Institutions and Economic Performance : Evidence from the Labor Market

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I. Introduction

Few facts have been highlighted more dramatically by recent events in the world economy than the need for supportive institutions for the smooth operation of markets. Whether these events are transition in Russia or financial liberalization in Asia, we are reminded that markets do not operate in an institutional vacuum.

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

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European economy recovered and grew at unprecedented rates.

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

Observing that national institutional developments moved in a similar direction and acquired their own momentum is not to say that their development is uniform or unresponsive to changes in the environment or to the unintended consequences of their own operation. Thus, in response to lagging international competitiveness, double digit unemployment, and unsustainable fiscal positions, politicians and their constituents have begun to reform labor relations to accommodate the economic and technological imperatives of the 21st century. But to understand the scope and shape that these reforms take in different countries we need to look at the interaction of exogenous pressures for change and the domestic institutions and policies that shape the effects of these pressures. Of course, national institutions and policy patterns are themselves the outgrowth of past economic, political and technological challenges, some of which have their origin in the turbulent period between the world wars. But this is to get ahead of our story.

II. The Shadow of History

The remarkable economic success of western Europe after World War II must be understood against the backdrop of prewar developments.[2] In an important sense, the industrial revolution spread beyond isolated pockets in Northern Europe and North America only in the final decades of the 19th century. Only then can it be said that Marx and Engels' vision of large-scale manufacturing animated by centralized power, housed in large factories, and manned by an anonymous proletariat became widespread reality. The challenge for the 20th century was thus to solve the problems of efficiency and legitimacy posed by the spread of this new system, and this required the creation of institutions and structures through which the participation and cooperation of the rising industrial working class could be secured.

19th century liberal capitalism, in its post-1848 form, had been predicated on limited-suffrage democracy, management control, and decentralized labor-market arrangements. By the end of the century, however, the rise of heavy industry, large corporations and mega-banks had raised troubling questions about the prevailing distribution of economic power and the legitimacy of existing political institutions. Organized labor movements, socialist parties and Catholic organizations (religious and political) challenged the legitimacy of both the electoral institutions and the existing social basis for production.

[2] The relevant points have been made by Maier (1987) and Toniolo (1996).

These were not problems on which Europe made much progress in the first half of the 20th century. The extension of the franchise destroyed the inherited political equilibrium without substituting another. The creation of new states and the adoption of new electoral systems, leading to party proliferation, did not simplify reaching mutually acceptable decisions; indeed, the opposite was true. The volatility of party systems, mass political mobilization, and a rapidly changing class structure constituted an unpredictable environment where far-sighted economic planning was difficult and where polarizing ideologies could thrive at the expense of cooperation and compromise. The sad fate of European democracy in the 1930s is testimony to this point.

However disruptive this grappling between the wars with the challenges for efficiency and legitimation posed by the new 20th century industrial system, there is an important sense in which this process planted the seeds of success after World War II. The institutions of economic governance elaborated after 1945 were themselves outgrowths of these, for the most part, less-than-successful interwar experiments. The labor codes of the National Industrial Recovery Act in the US, the labor policies of the Popular Front in France, and the Saltsjöbaden agreement in Sweden were all efforts to solve the problems of efficiency and legitimacy of the 1920s and the unemployment crisis of the 1930s. Such frameworks can be thought of in part as concessions to the labor movement by governments and elite interests seeking to head off more radical alternatives. In part they can be seen as cross-class alliances to advance the common interest in effective conflict-resolution mechanisms and macroeconomic recovery. With the exception of Austria, this is particularly true in the small European countries where a divided right and high exposure to international competition intensified the search for common ground (Katzenstein 1985). Typically they involved negotiations with the political arm of the labor movement, which had acquired a parliamentary presence.

The structure of these settlements, one of decentralized negotiations conducted under broad guidelines set down by government, contrasted with the starkly centralized agreements reached by state unions and industry organs in Mussolini's Italy and Hitler's Germany, whose legacy nevertheless also persisted into the postwar era (in the German case, for example, in the form of a dozen and a half national unions). Neither was the postwar reliance on ministerial controls over wages and working conditions and formal and informal incomes policy in, inter alia, France, Italy and the UK, in fact unprecedented and radically new; these devices were direct outgrowths of experiments with state direction in the 1930s and the even greater state control made necessary by total war.

