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The viability of advanced welfare states in the international economy. Vulnerabilities and options[1]

FRITZ W. SCHARPF*

The paper presents a preliminary and partial analysis of the information collected in a comparative 12-country study of the adjustment of national employment and social-welfare policies to the increasing internationalisation of product and capital markets. After the postwar decades, when national governments were still able to control their economic boundaries, the first international challenge came in the form of the oil-price crisis of 1973/74, which confronted industrial economies with the double threat of cost-push inflation and demand-gap unemployment. It could be met if countries were able to achieve a form of 'Keynesian agreement' in which expansionary monetary and fiscal policies would defend employment while union wage restraint could be relied on to fight inflation. For this solution, 'corporatist' industrial-relations institutions were a necessary, but not a sufficient, condition. Since the second oil-price crisis of 1979–80 was met by restrictive monetary and expansionary fiscal policies in the United States, the steep increase of real interest rates in the international capital markets forced other central banks to raise interest rates accordingly. As a consequence, employment-creating investments could only be maintained if the share of profits in the national product was significantly increased. Under the pressure of rapidly rising unemployment, unions in most countries were forced to accept this massive redistribution from labour to capital. In the 1990s, finally, the international integration of product and capital markets has been constraining private sector employment as well as the financial viability of the welfare state. Now, however, institutional differences among different types of revenue systems, welfare states and employment systems – Scandinavian, Anglo-Saxon and Continental – are creating important differences in vulnerability that can no longer be met by standardised responses. This paper concludes with an examination of the specific

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problems faced by, and the solutions available to, the different countries included in the study.

Introduction

Since the second oil-price crisis of 1979–80 was met by restrictive monetary and expansionary fiscal policies in the United States, the steep increase of real interest rates in the international capital markets forced other central banks to raise interest rates accordingly. As a consequence, employment-creating investments could only be maintained if the share of profits in the national product was significantly increased. Under the pressure of rapidly rising unemployment, unions in most countries were forced to accept this massive redistribution from labour to capital.

In the 1990s, finally, the international integration of product and capital markets has been constraining private sector employment as well as the financial viability of the welfare state. Now, however, institutional differences among different types of revenue systems, welfare states and employment systems – Scandinavian, Anglo-Saxon, and Continental – are creating important differences in vulnerability that can no longer be met by standardised responses. This paper concludes with an examination of the specific problems faced by, and the solutions available to, the different countries included in the study.

The rise of the capitalist welfare state

Modern welfare states have their roots in the last decades of the19th century and the first decade of the 20th century, when the international integration of capitalist economies had reached a high plateau. However, they only achieved their full development in the 'golden age' of the early postwar decades, under conditions of nearly closed national economies. After the rampant protectionism that followed the Great Depression and the complete breakdown of world markets in World War II, most currencies were not freely convertible, capital transfers were tightly controlled and internal financial markets were strictly regulated in most countries. The restoration of international trade in product markets was a slow process. Export dependence and import penetration were still limited, and the range of economic activities that were sheltered against international competition was quite large. Services were protected almost everywhere, as was agriculture in most countries, while manufacturing was generally more export oriented, except for Australia and New Zealand, which relied on agriculture and raw materials exports to sustain highly protected manufacturing industries. Whilst the competitiveness of internationally exposed aspects had became insufficient, the Bretton Woods system of fixed exchange rates allowed negotiated adjustments to restore the balance of payments.

Thus, while it would be wrong to speak of totally closed national economies in the early postwar decades, nation states were able to control both their own economic boundaries and the conditions under which trans-national economic transactions took place. Behind these protective barriers, national governments and unions could more or less ignore the exit options of capital owners, taxpayers and consumers. Government interest rate policy was able to determine, and vary, the minimal rate of return that captive capital owners could expect in the market for longer-term investment opportunities. By the same token, the level and the type

of taxes that governments could impose on captive taxpayers were primarily limited by political, rather than economic, constraints. If governments and unions were able to impose uniform regulations, taxes and wage increases on all competing firms, the higher production costs could generally be passed on to captive consumers without endangering the profitability of capitalist production.

Under these conditions, advanced industrial democracies were able to achieve the 'Great Transformation' (Polanyi 1957) that allowed them to exploit the economic efficiency of dynamic capitalism without having to accept its recurrent crises and highly unequal distributional consequences. Since they were able to control trans-national capital movements, most governments learned to dampen macro-economic fluctuations through Keynesian demand management, and to achieve and maintain relatively high rates of economic growth and full employment. At the same time, national control over external trade gave governments and unions great freedom to shape the conditions of production. Moreover, boundary control combined with the power to impose nationwide rules allowed redistribution of primary incomes through cross-subsidisation in the private sector, as well as secondary redistribution through public services and transfers financed through progressive taxation. Hence, a suitable wage policy could compress wage differentials between low-skill and high-skill groups with little regard for actual differences in labour productivity. Energy policy could require the use of domestic coal in electricity generation; agricultural policy could keep inefficient farms in business; national health systems could offer medical care free of charge to everybody; and national systems of social assistance, unemployment and disability benefits and pensions could provide generous levels of non-wage incomes.

However, even though all capitalist democracies used their new-found freedom of market-correcting political action to pursue full-employment, social security and egalitarian goals, the employment and welfare-state structures through which these common goals were realised differed greatly with regard to:

- the division of labour between formal employment and household production – in particular of services for the young, the sick and the aged;
- the importance of formal employment in the public or private sectors;
- the importance of the state, 'corporatist' bargaining, and the market in regulating wages and the conditions of formal employment;
- the relative importance of the formal welfare state or of the employment system in achieving aspirations of social security and social equality;
- the relative importance of social transfers or of social services in the formal welfare state;
- the relative importance of income maintenance or of basic security in social transfers;
- the relative importance of general tax revenue or of insurance contributions in financing the formal welfare state;
- the relative importance of opportunity oriented or outcome oriented egalitarian policies; and
- the relative importance attached to primary incomes or secondary redistribution in outcome oriented equalisation policies.

This list of institutional and structural differences (which could easily be extended) is sufficient to show that, of the 12 advanced welfare states that we have studied in detail, no two are truly alike. Nevertheless, there are greater or lesser differences among countries along each of the dimensions mentioned, and a cluster analysis of these differences seems to agree with the distinction between 'Scandinavian', 'Continental' and 'Anglo-Saxon' welfare states proposed by Esping-Andersen (1990).[2] I will return to the characteristic differences between these three clusters of welfare states in the concluding section of this paper.

What matters here is the fact that, during the postwar decades, all advanced industrial democracies were able to achieve their respective welfare-state goals without endangering the viability of their capitalist national economies. However, institutional differences began to matter from the early 1970s onward, when major changes in the international environment did increase the economic vulnerability of advanced welfare states. This is not meant to deny the importance of endogenous challenges, among which were the ageing of the population and the erosion of traditional family structures that also differed in their impact on different types of postwar welfare states. We will focus, however, on the impact of external economic challenges. In the period from the early 1970s to the mid-1980s, these were in the nature of macro-economic shocks; whereas, in the later period, and at present, they are characterised by intensified competition in international capital and product markets.

Challenges and responses of the 1970s and early 1980s

For most industrialised countries, the end of the postwar 'golden age' coincided with the breakdown of the Bretton Woods system of fixed but adjustable exchange rates and with the OPEC oil-price crisis in the early 1970s. The first of these created an environment of floating exchange rates and accelerated the growth of 'offshore' capital markets that were not under the control of any of the major central banks. The second confronted oil-dependent industrial economies with the double challenges of 'stagflation', i.e. the simultaneous impact of cost-push inflation, caused by the fourfold increase within a few months of the price of crude oil, and of demand-gap unemployment, caused by the diversion of purchasing power to OPEC countries that could not immediately 'recycle' their new wealth into additional demand for industrial products. Under these conditions, governments committed to Keynesian demand management were confronted with a dilemma. If they chose to fight unemployment with monetary and fiscal demand reflation, they would generate escalating rates of inflation. If, instead, they fought inflation with restrictive fiscal and monetary policies, the result would be mass unemployment.

