The viability of advanced welfare states in the international economy: vulnerabilities and options

Fritz W. Scharpf

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ABSTRACT The article represents a preliminary and partial analysis of information collected in a comparative project on the adjustment of employment and social policies in twelve advanced capitalist welfare states to changes in the international economic environment since the early 1970s. After the post-war 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 concertation’ 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. But now institutional differences among different types of revenue systems, welfare states and employment systems – Scandinavian, Anglo-Saxon, and Continental – create important differences in vulnerability that can no longer be met by standardized responses. The article concludes with an examination of the specific problems faced by, and the solutions available to, the different countries included in the study.

KEY WORDS Employment; globalization; governments; social policy; taxation; unions.

1. THE RISE OF THE CAPITALIST WELFARE STATE

Modern welfare states have their roots in the last decades of the nineteenth century and the first decade of the twentieth century, when the international integration of capitalist economies had reached a high plateau. But they only achieved their full development in the ‘golden age’ of the early post-war decades, when national
economic boundaries were effectively controlled. After the rampant protectionism following 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 strictly regulated in most countries, and 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 and 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. If the competitiveness of internationally exposed branches became insufficient, moreover, 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 post-war decades, nation states were indeed able to control their own economic boundaries and the conditions under which transnational economic transactions would take 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; and 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 transnational 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 nation-wide rules allowed the redistribution of primary incomes through cross-subsidization in the private sector as well as secondary redistribution through public services and transfers financed through progressive taxation. Hence, ‘solidaristic’ 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.

All countries in our project were capitalist in the sense that the private ownership of the means of production was accepted in principle, and all had in practice come to depend on profit-oriented private enterprise and market interactions for the creation of mass incomes and public revenue through economic growth. At the same time, however, they all relied on the state’s newly increased capacity for market-correcting action to pursue at minimum three socially valued purposes: full employment with ‘good jobs’ for all those who were expected to work for a living; social insurance against the risks of sickness, invalidity, unemployment, and old age; and social assistance to prevent the poverty of those without other sources of support.

Beyond these minimum aspirations, countries differed greatly with regard to the coverage and generosity of publicly provided social insurance, social assistance and social services, and even more so with regard to their commitment to reduce, or prevent, the social inequalities that are continuously generated and reproduced by capitalist market economies. They also differed greatly in the policy instruments employed, the mode of financing, and the institutions created, for the achievement of their market-correcting goals; and they also differed in the economic efficiency of their ‘golden-age’ solutions, whether measured in average rates of economic growth, per-capita GDP or employment rates.

In view of these differences in institutions, policy legacies and economic performance, it is fair to say that of the twelve advanced welfare states that we have studied in detail, no two are truly alike. Nevertheless, there are similarities among ‘clusters’ of countries which, by and large, correspond with the distinction between ‘Scandinavian’, ‘Continental’ and ‘Anglo-Saxon’ welfare states proposed by Esping-Andersen (1990). I will return to the characteristic differences between these three clusters of welfare states in the concluding section of this article. In spite of these differences, however, all advanced industrial democracies were able to achieve their respective welfare-state goals without endangering the viability of their capitalist national economies.

By contrast, institutional differences began to matter very much from the early 1970s onward, when major changes in the international environment did increase the economic vulnerability of advanced welfare states. That is not meant to deny the importance of endogenous challenges – among them technical changes that have revolutionized production and consumption patterns, the effects of expanding education, the ageing of the population, the transformation of traditional family structures and profound value changes – that also differed in their impact on different types of post-war welfare states. They are considered in the larger project from which this article is derived. But here the focus is 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 the later period and the present are characterized by intensified competition in international capital and product markets.
2. CHALLENGES AND RESPONSES OF THE 1970s AND EARLY 1980s

For most industrialized countries, the end of the post-war ‘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 created an uncertain environment of floating exchange rates and accelerated the growth of uncontrolled ‘offshore’ capital markets. 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 four-fold 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 they chose to fight inflation with restrictive fiscal and monetary policies, the result would be mass unemployment.

In the 1970s, as I have shown elsewhere, the dilemma could be avoided if, in addition to fiscal and monetary policy, wages could also be employed as a tool of macro-economic policy in 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 both sides, however, the concerted strategy was not incentive-compatible for all necessary participants. Its success depended on the support of the central bank which, in the face of strong inflationary pressures, would normally have preferred to impose a tight-money regime. On the union side, moreover, the strategy required the acceptance of real-wage losses in exchange for the government’s commitment to defend full employment.