It is hard to exaggerate the role of World War II itself as a selection mechanism for which of the innovations of the 1930s and early 1940s persisted into the postwar golden age. The creation of more hierarchical arrangements designed to facilitate the efforts of governments to harness the market economy for war bequeathed a set of more centralized structures ready to be applied to peacetime use. Fascism, Nazism and Bolshevism all worked to discredit the more radical solutions of Left and Right. And of course, the fact that the United States was the only capitalist superpower left standing conduced to the adoption of institutional solutions appealing to American foreign policy makers.

III. Labor Markets and Economic Growth

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

But in order to initiate and sustain economic growth, three problems that were highlighted by the polarized and turbulent interwar experience had to be solved.

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

(2) *Collective-action problems.* It is difficult to withhold the benefits of growth from those who refuse to support it. In the postwar setting this meant that individual unions inevitably

were tempted to raise their own wages even while benefitting from the favorable market conditions created by the restraint of other unions. The profits freed up by their restraint did not remain in the same sector; rather, they passed through the national capital market, boosting investment, productivity and labor incomes economywide. Firms for their part were tempted to underinvest in R&D and technical training in the belief that these investments benefitted competing firms that did not help to defray the costs. Collective-action problems had to be solved, in other words, to sustain economic growth.

(3) *Distributive conflict.* Like a messy divorce in which the family jewels are sold off to pay the lawyers' fees, a society riven by distributional conflict will be prone to dissipate the resources needed to sustain prosperity and growth. In particular, different groups of workers will only be willing to restrain their wages if they are confident that they reap a fair share of the benefits of that restraint. And an even distribution of the fruits of their labor today may be the only credible promise of an even distribution of those benefits tomorrow. Wage moderation, in other words, may presuppose wage solidarity.

Centralized and concertized bargaining of the form that emerged in Europe in the decades following World War II addressed these three problems simultaneously. The coordination of bargaining across sectors encouraged individual unions to exercise wage restraint by convincing them that other unions would do likewise. The government provided unemployment, health and retirement programs -- the institutions of the welfare state, in other words -- to reduce workers' uncertainty about their future welfare and therefore their temptation to engage in short-termism.[3]

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[3] On the relationship between uncertainty, short-termism, and wage militancy, see Pzreworski and Wallerstein (1982).

And tax policies penalizing dividends and conspicuous consumption reassured workers that wage restraint would translate into higher investment.

On the employer side, firms had to worry that the decision to invest would encourage their workers to raise their wage demands in order to appropriate the profits generated by that investment. But if wages were determined in economy-wide rather than enterprise-level negotiations, an individual firm's investment decision would no longer affect the wages it had to pay. In these circumstances, centralized wage negotiations led to a higher level of investment and, insofar as productivity was raised, to higher wages in equilibrium.[4]

Interlocking directorships and cohesive employers associations, operating under close government oversight, avoided the under-provision of technical training and R&D. Firms that would have otherwise been reluctant to provide training to their workers for fear that they would be poached by competitors were restrained by the threat of sanctions by both governments and industry associations. And institutionalizing union representation on corporate boards and government bureaucracies made it easier to monitor the parties' compliance with the terms of these agreements. It facilitated "common knowledge" about the cooperative equilibrium.

Together, then, these institutions and policies overcame the three obstacles to growth. But the viability of this solution hinged on the presence of a set of historically-specific supporting conditions and policies. First, cooperation was facilitated by the exceptional scope for rapid growth after the war. The European economy was functioning below capacity. The influx of labor from Eastern Europe and internal migration from low-productivity agriculture to high-productivity industry limited upward pressure on wages and supported the modern sector's

[4] These possibilities are modeled by Hoel (1990).

growth. Above all, there was a backlog of unexploited technologies left over from the years of war and depression, ready to be imported from the United States. For all these reasons, the return on investment was high. Restraint supporting that investment was generously rewarded.