In the 1970s, as I have shown elsewhere, this dilemma could only be avoided if, in addition to fiscal and monetary policy, wages could also be employed as a tool of macro-economic policy. What was needed was a form of 'Keynesian concertation' where the government would prevent job losses through demand reflation while the unions would reduce inflationary cost pressures through wage restraint (Scharpf 1991). On the government side, the success of that strategy depended on a close coordination between fiscal and monetary policy. In the face of strong inflationary pressures, however, that coordination did require either convergent (Keynesian) beliefs of policy makers in both areas, or a clear dominance of the government over the central bank. On the union side, a necessary (but by no means sufficient) precondition

was a degree of organisational concentration and centralisation that allowed the adoption of strategies that accepted the short-term sacrifice of real-wage losses in the interest of longer-term employment benefits.

The closest approximation to Keynesian concertation was achieved in Austria. In Germany and Switzerland, by contrast, governments were unable to reflate the economy because monetary policy was determined by an independent central bank that was unconditionally committed to the defence of price stability, which meant that the bank's tight-money policy would neutralise expansionary fiscal impulses. The same was true in Denmark, the Netherlands or Belgium, where the government tried to stabilise the exchange rate with the Deutschmark which, regardless of the institutional independence of the central bank, implied a restrictive monetary regime. Under these conditions, major job losses were unavoidable. They could only be ameliorated if real wages were quickly adjusted downwards. This was the case in Germany and Switzerland, but not in the other hard-currency countries that practised an imported (and perhaps less clearly understood) version of the Bundesbank's monetarism.

In countries where the central bank was willing to accommodate the rise of oil prices, government deficit spending was generally able to avoid major job losses in the 1970s. Inflation would then, however, escalate unless it was counteracted by effective wage restraint. In the absence of unemployment, and at a time when their real-wage position was eroding, this was more than most unions could have delivered even under favourable institutional conditions. Instead, they generally tried to defend the real wages of their members by pushing for settlements that anticipated (and thus generated) further price increases. This was particularly damaging in countries where public sector salaries, pensions and welfare benefits were automatically adjusted to the rise of private sector wages. As a result, the rate of inflation rose to very high, often two-digit levels. Moreover, the attempt to stabilise employment through demand reflation left most governments with very high budget deficits at the end of the 1970s.

By the end of the decade, therefore, governments and central banks in most countries had come to define loose money policies and fiscal irresponsibility as the critical policy failures of the 1970s. This greatly increased their willingness to switch to monetarist and hard-currency policy responses when the second oil crisis seemed to replay the challenges of the 1970s. The result was that unemployment rates now also rose steeply in most of the former soft-money countries that had been able to avoid major job losses in the 1970s.[3] Most important, however, was the fact that the monetary policy of the United States was no longer ready to accommodate oil-price inflation. As a consequence, real dollar interest rates, which had been close to zero or negative through most of the 1970s, rose steeply to very high positive levels of 3.1% in 1981, 5.4% in 1982, 7.2% in 1983 and 8.1% in 1984. Since the internationalisation of capital markets had progressed rapidly during the 1970s, most countries had become heavily indebted to them. National central banks, regardless of their institutional independence and theoretical orientations, were forced to raise interest rates accordingly, in order to avoid massive capital outflows (as had happened in France before the monetarist turnaround in 1983). This had major distributional consequences. Since minimal profits expected from real investments have to be significantly above the interest income from risk-free government bonds, the dramatic rise of real interest rates meant that the share of capital incomes in the national product had to rise at the expense of government and labour shares if investment and business employment were

to be maintained. The only question was whether the change in distribution was realised through reduced wage claims and tax 'reforms' favouring capital incomes, or whether it was realised through dis-investment and job losses in the private sector.

On the whole, therefore, the success or failure of countries during the crises of the 1970s depended primarily on their capabilities for macro-economic management, that is on the coordination between the fiscal and monetary policy choices of the state, and on the capacity and willingness of unions to practise effective wage restraint in the face of oil-induced inflation. In the early 1980s, however, avoiding inflationary wage increases was no longer enough. Now, private sector employment could only be stabilised if the share of labour in the social product was being reduced. Organisationally strong unions in countries with centralised or coordinated wage-setting systems were generally able to implement the shift from wages to profits through voluntary wage restraint which, in the Netherlands, Denmark, and Australia, was facilitated by the sense of a deep crisis at the beginning of the 1980s. In Belgium, the government was able to impose effective wage restraint in the face of continuing ideological divisions among unions. In countries with highly decentralised wage-setting systems (as they existed in the United Kingdom and, after the early 1980s, in France), market pressures alone were eventually sufficient to achieve this effect.[4] Thus, in the second half of the 1980s, private sector employment was again increasing in countries with either weak unions and decentralised wage setting (Britain, France and, to a lesser extent, Switzerland), with 'statist' wage determination (Belgium), or with 'corporatist' industrial relations systems (Sweden, Denmark, Austria, Germany, Australia). Business employment continued to decline only in New Zealand, with strong unions and highly decentralised wage bargaining, and in Italy, with centralised but competing unions in a confrontational industrial relations system.

After the mid-1980s, international macro-economic shocks had spent their force. Oil prices declined and, while real interest rates remained high, they had come down from the extreme levels reached in 1984. In most countries, employment was increasing again, and budget deficits could be reduced. At the same time, however, the internationalisation of markets for goods, services and capital was now reaching levels that equalled, and then exceeded, the degree of international economic integration that had existed in the decades before World War I.

Capital exchange controls, which had still protected the domestic financial markets of most countries in the early 1970s, had practically disappeared by the early 1990s.[5] Moreover, the European Community had decided to liberalise financial services, and most countries had deregulated their domestic financial markets as well. As a consequence, financial capital was again internationally mobile, and the minimal rate of return that investors can expect is no longer defined by reference to interest rates set by the national bank, but by the attractiveness of competing worldwide opportunities for speculative, portfolio, or real investments.

At the same time, successive rounds of GATT and WTO negotiations had progressively lowered the tariffs and quantitative restrictions protecting national markets for goods, services and investments. In Europe, the Single-Market programme had also eliminated the non-tariff barriers that still impeded the full integration of product markets. It had introduced international competition in a wide range of services and utilities, including telecommunications, postal services, rail, air and road transport, or electricity supply, which, previously, had been provided either by the state itself or by state-controlled monopolies and cartels. Moreover, the

completion of the internal market was followed by the commitment to create a Monetary Union.

This would not only remove monetary and exchange rate policy from the control of national governments, and impose severe constraints on the conduct of national fiscal policy, but it would also remove the last important barrier to real-capital mobility: firms would now be able to choose the lowest-cost location of production within the territory of the Monetary Union without having to consider either non-tariff barriers or exchange-rate fluctuations that might affect their access to the home market. By the same token, it has become much easier to move mobile tax bases, in particular business profits and other forms of capital incomes, to locations offering the least burdensome tax regimes.

As a consequence of these cumulative changes in the international economic and legal environment, national governments and national labour unions are no longer able to rely on the protective barriers that facilitated the achievement of their policy goals in the postwar decades. The internationalisation of capital markets has reduced the effectiveness, and increased the budgetary costs, of Keynesian full employment policies in the 1980s, and the exit options of investors, tax payers and consumers are constraining the capacity to regulate processes of production and to tax the profits from production. In that sense, it is indeed plausible to conclude that 'Polanyi's Great Transformation is over' (Cerny 1994: 339).

This is not meant to say that countries have lost all capacity to pursue the welfare goals they had chosen in the postwar decades, but it does imply that these goals must again be pursued within the constraints of international capitalism. It suggests that the vulnerability of national solutions will be the greater the more these had in the past relied on direct interventions into the operation of capital, product and labour markets. However, before it is possible to discuss the greater or lesser vulnerability of different countries, it seems necessary to specify more precisely the mechanisms through which the pursuit of employment, social security and social equality goals is constrained by economic internationalisation. In the following sections, I will focus on the two areas that are most directly affected – private sector employment and the financial viability of the welfare state.

