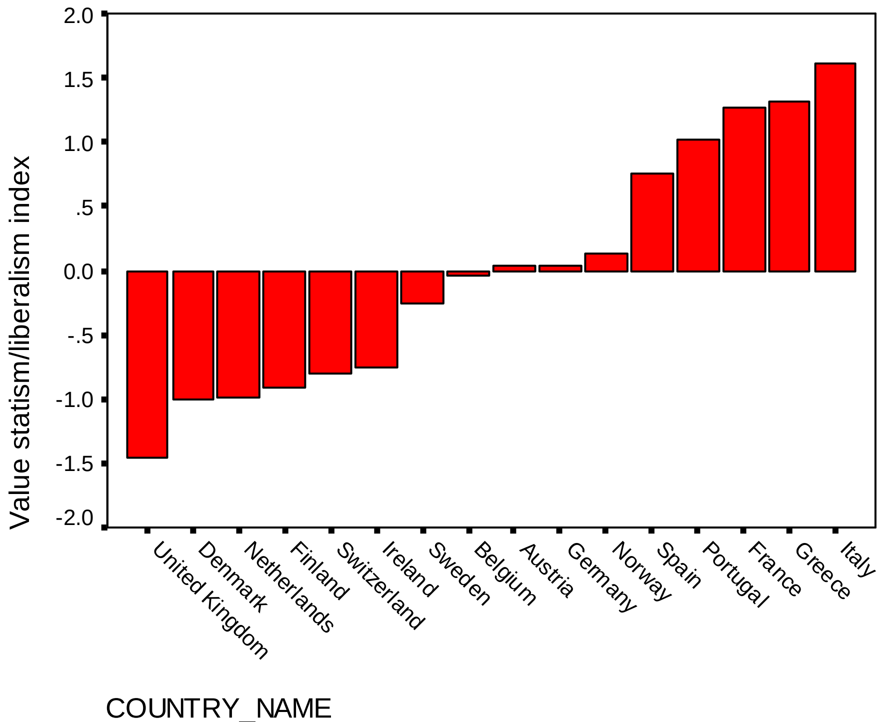
Structural Reform Scores and Total Government Outlays, Western Europe (early 2000s)



Sources: OECD Historical Statistics (government outlays 2000); Llewellyn *et al* 2003 (Lehman Brother structural reform rating 2002).

Figure Two

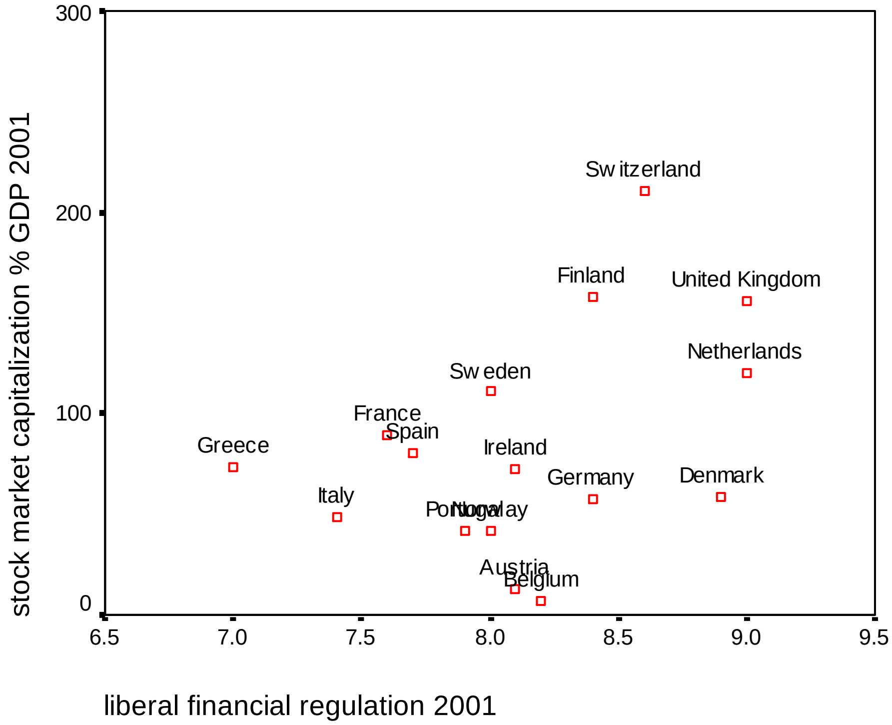
Scores on Statism/Liberalism Index, Western European Countries (late 1990s, early 2000s)



Sources: various, see Appendix.