In fact, a close approximation to Keynesian concertation was achieved only in Austria, where it was facilitated by the long-standing institutions of ‘corporatist’ co-operation between the ‘social partners’ and the government which, jointly, also controlled the decisions of the central bank. 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 – in which case the bank’s tight-money policy neutralized expansionary fiscal impulses. The same was true in countries like Denmark, the Netherlands or Belgium, where the government tried to stabilize 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 softened if real wages were quickly adjusted downwards, which was true in Germany and Switzerland but not in the other hard-currency countries practising an imported (and perhaps less clearly understood) version of the Bundesbank’s monetarism.

In countries where politically dependent central banks could be required to accommodate the rise of oil prices, government deficit spending was generally able
to avoid major job losses in the 1970s. But then inflation would escalate unless it was counteracted by effective wage restraint. In the absence of unemployment, however, and at a time when their real-wage position was eroding, that 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 – which 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, and the attempt to stabilize employment through demand reflation left most governments with very high budget deficits.

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 beliefs and hard-currency policy responses when the second oil crisis seemed to replay the challenges of the 1970s – with the result 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. Most important, however, was the fact that now the monetary policy of the United States was also no longer willing to accommodate 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 – 3.1 per cent in 1981, 5.4 per cent in 1982, 7.2 per cent in 1983 and 8.1 per cent in 1984. Since the internationalization of capital markets had progressed rapidly during the 1970s, and 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 distribitional 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 realized through reduced wage claims and tax ‘reforms’ favouring capital incomes, or whether it was realized through disinvestment 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, i.e. on the co-ordination 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, the role of fighting inflation had been taken over by monetary policy in most countries. As a consequence, unemployment did increase, but the extent to which it would rise depended primarily on unions and workers accepting wage settlements allowing a steep rise of business profits. Organizationally strong unions in countries with centralized or co-ordinated 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 decentralized wage-setting systems (as they existed in the United Kingdom and, after the early 1980s, in France), market pressures alone would eventually be sufficient for achieving this effect. Thus, in the second half of the 1980s private sector employment was again increasing in countries with either weak unions and decentralized wage setting (Britain, France and, to a lesser extent, Switzerland), or 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 decentralized wage bargaining, and in Italy, with centralized but competing unions in a confrontational industrial relations system.

3. CHALLENGES OF THE 1990s

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 internationalization of markets for goods, services and capital was now reaching levels that equaled, 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. Moreover, the European Community had decided to liberalize financial services, and most countries had deregulated their domestic financial markets as well. As a consequence, financial capital is now 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 world-wide opportunities for speculative, portfolio or real investments.

At the same time, successive rounds of General Agreement on Tariffs and Trade (GATT) and World Trade Organization (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, and it had introduced international competition in a wide range of services and utilities – among them telecommunications, postal services, rail, air and road transport, or electricity supply – which before had been provided either by the state itself or by state-controlled monopolies and cartels. Moreover, for some of the European welfare states, the completion of the internal market was followed by the commitment to create a monetary union which 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 which also removed
the last important barrier to real-capital mobility: firms are now 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 post-war decades. The internationalization 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, taxpayers 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).

That is not to say that countries have lost all capacity to pursue the welfare goals that they had chosen in the post-war decades, but it does imply that these goals must again be pursued within the constraints of international capitalism – and it suggests that, in contrast to the macro-economic shocks of the 1970s and early 1980s, a capacity for macro-economic co-ordination and union wage restraint is no longer sufficient for coping with the new challenges. Since governments and unions are no longer dealing with captive capital owners and captive consumers, national systems of taxation, regulation and industrial relations have now become vulnerable to the extent that they reduce the attractiveness of the national economy to mobile capital and the competitiveness of nationally produced goods and services in international product markets. But before it is possible to discuss the greater or lesser vulnerability of different countries, it is necessary to specify more precisely the mechanisms through which the pursuit of employment, social security and social equality goals is constrained by economic internationalization. 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.

### 3.1 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 industrializing and Central and Eastern European countries is forcing producers in high-cost countries to automate production or to specialize in ‘upmarket’ industrial products of high technical or aesthetic quality, and in highly productive services. Assuming that wages and non-wage labour costs are downward and inflexible, skill requirements will rise, and demand for unskilled workers will shrink as a consequence.6 At the same time, and of greater practical importance, competition among advanced industrial countries has also become more intense, contributing to the greater volatility of increasingly specialized 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 and their flexible adaptation to the volatile demand in specialized market niches (Streeck 1999). In other words, international competition will necessarily drive up productivity in those firms that are able to survive – which in the aggregate 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 (see Table 1), whereas 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’ (see Table 2).

From a social policy point of view, it is even more important that, in internationalized and liberalized markets for goods and services, firms have become price takers, and that among the member states of the European monetary union (EMU), 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 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

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\text{Table 1. Employment in exposed sectors as a percentage of the population aged 15–64, 1970–97 (ISIC 1–5, 7, 8)}
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1 Break in series after 1985
\(^2\) Break in series after 1990
\(^3\) Break in series after 1986
opportunities available internationally. 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 – as is true in the media, in wholesale and retail trade or in hotels.