Private sector employment

In the course of the last two decades, the international product markets served by advanced industrial economies have changed in two respects. On the one hand, lower-cost competition from newly-industrialising and Central and Eastern European countries is forcing producers in high-cost countries to automate production, or to specialise in 'upmarket' industrial products of high technical or aesthetic quality, or in highly productive services. Assuming that wages and non-wage labour costs are downward inflexible, skill requirements will rise, and demand for unskilled workers will shrink as a consequence.[6] On the other hand, competition among advanced industrial countries has also become more intense, contributing to the greater volatility of increasingly specialised markets for 'diversified quality production' (Streeck 1997). Hence employment in internationally exposed sectors of the economy can only be maintained through continuous product and process innovations that reduce the costs of production and/or improve the quality of products for flexible adaptation to the volatile demand in specialised market niches (Streeck 1999). In other words, international competition will

necessarily drive up productivity in those firms that are able to survive. In the aggregate, this will limit employment opportunities even in those countries that are doing well in the international markets. In fact, employment ratios in the exposed sectors of the economy[7] have declined practically everywhere in the advanced industrial countries since the early 1970s. Employment gains were achieved only in the sheltered branches of ISIC 6 and 9, i.e. in 'wholesale and retail trade, restaurants and hotels' and in 'community, social and personal services'.

From a social policy point of view, it is even more important that, in internationalised and liberalised markets for goods and services, firms have become price takers, and that among the member states of the European Monetary Union, governments have also lost the option of correcting a loss of international competitiveness through adjustments of the exchange rate. As a consequence, above-average cost increases can no longer be passed on to captive consumers. At the same time, firms are now facing investors who are no longer limited to national investment opportunities but will compare (post tax!) rates of return achieved by real or portfolio investments to benchmarks defined by the most profitable investment opportunities available internationally.[8] Moreover, the resulting pressures are felt not only in the exposed sectors of the economy, but also in sheltered branches supplying local goods and services to internationally exposed firms, as well as in capital-intensive branches providing services that are locally produced and consumed. This is comparable to the situation in the media, in wholesale and retail trade or in hotels.

As a consequence, private sector firms are now much less able to cross-subsidise between highly profitable and less profitable lines of production, or between highly productive and less productive jobs. Instead, and most obviously within the European Monetary Union, each product and, in the extreme, each job, must now earn its full costs of production plus an adequate rate of return on capital at internationally uniform prices.[9] For governments and unions this implies that the employment risks associated with strategies aiming at the 'de-commodification of labour' (Esping-Andersen 1990) have greatly increased. Solidaristic union wages, government minimum-wage legislation, social policies raising the reservation wage of unemployed job seekers, and taxes and regulations imposing non-wage labour costs are all now more likely than before to entail job losses if they raise production costs above the level that is compatible with expected earnings. Obviously, these risks will most directly affect service jobs whose productivity cannot easily be increased, and hence will reduce the employment opportunities of less skilled workers.

In summary, then, more intense international competition in product markets is driving up productivity and skill requirements, and it tends to limit or reduce employment opportunities in the exposed sectors of the economy in particular, for less skilled workers. The effect is reinforced by the higher rates of return demanded by internationalised capital markets, and this also affects employment in capital-intensive branches of the sheltered sector. As a consequence, it is now generally more difficult than before to instrumentalise private sector employment relations for the achievement of egalitarian welfare goals. If such purposes were, in the past, pursued through collective bargaining and government regulations of employment conditions, their continuing realisation will now depend to a larger degree on the formal welfare state and the tax system. These options, however, are also constrained by the impact of economic internationalisation on welfare state revenue.

Welfare state revenue

In the average OECD country, the proportion of taxes and social security contributions in GDP rose until the mid-1980s, but tended to stagnate thereafter. In Sweden, it is true, taxes have come down from a temporary peak of 55.6% of GDP in 1990 to 52% in 1996, and Italy has greatly increased its tax revenue from 34.2% in 1985 to 43.2% in 1996. However, annual figures otherwise seem to fluctuate cyclically at about the level reached in the mid-1980s. Remarkably, however, differences between countries have remained about as high as before. Australia and Switzerland have tax shares a little above 30% of GDP, the United Kingdom and New Zealand around or above 35%, Germany somewhat below, and Austria, Belgium, France and the Netherlands significantly above 40%, and Denmark and Sweden above 50%. In other words, there seems to be no convergence over time. Instead, the stagnation of tax revenues seems to have had, more or less, the same constraining effect on Scandinavian high-tax countries, Anglo-Saxon low-tax countries, and the Continental welfare states with their intermediate levels of taxation.

In order to understand this pattern, we must consider the upward as well as the downward pressures on public sector revenue. The upward pressures that had increased tax burdens everywhere in the 1970s and early 1980s have, of course, not abated. Unemployment, poverty, pensions and health care for an ageing population, rising demands on education and business-oriented infrastructure, all would, under earlier circumstances, have required – and justified – further increases of taxation. As for the downward pressures, the usual suspects are governments competing for revenue from internationally mobile tax bases (in particular, from corporate profits and capital interest) and for internationally mobile investments and production.[10] As a result, most countries have significantly cut the nominal rates of taxes on capital incomes since the mid-1980s. However, as is frequently pointed out in the literature, one nevertheless cannot observe a general 'race to the bottom' of *effective* rates of capital taxation (Garrett 1998a, 1998b; Quinn 1997; Swank 1998).[11] Instead, countries that cut their top rates have generally tried to defend their revenue position by simultaneously broadening the tax base. Even though the economic logic of that solution seems somewhat doubtful,[12] countries seem to have been pushed toward it by the disadvantages associated with the alternative courses of action, which they would have had to choose among if revenues from mobile sources were significantly reduced.

These alternatives include a sustained increase in public sector deficits, significant reduction of public expenditure, and a shift from mobile to less mobile bases of taxation. Closer inspection reveals, however, that each of these options is confronted with obstacles or associated with negative side effects that reduce their feasibility or attractiveness (Genschel 1999).

Deficit spending had increased in most countries during the 1970s and, even though it was continued in the 1980s, its budgetary costs increased dramatically with the rise of real interest rates. In the 1990s, the Maastricht criteria for membership in the European Monetary Union had the effect of foreclosing the deficit option for most European welfare states. Under conditions of high capital mobility, all other countries were also constrained to demonstrate their fiscal conservatism in order to avoid paying high risk premiums on their public debt. In short, deficit spending had ceased to be a sustainable national strategy in the 1990s. At the

same time, however, significant cuts in public expenditures were difficult to adopt in multi-party and corporatist political systems where hard choices depend on broad agreement among multiple actors. They were also difficult in Westminster-type two-party systems, where the governing party must fear political opposition and negative electoral reactions to significant and visible cuts in welfare benefits (Pierson 1994, 1996). In most cases, therefore, expenditure cuts were not, and are not, a solution that governments could pursue without incurring heavy political costs.[13] This shifts the emphasis to burden-shifting strategies. Among the less mobile tax bases, the ones with the largest revenue potential are taxes on consumption, social security contributions, and taxes on income from labour, all relatively immune to international tax competition.[14] In taking that course, however, governments need to consider the potential impact of tax increases on the costs of labour and, hence, on employment.

Contrary to widespread expectations, the statistical association between the *total* burden of taxes and social security contributions (measured as a share of GDP) and *total* employment (measured as a share of the working-age population) appears to be very weak. In fact, Denmark, the country with the highest tax burden, does as well or better in employment terms than the lowest-tax economies of the United States and Japan. Among the 12 countries covered by our project, the highest employment ratios are achieved by low-tax Switzerland together with high-tax Denmark and Sweden, while the low-tax Anglo-Saxon countries have intermediate and the remaining moderate-tax Continental countries have the lowest employment scores (Table 1).

If we look at the distribution between public and private sector employment, more systematic differences emerge. As is to be expected, high-tax Scandinavian welfare states are characterised by extremely high levels of public sector employment and relatively low private sector employment, whereas low-tax Switzerland and the Anglo-Saxon countries have very high employment in the private sector and low scores for government employment. More surprising is the employment performance of Continental welfare states with intermediate tax burdens: on average, they have as little private sector employment as the Scandinavian countries, and as few public sector jobs as the Anglo-Saxon countries.[15] Looking even more closely, it appears that the Continental deficit in private sector employment cannot be located in the manufacturing sector (where Germany actually has the highest employment ratio) but seems to be due to a lack of private service jobs. For these, employment in the branches included in ISIC 6 (wholesale and retail trade, restaurants and hotels) seems to be a good proxy.