Figure Three

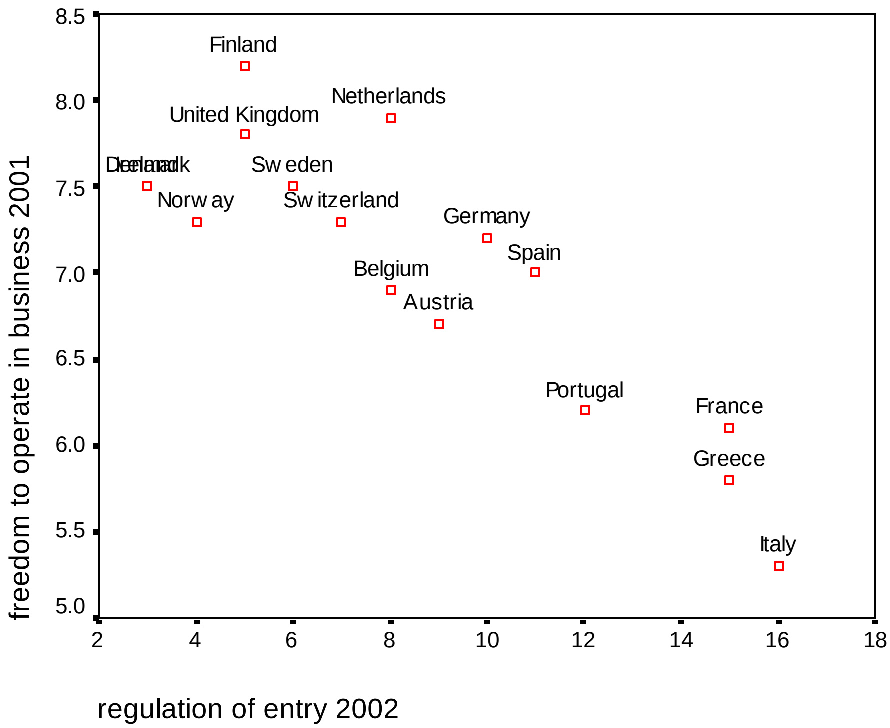
Stock Market Size and Degree of Financial Regulation, Western Europe (early 2000s)



Sources: World Bank, www.worldbank.org (stock market capitalization 2001); Fraser Institute, Gwartney *et al* 2001 (liberal financial regulation 2001).

Figure Four

Business Freedom and Regulation of Entry in Product Markets, Western Europe (late 1990s, early 2000s)



Sources: Fraser Institute, Gwartney *et al* 2001 (freedom to operate in business 2001); World Bank, www.worldbank.org, also Djankov *et al* 2002 (regulation of entry 2002).

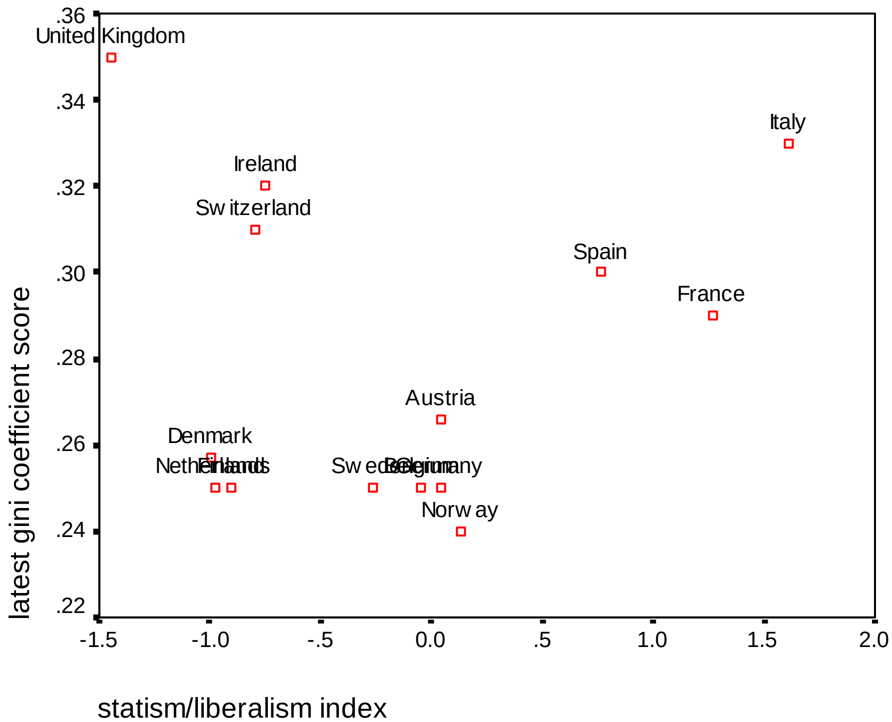
Figure Five

Degree of Regulation of Labour Market and Centralization of Wage Bargaining, Western Europe (1990s, early 2000s)

Sources: Botero *et al* 2003 (restrictiveness of employment law); Union Centralization Dataset, Golden, Wallerstein and Lange 1999 (collective bargaining 1996).

Figure Six

Income Inequality and Position on Statism/Liberalism Index, Western Europe (1990s, early 2000s)



Sources: statism/liberalism index, as above; Luxembourg Income Study www.lisproject.org (Gini coefficients)