As a consequence, private sector firms are now much less able and willing to cross-subsidize less profitable lines of production, or less productive jobs. Instead, and most obviously within the EMU, 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. For governments and unions that implies that the employment risks associated with strategies aiming at the ‘de-commodification of labor’ (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 – all these are 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 the employment opportunities of less skilled workers.

\[\text{Table 2 Employment in sheltered sectors as a percentage of GDP, 1970–97 (ISIC 6 + 9)}\]

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4 Break in series after 1985
5 Break in series after 1990
6 Data after 1989 estimated
7 Break in series after 1992
8 Break in series after 1986
In conclusion, 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 internationalized capital markets which also affect employment in capital-intensive branches of the sheltered sector. As a consequence, it is now generally more difficult than before to instrumentalize private sector employment relations for the achievement of egalitarian welfare goals. If such purposes were in the past pursued through collective bargaining and government regulation of employment conditions, their continuing realization 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 internationalization on welfare state revenue.

3.2 Welfare state revenue

In the average Organization for Economic Co-operation and Development (OECD) country, the share of taxes and social security contributions in GDP has risen steeply until the mid-1980s, but stagnated thereafter (see Table 3). In Italy, Switzerland and Denmark, it is true, total tax revenue continued to increase, and in the United Kingdom it declined somewhat, but otherwise, annual figures 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 – with Australia collecting about 30 per cent of GDP, Switzerland, the United

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<td>35.2</td>
<td>37.5</td>
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<td>30.8</td>
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<td>50.0</td>
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<tr>
<td>OECD 18</td>
<td>31.8</td>
<td>36.6</td>
<td>38.4</td>
<td>39.3</td>
<td>39.8</td>
</tr>
</tbody>
</table>

Kingdom, New Zealand and, remarkably, Germany, clustering around or above 35 per cent, the Netherlands, Italy, Austria, France and Belgium around or above 45 per cent and Denmark and Sweden above 50 per cent. 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 thereafter: unemployment, early retirement, pensions and health care for an ageing population, poverty, and rising demands on education and on business-oriented infrastructure – all would under earlier circumstances have required, and justified, further increases in 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. 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). Instead, countries that cut their top rates have generally tried to defend their revenue position by simultaneously broadening the tax base. Even though that solution also has its problems, countries seem to have been pushed toward it by the disadvantages associated with the alternative courses of action from which they would have had to choose if revenue from mobile sources were significantly reduced.

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

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 EMU had the effect of foreclosing the deficit option for most European welfare states, and 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, and speculative runs on their currencies. In short, deficit spending had ceased to be a sustainable national strategy in the 1990s. At the same time, however, significant cuts in public expenditure were difficult to adopt in multi-party and corporatist political systems where hard choices depend on broad agreement among multiple veto actors, and 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.\footnote{That leaves 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 of which are relatively immune to international tax competition.\footnote{In doing so, 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 ($R^2 = 0.12$). 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 (see Figure 1). Among the twelve 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

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure1.png}
\caption{Total tax burden and total employment (1997)}
\begin{flushleft}
\textit{Sources:} OECD Revenue Statistics, OECD Economic Outlook.
\end{flushleft}
\end{figure}
countries have intermediate and the remaining moderate-tax Continental countries have the lowest employment scores (see Table 4).

If we look at the distribution between public and private sector employment, however, more systematic differences emerge: as is to be expected, high-tax Scandinavian welfare states are characterized 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. Looking even more closely, it appears that the Continental deficit in private sector employment cannot be located in the manufacturing sector of ISIC 3 (where Continental Germany actually has the highest employment ratio) but seems to be due to a lack of private-sector service jobs – for which employment in the branches included in ISIC 6 (wholesale and retail trade, restaurants and hotels) seems to be a good proxy.

Table 4 Total and sectoral employment as a percentage of the population aged 15–64, 1997–8