While *total* taxation does not seem to have an influence on *total* employment, it seems plausible to search for causal effects by examining differences in the structure of employment as well as differences in the structure of taxation.

On the employment side, the first distinction is between public and private sector employment. As is to be expected, there is a positive association between the total tax burden and government employment ratios. The relationship is not very strong, however, and if Sweden, Denmark and Norway[16] were left out of the picture, it would disappear. Apparently, it is only these highly developed Scandinavian welfare states that have systematically translated high tax revenues into high levels of publicly financed social services, whereas Continental countries tend to cluster below the regression line.[17] The expected negative association between total taxation and business employment appears to be stronger, with

Table 1 Total and sectoral employment as % of the population 15–64, 1996

	Total Employment as % of Pop. 15–64	Government Employment as % of Pop. 15–64	Business Employment as % of Pop. 15–64	Industrial Employment as % of Pop. 15–64	Employment in ISIC 6 as % of Pop. 15–64
Australia	68.7	10.3	58.1	9.8	17.2
New Zealand	61.8	8.8	53.0	12.0	14.7
United Kingdom	69.3	9.6	59.1	13.2	13.7
Switzerland	79.1	11.0	68.3	15.7	15.2
Austria	62.6	14.2	49.5	14.5	14.4
Belgium	55.3	10.3	44.7	10.4	10.1
Germany	61.7	9.5	52.3	16.4	11.0
France	58.8	14.5	44.3	11.3	9.9[a]
Italy[b]	56.0	8.9	47.1	12.1	10.9
Netherlands[c]	51.4	6.8	44.8	10.2	13.4
Denmark	73.4	22.2	51.1	14.4	12.1
Sweden	72.2	22.4	49.6	13.5	10.6
OECD 18	66.5	12.6	52.7	13.0	13.0

a Data for 1989.
b Data for Italy in Columns 1–3 include estimates for jobs in the 'unofficial economy'.
c Data for the Netherlands in Columns 1–3 are full-time equivalents.

Sources: Columns 1–3: OECD Economic Outlook 1998;
Columns 4–5: OECD Labour Force Statistics 1998

Denmark and Sweden doing better, and Continental countries generally doing less well than would be expected on the basis of relative tax burdens.

Continuing on private sector employment, it is clear that diverse branches are included whose sensitivity to tax burdens may differ considerably. One theoretically meaningful distinction is between employment in those branches that are actually or potentially exposed to international competition. According to the definition proposed above, these include primary and secondary production and the production-related services (ISIC 1–5 and 7 + 8). Contrary to the usual assumptions in political and economic debates, there is practically no statistical association between the overall tax burden and employment in the exposed sectors. It is also remarkable that both high-tax countries like Denmark and Sweden and medium-tax countries like Austria and Germany have more jobs in the exposed sectors of the private economy than is true of the United States, one of the two countries with the lowest tax burden. The conclusion seems to be that employment in those branches that are facing international competition is relatively insensitive to the overall tax burden. By implication, this suggests that the strongly negative impact of tax burdens on business employment must primarily affect private services that are domestically produced and consumed. In OECD statistics, these services are included in ISIC 6 (wholesale and retail trade, restaurants, and hotels) and ISIC 9 (community, social and personal services), but, since the latter category includes both public and private sector

jobs, employment in ISIC 6 should provide a clearer test for the causal effect of taxation on domestic service employment. In fact, it is strongly negative.

The next question is whether differences in tax structures may explain some of the observed variance in negative employment effects. Distinguishing between three major blocks of revenue (personal and corporate income taxes, consumption taxes and social security contributions), it appears that the high-tax Scandinavian welfare states as well as the low-tax Anglo-Saxon countries rely primarily on personal and corporate income taxes for their revenue, whereas, in most of the Continental welfare states, social security contributions provide the lion's share of revenue. There is less of a clear pattern with regard to consumption taxes.

Considering private sector employment as a whole, one might conclude from current policy debates that taxes on corporate and personal incomes, which are thought to depress demand and discourage business investments should have the strongest negative effect. Remarkably, this expectation is again not supported by the data.[18] There is no statistical association between business employment and the GDP share of personal and corporate income taxes. That leaves social security contributions and consumption taxes, which are generally considered the most promising targets of burden-shifting policies, because they are relatively immune to international tax competition. Taken separately, each of these has a clear negative effect on overall business employment as well as on employment in ISIC 6. In combination, their joint effect on ISIC-6 jobs is very strong, accounting for just about all of the negative impact of the total tax burden.

We can, thus, conclude that the tax system does indeed affect private sector employment, but that these effects vary greatly on both the employment and the tax-side of the relationship. Employment in internationally exposed industrial and service branches seems hardly affected at all by the size of the overall tax burden. Instead, negative effects seem to be concentrated in branches in which services are produced and consumed locally. On the tax-side, in turn, it seems that private sector employment is not affected by differences in the levels of personal and corporate income taxes, whereas social security contributions and consumption taxes have strongly negative employment effects.[19]

The interpretation of these patterns is straightforward. Employment in manufacturing, but also in transport, communication or financial services is little affected by the overall tax load, since high productivity allows the burden to be shifted either to consumers or (more likely in competitive markets) to workers whose relatively high take-home pay is reduced accordingly. In contrast, the market-clearing wages of less productive services might be at or near the level of social assistance benefits that define the lowest net reservation wage in advanced welfare states. Hence, the cost of taxes and social security contributions levied on such jobs cannot be shifted to employees but must be borne entirely by the employer, with the consequence that such services may be priced out of the market.

The same argument explains the variation in the impact of different types of taxation. Consumption taxes reduce demand for all products, but they fall most heavily on services whose low productivity makes them vulnerable to automation, to self-service (Gershuny 1978) or to tax evasion. Similarly, social security contributions are usually (except in the Netherlands[20] and in Britain[21]) raised as a proportional tax on total wages, with a cap at medium wage levels. Hence, they fall heavily on low-wage jobs, while the burden on highly productive and highly paid jobs is relatively smaller. In contrast, personal income taxes are not collected

on wages below a basic-income exemption and, since their rates are generally progressive, taxes on the income elements that exceed the exemption begin at lower rates. Thus, the burden of income taxes on the cost of low-wage jobs tends to be minimal and, while they may have some effect on investments and on the ability of firms to attract high-wage professionals from low-tax countries, their negative impact on business employment is much weaker than is true of consumption taxes and social contributions.

If these effects are well understood, governments should seek to resist the temptation of shifting the tax burden from mobile capital to the less mobile bases of consumption taxes and social security contributions. Negative effects on employment would be smaller, it is true, if reduced rates on capital incomes were compensated by further increases in the taxation of high incomes from work. Here, however, political opposition is likely to be very strong in a period in which the real-income position of skilled workers has been declining while the tax resistance of high-income professionals has been reinforced by the dominant neo-liberal ideology.

Thus, under the pressure of international tax and investment competition, countries ought to cut taxes on capital and, under the pressure of high unemployment, they ought to cut taxes on labour inputs and on the consumption of services. Moreover, under the constraint of international financial markets, they ought to reduce public sector deficits. They could comply with these economic imperatives by raising personal income taxes or by cutting public expenditures. However, while these options might be economically innocuous, they have proven to be politically unpalatable in most cases. In other words, fiscal constraints have generally become tighter after the mid 1980s, and there is no obvious way in which they could be relaxed through strategies that are feasible at the national level.[22] Moreover, these constraints seem to operate at all levels of taxation, and there is no reason to think that low-tax countries should be under less pressure than high-tax countries. In fact, even countries like the United Kingdom and New Zealand, which have converted to radical versions of the neo-liberal creed, have not been very successful in reducing the total tax burden.

Characteristic challenges and options

Overall, then, the constraints imposed by international product and capital markets on employment and the welfare state may be summarised in the following conclusions.

- employment in the exposed sectors is generally shrinking and can be maintained only under conditions of high and rising productivity;
- employment losses in the exposed sectors can be compensated for by employment gains in the sheltered service sectors;
- the level of public-sector service employment is only weakly determined by the level of public sector revenue;
- opportunities for increasing public sector revenue have become severely constrained;
- employment in the sheltered private sector services is particularly vulnerable to the negative impact of social security contributions and consumption taxes;

- opportunities for egalitarian cross-subsidisation in private sector employment relationships, through solidaristic wage policy and social policies raising reservation wages, are generally being reduced.

