

2

The Evolution of Varieties of Capitalism in Europe

Peter A. Hall

We live in an era when processes of globalization and liberalization are inspiring changes in the political economy extensive enough to lead some analysts to question whether it still makes sense to speak of distinctive VoC. Some argue that CMEs are converging on liberal models (Lane 2004; Thatcher 2005). Others believe that most political economies are becoming 'hybrids' (Jackson 2005). As economic performance deteriorates in economies that once did well, while former laggards advance, some question whether there is still more than one route to economic success. Is the magnitude of challenge and change today rendering a 'varieties-of-capitalism' (VoC) approach to comparative political economy obsolete?

Au: Lane 2004
not listed.

If one fixates on the changes currently taking place in Europe, an affirmative answer to this question may seem appropriate. Institutional change is altering contemporary VoC. Measured against a static conception of how national institutions once differed, changes in regulatory regimes and institutional practices may seem to be rendering all political economies similar. From this observation, it is but a short step to the conclusion that national political economies diverge only marginally from some 'best practice' to which all are destined to converge and thus there is little value in construing political economies as distinctive VoC.

This chapter advances a different view. It argues that cross-national divergence in institutional practices and patterns of economic activity of the sort emphasized by VoC approaches persists over time, and that those approaches are important for understanding change in the political economy because they direct our attention to the ways in which the institutional structures of the political economy condition it. I argue that the institutional structures constitutive of distinctive VoC have influential effects, not only on the actions of firms and governments, but on the response of political economies to socio-economic challenges. While never fully determining that response, these

structures and the strategies they engender at the firm level tend to push political economies along distinctive adjustment paths. This perspective generates a dynamic conception of VoC that sees them, not as a set of institutional differences fixed over time, but as bundles of institutionalized practices that evolve along distinctive trajectories. Seen from this angle, institutional change of the magnitude that attracts attention today is not an uncommon occurrence or a sign that VoC are dissolving, but a continuous feature of VoC.

This perspective has implications for the formulations of Hall and Soskice (2001) that associate distinctive VoC with underlying modes of coordination. On the one hand, it explains why basic patterns of coordination in the economy often persist through periods of institutional change. As institutions that support the efforts of firms to manage some of their endeavours through strategic or market coordination shift, firms often find alternative sources of institutional support for such coordination, and the advantages they derive from distinctive modes of coordination give them incentives to do so. Institutional change can relax the tightness of coordination or shift its equilibria without eliminating strategic or market coordination altogether. In some cases, such loosening is instrumental for conserving capacities for strategic coordination in various spheres of the political economy.

On the other hand, this analysis extends the perspective elaborated in Hall and Soskice (2001). Into an analysis focused largely on national economic performance, it incorporates greater concern for the distributive effects of institutions and political problems associated with them. I observe that the institutional reforms undertaken by governments are often inspired by distributive conflict, and, building on the point that social policy is a crucial adjunct to coordination, I integrate an appreciation for variation across welfare states into a VoC analysis. Second, by comparing institutional change in several countries over time, I attempt to identify the circumstances under which institutional change that radically alters the modes of coordination used by firms is adopted. Third, into an analysis focused largely on the institutions of the domestic economy, I integrate international institutions in order to explore some ways in which the effectiveness of domestic institutions can be affected by how they interact with international institutions. Although this extension does not contradict the argument of Hall and Soskice (2001) that there is more than one path to economic success, it helps explain some of the variations in economic performance displayed over time by distinctive VoC.

My starting point is the premise that, if we are to appreciate the import of institutional change in Europe today, we have to put contemporary developments into historical perspective. Accordingly, this essay considers institutional developments in the wake of successive waves of socio-economic challenges. To structure the analysis, I consider the response to challenges

Evolution of Varieties of Capitalism in Europe

41

occurring in three periods: from the late 1940s to early 1960s, from the late 1960s to the early 1980s, and in the 1990s and early 2000s.¹ I focus on Britain, France, Germany, and Sweden, chosen because their political economies display much of the institutional variation relevant to contemporary typologies of capitalism.

I begin by proposing a stylized conception of what the institutions of the political economy do that integrates the formulations of Hall and Soskice (2001) with standard understandings of the welfare state. This formulation identifies three types of problems with which firms and governments must cope. Using it, I identify the challenges facing these four nations at each of the three periods and chart the principal changes to policy regimes and institutional practices taken in response to them. Without attempting a full explanation, I try to show how these responses are conditioned by existing institutional structures and cumulate into a set of adjustment trajectories with characteristic economic effects.

For some of the issues, this analysis is suggestive rather than dispositive. My principal goal is to put the institutional changes occurring today into historical perspective. This reveals that institutional change in the political economy is not a new phenomenon and VoC are best seen, not as a set of stable institutional models, but as a set of institutionally conditioned adjustment trajectories displaying continuous processes of adaptation. Indeed, some of the features most associated with contemporary models of capitalism appeared in the 1970s rather than the 1950s. However, similar socio-economic challenges rarely called forth identical national responses. Over six decades, the challenges have not swept away important cross-national differences in the organization of economic activity.

2.1. THE CORE PROBLEMATIC

The starting point for my inquiry is Eichengreen's pioneering analysis (1996) of post-war growth. He locates its roots in the confluence of international institutions that allowed an expansion of trade to feed aggregate demand and domestic institutions that restrained wages enough to allow investment to grow in tandem with that demand. These institutions resolved time inconsistency problems that might have prevented nations from realizing such high levels of investment and growth.

The regulation-school economists advance an analogous argument, suggesting that Fordist production regimes were underpinned by collective bargaining institutions and Keynesian economic regimes that sustained adequate

levels of domestic demand and apportioned productivity gains between wages and profits (Boyer 1990). In each case, the precondition for prosperity was an industrial economy that could increase productivity by moving labour out of agriculture into industry (Crafts and Toniolo 1996).

From Eichengreen's analysis, I take the insight that the effectiveness of the institutions of a domestic political economy depends on the international institutions with which they are paired. From the regulation school, I take the point that their effectiveness depends as well on their fit with production regimes. Both perspectives imply that the institutions of the political economy play two types of roles. They perform a coordinating role aimed at the contracting and time inconsistency problems that stand in the way of gains from exchange, and they resolve distributional conflict about who is to receive the fruits of economic growth. Their tasks are political as well as economic.

To sharpen this perspective, I suggest that the institutions of the political economy address three types of problems. The first is the problem of ensuring that wages increase at rates moderate enough to allow profits enabling firms to raise adequate levels of investment, yet high enough to sustain levels of demand consistent with growth. The associated distributive issue is how to allocate economic returns between capital and labour with a minimum of industrial conflict. I call this the wage problem.

The second problem is one of securing levels of employment high enough to ensure national prosperity, while providing levels of compensation to those without work high enough to secure social peace.² There is a loose trade-off here because payments to those not employed affect the terms on which they will seek work. The problem has a high political profile because it bears on the distribution of work and social benefits. It also turns on the resolution of the first problem because employment varies with levels of real wages and aggregate demand.³ I call this the work problem.

I term the third issue the problem of securing total factor productivity. Eichengreen (1996) treats economic growth primarily as a matter of ensuring adequate amounts of capital investment. As the Harrod–Domar models tell us, growth also requires adequate inputs of qualified labour. However, economic growth is not simply a matter of securing capital and labour. It also depends on the efficiency with which they are deployed. In many models that is treated as a simple function of the level of technology. But there is mounting evidence that institutions also affect the efficiency with which labour and capital are deployed.⁴ The problem is to specify just how the institutions of the political economy affect that efficiency.

Hall and Soskice (2001) provide terms for addressing this issue. Building on relational theories of the firm, they argue that the efficiency with which labour and capital are utilized depends on how well firms coordinate with

other actors to secure skills, technology, finance, and the engagement of their employees. They identify two ways of coordinating such endeavours, based on market competition and strategic interaction. The implication is that firms utilize resources more efficiently where market competition is sharper or where high-equilibrium outcomes can be reached via strategic coordination.⁵ The institutions of the political economy affect these outcomes by modulating the intensity of market competition and providing support crucial for strategic coordination. In short, by conditioning the ways in which firms coordinate their endeavours, national institutions enhance or erode the total factor productivity of the economy. The problem of total factor productivity entails developing sets of national institutions that provide appropriate levels of support for market or strategic coordination at the firm level.

Of course, this is a stylized portrait. Firms and policymakers in post-war Europe faced many other dilemmas. But there is value in focusing on the problems of wages, work, and total factor productivity. Few issues are more consequential for national well-being, and all have loomed large on the political agendas of post-war Europe.⁶

2.2. THE POST-WAR DEVELOPMENT OF VARIETIES OF CAPITALISM

In the fifteen years after 1945, each of the European nations developed distinctive solutions to these three problems. Those were built on institutional legacies with roots in the timing and character of industrialization, but the prospect of intense international competition following a war that was destructive in institutional as well as physical terms inspired a wave of institution building. It is beyond the scope of this chapter to describe how these institutional regimes were constructed.⁷ Governments and the political parties that led them played crucial roles, as did producer groups pressing for certain types of arrangements. Firms also contributed to institutional reconstruction, as they reconfigured production regimes to meet the challenges of post-war competition and sought new avenues of access to technology, skills, and finance.

Although I emphasize the import of post-war institutions for the three problems associated with economic prosperity, it is important to note that they were built by coalitions of actors with diverse interests.⁸ Many were designed to achieve a certain distribution of resources rather than simply to improve economic performance. Ruggie (1982) captures this dimension of the process when he notes that the institutions of post-war Europe embodied

specific visions of social purpose. One implication is that the stability of those institutions would rest, not only on their coordinating capacities, but on the continuing viability of those visions.⁹

My principal objective in this section is to show that Britain, France, Germany, and Sweden developed institutions that addressed the wage, work, and productivity problems in distinctive ways. The institutional architects of post-war Europe built VoC as well as engines for growth.

2.2.1. Britain

The institutional solutions that the British adopted to address their post-war economic problems were those of the classic LME described by Hall and Soskice (2001), heavily reliant on competitive market relationships underpinned by formal legal contracting. The wage problem was addressed by measures to regularize collective bargaining between trade unions and employers. However, the British tradition of craft unionism meant that, even when bargains were struck at the sectoral level, firms often had to negotiate several such bargains because more than one union was represented in their workforce, and shop stewards remained powerful in many parts of the economy. As a result, Britain never secured the high levels of wage coordination that Eichengreen associates with post-war European growth. Levels of industrial conflict were relatively high, and rates of investment and growth correspondingly low (see Tables 2.1 and 2.5). At periodic intervals, British governments intervened to secure an incomes policy or to seek industrial relations reform, but the wage question was never fully resolved. It remained high on the political agenda throughout the post-war years (Howell 2005).

The efforts of post-war British governments to address the employment problem turned on two sets of initiatives. One was the construction of a 'liberal' welfare regime, built, as Beveridge recommended, on benefits administered by the state but minimalist in the low replacement rates it provided.¹⁰ Broadly speaking, the motivating idea was to provide work for all, but only minimal support for those who did not work. That regime had important effects on the character of post-war economic development in Britain. It pushed a large portion of the labour force into employment, put little pressure on firms to increase wages, and provided workers with few incentives to develop industry-specific skills (Finegold and Soskice 1988).

The second dimension of the British approach to the work problem was an emphasis on activist macroeconomic policy, based on the principles of John Maynard Keynes. Keynes suggested that governments could secure full employment by responding to recessions with deficit spending to expand

Table 2.1. Comparative economic performance by period

Years	Economic growth			Real wages			Total factor productivity		
	1950–74	1975–85	1986–2004	1950–74	1975–85	1986–2004	1950–74	1975–85	1986–2004
Britain	2.8	1.7	2.7	3.1	0.9	1.9	1.7	1.5	1.4
France	5.0	2.0	2.3	4.7	2.1	1.2	3.1	1.6	1.0
Germany	5.8	1.9	1.9	4.5	1.2	1.7	2.0	1.0	1.3
Sweden	3.7	1.6	2.1	3.4	0.5	2.0	2.0	0.4	1.5

Source: The Conference Board and Groningen Growth and Development Center, Total Economy Database. Germany is West Germany until 1990. Figures are annual average percentage increases for the years indicated in the second row of the table.

consumer demand. Although influential across Europe, his ideas were embraced with most enthusiasm in his own country. Although they were constrained by a tenuous balance-of-payments, successive British governments operated an activist fiscal policy (Hansen 1968; Hall 1989).