<table>
<thead>
<tr>
<th></th>
<th>Total employment as % of pop. 15–64</th>
<th>Government employment as % of pop. 15–64</th>
<th>Business employment as % of pop. 15–64</th>
<th>Employment in ISIC 3 as % of pop. 15–64</th>
<th>Employment in ISIC 6 as % of pop. 15–64</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>73.9</td>
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<td>63.3</td>
<td>11.9</td>
<td>16.1</td>
</tr>
<tr>
<td>Australia</td>
<td>68.5</td>
<td>9.8</td>
<td>58.7</td>
<td>9.2</td>
<td>17.2</td>
</tr>
<tr>
<td>New Zealand</td>
<td>60.9</td>
<td>8.6</td>
<td>52.3</td>
<td>11.2</td>
<td>14.7</td>
</tr>
<tr>
<td>UK</td>
<td>70.3</td>
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<td>59.7</td>
<td>13.0</td>
<td>14.1</td>
</tr>
<tr>
<td>Switzerland</td>
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<td>18.4</td>
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<td>Austria</td>
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</tr>
<tr>
<td>Belgium</td>
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</tr>
<tr>
<td>Germany</td>
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<td>9.1</td>
<td>51.4</td>
<td>16.1</td>
<td>10.8</td>
</tr>
<tr>
<td>France</td>
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<td>44.6</td>
<td>10.5</td>
<td>10.1</td>
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<td>Netherlands</td>
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<td>52.1</td>
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<td>13.6</td>
</tr>
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<td>Denmark</td>
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<td>52.8</td>
<td>14.5</td>
<td>12.4</td>
</tr>
<tr>
<td>Sweden</td>
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<td>21.2</td>
<td>47.8</td>
<td>13.3</td>
<td>10.6</td>
</tr>
<tr>
<td>OECD 18</td>
<td>66.5</td>
<td>12.6</td>
<td>53.8</td>
<td>12.4</td>
<td>13.4</td>
</tr>
</tbody>
</table>


Even though 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 (see Figure 2). The relationship is not very strong, however ($R^2 = 0.35$), and a closer inspection of the scattergram suggests that it would disappear altogether if Sweden, Denmark and Norway were left out of the picture. 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. By contrast, the expected negative association between total taxation and business employment (see Figure 3) appears to be much stronger ($R^2 = 0.64$), but again Denmark and Sweden are doing better, and Continental countries are generally doing less well than would be expected on the basis of relative tax burdens.

*Figure 2* Total tax burden and public sector employment (1997)
*Sources:* OECD Revenue Statistics, OECD Economic Outlook.
Continuing on private sector employment, it is clear that it includes diverse branches 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 ($R^2 = 0.14$) between the overall tax burden and employment in the exposed sectors (see Figure 4). 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 which are facing international competition is relatively insensitive to the overall tax burden – presumably, because high labour productivity allows taxes that affect the cost of production to be shifted to workers. By implication that suggests that the strongly negative impact of tax burdens on
business employment represented by Figure 3 must primarily affect the less productive private-sector services that are domestically produced and consumed. In the 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, and jobs with high labour productivity (in health care, education and the media, for instance) as well as jobs with low labour productivity, data on employment in ISIC 6 should provide a clearer test for the causal effect of taxation on employment in domestic service branches with low labour productivity (see Figure 5). It is in fact strongly negative ($R^2 = 0.60$). Yet, again, there are interesting differences, with Denmark and Austria as positive, and Belgium, France, Italy and Germany as negative outliers.

Thus, 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 are primarily relying 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 (see Table 5). 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, however, this expectation is again not supported by the data. There is no statistical association ($R^2 = 0.08$) between business employment and the GDP share of personal and corporate income taxes (see Figure 6). That leaves social security contributions and consumption taxes which – because they are relatively immune to international tax competition – are generally considered the most promising targets of burden-shifting policies. Taken separately, each of these has a negative effect on overall business employment as well as on employment in ISIC 6. In combination, their negative effect on business

Figure 5 Total tax burden and private-sector service employment (1997)
employment (see Figure 7) is strong ($R^2 = 0.52$), and their negative effect on ISIC-6 jobs (see Figure 8) is equally strong ($R^2 = 0.53$).

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. By 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, on the one hand, and to self-service (Gershuny 1978) or tax evasion, on the other hand. Similarly, social security contributions are usually (except in the Netherlands$^{17}$ and in Britain$^{18}$) 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. By 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

**Table 5** Taxes and social security contributions as a percentage of GDP, 1997

<table>
<thead>
<tr>
<th></th>
<th>Total taxation as % of GDP</th>
<th>Social security contributions as % of GDP</th>
<th>Taxes on goods and services as % of GDP</th>
<th>Personal and corporate income tax as % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>28.5</td>
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<td>4.9</td>
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<td>Australia</td>
<td>30.4</td>
<td>2.0</td>
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<td>0.3</td>
<td>12.6</td>
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<td>12.5</td>
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<td>6.1</td>
<td>12.8</td>
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<td>12.9</td>
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<td>12.4</td>
<td>18.0</td>
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<td>17.1</td>
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<td>OECD 18</td>
<td>39.8</td>
<td>10.9</td>
<td>11.2</td>
<td>15.7</td>
</tr>
</tbody>
</table>

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.