From the perspective of welfare state goals, however, it matters more that these constraints are confronted by very different types of welfare states, with different employment structures, different revenue structures and different policy legacies. These all affect their greater or lesser vulnerability to competitive pressures, the major problems that they presently have to face, and the policy options that might be effective in coping with these problems.

In spite of the fact that no two countries in our project are alike with regard to all of the dimensions discussed above, it seems useful to discuss their differences by reference to distinctions between the Scandinavian, Anglo-Saxon and Continental regimes presented in Esping-Andersen's *The Three Worlds of Welfare Capitalism* (1990).

Scandinavian welfare states

In our project, the Scandinavian, or 'social democratic', regime is represented by Sweden and Denmark. Both of these countries are characterised by:

- very high levels of total employment;
- very high levels of female participation in the labour market;
- very high levels of taxation;
- very generous social policy, providing high levels of income replacement in cases of involuntary inactivity and in old age as well as comprehensive social services for the young, for the sick and handicapped, and for the aged;
- very low levels of wage differentiation and income inequality.

Both countries have succeeded in creating a virtuous cycle, in which the expansion of publicly provided child care, pre-school education, health care, and home care for the aged has freed married women to seek employment in the formal labour market, while providing both the jobs they could fill and the political support to sustain higher levels of taxation. As a consequence, public sector employment in the Scandinavian countries is almost twice the OECD-18 average.

Business employment, by contrast, is slightly below average. However, industrial employment as well as overall employment in the exposed sectors are above the average in both countries. Sweden, it is true, suffered a dramatic decline in the 1990s – which was, however, caused by a combination of unfortunate domestic policy choices and international conditions that do not seem related to specific vulnerabilities of the Swedish welfare state to international competition. Thus, the relative weakness in business employment must be located in the sheltered sector. In some fields (ISIC 9), private services are crowded out by the large public sector, but the weakness is also visible in ISIC 6 where public services play no role.

The explanation for the relative weakness of private service employment seems straightforward. Both Denmark and Sweden have strong unions committed to solidaristic wage policies which, together with reservation wages pushed up by generous income replacement ratios, have reduced wage differentials, i.e. the relation of normal to bottom wages of both sexes

Table 2 Taxes and social security contributions as % of GDP, 1996

	Total Taxation as % of GDP	Social Security Contributions as % of GDP	Taxes on Goods and Services as % of GDP	Personal & Corporate Income Tax as % of GDP
Australia	30.5	2.1	8.9	16.8
New Zealand	36.5	0.4	12.6	19.1
United Kingdom	35.5	6.2	12.7	13.1
Switzerland	33.7	12.4	6.2	12.5
Austria	41.5	18.1	11.7	10.4
Belgium	46.3	15.2	12.0	17.5
Germany	39.2	15.5	10.9	10.8
France	44.5	20.4	12.2	7.8
Italy	41.2	13.2	11.3	14.8
Netherlands	44.0	18.3	12.0	11.6
Denmark	50.2	1.8	16.7	29.7
Sweden	49.7	15.5	12.0	20.5
OECD 18	39.8	10.9	11.2	15.7

Source: OECD Revenue Statistics

taken together, to the lowest level among OECD countries. In other words, unskilled workers receive relatively high wages in Sweden and Denmark. As a consequence, one should expect that the less productive consumer and household services would be squeezed out of the market (Iversen and Wren 1998), presumably by self-service and do-it-yourself activities and by the 'unofficial economy'.

In fact, given the extremely low wage dispersion and the very high tax burden, it seems more surprising that employment in ISIC6 services should not be even further below the OECD average. For the reasons discussed above, that should be due, at least in part, to a relatively employment friendly tax structure (Table 2). Denmark, in particular, benefits from the fact that it primarily relies on income taxes, rather than on social security contributions for financing its generous welfare state. While the revenue from consumption taxes is also very high, much of it is due to high rates on (imported) 'luxury' goods that have little effect on domestic employment.

At the same time, however, private sector employment in Denmark benefits from two other deviations from the Swedish model. First, there is very little job security. Employment can be terminated at low cost and with short notice. This is considered socially acceptable since workers with average wages are assured of exceptionally generous unemployment benefits, replacing up to 90% of their income from work for a maximum of five years. In recent years, however, these benefits have been coupled with an obligation of recipients to participate in retraining and other 'activation' measures, and to accept suitable job offers. As a consequence, unions and workers will not resist layoffs when demand falls, and firms are willing to hire even if a perceived increase in demand seems insecure. Sweden, by contrast, has maintained the rules regarding employment protection that are generally characteristic of countries with highly

developed welfare states and powerful unions. The Danish system of collective bargaining has never attempted to achieve the degree of centralisation that was the pride of the Swedish model and, after the dramatic failure of the 1970s, it has moved to a two-tier system, which leaves considerable space for differentiated settlements at the level of individual branches and regions.

If Scandinavian welfare states are vulnerable, it is on the revenue side. Until the mid-1980s, the expansion of welfare transfers and services had depended on rising tax revenues and, in certain periods, heavy public sector borrowing. By the second half of the 1980s, however, the rise of tax revenues as a share of GDP had come to an end, partly as a result of the internationalisation of capital markets and the pressures of tax competition, and partly as a result of political tax resistance. At the same time, Denmark kept public deficits well below the 3% line defined by the Maastricht criteria, whereas Sweden was forced into excessive borrowing by the economic crisis of the early 1990s which, after the mid-1990s, was brought under control by drastic measures of fiscal consolidation.

In response to fiscal constraints, both countries have reduced the share of social expenditures in GDP after a peak in the early 1990s, but Sweden has done so to a greater extent – going from 37.4% of GDP in 1993 to 33.4% in 1995. Denmark reduced total social expenditures only from 33% in 1994 to 31.9% in 1996. This difference seems to explain the fact that the public sector employment ratio in Denmark remained stable at about 22% throughout the decade, whereas in Sweden it fell from 26.1% in 1989 to 21.9% in 1997. Since both countries have about maintained their levels of total taxation during the same period, the difference may be explained in part by the fact that Denmark has come to finance an increasing share of social services for families and for the elderly through means-tested co-payments.[23] Sweden, so far, has maintained its near-exclusive reliance on tax revenues for financing universal social services without regard to income differences.

In international comparison, however, both countries are still doing well on overall employment, and they are also doing very well on social security and social equality. The main problems that they confront are: first, difficulties in financing very expensive welfare states under conditions of high capital mobility and rising political tax resistance; and, second, a need to expand private sector employment to compensate for the stagnation or decline of employment opportunities in the public sector. It seems that Denmark is presently better placed than Sweden for coping with both problems because of its more employment-friendly tax system, its greater use of co-payments in the financing of public services, and because of its more decentralised wage-setting institutions, and more flexible regulations of conditions of employment. Nevertheless, even Sweden – which fell into a deep crisis in the early 1990s – seems capable of achieving economic and fiscal recovery without sacrificing the basic structures of its social-democratic welfare state.

Anglo-Saxon welfare states

In our project, the Anglo-Saxon or 'liberal' welfare states are represented by Australia, New Zealand and the United Kingdom. In some respects, Switzerland is also sufficiently similar to these to be discussed in the same context. All four countries are characterised by:

- high (in the case of Switzerland, very high) levels of total employment;

- relatively high levels of female participation in the labour force;
- low to moderately low levels of taxation;
- low to moderate levels of social expenditure, providing low to moderate (except in Switzerland) levels of income replacement in cases of involuntary inactivity and in old age, and low (except in the United Kingdom) levels of social services for the young, for the sick and handicapped, and for the aged;
- moderate to high levels of wage differentiation and income inequality.

Given their low levels of taxation, all four countries have low (but not exceptionally low) levels of public sector employment, whereas business employment is generally, and in Switzerland significantly, above the OECD average. Only in Switzerland, however, is this associated with exceptionally high employment ratios in the exposed sectors. Instead, the relative success of liberal welfare states is mainly due to jobs in the sheltered-sector services. Some of the explanations for this pattern are a mirror image of the ones discussed above with regard to the Scandinavian model.