The approach of British firms to the problem of total factor productivity was influenced by the institutional inheritance of early industrialization (Kurth 1979). Large firms obtained finance, skills, and technology via the types of competitive market relationships prominent in LMEs. In many cases, they secured finance through short-term bank credits and securities on terms that were sensitive to a firm's current profitability. Although a few sectors sponsored apprenticeship programmes, over the course of the 1950s, companies became increasingly reliant on the general skills provided by a formal educational system. The absence of serious legal limitations on lay-offs discouraged workers from investing in specific skills. Firms secured technology through licensing arrangements or the acquisition of companies with appropriate technology. Firm organization itself was highly hierarchical (Lane 1989).

These features of the institutional environment influenced the productivity strategies of British firms. Some retained long-standing reputations for high-quality production (HQP) based on highly skilled labour. But an industrial relations system prone to conflict limited the cooperation many firms could secure from their employees, and the abundance of general, relative to specific, skills encouraged firms to rely on high volumes of production and low labour costs for competitive advantage (Rubery 1994). Many British firms found it difficult to move up the value chain to compete in HQP niches.¹¹ As a result, rates of productivity growth lagged those on the continent (see Table 2.1).

2.2.2. Germany

Although their economy was in ruins after the war, the firms and policymakers of West Germany could draw on an institutional inheritance from late industrialization that included strong industry unions, well-developed employers associations, collaborative institutions for skill formation, and a Bismarckian welfare regime. These were soon adapted to the purposes of economic reconstruction. Post-war Germany built a CME that provided firms with substantial institutional support for strategic collaboration (Hall and Soskice 2001) and experienced an 'economic miracle' that saw the size of its economy quadruple over thirty years.

The institutional support Germany developed for strategic coordination is well displayed in the institutions it developed to address the wage problem.

In 1952, the government legislated a controversial system of co-determination that gave workers a powerful voice on the supervisory boards of many large firms and strong works councils. Facing a labour movement powerfully organized at the sectoral level, German employers began to collaborate in sectoral wage negotiations, usually guided by a leading settlement in the metalworking sector and moderated by threats from an independent central bank to retaliate against inflationary increases (Thelen 1991; Hall 1994). Bolstered by a plentiful labour supply and strong desires to rebuild the economy, this system kept wage increases in line with productivity gains throughout the 1950s and 1960s. Over time, however, it also put slow but steady upwards pressure on wages that encouraged firms to invest in high value-added forms of production. In many respects, the German system for wage coordination exemplifies the engine for growth that Eichengreen describes.

Its corollary was a particular approach to the work problem. Faced with the challenge of finding work for ten-million refugees from the east, the new Bundesrepublik rebuilt an economy that produced full employment by the early 1960s.¹² However, it did so by focusing investment on an industrial core whose production regimes relied heavily on a male labour force equipped with high levels of industry-specific skills generated by intensive training schemes run collaboratively by employers associations and the trade unions. Pension and unemployment schemes supplying increasingly generous benefits pegged to wages provided young men with the incentives to secure the sector-specific skills that would ensure them high wages (Mares 2004). The result was a system well equipped to channel men into industrial occupations but less good at providing jobs to women or those without specific skills. Built on a male breadwinner model, the system of social benefits assumed that most women would prefer to work at home rather than in paid employment. As a result, once the industrial economy had been reconstructed, further expansion of the labour force was discouraged, and the proportion of the population in employment grew more slowly than in many nations (see Table 2.2). German institutions also encouraged firms to take particular approaches to the total factor productivity problem. Despite the efforts of the Allies to eliminate cartels, Germany's banks soon assumed key roles in industry, as sources of long-term finance and the representatives of investors (Zysman 1984). Powerful employers associations helped German firms form close relationships with other firms to operate vocational training schemes or to secure technology through collaborative ventures. While British firms acquired finance, technology, and skills on competitive markets, German companies relied more heavily on collaborative relationships with other firms rooted in the reputations they built up in dense inter-corporate networks (Streeck 1992).

Au: Zysman
1984 not
listed.

Table 2.2. Average rates of growth of gross domestic product and employment

	Growth of GDP				Growth in employment			
	UK	France	Germany	Sweden	UK	France	Germany	Sweden
1951–64	2.9	5.0	7.2	3.9	—	—	—	—
1965–74	2.6	4.9	3.9	3.5	0.17	0.92	0.06	0.78
1975–84	1.5	2.1	1.9	1.6	–0.29	0.13	–0.06	0.72
1985–94	2.6	2.2	2.3	1.3	0.65	0.21	0.03	–0.59
1995–2004	2.9	2.3	1.5	2.9	0.99	1.02	0.04	0.70

Source: The Conference Board and Groningen Growth and Development Center, Total Economy Database. Figures are average annual percentage increase for the period.

Regulatory regimes that privileged stakeholders (including creditors, managers, collaborators, and workers) over shareholders reinforced this type of strategic coordination (Casper 2001). Powerful works councils and the two-board supervisory system privileged consensus decision-making. Because these institutions made it difficult for firms to lay-off workers, many began to base their competitive strategies more heavily on quality rather than cost considerations. Rather than move aggressively into new lines of business, many firms found it easier to cultivate a skilled workforce and use it to make continuous improvements to existing product lines and production processes. As a result, by the end of the 1960s, West Germany had the largest industrial economy in Europe. More than half of its workforce was employed in the industrial sector, well compensated, and highly skilled.

2.2.3. Sweden

Neutral during the Second World War, Sweden was well placed to benefit when it ended. During the 1950s, the nation developed a distinctive approach to wage, work, and productivity problems known as the ‘Rehn–Meidner’ model after its two most prominent exponents. That model was built on three institutional pillars. The first was a system of ‘solidaristic’ wage-bargaining at peak level between a centralized union movement and employers confederation designed to tie wage agreements to average increases in national productivity.¹³ The effect was to narrow wage differentials and force less efficient companies to close down or become more productive. Its second pillar was a set of macroeconomic policies that used restrictive fiscal policy to encourage firms to rationalize, and an accommodating monetary policy to provide low-cost capital for doing so, as well as taxes on uninvested profits to assure workers that wage moderation would be rewarded. The third pillar was

a set of active labour market policies designed to facilitate the movement of workers out of less productive firms into more productive ones, by upgrading their skills and supporting the job search (Martin 1978).

Au: Martin
1978 not
listed.

These institutions offered a solution to the wage problem that conforms closely to Eichengreen's conception of how such institutions should work. In exchange for wage moderation, workers were given assurances that capital would invest in productive endeavours. The work problem was addressed by active labour market policies designed to improve the skills of the workforce and find jobs for the unemployed. In keeping with the emphasis on moving people into work, the duration of unemployment benefits was limited to six months. In order to encourage workers to acquire skills, however, benefit rates were tied to previous wages, as were retirement benefits from 1960.

These institutions encouraged firms to take approaches to the problem of total factor productivity characteristic of a CME. Steady wage pressure forced firms to seek continuous improvements to products and production processes, and it encouraged them to cultivate the high-skill levels that make such innovation feasible. Social benefits tied to wages encouraged workers to invest in such skills. Extensive cross-shareholdings that protected companies from hostile takeovers allowed them to privilege investment over profitability, and strong employers associations promoted the close ties among firms that facilitate collaborative research and development.

2.2.4. France

At the end of the war, the leaders of France were eager to declare a military victory but anxious about the prospect of economic defeat in a more open world economy. A third of the nation's labour force was still employed in agriculture, and many of its firms were too small to compete on the world stage. Accordingly, French officials decided to break with the past and modernize the economy from above, seeking support wherever they could among the fractious parties of the Fourth Republic.

Industrial relations were regularized by laws that gave unions legal standing and mandated collective bargaining at the sectoral level, but officials hesitated to strengthen a labour movement dominated by a communist union. Thus, the state assumed a leading role in wage coordination. It set a minimum wage to which the wages of 40 per cent of employees were ultimately linked and assumed the statutory authority to impose wage agreements negotiated with some unions on entire sectors. By the 1960s, almost 80 per cent of employees were covered by such agreements.

The French approach to the work problem had several dimensions. A programme of aggressive agricultural modernization pushed labour into the industrial sector. But support for those who could not find work increased only gradually. Old-age pensions were introduced after the war, but unemployment insurance remained a patchwork quilt of benefits administered by trade unions and employers associations, tied closely to employment status, and financed from social charges on employers and employees. Although the government funded day care facilities, many women remained outside the workforce. Like Germany, France retained a 'continental' welfare state (Esping-Andersen 1990).

Au: Esping-Andersen 1990 not listed.

The approach French officials took to the problem of total factor productivity was more aggressive. In 1947, they established a system of indicative economic planning bolstered by tripartite 'modernization commissions' that channelled funds into priority sectors with the support of a financial system dominated by state-owned banks. By the 1960s, the government was heavily subsidizing firms designated 'national champions' (Zysman 1978, 1984; Hall 1986). Para-public institutions were set up to promote research and development (Ziegler 1997). As a result, large French firms modernized quickly, but depended heavily on the state for access to finance, technology, and skills. A cohesive set of social networks revolving around the *grands écoles* and *grands corps* linked senior executive closely to civil servants (Suleiman 1979). Among large firms in post-war France, there was a good deal of strategic coordination orchestrated by the state. Relations inside the firm, however, were slower to change. Companies responded to a fractious labour movement by clinging to rigid job classifications and steep managerial hierarchies that allowed firms to operate mass production successfully but limited the autonomy of workers and the scope for incremental innovation in production processes (Crozier 1968; Maurice, Sellier, and Silvestre 1986). There was a sharp division between middle managers drawn from the ranks of the firm itself and senior managers, who were often parachuted in from the outside world of public affairs.

Au: Zysman 1978, 1984 not listed.

Au: Is it *grands écoles* or *grands écoles*? Pl. check.

Au: Suleiman 1979 not listed.

2.2.5. Comparative Perspectives on Institution-Building

During the 1950s and 1960s, Britain, France, Germany, and Sweden developed institutional solutions to wage, work, and productivity problems successful enough to allow these countries to grow more rapidly than they ever had before. Although Eichengreen stresses the institutions these nations had in common, there were striking differences in the institutions each developed to address similar economic problems. By 1965, Western Europe had distinctive and familiar VoC.

Some of those differences are well described by the distinctions Hall and Soskice (2001) draw between LMEs and CMEs. In Britain, firms secured access to outside finance, skills, and technology primarily via competitive markets. Although wage bargaining was often collective, it was not strategically coordinated across the economy. By contrast, strategic coordination was more prominent on the continent. However, there was substantial variation in how it was achieved. In France, the state played a central role in the coordination of industrial relations, corporate governance, and technological development. In Germany, employers associations and trade unions coordinated wage-setting and vocational training at the sectoral level, while wage-setting was coordinated at the peak level in Sweden where the state also bore more responsibility for vocational training. Influential banks and networks in both nations built on cross-shareholding played major roles in the allocation of capital, and many firms acquired technology through collaboration with other firms.

It is important to note that national differences extended all the way down to corporate strategies and production regimes. Firm strategies and national institutions tend to adjust to one another over time. By making some types of strategies easier and others more difficult to pursue, the macro institutions of the political economy tend to push firms in distinctive directions.¹⁴ Systems of wage coordination that raised wage floors in Sweden and Germany, for instance, pushed their firms towards diversified quality production (DQP) (Streeck 1991). Limited institutional support for the development of industry-specific skills encouraged many firms in France and Britain to focus on Fordist modes of production.