Second, centralization was facilitated by the homogeneity of the labor force, which made it easier for workers to reach understandings about wage relativities and for employers to live with wage compression. The dominant Fordist mode of production, which relied on high-speed-throughput technologies, an extensive division of labor, and semi-skilled workers, was little hindered by wage compression that pushed up the cost of unskilled labor and depressed the wages of the most highly skilled, since European industry made heavy use of workers in neither tail of the feasible skill distribution. Indeed, insofar as centralized and solidaristic bargaining delivered wage restraint, it enhanced the cost competitiveness of the continent's largest, most dynamic firms.

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

An important question, not often asked, is how the state could be relied upon to perform these tasks. While this issue needs further study, a few observations are in order. For one, the mainstream parties that emerged from Europe's experience with left- and right-wing extremism before and during the war were more inclined to pursue a common interest in economic growth than to engage in polarizing distributive politics. The Cold War reinforced their pragmatism and moderation, and, with the notable exceptions of Britain and, to a lesser extent, the US and Japan, proportional-representation electoral systems gave party elites a strong incentive to seek compromise in order to form governing coalitions. In turn, elites' emphasis on growth, distributional justice, and consensus-building encouraged voters to judge government performance on precisely those dimensions, while a "frozen" party system characterized by stable voting blocks reduced the incentives of parties to try to buy off each others' constituencies through policy overbidding and fiscal largess.[5]

Insofar as parties owed their electoral success as much to the efforts of highly centralized organizations of capital and labor (the latter in particular) as to their own, governments had an incentive to consult and involve labor organizations in the preparation of new legislation and to seek their consent in its implementation. In effect, the existence of these disciplined mass organizations enabled the mainstream parties to credibly commit to the consensus policies of postwar Social Democracy.

The story through the end of the 1960s is one of institutional complementaries and self-reinforcing dynamics, as these interacting components worked to stabilize the operation of the European mixed economy and to propel the -growth process forward. Governments supported centralized bargaining because strong unions and employers organizations and rapid growth

[5] The notion of a frozen party system is due to Lipset and Rokkan (1967).

favored the electoral fortunes of the mainstream parties. Politicians nurtured the institutions of centralized bargaining by granting representational monopolies to the peak associations of capital and labor, rewarding unions for their restraint and attending to their distributional interests. In turn, those strong unions and employers associations supported incumbent governments at the polls.

IV. National Variations

The Scandinavian countries, notably Sweden, came closest to the ideal type. The Basic Agreement reached at Saltsjöbaden in 1938 had created a stable and mutually accepted set of rules governing the industrial relations system, but during the 1950s a booming Swedish economy and a secure Social Democratic government committed to full employment convinced employers that it was necessary to further centralize the wage bargaining process in order to contain mounting wage pressures. On the union side, centralization and wage restraint were coupled with demands for redistribution, and the Rehn-Meidner model of solidaristic wage policies adopted at the Swedish LO’s congress in 1951 institutionalized the principle of "equal wages for equal work." Wage compression favored the most dynamic sectors of the economy and forced inefficient firms to modernize or die. Though peak-level bargaining emerged later in Denmark and Norway, partly because labor markets were not as tight as in Sweden, this move towards centralization was likewise built on a national compromise achieved in the pre-war period (in Denmark dating back to 1899), and it was accompanied by wage solidarism.

Fiscal policies in Norway and Sweden were mildly counter-cyclical, but both countries ran surpluses most of the time, with the savings ploughed back into the economy through an investment policy based on low interest rates and public savings.[6] Keeping interest rates below international levels enabled governments to pursue active industrial policies by rationing and directing credit, while swings in the business cycle could be counteracted by requiring businesses to deposit part of their surplus into public investment funds that could only be drawn upon during economic downturns (Pontusson 1992). The future welfare of workers was secured by the rapid expansion of pension and other social rights and by a government committed to the pursuit of full employment. In part this commitment was made credible by an expansion of employment opportunities in the public sector, where more and more social services were provided. Correspondingly, government spending increased considerably during the 1960s (see Figure 1), but as long as unions did not demand wage compensation for higher taxes, such spending did not threaten profitability and investment. Union cooperation was facilitated by drawing representatives of the main labor market organizations into the preparation and implementation of literally every new piece of social or economic legislation.