In Australia and New Zealand, average replacement rates of unemployment insurance are quite low, whereas social assistance has been reformed in the 1980s according to principles of a 'negative income tax'. In the United Kingdom, similarly, unemployment benefits are flat-rate, rather than income related, and relatively generous levels of social assistance have been reformed to place greater emphasis on in-work benefits. As a consequence, there are fewer incentives to remain in socially supported inactivity, while seeking low-paid or part-time work is being financially rewarded. In New Zealand and the United Kingdom, moreover, labour markets have been deregulated while unions have recently lost their former power to determine wage rates and employment conditions through collective-bargaining agreements. In Australia and Switzerland, by contrast, collective bargaining has remained effective, but is practised in highly decentralised forms that allow for considerable differentiation and flexibility (which is reinforced in Switzerland by the continuing role of seasonally employed foreign workers in the service branches). In short, wage differentiation and flexible employment conditions have greatly facilitated the expansion of private services.

At the same time, the liberal welfare states also benefit from relatively employment friendly tax structures. Switzerland and Australia are significantly below average on consumption taxes, whereas the reliance on social security contributions is relatively low in New Zealand, Australia and the United Kingdom. As a consequence, overall labour costs are not greatly pushed up by either the industrial relations systems or the social benefits or the taxation systems of liberal welfare states. Hence, they all have relatively high employment ratios in the less productive service branches of the private sector.

Beyond that, patterns diverge. Switzerland has high shares of industrial employment based on a well-trained labour force, cooperative industrial relations and a specialisation on export-oriented high-quality production in the chemical and engineering industries. At the same time, the country has maintained its traditional strengths in financial and business services and in high-class tourism. Moreover, the Swiss welfare state, which has traditionally relied heavily on (publicly subsidised) private insurance, has in recent decades expanded the coverage of collectively financed unemployment and pension insurance. In combination with very high

levels of employment, therefore, Switzerland has not been affected by the inequality and poverty problems that otherwise are characteristic of the liberal welfare state.

Australia and New Zealand had traditionally relied on highly competitive agricultural and raw materials exports to cross-subsidise incomes in highly protected industrial and service sectors. Social security and a relatively high degree of social equality had been achieved by the unique combination of a very lean welfare state, providing mainly low, flat-rate benefits, with a highly regulated employment system in which import protection ensured full employment while state arbitration courts ensured an adequate 'family wage' for full-time workers in all sectors. When the deterioration of export markets undermined the economic viability of these arrangements, so that both countries were forced to liberalise their manufacturing and service sectors, their paths diverged.

In New Zealand, the post-1984 Labour government imposed radical liberalisation on product and capital markets, while strong but decentralised unions continued to strike for highly inflationary wage increases. The result was massive job losses, which were only reversed in the 1990s after a Conservative government had scrapped the arbitration system and substituted individualised for collective wage bargaining in the Employment Contracts Act of 1991. In Australia, in contrast, post-1983 Labour governments managed to negotiate a series of corporatist 'Accords', in which unions were willing and able to trade wage restraint for more gradual liberalisation and an increase of social assistance benefits. Employment increased rapidly after the mid-1980s, and fluctuated thereafter at high levels while wage inequality remained moderate.

In the United Kingdom, industrial employment fell precipitously in consequence of Margaret Thatcher's switch to monetarism and a hard-currency policy after 1979. In addition, the power of the labour unions was severely weakened by the elimination of earnings-related unemployment benefits and by industrial relations legislation outlawing secondary strikes. Employment conditions were deregulated and collective bargaining, to the extent that it still takes place in the private sector, became even more decentralised than before. In the exposed sectors, the continuing loss of manufacturing jobs (in spite of the rise of foreign direct investment) was not fully compensated by the steep increase of employment in the financial and business services. Thus, the relatively positive overall trend is, again, owed to the expansion of services in the sheltered sector.

In effect, New Zealand and Britain have moved to extremely deregulated labour markets and highly decentralised, or even individualised, wage setting. They have, thus, no problem with wage differentiation and employment flexibility. There is also no more organised resistance to the rapid introduction of process and product innovations. Neither, however, is there much investment in skills and in the practices of trustful cooperation between management and labour that are important for highly productive and high-quality industrial production. It is perhaps indicative that, after investing years of managerial effort and hundreds of millions of pounds, BMW never achieved German levels of quality, productivity and profitability in its British Rover plant. In contrast, Britain seems to be doing very well in some high-tech industrial branches and in financial services, where success depends on the creativity and motivation of highly skilled professionals, on the availability of venture capital, and on the freedom to capture the profits from rapid innovation in deregulated markets.

On the whole, therefore, the liberal welfare states have been able to achieve high rates of

private-sector service employment, at both high and low skill levels. At the same time, their overall tax burdens are relatively low, and their welfare states are relatively lean. In comparison, therefore, neither employment nor the financing of the welfare state appears to be an acute problem. What is a problem in Britain and New Zealand, however, is increasing social inequality and the poverty of workers in low wage service jobs and their families. A partial solution is provided by forms of social assistance and of in-work benefits that are modelled on the Earned Income Tax Credit in the United States. By combining earned incomes with social incomes according to the logic of the negative income tax, these programmes allow low-skilled workers to accept low-wage service jobs without becoming victims of extreme poverty. In order to reduce the increasing inequality of life chances, however, they would still need to be complemented by measures that provide opportunities for training and upward mobility for those who enter the labour market by accepting low-skilled and low-wage jobs (Esping-Andersen 1999).

It needs to be noted, however, that among the liberal welfare states, Australia and Switzerland have achieved similar or superior levels of business employment without accepting nearly the same degree of insecurity and inequality as has been the case in Britain and New Zealand. There is reason to think, therefore, that the socially disintegrative consequences of 'classical' Anglo-Saxon liberalism can be greatly mitigated without endangering its superior economic efficiency.

Continental welfare states

The last group of countries is more heterogeneous. Nevertheless, it is possible to say that, in general, Continental or 'Christian-Democratic' welfare states are characterised by:

- low or very low rates of total employment;
- low or very low rates of female participation in the labour market;
- moderate levels of taxation;
- moderate levels of social expenditure, providing relatively high levels of income replacement in cases of involuntary inactivity (except for Italy) and in old age, but only limited social services for the young, the sick and handicapped, and the old;
- low or moderate levels of wage differentiation and income inequality.

With the exception of Austria and France, Continental welfare states have not converted their intermediate levels of taxation and social spending into correspon – ding levels of public sector employment. In the tradition of the 'Bismarck model', they are transfer intensive, but not service intensive, providing income-maintaining insurance for the (male) breadwinner and his family, but relying mainly on the unpaid services of mothers, wives, and daughters to provide care for the young, the sick and the aged (Esping-Andersen 1990). Remarkably, however, Continental welfare states also have lower rates of business employment than their intermediate tax levels would lead one to expect.

In those sectors of business employment that are exposed to international competition, however, Austria and Germany are above the OECD average, and while the Netherlands are still below the average, it is the only country in which exposed-sector employment has increased significantly since the mid 1980s. By contrast, employment ratios in Belgium, Italy,

and France are considerably below the OECD average. On the assumption that exposed-sector employment and, in particular, manufacturing employment in high-cost countries has become increasingly vulnerable to above-average wage increases and increasingly dependent on productivity-increasing forms of work organisation and industrial relations (Streeck 1999), it seems plausible to think that differences in the structures of industrial relations systems would make a difference here.

Austria, Germany, and the Netherlands have relatively strong industrial unions and patterns of 'coordinated' sectoral wage bargaining that normally permit the effective adjustment of *average* wage increases to given macro-economic conditions and to the pressures of international competition. In the Netherlands, the traditional patterns of corporatist bargaining were disrupted by political conflicts in the 1970s, but were re-established in the early 1980s. Since then, a strategy of sustained, competitiveness-oriented wage restraint has contributed to the dramatic turnaround of Dutch employment (Visser and Hemerijck 1997). At the same time, there are strongly institutionalised forms of vocational training and of worker participation at the firm level, which facilitate high-quality production and cooperative adjustment and innovation. The downside, under present conditions, seems to be a tendency to over-regulate employment relationships, to over-protect existing jobs, and to over-standardise wages and working conditions. These dangers are most manifest in Germany, where wage compression has actually increased in the last decades, while Dutch and Austrian industrial relations have allowed more differentiation and flexibility.