As this suggests, there was no 'big bang' here. These VoC were constructed via incremental processes, marked by experimentation by firms and governments, the layering of institutions on top of one another, and gradual mutual adjustment of strategies to institutions (Thelen 2004; Streeck and Thelen 2005). Some of the features later associated with distinctive welfare states and national patterns of economic activity developed only gradually. In 1960, for instance, the European country with the highest proportion of the adult population in employment was Germany, and the one with the lowest proportion of women in employment was Sweden (Crouch 1999: 58).

2.3. THE RESPONSE TO CHALLENGES IN THE LATE 1960s AND 1970s

How do VoC respond to economic challenges? Do powerful economic shocks erase the institutional differences between them? As I have noted, many are

asking those questions today. One way to answer them is to examine the response of political economies to previous challenges. For that purpose, the late 1960s and 1970s provide a natural experiment, since that was an era when the European political economies came under serious strain.

This period is revealing about the sources of the challenges that put political economies under pressure. Some analysts treat such challenges as exogenous shocks, arising, for instance, from developments in the international economy (cf. Frieden and Rogoswki 1996). However, the history of this period suggests that some of the most profound challenges facing political economies are endogenous by-products of existing institutions or the patterns of economic development they promote. By the end of the 1960s, three kinds of developments were putting serious pressure on the institutions of the European political economies. They were rooted in (a) an important change in international regimes, (b) structural developments in the economy, and (c) unintended effects flowing from the operation of existing institutions.

Eichengreen's observation (1996) that the effectiveness of domestic institutions depends on the character of international regimes was confirmed by the collapse of the Bretton Woods exchange-rate regime in 1970. Its exchange-rate anchor had limited wage demands and inflationary pressures in the European economies. It allowed some countries, such as Germany, to maintain undervalued exchange rates to foster export-led growth and others, such as France, to devalue in an orderly way when distributive conflict that domestic institutions could not resolve spilled over into inflation, thereby offsetting the impact of wage increases on the nation's international competitiveness. In such ways, the Bretton Woods regime provided crucial support for the domestic institutions regulating distributive conflict. The move to a regime of floating rates in 1971 made such conflict more difficult to contain, thereby increasing the likelihood that it would spill over into inflation.¹⁵

Structural economic developments intensified distributive pressure. By the end of the 1960s, the movement of West European labour out of agriculture into industry was largely at an end. As a result, productivity began to increase more slowly (Blanchard and Wolfers 2000).¹⁶ This meant that the 'productivity increment' available for distribution among capital, labour, and the state began to decline, thereby intensifying the challenges facing the institutions developed to regulate conflict about the distribution of this increment, such as those in the arena of collective bargaining.

The patterns of economic development to which the institutions of the European political economy contributed also began to undermine them. As I have noted, most of the European countries developed collective bargaining institutions that sustained relatively powerful trade unions. By the middle of the 1960s, these nations had also secured high levels of employment that

strengthened the trade unions further. As a result, they were able to increase the share of value-added going to labour relative to the share going to capital, ultimately cutting into the profits that inspired investment (Armstrong, Glyn, and Harrison 1991). Prosperity also began to shift cultural values in ways that brought more women into the labour force and improved national productive capacity but intensified the problem of finding employment for a larger labour force (Inglehart 1990).

By the end of the 1960s, these developments were resulting in stagflation, the pernicious combination of rising rates of inflation and unemployment. Inflation rose as distributive conflict in the industrial arena increased and gave rise to inflationary wage settlements, unrestrained by an exchange-rate anchor (see Table 2.5). Unemployment increased as more people sought work in a context where profits had been eroded enough to depress investment. That erosion was linked both to more assertive trade unions and to the difficulties of apportioning a lower productivity increment among profits, wages, and the social wage administered by the state. However, these problems were greatly intensified by rapid increases in the price of oil in 1973–4 and 1979–80 that drove rates of inflation up and rates of growth down. The wage, work, and productivity problems of Britain, France, Sweden, and Germany intensified. How did their institutions shift in response to these challenges?

2.3.1. Britain

The British political economy was ill-suited to cope with increasing rates of inflation in the late 1960s and the intense distributive conflict behind them because it had never developed institutions for effective wage coordination. As a result, rates of inflation rose steadily to peak briefly at 23 per cent in the spring of 1975 even though unemployment was also rising. Not surprisingly, much of the British response focused on efforts to improve wage coordination. In theory at least, this might have been a period in which Britain developed more effective institutions for strategic wage coordination of the sort visible in CMEs on the continent. Successive governments took steps in this direction, beginning with the ill-fated *In Place of Strife* proposals of the late 1960s and culminating in the Social Contract negotiated between the unions and 1974–9 Labour government (Crouch 1977).

The failure of these efforts is an indication of how difficult it is to transform an LME into a CME (see Wood 2001).¹⁷ The structure of the British labour movement was a major impediment. Although the Social Contract brought down rates of inflation, by narrowing wage differentials it fuelled pressures in the fissiparous union movement for their restoration that ultimately

precipitated a wave of industrial conflict during the 1979 'winter of discontent'. The weakness of British employers associations made the task more difficult. They had little to offer the government in the way of support. In the end, these efforts to control inflation by regulating wages from Westminster strained the reservoir of legitimacy of the British state, and the 1970s saw a political reaction against state-led efforts to intervene in the economy.

The beneficiary of that reaction was Margaret Thatcher who came to power in 1979 on a platform that promised to roll back state intervention in the economy. Under her leadership, a series of Conservative governments responded to the economic crisis by sharpening the intensity of competition in Britain's LME. They broke the power of the unions, moved away from Keynesian demand management, deregulated markets, privatized the national enterprises, and shifted Britain's social policy regimes so as to force the able-bodied even more aggressively into employment (Riddell 1994). After experiments with more forceful state intervention in the late 1960s and 1970s, Britain ultimately responded to the challenges of the period by reinforcing the institutions of its LME.

Au: Riddell
1994 not
listed.

2.3.2. France

The response of France to the socio-economic challenges of the 1970s was, by contrast, transformational. As in Britain, the initial inclination of French governments was to treat the economic downturn of the 1970s as a temporary recession, rather than a structural change, and to address it with traditional policy instruments. A series of governments under President Valéry Giscard d'Estaing increased state aid to industry and expanded social programmes for those without employment (Berger 1985). The Socialist government elected in 1981 under President François Mitterrand initially deepened the dirigiste response, raising the minimum wage to reflate the economy and increasing subsidies to industry on the premise that public investment could be used to replace private investment, which had been stagnant since 1974.

If these measures had been successful, the French model might not have changed, but they failed to restore rates of growth or investment, and growing public sector deficits put downwards pressure on the franc, forcing Mitterrand to choose, in the spring of 1983, between his dirigiste strategy and his commitment to the European monetary system, established in 1979 to stabilize exchange rates in Europe. Disillusioned with the fruits of his strategy, Mitterrand abandoned it in favour of an effort to revive the French economy by promoting more open European markets, a goal that was to be enshrined in the Single Europe Act 1986.

Evolution of Varieties of Capitalism in Europe

55

The question of the day was how to alter the institutions and regulatory regimes of the French political economy so as to ensure it prospered on those markets. About this, there was a lively debate. Some argued for the value of moving towards the CME model exemplified by Germany (Albert 1980; Maurice, Sellier, and Silvestre 1996). Its egalitarianism and success in high value-added sectors were attractive to many in France. But the effectiveness of the German model rested on the presence of powerful employers associations and trade unions. Not only would those have been difficult to create in France, where the labour movement was deeply divided, but some politicians had qualms about trying to strengthen a labour movement that had been a thorn in the side of many governments and in which a communist trade union was prominent. As a result, the efforts of the government to give the unions a greater role in firm-level bargaining, with the Auroux laws of 1982, and to promote regional cooperation between business and labour were desultory at best (Howell 1992; Culpepper 2003).

Beginning in 1983, a series of governments opted for regulatory changes that would put firms under more intense competitive pressure and enhance the extent to which they depended on markets to coordinate their endeavours. Two factors made this a viable strategy. One was the special role of the state in the economy. Up to this point, strategic coordination had been a prominent feature of the French economy, but much of that coordination had been orchestrated by the state. Therefore, the government could shift the ways in which firms coordinated their endeavours by reducing its own coordinating role. The other relevant factor was the industrial weakness of the union movement. Although a potent force in politics, the French trade unions were poorly organized in the industrial arena and weakened by the unemployment of the 1980s. As a consequence, they could offer little resistance to the shifts in firm strategy that more intense market competition dictated Goyer (2005).

Au: Goyer
(2005) not
listed.

Although policy moved in fits and starts, seen from afar, the French governments of the 1980s pursued what might be described as a new kind of modernization strategy. During the 1950s and 1960s, the French state had modernized the economy from above through active state intervention (Hall 1986). In the 1980s, by contrast, the state put pressure on firms from below—enforcing modernization by exposing them to increasingly intense market competition. Policymakers sold off the state's holdings in banking and industry and encouraged companies to seek finance on international markets. They expanded the Paris Stock Exchange, welcomed foreign investors, and fostered a competitive market for corporate control. Many markets were deregulated, industrial subsidies reduced, and French firms were forced to compete in a new 'single European market' initially under a high exchange rate that put them at a competitive disadvantage. Although the state retained the right to

fix minimum wages and to impose wage agreements across sectors, it used these powers sparingly to encourage firm-level bargaining instead (Lallement 2006).

Au: Hancké
2000 not
listed.

The result was a revolution in corporate practices. Renault laid off half its workforce in the space of five years (Hancké 2000). By the end of the 1990s, almost 40 per cent of the shares in the leading French firms of the CAC40 were in the hands of foreign investors. Although close ties between corporate executives, often forged during an elite education, continue to give French companies capacities to coordinate with each other that their British counterparts do not always enjoy, markets have assumed a more important role in the coordination of firm endeavours. In important respects, France converged towards the practices of an LME.

Where it continued to diverge from those practices, however, was in its approach to the work problem. In contrast to the British governments of the 1980s that reduced employment protection and tightened eligibility for social benefits, the French governments of the 1980s initially responded to the unemployment of the 1970s and 1980s by expanding early retirement programmes, so as to reduce the numbers seeking work. The effect was to hold down the size of the workforce, even though women were entering it in increasing numbers. The proportion of men over 50 years of age in the workforce declined from 51 per cent in 1975 to 36 per cent by 1990. French social benefits became increasingly generous, and governments that had once lavished subsidies on industry now spent equivalent sums to subsidize training schemes and the social charges of employers who took on young or unemployed workers. By 1986, the French state was spending 4 per cent of gross domestic product (GDP) on such schemes.

From the perspective of conventional liberal theory, which expects more intense market competition to be accompanied by meager social benefits, the result is a remarkable dualism. In response to a more open European economy, France made its markets more competitive and increased its levels of social protection at the same time. By 1990, its social spending almost reached Swedish levels (see Figure 2.1). Moreover, the posture of the state had undergone a quiet reversal. In 1960, the French state provided minimal social benefits but lavished subsidies on protected industrial firms. By 1990, it had given up on industrial protection in favour of social protection.