As we move south and west from Scandinavia, one or more elements of the postwar model – centralized bargaining, government commitment to full employment, and egalitarian wage and social policies -- are weakened, but in no case are all three missing. Thus, Germany, Austria and Switzerland all developed highly coordinated and ordered systems of industrial relations in the 1950s, but in none of these cases was bargaining centralized at the national level. Even in Austria, bargaining was actually conducted at the industry and firm level, albeit with the labor confederation in a strong coordinating role. In Germany and Switzerland there was little

[6] Supply-side credit policies were not as developed in Denmark, and the government often ran deficits.

peak-level steering of bargaining, although Germany experimented with centralized coordination during the Concerted Action program initiated in 1967 (subsequently abandoned in 1978). Even without centralized intervention, however, industry bargaining in all three countries developed into a highly-coordinated system with the exposed engineering sector in the role as the wage leader. For this reason wages were set with an eye to international competitive conditions, something that in the Scandinavian countries was accomplished only through a negotiated consensus.

In the first decade after World War II the success of industry bargaining in Germany, Austria and Switzerland can in part be explained by the influx of labor from eastern and southern Europe, which placed downward pressures on wages, an element was missing from the more insulated Scandinavian labor markets.[7] As that immigration slowed and labor markets tightened, coordination came to depend more on the capacity of politically independent central banks to discipline unions and employers tempted to make aggressive wage and price demands. So long as bargainers could rationally expect inflationary settlements to be met by higher interest rates and hence less labor demand, they had an incentive to exercise restraint (Iversen 1999). This mechanism was only effective, however, because non-accommodating monetary policies also deterred governments from pursuing excessively expansionary fiscal policies.[8] Partly for this reason, and partly also because of the political influence of Christian Democratic parties, the public sector was never used as an instrument in the government's employment policy as in

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[7] See Eichengreen (1999).

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

Scandinavia. Thus, in 1960 4.5 and 4.8 percent of the working age population was employed in the civilian public sector in Switzerland and Germany, whereas the comparable figures for Denmark and Sweden were 6.8 and 7.5, a gap of about 2.5 percentage points. By the end of the 1960s this gap had widened to over 4 percentage points, and it grew considerably larger in the 1970s (as discussed below).[9] Austria is in an intermediate case because it had a large nationalized sector which served employment objectives as in the Scandinavia (Freeman 1989, ch. 7), but did not grow at the same rate as public employment in these countries.

While the Germanic countries differed from the Scandinavian in their level of public service provision and employment, they passed generous entitlement legislation, such as Adenauer's 1957 pension reform, which greatly increased social spending. Likewise, they instituted extensive legal and regulatory protection of the employment relation, and they supported or mandated the creation of employee workplace representation.[10] These measures, combined with the social commitments, reassured unions that the future welfare of their members was secure and that wage sacrifices would be put to productive use. Politically, stability was guaranteed by federalist institutions and by PR electoral systems that encouraged government power sharing. Epitomizing this approach, Switzerland was constitutionally wedded to a proportional distribution of government portfolios between the main parties, a system that more or less ensured that the only way for any party to advance its own interest was to advance the interests of all.

Belgium and the Netherlands were somewhere between the Scandinavian and Germanic

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

[10] The laggard here is Denmark, partly because its industrial structure is so dominated by small firms.

poles. Wage-setting was coordinated at the peak-level through tripartite negotiations, but unions in both countries were divided between confederations of Socialist, Catholic, and Protestant (in the Netherlands) or Liberal (in Belgium) orientations. This posed difficulties for peak-level coordination, while increasing the need for such coordination to prevent damaging wage competition. Fortunately, neither unions nor their political-party counterparts competed for one another's members (Flanagan et al. 1983, 102). Both societies were highly segmented, or "pillarized," and no pillar could reasonably hope to become hegemonic. Coupled with a PR electoral system, this meant that parties were forced to compromise in order to govern and could hope to advance their own interest only by advancing the interests of each other.