In Belgium, France and Italy, in contrast, unions are politically divided and industrial relations were traditionally highly conflictual, with a correspondingly large role for state intervention in the wage setting process. In the 1970s, however, intervention had failed to control wage-push inflation an all three countries. From the early 1980s onward, Belgian governments were finally able to impose effective wage restraint but only at the price of an increasing compression of wage scales. In France, in contrast, private sector unions were nearly destroyed by legislation that was intended to facilitate plant-level worker participation. Since the state also ceased to intervene in collective bargaining, private-sector wage negotiations have become extremely decentralised and settlements highly differentiated. Nevertheless, the state still legislates on working conditions and working hours, and it also continues to define statutory minimum wages. However, in both countries, government intervention cannot substitute for a lack of organised cooperation that would facilitate 'productivity coalitions' between management and organised labour at the level of industries and individual firms. In Italy, finally, the state was never strong enough to exercise control over the wage-setting process but, in contrast to France, unions remained strong, and in the 1990s they were finally willing and able to coordinate their bargaining strategies with a view to the macro-economic requirements of European monetary integration. In the process, Italian industrial relations have also become transformed in ways that approximate to the 'corporatist' model.

With regard to sheltered sector employment (ISIC 6 + 9), all Continental countries are below the OECD average[24] which in part reflects the generally low levels of public sector employment. Focusing more narrowly on private services in ISIC 6, it appears that Austria and the Netherlands are somewhat above, and France, Belgium, Italy, and Germany, significantly below the OECD average. As was pointed out above, an explanation for this generally poor performance is provided by the fact that Continental welfare states have

traditionally relied not on general taxation but on social insurance contributions from workers and employers to pay for social expenditures. These are particularly damaging in their effect on the less productive private services. The position of Austria as an extreme positive outlier remains a puzzle that is probably not completely explained by above average employment in tourism. The Netherlands, by contrast, seem to have benefited from the fact that social security contributions were integrated into the income-tax schedule in 1990.[25]

In addition, several of the factors that constrain private service employment in the Scandinavian countries are also present in Continental welfare states. In most countries (except for Italy), relatively generous social assistance and income maintaining benefits for the unemployed have the effect of raising the reservation wages of job seekers in the private sector. At the same time, employment is highly regulated, dismissals are expensive, and firms hesitate to start hiring in the face of uncertain demand in their product markets. In Belgium, Germany, and the Netherlands, wage scales are also compressed by minimum wage legislation or by the solidaristic wage policies pursued by strong unions. In Austria, in contrast, very high wage differentials seem to favour private service employment.[26]

With regard to the fiscal constraints, the comparatively high dependence of Continental welfare states on social insurance contributions also creates specific vulnerabilities. On the one hand, job losses will, at the same time, reduce the revenue of insurance funds and increase the expenditures for unemployment and other forms of subsidised inactivity. On the other hand, the fact that social security is institutionalised in the form of compulsory insurance programmes tends to create entitlements (or even legally protected property rights) in expected benefits that are more resistant against cutbacks or against means testing than is generally true in the case of tax-financed benefits. As a consequence, job losses will typically create a need to raise the rates of social security contributions. In other words, Continental welfare states are vulnerable to a vicious cycle in which rising unemployment will lead to increases in non-wage labour costs that will further reduce employment opportunities in private sector services.

Given these conditions, all Continental welfare states are presently confronted with two major problems, insufficient employment and an over-committed transfer system. These problems are closely connected. On the one hand, the financial viability of a generous transfer system is undermined if the size of the inactive population that depends on welfare transfers increases relative to the size of the active population. On the other hand, cost-sensitive private sector employment will shrink if the increasing burdens of the welfare state are primarily financed as a surcharge on wages. At the same time, the political cleavage between those who are asked to pay for, and those who depend on, the welfare state is likely to become sharper. The consequence is that the political viability of governments is undermined by massive political opposition, regardless of whether they try to respond to the dilemma by increasing tax burdens or by cutting welfare-state benefits. In other words, there is a huge financial and political premium on solutions that will increase overall employment levels.

Fiscal problems are most acute in Continental countries where, with partial exceptions for the Netherlands and Italy, public transfers are expected to provide status-maintaining unemployment, disability, sickness, and retirement incomes through pay-as-you-go insurance systems that are financed through surcharges on labour. These are most obvious in the field of old-age pensions. While they are similarly generous, the Scandinavian, Dutch and Swiss pension systems are typically three- or four-tiered, combining (1) a universal and tax-financed[27]

basic pension at or near the social-assistance level with (2) a compulsory but limited supplemental-pension insurance, (3) a funded and income-related labour-market pension financed through (compulsory or collectively negotiated) wage-based contributions, and (4) voluntary but tax-subsidised private insurance or pension funds. Whereas the first and second tiers are strongly redistributive, the third and fourth tiers presuppose strict equivalence between contributions and benefits. In a financial squeeze, therefore, it is possible for governments to increase the redistributive effect of first- and second-tier pensions by introducing means testing, whereas entitlements in the third and fourth pillars must be treated as sacrosanct property rights.

The typical continental pension system (except for the Netherlands, whose three-tiered pension system resembles Scandinavian models) combines redistribution and equivalence in a single scheme which, because it is redistributive, is resented as a (highly regressive!) form of taxation. Because it is organised as a contribution based insurance system it does not allow means-testing and other forms of discretionary retrenchment. From a social security point of view, the lack of a basic pension means that persons with incomplete work biographies that include longer stretches of inactivity or part-time work will not be able to have retirement incomes above the social-assistance level. From an employment point of view, this form of pension insurance reinforces the male-breadwinner pattern and discourages part-time work, which is even more true if the income-tax system also privileges non-working wives.

To the extent that the need to increase employment (as distinguished from efforts to reduce open unemployment) has been accepted as a policy priority, Continental welfare states seem to concentrate efforts on improving the international competitiveness of exposed-sector industries. Since significant increases of industrial employment are not to be expected, the emphasis should be on the highly productive information, communication, financial and business services. However, even if growth is facilitated by the deregulation of product markets, these branches will provide jobs only for highly qualified workers. Thus, if the employment deficit of Continental welfare states is to be overcome, major gains will also have to occur in the less productive consumer-oriented, household-oriented and personal services.

In order to realise such gains, however, several preconditions must be met. On the demand side, Continental countries need to reduce the excessive burden of non-wage labour costs that so far prevent the development of a low-wage market for private services. Important steps in that direction were taken by the integration of social security contributions into the income-tax schedule in the Netherlands in 1990, and by the French decision to relieve employers from social-insurance contributions for low-wage workers in 1999. On the supply side, it would be useful for Continental countries to follow the Anglo-Saxon tendency to shift from social assistance to in-work benefits that eliminate the prohibitive taxation of the earned incomes of welfare clients. Moreover, some deregulation of product markets and of employment relations may be necessary if private services are to expand in areas that are presently not included in the formal economy.

With regard to fiscal constraints, the main challenge confronting Continental welfare states seems to be the difficult transition from all-inclusive pay-as-you-go insurance systems to solutions that separate interpersonal redistribution and basic-income support from arrangements insuring individual risks or providing for status-maintaining retirement incomes. While the former should be compulsory or tax-financed, and pay-as-you-go, the latter could be based on income-related contributions, funded, and in part voluntary. However, while the desirability

of such changes is widely accepted, the main obstacle is the design of transition strategies that avoid the double burden on the presently active generation, who would have to finance both the benefits to pensioners entitled under the present regime and the contributions necessary to build up their own retirement funds (Miegel and Wahl 1999).