This is not meant to say that tax levels and tax structures are the only factors having a negative impact on employment in the private services. Government minimum wage legislation and solidaristic union wage policies may also have the effect of raising the labour costs of less productive services above the market-clearing level (Iversen and Wren 1998). The best available indicator is the D5/D1 earnings ratio for both genders (see Table 6). While the association between this indicator of wage differentiation and private-sector service employment is positive (see Figure 9), it is not strong ($R^2 = 0.32$). Nevertheless, it may help to explain some of the outlier positions in Figure 8. Thus, the fact that Austria has more ISIC-6 jobs than is explained by the tax factors may indeed be related to the fact that, for both

\[ \text{Figure 6} \quad \text{Income taxes and business employment (1997)} \]
\[ \text{Sources: OECD Revenue Statistics, OECD Economic Outlook.} \]
The D5/D1 ratio is higher in Austria than in any other country included in our project (Table 6). A second factor which is often assumed to have a negative impact on service employment are the difficulties, and the costs, associated with hiring and firing, which are thought to prevent employers from responding flexibly to uncertain increases of demand (OECD 1994). The OECD attempts to capture these differences in a synthetic index integrating various dimensions of ‘employment protection legislation’ in a single EPL rank ordering (see Table 6). As expected, the association with ISIC-6 employment is negative (see Figure 10), but it is not very strong ($R^2 = 0.40$). While this factor may also help to explain some of the residuals in Figure 8, its impact is again not as strong as the tax factor.

We can thus conclude that the tax system does exert a powerful influence on business employment, but that these effects vary greatly on both the employ-
ment 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.

If these effects are well understood, governments should want 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. But here political opposition is likely to be very strong in a period in which the real-income

**Figure 8** Social security contributions plus consumption taxes and private-sector service employment (1997)

<table>
<thead>
<tr>
<th></th>
<th>Female labour force participation (%) (1996)</th>
<th>Total social expenditure as % of GDP</th>
<th>Services for families and the aged as % of GDP</th>
<th>Replacement rate of unemployment benefits (%)&lt;sup&gt;1&lt;/sup&gt;</th>
<th>Employment protection legislation rank</th>
<th>Earnings dispersion D5/D1 (both genders)</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>72.0</td>
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<td>0.36</td>
<td>58</td>
<td>1</td>
<td>2.09</td>
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<tr>
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<td>15.7</td>
<td>0.56</td>
<td>37</td>
<td>4</td>
<td>1.64</td>
</tr>
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<td>68.0</td>
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<td>0.15</td>
<td>37</td>
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<td>1.16</td>
<td>52</td>
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<td>65</td>
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<td>70</td>
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<td>France</td>
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<td>76</td>
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<td>1.03</td>
<td>75</td>
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<tr>
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<td>1.63</td>
<td>n.a.</td>
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</table>


<sup>1</sup> Single worker, at level of average production wage, in the first month of benefit receipt.
position of skilled workers has been declining while the tax resistance of high-income professionals is 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. But while these options might be economically innocuous, they have been 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.\textsuperscript{21} Moreover, these constraints seem to operate at all levels of taxation, and there is no reason to think

\textit{Figure 9} D5/D1 wage differentiation (1994–5) and private-sector service employment (1997)
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 yet been very successful in reducing the total tax burden (see Table 3).

4. CHARACTERISTIC CHALLENGES AND OPTIONS

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

- employment in the exposed sectors is generally stagnant or shrinking and can be maintained only under conditions of high and rising productivity;
employment losses in the exposed sectors can be compensated 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; and
opportunities for egalitarian cross-subsidization 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 confronting very different types of welfare states, with different employment structures, different revenue structures and different policy legacies – all of which affect their greater or lesser vulnerability to competitive pressures, the major challenges which they have to face at present, and the policy options that might be effective in coping with these challenges. In spite of the fact that no two countries in our project are truly alike with regard to their employment and welfare state structures, it seems useful to discuss their differences by reference to distinctions between Scandinavian, Anglo-Saxon and Continental regimes presented in Esping-Andersen’s The Three Worlds of Welfare Capitalism (1990). To the extent that they have not been discussed above, salient performance indicators are presented in Table 6.

4.1 Scandinavian welfare states

In our project, the Scandinavian or ‘social democratic’ regime is represented by Sweden and Denmark. Both these countries are characterized by:

- very high levels of total employment,
- very high levels of female participation in the labour market,
- very high levels of taxation,
- a very generous social policy, providing high levels of income replacement in cases of involuntary inactivity and old age as well as comprehensive social services for the young, the sick and the handicapped, and the aged, and by
- 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 did free married women to seek employment in the formal labour market, while providing both the jobs which they could fill and the political support to sustain the high levels of taxation needed to pay for them. As a consequence, public sector employment in the Scandinavian countries is almost twice the
OECD-18 average (see Table 4). Business employment, by contrast, is slightly below average. However, industrial employment as well as overall employment in the exposed sectors (see Table 1) are above the average in both countries. Sweden, it is true, suffered a dramatic decline in the 1990s – which, however, was caused by a combination of unfortunate domestic policy choices and international constellations 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 will be crowded out by the large public sector, but the weakness is also visible in ISIC 6 (see Table 4) where public services play no role.