The result was a complex system of multi-level bargaining involving the government, the three union federations, and employers, and, within the union federations, the peak level and individual unions. Compared to the Scandinavian countries, the government was more proactive in the bargaining process, in the Netherlands through the Board of Mediators which approved all collective agreements, and in Belgium through regular interventions into bilateral negotiations. Since these interventions involved some exchange of wage restraint for an increase in the social wage, they bound the government as much as the social partners. In Belgium, for example, the first postwar government adopted a social security scheme in return for labor's adherence to a Social Pact limiting wage increases, and the Dutch social security system embraced by the social partners was second to none in Europe in terms of generosity. At the same time, Christian Democratic parties, just as in Germany, vetoed increases in state provision of services traditionally handled by church organizations or the family.

France, Italy and the United Kingdom deviate most sharply from the ideal type. All suffered coordination problems because of fragmented labor movements and weak employer organizations. In France and Italy, unions were riven by ideological and confessional cleavages and many had allied with politically marginalized communist political parties. The latter saw the unions not just as vehicles for workers' material progress but also as important organization resources for the effort to mobilize and expand a mass base. Partly for this reason, governments in both countries were reluctant to pursue policies that might strengthen the communist unions. It was precisely the *absence* of this a competition for the "hearts and minds" of workers which made compromise and coordination possible in Belgium and the Netherlands despite the existence of multiple and deep-seated cleavages.

For a brief period after World War II, circumstances in Italy hinted at what could be accomplished through compromise. The main unions had agreed to form a single confederation (the CGIL), and the country was governed by a broad coalition of Christian Democrats, Socialists, and Communists. This constellation produced the *scala mobile*, which indexed wages to inflation based on a flat rate payment principle. In effect, this was the first step towards a solidaristic wage policy. The large state holdings inherited from the Fascists were also used to pursue industrial modernization and employment objectives. But the experiment did not last. From 1947 onwards the Communists were eliminated from government participation, and the labor confederation broke into its three main parts. Christian Democratic hegemony over government power was subsequently used to undermine the organizational strength of unions, while employing deflationary policies and migration from the *Mezzogiorno* to subdue wage militancy.

By the 1960s, rapid economic growth had greatly reduced the ranks of the unemployed, thereby strengthening the unions, and the Christian Democratic Party (DC) lost much of its electoral support to the Socialists and the Communists, destroying its monopoly over government power. Against this background the DC decided to form a coalition with the Socialists and endorsed the goals of full employment and (moderate) redistribution of income and wealth (Flanagan et al., 1983, 514-5). These policies were not accompanied by institutional reforms that could overcome collective action problems in the labor market, however, an omission that would haunt the Italian economy long after the labor upheavals of the "hot autumn" in 1969 had subsided. Italy has had one of the worst unemployment and inflation records in Europe, and lack of coordination in the labor market is at least partly to blame.

As in Italy, unions in France emerged from the war weak and divided, although wage bargaining was relatively well organized at the industry level, and extension laws ensured that collective agreements within a particular industry would apply to all workers in that industry. The French state, unlike the Italian, could also rely on extensive administrative levers to pursue aggressive investment and industrial restructuring policies. In this and other respects, France resembled Japan where the state, especially the powerful Ministry of International Trade and Industry (MITI), played an important role in accelerating and directing the industrialization process (Zysman 1983, ch. 4). Using its control over banks and credit, the French government sought to overcome problems of under-capitalization and under-investment in R&D in small-firm dominated domestic industry by nationalizing key sectors and attempting to create "national champions." The policy was guided by economic plans empowering bureaucrats to monitor and reward firms that complied with growth-oriented goals. Large industrialists and to lesser extent trade unionists were consulted, but neither had the power to halt implementation of the plans.