2.3.3. Sweden

Like its neighbours, the Swedish political economy was also buffeted by the economic waves of the late 1960s and 1970s. In the wake of intense distributive

Evolution of Varieties of Capitalism in Europe

57

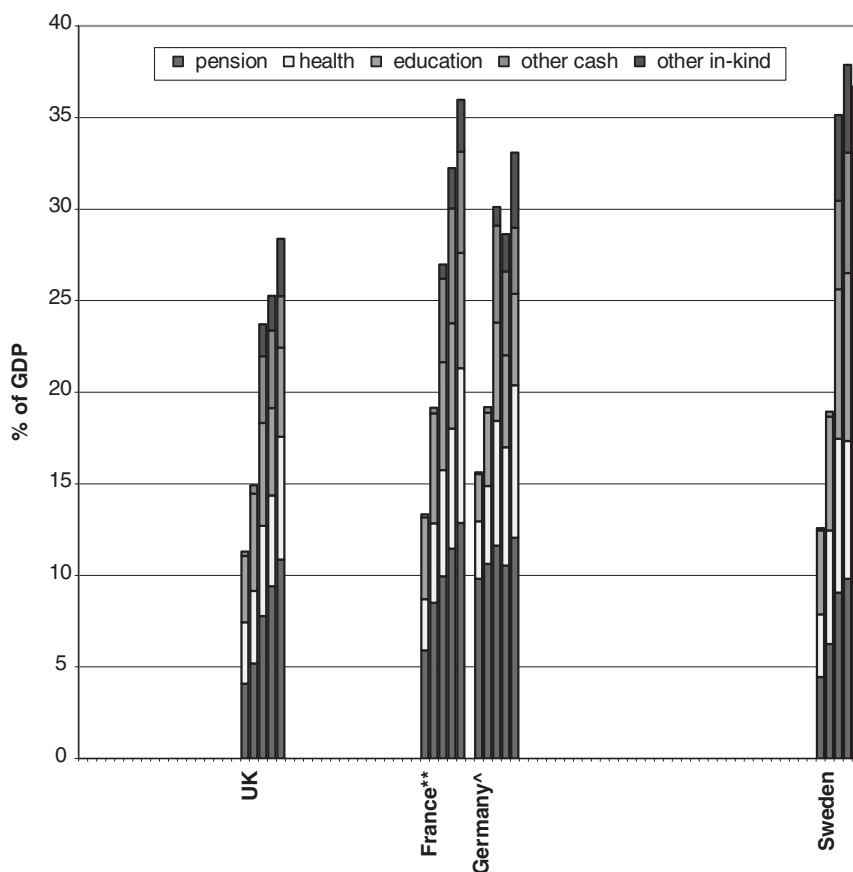


Figure 2.1. Gross size and composition of welfare states (FY 1960, 1970, 1980, 1990, and 2001)

Source: OECD and Irwin Garfinkel, Lee Rainwater, and Timothy Smeeding. 2007. *The American Welfare State: Laggard or Leader?* New York: Russell Sage Foundation: forthcoming. Chapter 4.

** 1960 education estimated by 1975 data; 1970 education estimated by 1975 data.

^ Data for 1960 to 1990 are from Western Germany; data for 2001 are from the unified Federal Republic of Germany.

conflict, important modifications were made to its institutions addressing the work and wage problems.

In Sweden, the work problem became an important concern in the second half of the 1960s, as growing numbers of women began to seek paid employment. In a CME that relies heavily on highly skilled labour, female employment poses a special problem because women are more likely than men to take time out from work for childrearing. As a result, they have fewer incentives to

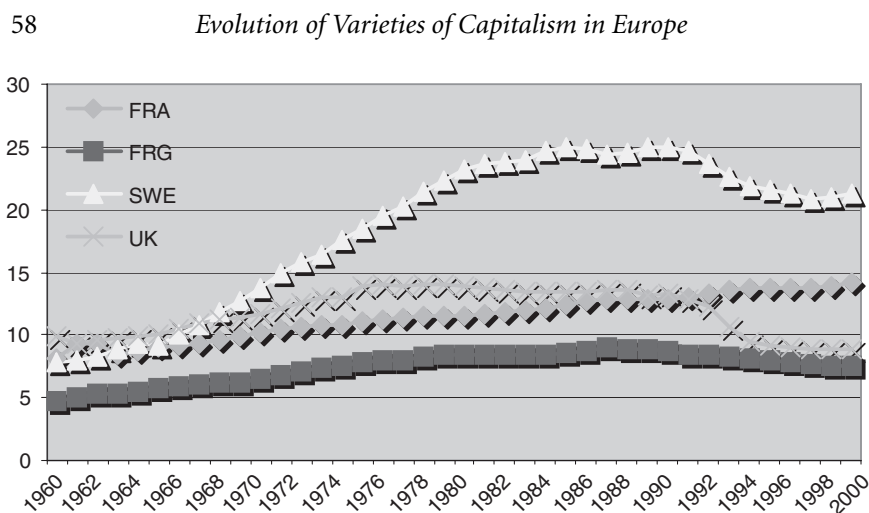


Figure 2.2. Government employment as a per cent of working age population 1960–2000

Source: Huber and Stephens data-set, Luxembourg Income Studies, compiled by Thomas Cusack.

acquire skills that they might be used for shorter periods or become outdated when they are not in work, and firms that depend on a committed labour force are less likely to invest in providing women with those skills (Estévez-Abe, Iversen, and Soskice 2001). After considerable debate, the Swedish government responded to this problem by increasing the number of jobs in the public sector and expanding a public day care system that made it easier for women to work. The number of employees in the Swedish public sector doubled between 1965 and 1980, and 500,000 of the 700,000 new jobs went to women, who served as providers of public health care, day care, education, and medical services (see Figure 2.2). By 1980, 72 per cent of adult Swedish women were working, compared to 55 per cent of British women (Benner and Vad 2000).

This is when the Swedish welfare state acquired the distinctive character so often associated with it today, namely as one that provides exceptionally high levels of public services based on high levels of female employment (Esping-Andersen 1990). There is nothing primordial about this type of welfare state. As late as 1970, social spending in Sweden was actually lower than it was in France and Germany (see Figure 2.2).

However, this shift in the approach to the work problem put further strain on the institutions Sweden had developed for resolving the wage problem. As employment in the public sector grew, the Swedish union confederation saw an increasing proportion of its members drawn from the non-traded sector, where concerns about maintaining internationally competitive wage

levels were not as intense as they were among workers and employers in the traded sectors of the economy. Partly as a result, wage levels began to increase (and wage differentials began to decrease) to the point that firms in the large traded sector began to worry about whether they could maintain their competitiveness.

These pressures were exacerbated by the boom and bust years of the 1970s that generated unexpected profits in the first half of the decade for which unions sought recompense in the second half, just as a global recession hit the economy. The government's response to recession worsened the problem. By increasing industrial subsidies and relaxing fiscal policy in the hope of reflating the economy, the government violated the dictates of the Rehn–Meidner model that called for austere fiscal policy in order to discipline wage bargainers. As wage rates increased faster than the rate of productivity in the second half of the 1970s, unit labour costs soared and many smaller firms were forced out of business.¹⁸ The government responded by intervening more actively in wage negotiations, offering tax incentives in exchange for wage moderation and ultimately legislating an incomes policy. When these measures failed, it devalued the exchange rate to offset the impact of wage increases on the traded sector. More active government intervention in wage bargaining was a feature of the response of most European nations to the strains on wage regulation in this period.

Although the devaluation of 1982 stabilized Swedish wages, the long-standing system of peak-level wage bargaining collapsed under the weight of these pressures. Some of those pressures were endogenous to the system itself. By narrowing wage differentials, successive solidaristic wage settlements undermined the incentives on which employers relied to recruit and motivate skilled labour, notably in the traded sector. Seeking greater flexibility in the face of foreign competition, the engineering employers federation withdrew from centralized bargaining in 1983 to strike a separate deal with the metalworkers union (Pontusson and Swenson 1996). Over the next decade a series of efforts were made to find a new mode of wage coordination, issuing ultimately in sectoral-level bargaining loosely coordinated across sectors.

These developments took a toll on Swedish companies, which responded in two broad ways. Some intensified mass production with a view to reducing the share of labour in total costs. Others, such as Volvo, took advantage of skilled labour to develop more flexible production regimes, focusing on high value-added products and high levels of quality control (Pontusson 1997: 66). On the whole, however, the approach of Swedish firms to productivity issues did not change dramatically during the period, and the economy continued to perform well relative to others in Europe (see Tables 2.1 and 2.2).

2.3.4. Germany

In Germany, an industrial relations system that successfully tied wages to productivity between 1950 and 1972 worked badly during the 1970s when rates of profit rose and fell unexpectedly. As levels of industrial conflict rose, unit labour costs increased by 56 per cent between 1972 and 1975. Tensions grew between an independent Bundesbank, quick to retaliate against inflationary wage settlements with restrictive monetary policy, and governments that took a more Keynesian approach to economic management in the late 1960s. But the German system for wage coordination survived these shocks—a measure of its robustness—and delivered wage increases moderate enough to restrain inflation throughout the 1980s (Hall 1994; Streeck 1994).

As the German work problem in the 1960s became one of labour scarcity, firms responded by importing foreign labour. Between 1959 and 1971, over two million ‘guest workers’ had entered the country. During the 1970s, however, unemployment rose to 4 per cent, and employment began to shift out of industry into services.¹⁹ The government reacted with more activist macro-economic management and restrictions on immigration. However, the most notable feature of the German response to the work problem was an effort to hold down the size of the workforce. A liberal definition of disability allowed older workers to move onto generous benefits, and those who had been unemployed for a year could claim full pension benefits at age 60, thereby making it feasible for firms to push workers into retirement at age 59. In 1972, legislation raised pension benefits for the low-paid and mandated early retirement at age 63. By 1985, the proportion of German men between the ages of 55 and 64 in paid employment had fallen to 60 from 80 per cent in 1970. Concerned about the fiscal consequences, the Kohl government took the replacement rate for unemployment insurance down five points to 63 per cent of previous wages and the social assistance rate down two points to 56 per cent in 1983–4. However, these measures did not substantially alter a strategy designed to limit the size of the labour force.²⁰

During the 1970s, German firms also faced challenges to the practices they had used to ensure high levels of total factor productivity. During the 1960s, they had benefited from an undervalued exchange rate that lowered the price of German goods relative to foreign ones. Partly as a result, Germany became the world’s second-largest industrial exporter, and its exports rose from 8 per cent to 24 per cent of GDP between 1950 and 1974. With the collapse of the Bretton Woods regime, however, a low exchange rate could not be sustained without importing inflation, and as the exchange rate rose, German firms came under more intense competitive pressure. Because of the power of works councils and unions, firms could not readily respond

by reducing wages. Instead, they focused on increasing the productivity of labour.

There were two components to the strategies many firms used to increase productivity. One was to use labour more flexibly. To secure union support for such efforts, companies traded reductions in working hours for more flexible work arrangements. In 1985, the large metalworking union, IG Metall, agreed to such arrangements in return for a reduction in the workweek from 40 to 38.5 hours. The union hoped that, if working hours were shorter, more employees would be hired. The second notable element of firm strategy turned on higher levels of investment designed to make each worker more productive, in effect substituting capital for labour. Between 1970 and 1985, the capital intensity of German industry rose dramatically, and the proportion of adult men in employment fell from 93 to 82 per cent.

By and large, these responses were successful. Germany weathered the crises of the 1970s with the institutions of its political economy intact. Rather than abandon DQP, German firms fine-tuned it, and the industrial relations system managed the trade-off between inflation and unemployment well. Relative to that of its neighbours, Germany's economic performance in the 1980s was good. However, the approach to the work problem adopted in this era capped the size of the labour force and reduced working hours. In the short term, the results satisfied many. Those who had work were well paid, and those who did not enjoyed generous social benefits. But this approach was to haunt the German political economy in later years.

2.3.5. The Adjustment Process in Comparative Perspective

The response of these countries to the socio-economic challenges of the late 1960s and 1970s is informative about the processes whereby political economies adjust to socio-economic challenges. Several features are striking.

As the institutions regulating distributive conflict began to founder, all of these countries saw higher levels of state intervention. Governments intervened to stabilize wage bargaining systems under strain. The French state could have been expected to quell the general strike of 1968, but even British governments, whose stance is customarily less interventionist, imposed statutory incomes policies on unions and employers. The Swedish government began to play a more active role in wage negotiations, and even Germany experimented with tripartite wage talks. In the wake of the oil price shocks, every government increased subsidies to industries.

In each case, however, there were two phases to the government's response. During the 1970s, governments reacted to new challenges with familiar

formulae. All initially responded to rising unemployment with a Keynesian stimulus, of the sort often used in Britain and France but taken up with new enthusiasm in Germany and Sweden. Instead of provoking cutbacks in spending, the sharp downturn in economic growth inspired new social programmes designed to cushion the populace against the effects of recession. As a proportion of GDP, social spending was to grow faster across Europe during the 1970s than ever before or since, partly because of new programmes and partly because the denominator grew more slowly (see Figure 2.2). Many of the social benefits being cut in the 1990s are ones established during the 1970s. These developments confirm that governments see through a glass darkly. Many responded as if the slowdown in growth that began in 1974 was a temporary recession rather than the climacteric it proved to be. Few saw that the taxes used to pay for new social programmes would bite deeply into the share of value-added that might otherwise be used for investment.