Conclusions

Compared with the decades after World War II, economic internationalisation has confronted all advanced welfare states with new challenges. In the 1970s, these could have been met by more effective macro-economic coordination but, in the 1980s and 1990s, internationalisation came to have a more direct effect on the structures of national employment and social-policy systems. In product markets, international competition intensified and spread to sectors of national economies that had previously been sheltered. At the same time, mobile firms were enabled to choose among national production locations, and mobile capital is now able to seek the most attractive investment opportunities worldwide. As a consequence, the terms of trade between capital, labour, and the state have shifted in favour of capital interests, and national powers to tax and to regulate have become constrained. Governments and unions wishing to maintain employment in the exposed sectors of the economy must seek ways to increase productivity, rather than redistribution. At the same time, welfare state revenue is constrained by international tax competition, by the need to reduce non-wage labour costs, and by the need to avoid public sector deficits, while welfare state retrenchment is encountering massive political opposition.

Under these conditions, all countries are under pressure to increase private sector employment, to increase the efficiency of welfare state spending and, in particular, to reduce the employment-impeding effects of welfare state financing and welfare state benefits. But these pressures are affecting countries that differ greatly with regard to levels and structures of employment, with regard to levels and structures of welfare state spending, and with regard to levels and structures of public sector revenue. As a consequence, national welfare states differ greatly in their vulnerability to international economic pressures, and in the specific problems that they need most urgently to address. They differ also in the policy options that they could reach under the path-dependent constraints of existing policy legacies, and under the institutional constraints of existing veto positions. There is, in other words, not one best way through which advanced welfare states could maintain their economic viability in an environment of internationalised capitalism without abandoning their employment, social security and egalitarian aspirations. However, as countries such as Denmark, Switzerland, Australia, or the Netherlands demonstrate, there is also no reason to think that economic viability should be incompatible with the successful pursuit of these aspirations.

Notes

1. This paper draws on the preliminary results of a conference project, directed jointly by Vivien A. Schmidt (Boston University) and myself, that compares the adjustment of employment and social policy to economic internationalization after the 1970s in 12 advanced welfare states (Austria, Australia, Belgium, Denmark, France, Germany,

Italy, the Netherlands, New Zealand, Sweden, Switzerland and the United Kingdom). The country reports, special studies and comparative analyses produced by the project are published this year, co-edited by Vivien A. Schmidt, in two volumes as *Welfare and Work in the Open Economy: From Vulnerability to Competitiveness* by Oxford University Press.

2. Based on indicators for household production (participation of women in the labour force), public sector employment, total employment, social security contributions, and D5/D1 wage differentials, a Cluster analysis produced the following three groups of countries: Sweden/Denmark; Australia/New Zealand, United Kingdom and Switzerland; Austria/France, Germany/Belgium, the Netherlands, and Italy.
3. One exception was Sweden, where the incoming Social Democratic government chose to stimulate export demand through a massive devaluation in 1982 (while embarking on a policy of fiscal consolidation), and where the export-sector unions were finally willing and able to practise wage restraint that did maintain the competitive advantage through most of the decade. By contrast, France, which had tried Keynesian reflation when the Socialists came to power in 1981, failed to contain inflationary pressures and escalating deficits, and was forced into a late and painful monetarist turnaround in 1983.
4. It should be noted, however, that even with significantly higher unemployment, real-wage increases in the mid 1980s were higher in Thatcherite Britain than in Germany – mainly because decentralised wage setting did allow bargainers to exploit the above-average ability to pay off profitable firms, while workers in less successful firms were still able to fight for adherence to 'comparability' norms.
5. According to an indicator of capital-exchange liberalisation constructed by Dennis Quinn on the basis of IMF data (where a score of 14 marks total liberalisation), in 1970 11 of 20 OECD countries had scores below 10, and only one country (Germany) had a score of 14. By 1993, only one country (Greece) still scored below 10, and nine countries now had a score of 14.
6. Given these conditions, the dispute about the major cause of the deteriorating position of low-skilled workers (technical change or competition from low-wage countries) seems quite pointless: If low-wage competition does not displace production in high-wage countries, it will speed up productivity-increasing technical change.
7. Since competition works at the margin, we are not relying on indicators measuring differences in the 'openness' of economies (which in any case are highly correlated with the size of countries), but have chosen to define all industries as being 'exposed' in which imports and exports play any role at all. Hence, our definition includes employment not only in manufacturing industries but also in primary production and in a wide range of production-related services, such as transport, communications, financial and business services (i.e. ISIC 1–5 and 7 + 8, according to the International Standard Industrial Classification of all Economic Activities).
8. In effect, target rates of return for business investments continue to rise even though real interest rates for long-term government bonds have long come down from the peak reached in the mid-1980s. It is unclear to what extent this divergence reflects higher risk premia associated with increasingly speculative markets for equity investments or the self-reinforcing effects of shareholder-value oriented management techniques (Vitols 1997).
9. In other words, competitiveness is no longer defined by national *averages* of cost and productivity increases. That is why the disappearance of the 'special relationship' between the German Bundesbank and the German metal workers' union under the EMU regime will not have the destabilizing effects feared by Soskice and Iverson (1997). Within the Monetary Union, each national branch union is in direct competition for jobs against unions organising the same branch in other member

countries. Thus, above-average wage increases will be punished by job losses regardless of whether the European Central Bank will target its Europe-wide monetary policy toward the German or the European economy.

10. Competition for revenue and competition for investments will often, but not invariably, imply similar tax-cutting strategies. The differences are explicated by Ganghof (1999).
11. On the difficulties of empirical confirmation or falsification, see Ganghof (1999).
12. Presumably, rational investors would consider effective, rather than nominal, tax rates. Moreover, the elimination of exemptions could reduce the relative attractiveness of real as compared to portfolio investments (Sinn 1990; Ganghof 1999).
13. Obviously, however, party-political constellations do matter: Margaret Thatcher faced a divided opposition, in New Zealand the neo-liberal policies introduced by a Labour government were not challenged by the conservative opposition, and in the Netherlands, welfare cuts were adopted by inclusive coalition governments (Green-Pedersen 1999).
14. For consumption taxes in the form of the value-added tax, that is true as long as they are raised according to the 'country-of-destination' principle, by which exports are exempted and imports taxed at the domestic rate. Even though that does constitute a (bureaucratic) burden on international trade, the European Commission seems to have abandoned its former efforts to switch to the country-of-origin principle for VAT.
15. For the Netherlands, OECD figures for government and business employment represent full-time equivalents, while all other data include full-time and part-time jobs.
16. The Norwegian position is, of course, influenced by the availability of oil revenues, which do not count as taxes.
17. The Dutch position as an extreme low outlier is in part explained by the statistical anomaly mentioned in note 13, and in part by the fact that some social services are subsidised by the state but provided by charities (as is also true in Germany).
18. Here Dutch figures are comparable with those of all other countries.
19. I have presented only bivariate relationships. But the patterns reported here have survived first attempts at multivariate analysis.
20. In the Netherlands, social security contributions were integrated into the income-tax schedule after 1990. Thus, they are only collected on incomes above the basic exemption of Dfl 8000 per year, and they are also progressive.
21. In the United Kingdom, social security contributions are progressive.
22. I leave out a discussion of the obstacles to international or European tax harmonization, and of the chances that they might be overcome.
23. Denmark is also the only OECD country where, between 1960 and 1990, private expenditures for health care have increased more rapidly (from 0.4 to 2.7% of GDP) than did public expenditures (from 3.2 to 5.0 percent of GDP) (Schmidt 1999, Table 1).
24. The relatively high scores for the Netherlands are affected by a change in the statistical series, which is reflected in an increase of 3.1 percentage points from 1986 to 1987. The largest annual increase in other years between 1974 and 1996 was 1.1 percentage points.
25. Thus, contributions are only collected on incomes above the basic exemption of about Dfl 8500 per year – which in comparison with most other countries constitutes a considerable subsidy to low-wage and part-time employment.
26. Even though Austrian unions are highly centralised, wage equalisation between skill groups, sectors and regions was never a salient union goal, whereas in Germany sectoral unions have traditionally tried to achieve disproportionate gains for low-wage groups, and to match the percentage increases achieved by the 'wage-leader' union

(usually the metal workers). In Belgium, increasing wage equalisation was the price governments had to pay for imposing wage restraint on non-cooperative unions during the 1980s and 1990s.

27. The Swiss pension system is structurally similar, with a first pillar that relies on income-based 'social security contributions' to pay for what is, in effect, a tax-financed and highly redistributive basic pension system.

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