The explanation for the relative weakness of private-sector 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 D5/D1 wage differentials to the lowest level among OECD countries (see Table 6 and Figure 9). 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 are 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 ISIC-6 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 (see Table 5 and Figure 8). 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 – which is also reflected in Denmark’s relatively low position in the OECD’s employment-protection ranking (see Table 6 and Figure 10). Employment can be terminated at low cost and with short notice – which is considered socially acceptable since workers with average wages are assured of exceptionally generous unemployment benefits replacing up to 90 per cent 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. In addition, the Danish system of collective bargaining has never attempted to achieve the degree of centralization 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 internationalization 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 per cent 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 per cent of GDP in 1993 to 33.4 per cent in 1995, whereas Denmark reduced total social expenditures only from 33 per cent in 1994 to 31.9 per cent in 1996. This difference seems to explain the fact that the public-sector employment ratio in Denmark remained stable at about 22 per cent throughout the decade, whereas in Sweden it fell from 26.1 per cent in 1989 to 21.9 per cent in 1997 (OECD Social Expenditure Data Base 1980–96). 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 the elderly through means-tested co-payments, whereas 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 which 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 at present better placed than Sweden to cope with both problems – because of its more employment-friendly tax system, its greater use of co-payments in the financing of public services, its more decentralized wage-setting institutions, and its more flexible regulation 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.

4.2 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 characterized 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 old age, and low (except in the United Kingdom) levels of social services for the young, the sick and the handicapped, and the aged, and by
moderate to high levels of wage differentiation and income inequality.

Given their low levels of taxation, all four countries have low (but not exception-
ally 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 (see Table 1). Instead, the relative success of liberal welfare
states is mainly due to jobs in the sheltered sector services (see Tables 2 and 4). 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 was 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 were 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 lost most of 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 decentralized 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 (see Table 6 and Figures 9 and 10).

At the same time, the liberal welfare states also benefit from relatively
employment-friendly tax structures (see Table 5 and Figure 8). 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 employ-
ment based on a well-trained labour force, co-operative industrial relations and
a specialization 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 had traditionally relied on (publicly subsidized) 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 is not 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-subsidize 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 assured full employment while state arbitration courts assured an adequate ‘family wage’ for full-time workers in all sectors (Castles 1989). When the deterioration of export markets undermined the economic viability of these arrangements, so that both countries were forced to liberalize their manufacturing and service sectors, their paths diverged (Quiggin 1998).

In New Zealand, the post-1984 Labour government imposed radical liberalization on product and capital markets, while strong but decentralized 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 individualized for collective wage bargaining in the Employment Contracts Act of 1991. In Australia, by 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 liberalization and an increase of social assistance benefits. In effect, therefore, 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 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 decentralized 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, because of the expansion of services in the sheltered sector.

In effect, New Zealand and Britain have moved to extremely deregulated labour markets and highly decentralized or even individualized wage setting. They have thus no problem with wage differentiation and employment flexibility. There is also no more organized resistance to the rapid introduction of process and product innovations. But neither is there much investment in skills and in the practices of trusting co-operation 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 is still far from achieving German levels of quality, productivity and profitability in its British Rover plant. By 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, the availability of venture capital, and 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 comparative perspective, 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 in-work benefits that are modelled on the Earned Income Tax Credit in the United States. By combining earned incomes with (degressive) 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 investments in education and measures that increase 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 economic efficiency.

4.3 Continental welfare states

The last group of countries is more heterogeneous than the others. Nevertheless, it is possible to say that, in general, Continental or ‘Christian Democratic’ welfare states are characterized by:

- low or very low rates of total employment,
- low or very low rates of female participation in the labour market,
- moderate levels of total taxation, but a high reliance on social security contributions,
- moderate to high 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 the handicapped, and the old, and by
- 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 corresponding levels of public sector employment (see Figure 2). 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 1999). Remarkably, however, Continental welfare states also have lower rates of business employment than their intermediate tax levels would lead one to expect (see Figure 3).

In those sectors of business employment that are exposed to international competition, however, Austria and Germany are above the OECD average (see Table 1) and also above the regression line (see Figure 4), 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 rates 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 organization 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 ‘co-ordinated’ sectoral wage bargaining which normally permit the effective adjustment of average wage increases to given macro-economic conditions and to the pressures of international competition (Iversen 1999). 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 turnaround of Dutch employment (Visser and Hemerijck 1997). At the same time, these countries have strongly institutionalized forms of vocational training and of worker participation at firm level which facilitate high-quality production and co-operative 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 under-standardize wages and working conditions. These dangers are most manifest in Germany, where wage compression has actually increased in recent decades, while Dutch and Austrian industrial relations have allowed more differentiation and flexibility (see Table 6 and Figure 10).