The second phase of policymaking was a reaction to the first, born of rising disillusionment with the fruits of heightened government intervention. To one extent or another, the governments of the early 1980s moved towards more restrictive fiscal and monetary policies and a supply-side view of employment that led to cuts in industrial subsidies in favour of manpower policies. The turning points were 1979 in Britain, 1982 in Germany, 1983 in France, and 1985 in Sweden. The Single Europe Act 1986 ratified a 'move to the market' that was a reaction against the poor economic performance of the 1970s and the activist state intervention associated with it (Hall 1986).

Although their role is often unacknowledged, firms were also important agents of adjustment in this period. German and Swedish firms replied to wage pressure by reorganizing production to secure more value-added per unit of labour, negotiating more flexible wage and work arrangements with trade unions. To do so, Swedish employers dismantled the system of centralized wage bargaining in which they had participated for decades. Even in France, given a green light by the state, large firms took the initiative to reorganize financial relations and supplier networks (Hancké 2002; Culpepper 2005).

The response to the crises of the 1970s suggests that VoC are often resilient in the face of socio-economic challenges. In three of these four cases, firms turned to modes of coordination they had long used to adjust to the challenge, and governments did not radically alter the institutional framework of the political economy. In Britain, market competition was intensified. In Germany and Sweden, strategic coordination remained central to the operation of the economy. Only in France were the ways in which firms coordinate their endeavours radically altered, as coordination under the aegis of the state gave way to modes of allocating resources in which market competition played a more prominent role.

Au:
Culpepper
2005 not
listed.

How might these continuities be explained? To some extent, governments remained committed to economic modalities with which their nations had long been familiar. Thatcher broke with a Keynesian style of policymaking that had become mildly more interventionist, but only to embrace market principles that had long been an important part of British economic ideology (Wood 2001). Kohl's flirtation with a *Wende* in 1982 was half-hearted at best and quickly abandoned when found to conflict with the principles of a social market economy. The limiting case here is France, where successive governments dismantled many of the pillars of dirigisme, albeit without forsaking all of its rhetoric. However, the move away from strategic coordination in France can be explained, at least in part, by the fact that the French state was responsible for much of that coordination. In reaction to the 1970s, there was a retreat from state intervention across Europe, and in France, when the state retreated, strategic coordination was bound to decline. French policymakers flirted with the idea of trying to move towards strategic coordination built on the German model, only to find that the legacy of dirigisme was a set of producer groups too weakly organized to support it (Albert 1982; Levy 1999).

Au: Albert
1982 is not
listed.

The stance taken by producer groups also explains some of the resilience of VoC in this period. Firms were reluctant to endorse institutional reforms that threatened the viability of corporate strategies in which they had made major investments. Tempted though they were by policies that might have weakened the trade unions, many large German firms were reluctant to dismantle the institutions that allowed them to coordinate with other firms and operate production regimes requiring close cooperation from the workforce (Wood 2001). Swedish employers withdrew from centralized bargaining arrangements when those no longer served their purposes, but they soon embraced new forms of strategic wage coordination.

In such contexts, power relations between capital and labour matter. French firms were willing to embrace a more competitive market for corporate governance, partly because the French trade unions were too weak to prevent them from pursuing the profit-oriented strategies required to prosper in such an environment (Goyer 2006). During the early 1980s, German firms hesitated to dismantle wage coordination, fearing the consequences of decentralized bargaining with powerful unions. Only when those unions were weakened further by membership losses and high unemployment during the 1990s did firms begin to defect in significant numbers from cooperative bargaining arrangements (Thelen and Winjbergen 2005). The Thatcher government is the exception that defines the limits to this rule. It took on the trade unions and dramatically reduced their power. However, Thatcher did so from a position of considerable strength. Facing a divided opposition, she was electorally secure,

Au: Thelen
and
Winjbergen
2005 not
listed.

and the British trade union movement was not only divided but weakened by high levels of unemployment.

2.4. THE RESPONSE TO THE CHALLENGES OF THE 1990s AND 2000s

Over the past decade, Europe has faced another set of socio-economic challenges substantial enough to threaten VoC. Many see their origins in 'globalization' construed as an exogenous shock. However, the precise nature of the challenge should be specified. The imports of cheap foreign goods with which it is often associated do not pose a dramatic challenge to countries long used to operating open economies. Two other dimensions of globalization pose greater problems.

One arises from the expansion of markets in emerging economies, including Russia, China, Brazil, and India, as well as Eastern Europe where the collapse of communism in 1989 opened up neighbouring markets.²¹ Although the volume of European imports from these economies is small relative to intra-European trade, their emergence has shifted the opportunity structure facing European firms. These economies offer growing markets that large firms cannot ignore, lest they lose economies of scale to foreign competitors, and some are attractive sites for high-volume production of goods made with moderately skilled labour. As a result, investment that might have gone into domestic production has shifted to emerging markets, and domestic operations using low-skilled labour have been closed in favour of foreign ones (Wood 1994). These developments have intensified the work problem, putting pressures on the European political economies to raise skill levels and create jobs in high value-added manufacturing or the service sector.

The second challenge posed by globalization stems from the internationalization of finance. Although foreign investment has been rising for decades, it has recently increased exponentially. As a result, international investors are now an important source of finance for most large firms, and the largest European banks have reduced their commitments to domestic firms in order to secure global market share.²² These developments have unsettled the relationship with domestic funders that gave many European firms access to finance on terms that allowed them to concentrate on long-term growth rather than current profitability (Hall and Soskice 2001). Foreign investors are pressing firms to secure higher returns and governments to render markets for corporate governance more open and transparent.

Alongside the issues of globalization that capture headlines, however, the European economies confront another set of challenges endogenous to institutional development in Europe itself. As they have in the past, those challenges stem from changes in international regimes, structural changes, and the unintended effects of institutional development.

With the Maastricht Treaty of 1992 and the maturing of the '1992 initiative' embodied in the Single Europe Act 1986, Western Europe shifted its trade and monetary regimes. The advent of a single market forced all major firms to reorganize to meet more intense European competition. The result was an intense process of 'creative destruction' that created new jobs and eliminated many others (Schumpeter 1949). Europe suddenly faced a new work problem, as nations struggled to find positions for workers displaced by processes of economic reorganization.

Equally important has been a shift in the power and posture of the European Union. Over the past twenty years, the powers of its Commission, Court, and Council have increased, and a Union once inspired by the ideal of political integration has become an agency dedicated to market liberalization. As a result, its member-states now face a supranational agency that puts continuous pressure on them to deregulate protected markets, eliminate industrial subsidies, and promote free flows of capital. Across its member-states, the European Union imparts a liberal bias to initiatives for institutional reform (Scharpf 1995).

In 1992, twelve of the member-states also agreed to create an EMU managed by a central bank independent of political control.²³ The EMU, and the stringent requirements for entry into it, restricted the macroeconomic instruments available to national governments for responding to economic shocks. Devaluation was no longer an option for offsetting the impact of wage increases on national competitiveness. The scope for responding to a downturn in demand with a fiscal stimulus was restricted, and member governments lost control over monetary policy altogether.²⁴ As a result, the member-states have had to address adjustment issues on the supply side, through manpower policies or structural reforms to markets for capital, goods, and labour.

Structural changes intensify some of the dilemmas. A continuing shift in the locus of demand towards services means that virtually all job creation has to be in the service sector, and low birth rates are putting pressure on Europe to secure high levels of employment, because a smaller workforce will now have to support a larger proportion of the population in retirement (Iversen and Wren 1998; Scharpf 2000; Pierson 2001).²⁵

The confluence of these developments has magnified the European work problem. Just when the corporate sector was shedding labour to reorganize, first for the single market and then for emerging markets, demand was shifting

towards services. Not only must jobs be found for displaced workers, but jobs in services have to be found for workers equipped with industrial skills. Of course, early retirement is the logical option for many, but demographic pressures now militate against the extension of early retirement. Moreover, just as they faced this work problem, the members of EMU lost their macro-economic instruments for coping with it and have had to depend entirely on structural policies. If the 1970s was dominated by a wage problem, the principal challenge facing Europe in the 1990s has been a work problem.

How have Britain, France, Germany, and Sweden responded to these challenges? I will compare their responses with an emphasis on the distinctive features of national adjustment trajectories.

2.4.1. Britain

The new single market proved congenial to British firms because they were accustomed to coordinating their endeavours through competitive markets rather than strategic forms of interaction. The liberalizing initiatives of the European Commission simply sharpened the types of market coordination on which most British firms depended for comparative advantage, and many found the new market propitious terrain for expansion. Between 1990 and 1994, Britain's share of European trade increased accordingly. In the wake of Thatcher's initiatives, British firms were able to reorganize relatively easily. By the 1990s, barely a third of them had any employees represented by a union, and most could alter wages and work processes relatively freely. That flexibility was reflected in a widening of pay differentials more substantial than those in most continental countries.

The institutions of an LME also made it relatively easy for Britain to move resources out of industry into services. A skill-setting system that privileged general skills enhanced labour mobility, and British governments were able to raise levels of general skills by increasing formal schooling. The British welfare state was also well suited to the creation of jobs in services. Levels of employment protection were low and part-time employment encouraged. Minimalist social policy regimes provided few incentives for people to linger on the unemployment rolls. The 'New Deal' of the 1997 Labour government strengthened the relevant incentives by making receipt of social benefits contingent on an active work search or participation in training schemes (Rhodes 2000).

Britain declined to enter EMU and adopted a floating exchange-rate regime. Where trade unions are powerful, such regimes can be a disadvantage, as Britain found during the 1970s. But Thatcher had dramatically reduced the

Evolution of Varieties of Capitalism in Europe

67

Table 2.3. Employment in services as a percentage of total employment

	1963	1973	1983	1993	2003
Britain	48	54	63	69	75
France	40	48	57	66	72
Germany	40	45	53	57	65
Sweden	46	56	65	71	75

Source: OECD.

power of the British labour movement. Between 1979 and 1992, union membership fell from 50 to 30 per cent of the workforce, and the proportion of firms in employers associations declined from 25 to 13 per cent (Rhodes 2000: 50). As a result, wage pressures remained moderate. Moreover, British governments retained macroeconomic tools denied its continental counterparts and used them to maintain domestic demand at high levels.²⁶ They used judicious depreciations to offset the effects of domestic inflation on competitiveness. As his European neighbours were cutting back spending, the Chancellor of the Exchequer embarked on a spending spree on public services.

Not surprisingly, rates of growth of employment and national product have been higher in Britain than in France or Germany over the past fifteen years (see Table 2.2). The move to service-sector employment has also been more extensive (see Table 2.3). The weaknesses continue to be those that have long afflicted Britain's LME. Because many firms compete by holding down labour costs rather than by investing in new technology or highly skilled labour, average wages remain low, and GDP per capita remains lower than it is in the other three countries examined here.

The shift in international regimes of the 1990s did not induce radical institutional change in the British political economy. Its institutions were already well suited to the competitive environment of the single market, and the City of London was well placed to profit from the internationalization of finance. The reforms made to education and social policy over the past decade reinforced the market coordination and general skills regime already characteristic of the economy, and efforts to improve corporate governance in the wake of the Cadbury commission were consonant with a highly fluid capital market.

2.4.2. Germany

By contrast, the shifts in international regimes of the 1990s posed severe challenges to the German political economy. Germany coped well with the

economic turbulence of the 1970s, when the principal problem was to secure wage moderation, because it had robust institutions for strategic wage coordination. However, those institutions made rapid industrial reorganization more difficult to achieve. In order to reorganize production regimes or shift resources across endeavours, German firms had to engage in intensive negotiations with powerful works councils and trade unions reluctant to agree lay-offs, larger wage differentials, or more onerous working conditions. As a result, the process of economic reorganization in Germany was inevitably more protracted than elsewhere.

Moreover, these challenges coincided with German reunification, greatly exacerbating the work problem (Streeck 1997). Because few east German firms were equipped to compete in open markets, east German workers swelled the ranks of the unemployed, and efforts to cushion that adjustment increased the fiscal pressure on the German government. Since 1990, 4 per cent of GDP a year has been spent on social transfers to the east, and taxes were increased substantially to fund them. The pace of job loss was accelerated by a 'solidarity pact' in 1991 that specified wages in the east should match those in the western Länder. Although rates of unemployment in the west were a hefty 7 per cent by 2000, they hovered around 20 per cent in the east.

Membership in EMU has also eroded, rather than enhanced, the effectiveness of adjustment in Germany. In some respects, the institutions of Germany's CME operate less well under EMU than they did when German institutions controlled monetary and fiscal policy. Given the structure of its taxation system, the non-wage costs of German firms are high. To meet competition from the single market and the east, those firms have had to hold down wages. Strategic wage coordination allowed them to do so. The effect has been to restore the competitiveness of German industry, as rising export levels indicate. But the slow growth of wages has depressed domestic demand, and the macroeconomic environment has not been propitious for growth. The CMEs can generally control inflation effectively. However, because nominal interest rates set by the European central bank respond to continentwide rates of inflation, they have often left German firms facing real interest rates higher than those in other member-states, where wage bargaining is less coordinated and inflation higher. German fiscal policy has also been constrained by the accompanying Growth and Stability pact that proscribes deficits above 3 per cent of GDP. As a result, although German exports reached record levels in the early 2000s, its domestic economy stagnated. German firms reorganized themselves to become more competitive, but the economy has been unable to create jobs for the workers they shed.

As Soskice (this volume) observes, CMEs have special trouble coping with high levels of unemployment or low levels of demand because they deploy a

labour force equipped with industry-specific skills. In the face of unemployment, workers with specific skills find new jobs at comparable wage rates more difficult to secure than do workers equipped with general skills. Accordingly, they respond to rising levels of unemployment by increasing their level of savings more than workers in LMEs. That magnifies the effect of unemployment on domestic demand. The solution lies in reflationary fiscal or monetary policy, but monetary union deprived Germany of this option.

The commitment of the European Commission to market liberalization has also posed challenges to German institutions. In many spheres, German firms depend on forms of strategic coordination that more intense competition would undercut. As a result, German politicians have often resisted such initiatives (Callaghan 2004). However, as German firms reorganized to meet the competitive challenges of a more open global economy, there have been significant changes to established practices that are often read, with some justification, as a liberalization of the German economy. Examined closely, however, they can also be seen as a loosening of some aspects of strategic coordination, that preserves residual capacities for such coordination, should they subsequently be needed.

Developments in the realm of wage coordination are a prominent example. Many smaller firms have defected from sectoral agreements in order to seek concessions from the unions at the firm level (Schröder and Silvia 2006). As a result, wage rates are less uniform and local deviations from sectoral agreements more common. Wage rates in the east are now 62 per cent lower on average than in the west. Facing unionists willing to make concessions because unemployment is high and large firms unwilling to tolerate the industrial conflict necessary to enforce sectoral wage moderation, many firms have preferred to negotiate locally (Winjbergen and Thelen 2004).

Au: Schröder
and Silvia
2006 not
listed.

Au:
Winjbergen
and Thelen
2004 not
listed.

These developments represent a substantial loosening of wage coordination. But they can also be seen as a sign of the flexibility with which the wage-setting system can respond to competitive exigencies. Many of the capacities for strategic coordination embodied in the system remain intact and could be called upon should labour-market conditions tighten. Employers associations have adjusted to defections by devising new forms of membership (Hassel and Williamson 2004). Wages and working conditions continue to be bargained with works councils and unions. Sixty per cent of the German workforce is still covered by a collective bargain, compared to 20 per cent in Britain, and industry and labour continue to operate collaborative training schemes conferring high levels of industry-specific skills.

Parallel developments in the financial sector are open to a similar interpretation. The large German banks have reduced their commitments to domestic industry in order to retain the scale to compete on more open global

markets. Legislation mandating more transparent balance sheets and protection for minority shareholders has encouraged firms to reorganize under the rubric of securing 'shareholder value'. But most firms still fund investment from retained earnings and bank finance, and the government has resisted measures that would enforce shareholder value by promoting hostile takeovers (Callaghan 2004). Although cross-shareholdings have shifted, enough exist to protect many firms from takeovers (cf. Beyer and Höpner 2004).

To address a severe fiscal crisis and move the unemployed into work, the Schröder government trimmed social benefits and required training or a job search in return for them. But the structure of the German welfare state has not been seriously altered. Benefits continue to be funded by social charges and early retirement programmes still assist firms seeking to reduce their labour force (Streeck and Trampusch 2005).

Au: Streeck
and
Trampusch
2005 not
listed.

The principal institutional transformation in the German political economy has been the development of a dual labour market, based on the promotion of part-time 'mini jobs' now occupied by more than four million workers on whom social charges are not levied. At 20 per cent of jobs, part-time employment in Germany is now almost at British levels and employment protection in this secondary labour market is low. The key issue is whether this development will gradually enforce similar changes in the core labour market, now dominated by skilled industrial labour, but Japan's capacity to operate dual labour markets suggests that it need not do so.

Broadly speaking, coordination in some spheres of the German political economy has been loosened in response to the challenges of the 1990s but strategic coordination remains prominent in the endeavours of many firms. After a painful decade, German firms have reorganized themselves effectively. Unit labour costs are again competitive (see Table 2.4). Female labour force participation has increased from 61 per cent in 1991 to 66 per cent in 2005, and service-sector jobs are being created at a pace in line with the European average (see Table 2.3).²⁷ But the work problem remains unresolved. Five million unemployed drag down German rates of growth and

Table 2.4. Real unit labour costs (1995 = 100)

	1963	1973	1983	1993	2003
Britain	104	104	101	103	101
France	108	105	112	102	99
Germany	104	108	106	102	99
Sweden	117	111	112	105	107

Source: OECD.

put intense fiscal pressure on the government (Streeck 2006). A political economy that performed well in the industrial era has been unable to create jobs fast enough to absorb the large eastern labour force it inherited with reunification.

To some extent, these problems are an artefact of the German model itself, which has remained competitive by substituting capital for labour in a core industrial sector that remains the largest in Europe. That strategy delivered high incomes and substantial amounts of leisure time to a core labour force but created employment only slowly. Called upon to create jobs more rapidly, Germany has turned towards a secondary labour market that is generating jobs on terms that threaten the egalitarian values long associated with its economic model. The result is political disillusionment and widespread insecurity, as those in the core economy face cuts in benefits to which they have become accustomed, while stagnating levels of demand impede the creation of jobs.

2.4.3. France

French governments were enthusiastic sponsors of the single market and EMU, in the belief that the latter would offer monetary policies more accommodating than those of the German Bundesbank to which France had been in thrall during the 1980s. When these hopes were disappointed, the French found themselves in a relatively austere macroeconomic environment with stubbornly high levels of unemployment. The government reacted with a two-pronged strategy that extended the approach to such problems developed during the 1980s.

One dimension of government strategy was to promote the role of markets in the allocation of resources. In 1993, the government resumed the privatization of public enterprises (on hold since 1988) and allowed sales of the core shareholders assembled to protect newly privatized companies. France saw a wave of mergers and acquisitions, as many French conglomerates reorganized around more focused sets of operations. The amount of equity raised by French corporations increased by 38 per cent during the 1990s, and foreigners owned almost 40 per cent of the shares of the leading 40 French corporations by 2003 (Culpepper 2006). In the sphere of industrial relations, a series of government initiatives encouraged bargaining at the firm, rather than the sector, level between employers and a weakened set of trade unions, whose membership, at 5 per cent of the labour force, fell to the lowest level in Europe. The effect of these steps was to improve the efficiency of French business, whose unit labour costs fell during the 1990s.

The second dimension of French policy was orthogonal to the first. Successive governments increased public spending to create subsidized jobs, notably for the young or unemployed, and to provide social benefits as a cushion against the unemployment generated when French firms rationalized. When an effort to create jobs by reducing the workweek to 35 hours had little effect on unemployment, these subsidy programmes were expanded. The Jospin government created new positions in the public sector and made few cuts to the generous benefits available to those in the most privileged positions of France's welfare state. As a consequence, public spending rose faster in France than elsewhere in Europe, reaching Nordic levels at 51 per cent of GDP in 2004.

If France moved towards market modes of coordination by intensifying competition, the character of its social policies continued to distinguish France from classic LMEs, such as those of Britain or the USA, where low social benefits are used to push workers into jobs. However, the nation moved faster than Germany to reform its continental welfare state. In both countries, a social policy regime that funds benefits from social charges on labour has discouraged the creation of low-wage jobs (Scharpf 2000). However, French governments began earlier to shift costs to general taxation, increasing the CSG (contribution sociale générale), introduced in 1990 as a temporary 1.1 per cent surtax on income, to 7.5 per cent of income by 1998. They have also used a national minimum income, the RMI (revenu minimum individuel) like an earned-income tax credit to encourage the unemployed to take low-paying jobs. Like Germany, therefore, France has begun to encourage the development of a dual labour market. Many employees in the public service and some segments of the private sector enjoy high levels of employment protection and generous retirement benefits (Smith 2004). By easing restrictions on part-time and temporary employment over the course of the 1990s and early 2000s, the government has begun to create a sizeable secondary labour market where employees work without substantial benefits or job security.

These measures dramatically improved the performance of French business (see Table 2.4). By 2000, the average French worker was as productive as his American counterpart, and rates of growth in France have remained close to the EU average over the last decade (Blanchard 2004). But, at 12 per cent in 2006, French unemployment has remained persistently high, and political discontent is palpable (Hall 2005). In May 2005, French voters rejected the constitution of the European Union, which many saw as the agent of liberalization, and, in May 2006, massive demonstrations forced the government to withdraw a plan to introduce short-term labour contracts for those under the age of 26.

2.4.4. Sweden

Swedish institutions proved effective enough to secure high levels of employment and growth during the 1980s, and the country did not enter the EU until 1995, thereby putting off some of the challenges facing its neighbours. But Sweden experienced a crisis of its own at the beginning of the 1990s. Sparked by the deregulation of credit markets in 1985, an asset boom fuelled wage pressures that a bargaining system, still reeling from the collapse of centralized negotiation, could not contain. In the years immediately after 1990, inflation rose to 10 per cent, Sweden experienced negative rates of growth for three successive years, and the public-sector deficit ballooned to 17 per cent of GDP.

Some of Sweden's capacities for strategic coordination had clearly failed. The question was whether they could be revived and, if so, in what form. In the medium term, concerted action by the government and producer groups eventually re-established a stable system for wage coordination. Although reaching agreement proved difficult, by 1997, the government and producer groups had negotiated new arrangements that provided for more formal mediation and a government-sponsored council to provide wage guidance for bargains generally struck at the sectoral level (Elvander 2003). Around these bargains, however, there was to be more scope for firm-level agreements on wages and working conditions, which Swedish firms have used to reorganize production in the face of international competition. That system has proved durable.

In the short term, the exchange-rate regime proved crucial to Sweden's capacity to recover from this disastrous episode of distributive conflict. Taking advantage of a floating exchange rate, in 1992, the government initiated a devaluation that ultimately reached 32 per cent, and the trade unions accepted most of the reduction in real wages it implied, partly because the crisis had taken the rate of unemployment to 8 per cent. By 2000, Sweden's competitiveness had been restored enough to generate a trade surplus of 2 per cent of GDP. The case provides an example of how a flexible exchange-rate regime can be used to address the problems that result when the institutions normally charged with resolving distributive issues fail.

Less obvious but equally consequential were reforms made during the 1990s in the sphere of corporate governance. As the share of investment financed from abroad increased around the world, Swedish firms became concerned about securing access to it. Accordingly, they pressed the government to lift existing restrictions on the foreign purchase of shares, and, in order to attract investors, many of the family groups that long dominated the stock exchange began relinquishing their preferred shares, which had put minority investors at a disadvantage. Partly as a result, the Stockholm stock market grew 24-fold

during the 1990s and, by 2001, 43 per cent of its equity was foreign-owned by 2001, compared to 8 per cent in 1990 (Reiter 2003: 113).