In Belgium, France and Italy, by 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 in all three countries. From the early 1980s onward, Belgian governments were finally able to impose effective wage restraint – but only at the price of above-average increases for low-paid workers and an increasing compression of wage scales. In France, by 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 decentralized and settlements are highly differentiated. Nevertheless, the state still legislates on working conditions and working hours, and it also continues to define statutory minimum wages (Schmidt 1996; Levy 1999). However, in both countries government intervention cannot substitute for the lack of organized co-operation that would facilitate ‘productivity coalitions’ between management and organized 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 co-ordinate their bargaining strategies with a view to the macro-economic requirements of European monetary integration. In the process, Italian industrial relations have also been transformed in ways that approximate to the ‘corporatist’ model (Regini and Regalia 1997; Ferrera 1997).

With regard to sheltered sector employment (ISIC 6 + 9), all Continental countries are below the OECD average (see Table 2)\(^2\) 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 (see Table 4). 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 – which are particularly damaging in their effect on the less productive private services (see Figure 8). In this regard, the position of Austria as an extreme positive outlier (see Figures 5 and 8) is not fully explained by above-average employment in tourism, but seems to be related to a very high ratio of D5/D1 wage dispersion (see Table 6 and Figure 9). The Netherlands, by contrast, seem to have benefited from the fact that social security contributions were integrated into the income-tax schedule in 1990.

In addition, several of the factors that constrain private-sector 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, but not in Austria, wage scales are also compressed by minimum wage legislation or by the solidaristic wage policies pursued by strong unions (see Table 6).\(^2\)

With regard to 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 subsidized inactivity. On the other hand, the fact that social security is institutionalized in the form of compulsory insurance programmes tends to create
entitlements (or even constitutionally 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 which will further reduce employment opportunities in private sector services.

Given these conditions, all Continental welfare states are at present confronted with two major problems: insufficient employment and an over-committed transfer system. Both 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 – with the consequence 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 should be a big financial and political premium on solutions that will increase overall employment levels without challenging the social security of beneficiaries of the present system.

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 financed through surcharges on labour, and they are most obvious in the field of old-age pensions. While similarly generous, the Scandinavian, Dutch and Swiss pension systems are typically three- or four-tiered, combining (1) a universal and tax-financed 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-subsidized 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.

By contrast, the typical Continental pension system (except for the Netherlands, whose three-tiered pension system resembles Scandinavian models) combines redistribution and contribution-related insurance in a single scheme which – because it is redistributive – is resented as a (highly regressive!) form of taxation, but which – because it is organized as a contribution-based insurance system – does not allow means-testing and other forms of discretionary retrenchment. From a social security point of view, the lack of a basic pension deprives individuals with
‘incomplete’ work biographies (including longer stretches of inactivity or part-time work) of retirement incomes above the social-assistance level. From an employment point of view, therefore, 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 in industrial employment are not to be expected, the emphasis should be on the highly productive information, communication, financial and business services. But 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.26

In order to realize 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 prevents 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 recent decisions in France and in Belgium that will relieve employers from social-insurance contributions for low-wage workers. 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 employment relations may be necessary if private services are to expand in areas which at present are 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 currently active generation which would have to finance both, i.e. the benefits to pensioners entitled under the present regime and the contributions necessary to build up their own retirement funds (Miegel and Wahl 1999).

5. CONCLUSIONS

In comparison to the decades after World War II, economic internationalization has confronted all advanced welfare states with new challenges: in the 1970s, these could have been met by more effective macro-economic co-ordination, but in the 1980s
and 1990s internationalization 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 can now pick and choose among production locations, and mobile capital is able to seek the most attractive investment opportunities world-wide. As a consequence, the terms of trade between capital, labour and the state have shifted in favour of capital interests, national powers to tax and regulate have become constrained, and 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, raise the efficiency of welfare state spending, and in particular 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, levels and structures of welfare state spending, and 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 which they need most urgently to address – and 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, no one best way through which advanced welfare states could maintain their economic viability in an environment of internationalized capitalism without abandoning their employment, social security and egalitarian aspirations. But, as countries like 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.