Based on cross-shareholdings revolving around several large family-owned firms, strategic coordination in corporate governance had long been high in Sweden. The effect of these measures was to reduce the level of strategic coordination and expose firms to more market pressures. These moves went substantially further than analogous reform efforts in Germany. Why were they practicable in its CME?

Part of the answer may lie, as in the cases of France and Germany, in the character of labour markets. The organization of industrial relations conditions the feasibility of reforms in corporate governance (Hall and Gingerich 2004). German firms have been hesitant to expose themselves to intense competition in the market for corporate governance because the commitment of powerful works councils and trade unions to employment protection make it difficult for them to respond to the demands of aggressive shareholders. Although trade unions are equally powerful in Sweden, they are much less committed to employment protection, by virtue of the arrangements developed under the Rehn–Meidner model. Those promote labour mobility, offering high unemployment benefits in the short term (with replacement rates reaching 90 per cent of previous wages for 180 days) and substantial assistance in the job search in lieu of employment protection. The system encourages investment in the industry-specific skills on which Swedish firms depend, not by protecting jobs, but by offering assurances that another job will soon be found and few wages foregone in the search (Estévez-Abe, Iversen, and Soskice 2001). Swedish firms could embrace a more competitive market for corporate governance because labour market arrangements made it relatively easy for them for them to shed labour if they had to meet heightened demands for profitability.

Moreover, the Swedish reforms did not go as far as those in France. Despite the waning dominance of its old family firms, Swedish equity markets are still characterized by many cross-shareholdings that protect companies, such as Sandvik and Skanska, from hostile takeovers. Closed-end investment funds that often perform such functions have substantial holdings on the Stockholm Stock Exchange (Högfeldt 2004). Sweden moved from a bank-based system of corporate finance towards an equity-based system that draws heavily on foreign investment without exposing its firms to all the pressures characteristic of an LME (cf. Henrekson and Jakobsson 2003).

In tandem with these developments in the sphere of corporate governance, Swedish governments took steps to enhance the mobility of labour. Spending on active labour market policy was intensified, rising from 3 per cent of GDP in 1990 to 5 per cent by 1995, the highest level in Europe, and employment

Evolution of Varieties of Capitalism in Europe

75

Table 2.5. Days lost in industrial conflict

Years	1953–61	1962–6	1967–71	1972–6	1977–81	1982–7
Britain	28	23	60	976	112	88
France	41	32	350	34	23	13
Germany	7	3	8	3	8	9

Source: Employment Gazette (various issues); Armstrong et al. (1985). Average number of days per year occupied in industrial conflict per 100 workers in industry and transport.

Au:
Armstrong
et al. (1985) is
not listed.

in the public sector was increased to absorb those who had difficulty finding work. However, the government also reduced the marginal tax rate for many individuals and its own revenue by about 3 per cent of GDP, agreed to fund social services operated by private organizations, and made reforms to sick pay that reduced absenteeism rates (Benner and Vad 2000; Steinmo 2000).

These institutional innovations have worked well. For almost a decade, Sweden has again secured rates of growth well above the EU average and rates of unemployment well below it. Its institutions for wage-setting have been rendered more flexible but remain coordinated enough to deliver real wage increases commensurate with increases in productivity, and its approach to the work problem, based on active labour market policy and public employment, remains intact. Using its capacity to mount autonomous fiscal and monetary policies, the government has smoothed periodic fluctuations in demand. It may not be coincidence that the two economies among our cases that have performed best over the past decade—one liberal and one coordinated—are those that remained outside EMU.

2.5. CONCLUSION: ASSESSING INSTITUTIONAL TRAJECTORIES

I have argued that, over the course of the post-war years, the nations of Western Europe developed distinctive sets of institutions for managing the wage, work, and productivity problems confronting them. Extending from institutions for firm-level coordination to features of the welfare state, these institutions were constitutive of distinctive VoC, and I have traced the ways in which those institutions changed, as firms and governments encountered successive waves of socio-economic challenges. What lessons does this survey contain for those interested in the fate of VoC today?

It provides grounds for scepticism about claims that the magnitude of the challenges and institutional reforms in Europe today are rendering VoC

Au: Please
provide
Figure 2.3.



Figure 2.3. Trends in deindustrialization and trade in the OECD 1955–95

Source: OECD, National Accounts, Part II; Iversen (2005). Trade is sum of exports and imports as a percentage of GDP. Deindustrialization is 100 minus the sum of employment in agriculture and industry as a percentage of the working age population.

approaches to comparative capitalism obsolete. On the one hand, the socio-economic challenges that preoccupy these political economies today are far from the first they have faced, and many of the developments considered corrosive of VoC are not new (see Figure 2.3). Measured by the exports of the average West European nation, trade grew by almost 9 per cent a year from 1950 to 1970. As early as the 1960s, firms were preoccupied by technological change, and policymakers by foreign investment. Employment also began to shift sharply from industry to the service sector in the 1960s (Servan-Schreiber 1969; Bell 1974; Iversen and Cusack 2000). There is little basis for seeing ours as a uniquely convulsive era.

On the other hand, institutional change is not new. Each of these political economies experienced continuous institutional change throughout the post-war period. Firms and governments frequently revised their strategies to meet emerging conditions, and some of the features most associated with distinctive models of the political economy, such as the use the Nordic nations make of public employment, are relatively recent developments. From this vantage point, it is not surprising to find institutional change in Europe today. Those who see in it a sign that VoC will soon cease to exist misunderstand the character of those varieties.

I have tried to show that VoC are constituted, not by static sets of institutions, but by distinctive trajectories that are institutionally conditioned, as new practices are developed to cope with the problems generated by past practice and integrated into a network of interacting institutions, some of which remain stable as others change. As a result, while configured somewhat differently than in the past, the political economies examined here continue

to display divergences in institutionalized practices as pronounced as those at most moments since the war.

In large measure, that divergence extends to the modes of coordination that Hall and Soskice (2001) associate with different VoC. Over time, competitive markets have become an even more important feature of coordination in Britain's LME. Market relations have also become more important to the coordination of some types of firm endeavours in Germany and Sweden. Their large firms are now more likely to seek capital on competitive international markets. Sweden has scaled back employment protection to create a more fluid labour market, and Germany has adopted regulations that allow for the growth of a low-wage, part-time labour market in which wages are not collectively bargained. Coordination of wages at the sectoral level in Germany has become looser, as small firms defect from sectoral agreements to reach firm-level accords with unions and works councils (Thelen and Kume 1999; Schröder and Silvia 2006).

However, to emphasize these developments is to neglect the many respects in which strategic coordination is still important in Sweden and Germany. Sectoral wage agreements, while looser than they once were, are still key features of these political economies. At the firm level, wages and working conditions in Germany are more often bargained with works councils than set arbitrarily. Cross-firm collaboration remains an important element of technology transfer, and of vocational training in Germany. The industrial sectors of Germany and Sweden continue to operate production regimes that rely on highly paid workers equipped with industry-specific skills, while British firms make greater use of general skills and low-wage labour. Although foreign investors now supply a greater proportion of investment everywhere, German firms continue to draw more heavily on long-term bank-based finance than British firms, and hostile takeovers are much less frequent in Germany and Sweden than in Britain.

Some argue that the introduction of more competitive market relations into various spheres of these economies is the thin end of a wedge that will drive them inexorably away from coordinated capitalism (Höpner and Jackson 2001). Hall and Soskice (2001) provide some grounds for thinking this when they observe that strategic coordination in one sphere of the economy often enhances its value elsewhere. However, recent developments suggest that efforts to render some markets more competitive need not erode strategic coordination elsewhere in the political economy. Among those examined here, the move by Sweden towards more competitive markets in corporate governance is one striking case, and the dual labour market developing in Germany another.²⁸ It is important to acknowledge that some forms of market competition are compatible with strategic coordination of other endeavours.²⁹

The analytic challenge here, deserving of more research in the coming years, is to establish which kinds of moves towards more intense market competition erode existing capacities for strategic coordination and which are compatible with them. That issue has been obscured by the tendency of the literature to describe institutional reform in Europe as part of a monolithic process of 'liberalization' sweeping over the continent. That captures an important feature of the political *Zeitgeist*: liberal reform is popular in international circles and that popularity lends political impetus to measures adopted across Europe, including increases in part-time employment, temporary labour contracts, benefit cuts that push people into work, and measures to render balance sheets more transparent or to protect minority investors.

With respect to impact, however, the concept of 'liberalization' is misleading. Measures that are all described as 'liberal' can have different economic or institutional effects (Hall and Thelen 2005).³⁰ Some are corrosive of strategic coordination elsewhere in the economy, while others enhance it. Balance sheets can be rendered more transparent without much impact on how firms raise finance, but measures to encourage hostile takeovers have dramatic effects on firm strategies. Similar developments can also have impacts that vary across institutional settings. In Britain, devolving wage bargaining to the firm in Britain usually means setting wages by demand and supply in local labour markets, while similar moves in Germany usually mean that wages are negotiated with trade unions or works councils at the firm level. We need to disaggregate the concept of 'liberalization', lest we overstate its impact. Despite important common trends, the political economies of Europe are not converging rapidly on a common liberal model.

However, those political economies are changing. I have suggested that VoC follow institutionally conditioned adjustment trajectories and, in keeping with that account, we can see some important points of divergence in those trajectories. The most dramatic occurred in the case of France, where strategic coordination in the spheres of corporate governance and labour relations recedes, in the decades after 1985, to give way to forms of coordination in which market competition plays a more prominent role. Although the French state has not lost all of its capacities, it has relinquished important elements of the coordinating role it once played in the economy.

Another occurred in the 1970s, when Sweden and Germany responded differently to the prospect of rising unemployment. The Swedish government expanded public employment to provide a reservoir of jobs for those with general skills, thereby bringing large numbers of women into the labour force. At roughly the same time, the German government reacted with early retirement and disability schemes designed to reduce the numbers seeking employment. Although both routes proved compatible with the operation of a CME, over

the long term, these were fateful decisions. Facing demographic pressures that foretold fiscal crisis, Germany was subsequently to find it difficult to increase the share of the population in employment. As the result of the accumulated effects of such choices, there have been important divergences in the institutional trajectories of CMEs.

2.5.1. Institutions and Economic Performance

This analysis helps explain why some types of political economies perform better in some eras than others. It provides an account of the impact of institutions on economic performance that highlights three types of effects. As others have noted, institutions mediate the response to (partly) exogenous shocks (cf. Blanchard and Wolfers 2000). Two prominent shocks in this era provide examples—the stagflation of the 1970s and shift of employment to services. Faced with stagflation, the CMEs of Sweden and Germany secured better levels of performance, largely because their institutions for wage coordination contained the effects of inflation more effectively. Their institutions were well configured for coping with inflation. Because they set high wage floors and privileged specific skills, however, their institutions were less suited to creating jobs in the service sector. Swedish governments responded better by expanding public employment based on general skills, while Germany did not. By contrast, Britain and France suffered more economic losses in the inflation of the 1970s, but created jobs faster in the service sector, partly because their economies were already geared towards general skills. Of the two, Britain was more successful, arguably because its low minimum wages and social charges encouraged firms to create service-sector jobs (Scharpf and Schmidt 2000; cf. Iversen 2005).

However, institutions do not simply mediate the response to economic shocks. Over time, they contribute to the challenges an economy faces. European inflation was generated, in the late 1960s and 1970s, partly by institutions that gave trade unions a powerful role in wage bargaining; and national variations in rates of inflation corresponded to differences in the institutions coordinating wage bargaining (Crouch and Pizzorno 1978; Hall and Franzese 1998; Iversen 1999). The slow growth of employment in Germany during the 1980s and 1990s had roots in an institutional model developed to secure increases in productivity via continuous innovation by highly paid skilled labour whose social benefits were funded from charges on employment. High labour costs encouraged firms to increase labour saving investment rather than take on new employees (Manow and Seils 2000). In Britain, institutional support for low-wage employment expanded the labour force but

Au: Scharpf
and Schmidt
2000 not
listed.

discouraged firms from moving into high value-added lines of production, thereby limiting the growth of national income. In each case, the institutional solutions devised by firms and governments to address the problems of one era conditioned the shape of the challenges they were to face in later periods.