Address for correspondence: Fritz W. Scharpf, Max Planck Institute for the Study of Societies, Paulstrasse 3, D-50676 Köln, Germany. email: scharpf@mpi-fg-koeln.mpg.de

NOTES

1 The project, which is directed jointly by Vivien A. Schmidt (Boston University) and myself, includes country reports covering Sweden and Denmark (Mats Benner and Törben Vad), Austria, Belgium and the Netherlands (Anton Hemerijck, Brigitte Unger and Jelle Visser), Germany (Philip Manow and Eric Seils), France (Jonah Levy), Switzerland (Giuliano Bonoli and Andre Mach), Italy (Maurizio Ferrera and Elisabetta Gualmini), the United Kingdom (Martin Rhodes), and Australia and New Zealand (Herman Schwartz). In addition, special studies focus on female employment (Mary Daly), early retirement (Berhard Ebbinghaus), privatized public services (Adrienne Héritier and Susanne Schmidt) and tax competition (Steffen Ganghof). Together with a
Based on quantitative indicators for the participation of women in the labour force, public sector employment, total employment, social security contributions as a percentage of GDP, and D5/D1 wage differentials, a cluster analysis produced the following three groups of countries: (1) Sweden/Denmark; (2) Australia/New Zealand, United Kingdom, Switzerland; and (3) Austria/Spain, Portugal/Belgium, the Netherlands, Italy.

One successful exception was Sweden where the Social Democrats, returning to power in 1982, chose to stimulate export demand through a massive devaluation (while embarking on a policy of fiscal consolidation), and where export sector unions were finally willing and able to practise effective wage restraint that did maintain the competitive advantage through most of the decade. By contrast, France, which had tried Keynesian reflaction 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.

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 decentralized wage setting did allow bargainers to exploit the above-average ability to pay of profitable firms, while workers in less successful firms were still able to fight for adherence to comparability norms.

According to an indicator of capital-exchange liberalization constructed by Dennis Quinn on the basis of IMF data (where a score of 14 marks total liberalization), in 1970 eleven of twenty 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.

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.

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, construction, energy, 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).

In effect, target rates of return for business investments continue to rise even though real interest rates for long-term government bonds have come down from the peak reached in the mid-1980s. It is unclear to what extent this divergence reflects higher-risk premiums in increasingly volatile markets for equity investments or the self-reinforcing effects of shareholder-value oriented management techniques (Vitols 1997).

In other words, international competitiveness is no longer merely a balance of payments problem constituted by differences among national averages of cost and productivity increases (and corrected through exchange-rate adjustments). Instead, it has become a problem of individual products and producers. That is why the disappearance of the ‘special relationship’ between the German Bundesbank and the German metal workers’ union under the EMU regime is unlikely to have the destabilizing effects feared by Koski and Iverson (1997). Within the monetary union, each national branch union is in direct competition for jobs against unions organizing the same branch in other member countries. Thus, above-average increases of unit
labour costs in, say, the auto industry of one country 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.

Competition for revenue and competition for investments will often, but not invariably, imply similar tax-cutting strategies. The differences are explicated by Ganghof (forthcoming).

On the difficulties of empirical confirmation or falsification, see Ganghof (forthcoming).

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, forthcoming).

But obviously, 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).

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.

For some countries, data on government and business employment have been adjusted (by correcting for differences in the treatment of part-time employment) so as to conform to (OECD Economic Outlook) data on total employment.

The Norwegian position is, of course, influenced by the availability of oil revenues which do not count as taxes.

In the Netherlands, the major part of social security contributions was integrated into the income tax schedule after 1990. Thus they are only collected on incomes above the basic exemption of 8,700 guilders per year and at the lowest rate of the income tax schedule.

In the United Kingdom, social security contributions are progressive.

For men, the D5/D1 wage differentiation in Austria was 1.67 in 1994 – still higher than in the Scandinavian and other Continental countries, but somewhat below the United Kingdom and New Zealand, and far below the United States. In other words, the employment effect seems to be mainly due to lower wages for typical ‘women’s jobs’ in the retail trade, hotels and restaurants.

In a multivariate analysis including all three factors, only the effects of social security plus consumption taxes on ISIC-6 employment are statistically significant. But the signs of the other two factors are in the expected direction.

I omit a discussion of the obstacles to international or European tax harmonization, and of the chances that they might be overcome.

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 per cent of GDP) than public expenditures (from 3.2 to 5.0 per cent of GDP) (Schmidt 1999: table 1).

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.

Even though Austrian unions are highly centralized, wage equalization between genders, 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, a similar increase in equalization was the price that governments had to pay for imposing wage restraint on non-cooperative unions during the 1980s and 1990s.

The Swiss pension system is structurally similar, with a first pillar that relies on income-(rather than wage-based) ‘social security contributions’ to pay for what is in effect a tax-financed and highly redistributive basic pension system.
Since most Continental countries have health care and education systems that are almost totally financed from taxes and social security contributions, the fiscal constraints on the welfare state have also prevented the rapid expansion of high-quality and highly paid services in these branches which has occurred in the United States, where the expansion is primarily driven by rising private demand.

REFERENCES


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