I have also argued that changes in international regimes affect economic performance by virtue of how they interact with the institutions of domestic political economies. The move to floating rates in the 1970s eroded the effectiveness with which European systems for wage coordination operated (Eichengreen 1996; Iversen 1999). By reducing the scope for national reflation and focusing cross-national competition on unit labour costs, the subsequent move to EMU hit CMEs with high non-wage costs and highly skilled labour relatively hard, as firms held down wages to compete and highly paid workers increased their savings to guard against unemployment (Soskice, this volume). In short, institutions that deliver high levels of performance under one set of international regimes or in the face of some socio-economic challenges may not do so under others.

2.5.2. Explaining Institutional Trajectories

The image of political economies presented here sees them as institutional ecologies built up gradually over time. How can the shape and direction of those trajectories be explained? That is a question to which answers are only beginning to emerge (see Streeck and Yamamura 2001; Thelen 2004). However, these cases suggest some observations.

Given the impact of regulatory regimes on the political economy, the partisan complexion of government is likely to play a role in the construction of the political economy. Political parties use ideologies to build reputations, and differences in the ideologies of social democratic, Christian democratic, and liberal parties are salient to the political economy (Esping-Andersen 1990; Iversen and Wren 1998; Huber and Stephens 2001). Social democratic parties tend to have a high tolerance for public spending and an interest in expanding employment (Bradley and Stephens 2007). Christian democratic parties have been less inclined to move women into the labour force. Divergence in the paths taken by Sweden and Germany during the 1970s and 1980s may be attributable partly to the influence of social democracy in Sweden.³¹ The neoliberal initiatives in Britain during the 1980s owe something to the ideology embraced by its Conservative Party.

However, the initiatives taken by parties vary over time and space more than an emphasis on partisan ideology usually allows, and the evolving character

of the political economy can influence the positions parties take on issues of institutional reform. We need analyses of the construction of the political economy that incorporate a role for partisan competition but allow the accumulated institutions of the political economy to influence partisan positions. The first step is to acknowledge that the behaviour of governing parties also depends on the coalitions they can organize among the electorate. The next step is to identify how institutions influence that process of coalition formation. Iversen and Soskice (2006) move in this direction when they note that the latter depends on the structure of the electoral system (see also Swank 2003). Existing policy regimes can also influence the interests of potential coalition partners. Pierson (2002) notes that actors acquire vested interests in policy regimes by virtue of their network externalities. Iversen (2005) suggests that skill systems and related production regimes generate variations in the electoral support available for different types of social policy regimes. By virtue of the divisions of interest they create between economic insiders and outsiders, the institutions of the political economy also influence the types of coalitions that social democratic parties can assemble (Rueda 2005, 2006). Each of these perspectives suggests that, as the institutional structure of a political economy develops, it conditions the terms of partisan competition in ways that tend to create distinctive institutional trajectories. We need further research into the ways in which the platforms and fortunes of parties vary over time with the institutional development of the political economy (Kitschelt and Rehm 2004).

Au: Swank
2003 not
listed.
Au: Pierson
2002 not
listed.

In the same vein, Swenson (2001) points to the ways in which the character of institutions conditions the demands emanating from producer groups for reform. Following Goyer (2005, 2006), I have argued that French employers were supportive of the liberalization of French markets for corporate governance, partly because the character of industrial relations in France posed few impediments to corporate reorganization. In Britain, the Blair governments made few moves to restore the power of the trade unions, partly because employers had developed production regimes congruent with the market reforms initiated by the preceding Thatcher governments. Here, as elsewhere, social democracy adapted itself to the institutional configuration of the political economy.

Au: Swensen
2001 not
listed.

Of course, such processes are far from mechanical. Governing parties respond to the electorate as well as producer groups. They often face conflicting factions within each, and all governments have minds of their own. Their measures are frequently inspired by distributional concerns rather than economic optimality (Hall and Thelen 2005). Over the long term, however, political feedback effects from the structure of the political economy sustain distinctive VoC.

2.5.3. The Prospects for Europe

As Mark Twain might have said, rumours of the death of CMEs are greatly exaggerated. In some countries, such as Sweden, they are performing reasonably well. Even in Germany, where the headlines stress high levels of unemployment, reorganization in the corporate sector has been profound, as in France. Many of Germany's firms are highly profitable, and its exports have reached record levels. Although intensified by the challenges of reunification, its adjustment process there has been protracted but highly effective in some respects. I read the loosening of sectoral coordination as an adjustment that preserves many of the strategic capacities inherent in German institutions. It is not surprising that wage coordination should operate differently when unemployment, rather than inflation, is the main economic problem. However, it is undeniable that France and Germany are suffering from high levels of unemployment that depress their rates of growth. Their institutions have been better at improving productivity than at creating jobs, and that fact is creating political, as well as economic, dilemmas.

Eichengreen (1996) notes that the institutions of the macroeconomy resolve coordination problems, but I have stressed that they also regulate distributive conflict. When they failed to do so during the 1970s, the result was inflation (Goldthorpe 1978). Today, however, the conflict is about the distribution of work, and the approaches nations are taking to the problem are creating distinctive political dynamics. Building on institutions developed in the 1960s and 1970s, Sweden is promoting labour mobility and secure public sector employment oriented to general skills.³² The effect has been to lower the institutional divisions between economic insiders and outsiders, making it more feasible for the Swedish social democrats to build cohesive political coalitions.

By contrast, France and Germany are building dual labour markets that create a growing number of temporary or part-time positions at relatively low wages alongside those in the industrial or public sectors that offer higher levels of wages and job security. In each economy, more than four million people now hold such jobs. From the perspective of job creation, the strategy has merit, and it may not seriously damage the capacities for strategic coordination elsewhere in the German economy. But the political effects of such strategies may be more deleterious. They drive a wedge between insiders with relatively secure jobs and outsiders in precarious employment.³³ That makes it more difficult for social or Christian democratic parties to retain the support of a cohesive coalition in the electorate and opens up opportunities for parties on the fringes of the political spectrum to mount appeals tailored to those in precarious employment. In Germany and France, parties on the radical

right and radical left have been doing precisely that. The result is centrifugal pressure that further erodes the capacity of mainstream parties to take bold measures to address their nations' problems.

In these countries, the class compromise that underpinned post-war institutions is fraying at the edges, and governments face problems that are as intractable in political terms as they are in economic ones. More is at stake than economic performance. The effort of the European Union to find a new legitimating ideal in a commitment to open markets is failing in the large economies at its heart, even as that commitment makes it difficult for their governments to experiment with alternative formulae. Unless another wave of prosperity lifts Europe's boats, the result is likely to be a new era of political conflict that will once again shake, if not reform, its VoC.

NOTES

1. When this chapter speaks of Europe, the reference is to Western Europe and references to Germany are to West Germany up to 1989 and reunified Germany thereafter.
2. This is a problem to which Polanyi (1944) directs our attention.
3. New classical economists would attach more importance to the level of real wages, while post-Keynesian economists put more stress on levels of aggregate demand, whether domestic or international.
4. For important efforts to do so, however, see Acemoglu, Johnson, and Robinson (2004) and endogenous growth theory more generally (Aghion and Howitt 1988; cf. Lieberman 1978 on X-efficiency). Au: Lieberman 1978 not listed.
5. Of course, some analysts contend that market competition is the only viable route to efficient performance. For a telling account of how strategic coordination can deliver equally good results in some spheres, see Finegold and Soskice (1994). Au: Finegold and Soskice 1994 not listed.
6. In the 1940s and 1950s, for instance, many analysts and policymakers were highly critical of the strategies pursued by British firms and the *malthusienisme* of French firms (cf. Landes 1949; Baum 1958; Shonfield 1958).
7. For a classic overview, see Shonfield (1969).
8. See Rosanvallon in Hall (1989) and Manow (2001).
9. Compare Beer's account (1969) of the ways in which post-war British institutions reflected new understandings of collective purpose and of how economic and political institutions serve such purposes.
10. The 'replacement rate' is the proportion of previous wages that a worker on unemployment benefit receives.
11. On Fordist modes of production, see Boyer (1990) and the references there. My approach to these issues is deeply influenced by the efforts that he and other

founders of the 'regulation school' have made to link the institutions of the macroeconomy to production regimes. See also Amable (2003).

12. These were in the inflows of 'guest workers' between 1959 and 1971. By 1980, there were about four million of these workers and their family members in the country.
13. This feature of the model was influenced by the bargaining system developed amidst labour scarcity during the 1930s, when employers and unions in the export sector joined with employers in the construction sector to negotiate at the peak-level of the economy (Swenson 1991).
14. Around such central tendencies, of course, the strategies adopted by firms in any one country also vary substantially.
15. Of course, the growth of the overseas dollar balances that contributed to the collapse of Bretton Woods also fed these inflationary conditions.
16. A second shift of employment from industry to services that began on a large scale during the 1960s reduced the rate of growth of productivity further, because the productivity gains available in services tended to be smaller than those available in industry.
17. As the Irish case indicates, however, it is not impossible to establish a durable social partnership in LMEs.
18. The average size of a plant in Sweden increased by 23% from 1971 to 1988 (Pontusson 1997).
19. Industrial employment in Germany shrank by 11% between 1970 and 1975 (Kreile 1978).
20. However, these measures indicate that the experience of cutbacks to social benefits, which many see as a recent phenomenon, goes back twenty years.
21. For Germany, of course, the collapse of communism was especially consequential since the reunification of East and West Germany that followed was also an immense economic shock for the political economy. See Streeck (1997).
22. The reorientation of the large German banks is a striking example. Many have reduced their equity stakes and involvement in the management of domestic enterprises in order to focus on global markets. The law of 1999 abolishing capital gains tax on the sale of inter-corporate shareholdings was designed, in part, to allow them to do so.
23. For analyses of why these nations entered into monetary union, see Eichengreen (1997), McNamara (1998) and Dyson and Featherstone (1999).
24. Honoured in the breach as well as the observance, this pact nonetheless inhibits governments from taking exceptionally reflationary steps, thereby also altering their capacity to assure firms that domestic demand, so crucial to investment, will remain robust.
25. On current trends, xx % of the EU population will be over the age of 65 in 2010, up from xx % in 1980.
26. This is reflected in the British balance of payments deficit, which averaged xx % from 1995 to 2005 compared with an average of xx % of GDP in Germany and xx % in France.

Au: Please provide the extract percentage numbers in Place of 'xx' in endnotes 25, 26, 27.

Evolution of Varieties of Capitalism in Europe

85

27. Employment in the German service sector increased by xx % from 19xx to 20xx, compared to xx % in the EU15. Au: Please
28. Of course, the striking model for this postulate is Denmark. See Boyer (2006), Campbell, Hall and Pedersen (2006). Au: provide the
29. Hall and Soskice (2001) acknowledge this point, observing that coordinated economies are coordinated *market* economies. Au: extract year in
30. I owe this point to Kathleen Thelen. Au: place of 19xx
31. Between 1970 and 1996, a social democratic party held on average 43% of the legislative seats in Germany and 64% in Sweden, while Christian democrats held 41% of the seats in the former and 2 % in the latter. (Iversen 2005: 251). Au: and 20xx.
32. At 2.6% of GDP, Sweden is spending more an active labour market policy than any other European country. Au: Boyer
33. Rueda (2006) reports that respondents with more job security are less likely than those with less security to support increases in taxes designed to advance job creation. Au: 2006 not
34. I am grateful to Jan-Emmanuel de Neve for efficient research assistance, to Tom Cusack, Torben Iversen, and Tim Smeeding for sharing their data, and to Cathie Jo Martin, Bo Rothstein, and Mark Thatcher for comments. This essay benefits from what I have learned in joint work with Kathleen Thelen and support from the Wissenschaftskolleg, Berlin. Au: This
- Au: endnote is not cited in the text. Please check.