To the extent that heavy investment and demand stimulation created bottlenecks and inflationary pressures, these were met with devaluations. This strategy did not accord much attention to reducing inequalities, except as was needed for governments to retain their political legitimacy. Yet, despite lack of redistribution and the weakness of organizations of labor and capital, the emphasis on full employment and the promotion of investment through aggressive industrial policies and real wage containment helped overcome the problems of collective action and short-termism that we identified earlier.

Britain never developed effective solutions to any of the three obstacles to growth. Following the war, a reform-minded Labour government nationalized several industries, but otherwise industrial policies were arm’s-length, in part as a result of a market-based financial system that did not lend itself to French-style *dirigisme* (Zysman 1983). The financial system was also an important impediment to the pursuit of full employment. Because British banks were heavily oriented towards international banking, they opposed devaluation. Consequently, when the government tried to address internal imbalances through demand stimulation, it would often find itself reversing policies so as to not cause a politically unacceptable depreciation of the pound (Hall 1985, ch. 4). The resulting "stop-go" pattern was clearly not conducive to far-sighted investment and wage strategies.

The only component of the postwar model pursued with vigor in Britain was the expansion of the welfare state, a notable example being the creation of the National Health Service. While representatives of employers and unions were consulted on economic policy matters, legislation designed to diffuse distributive conflict did little to induce wage restraint for the simple reason that no individual union had much incentive to cooperate with the government's incomes policy, given that membership was divided among a large number of mainly craft-based unions. Attempts under the Conservative Heath government to use statutory incomes policies merely got the government mired down in a bitter struggle with the miners union. Commensurate with the incapacity of British institutions to solve problems of collective action and short-termism, investment faltered, and the British economy underperformed the rest of Europe.

In several respects, the postwar British political economy can be seen as a problematic hybrid of Northern European and US capitalism. As in Northern Europe, unionization rates were much higher in Britain than in the US, but like the US, the labor movement and business community was far more fragmented than in Northern Europe. Indeed, it can be argued that because of the concentration of American unions in the automobile industry, and because unions in that industry were fairly well organized and engaging in pattern bargaining, US wage setting in the unionized sector was more coordinated than in Britain. And outside the much smaller unionized sector in the US, wage pressures were kept in check by highly competitive labor markets. Another contrast between the two cases is that there was no parallel in the US to the City's distortionary influences over macroeconomic policies, and despite similar electoral systems, the American system of checks and balances averted the stop-go pattern characteristic of British policies. This created a stable macroeconomic environment that was more conducive to the mass production model pioneered in the US. In terms of the welfare state, although the Great Society Program under the Johnson administration boosted social transfers considerably during the 1960s, spending in Britain grew at a faster pace from a larger base (see Figure 1). Finally, unlike Britain, the US government enjoyed some capacity to pursue active industrial policies through the large and publicly funded defense industry. In sum, the combination of strong but fragmented unions, welfare state expansion without wage discipline, and a "weak" state beholden to financial interests, made it far more difficult to design a coordinated and effective long-term economic strategy in Britain than in either the US or Northern Europe.

V. The End of the Postwar Growth Miracle

The postwar model operated smoothly through much of the 1960s, as corporatist institutions were elaborated and extended. The rate of growth of output per employed person accelerated from an impressive 3.6 per cent per annum in the 'fifties to 4.2 per cent in the 'sixties (see Table 1). Investment remained at high levels, and inflation was subdued. This, however, was the calm before the storm. Starting with the hot summer of 1968, wage moderation collapsed and inflation exploded. The increases won by strikers in 1968-69 were about twice those of the preceding three years.[11]

What were the sources of this inflationary pressure? Most obviously, unemployment continent wide had fallen to low levels. With the share of employment in agriculture having declined to less than 15 per cent, elastic supplies of underemployed labor from the agricultural sector no longer capped industrial wage demands. Johansen's (1987, pp.148-9) description of the situation in Denmark is representative. "In the mid-1960s," he writes, "the registered unemployed were either workers who were in the process of changing from one job to another and had a few idle days in between, or older people staying in isolated municipalities in Northern Jutland or the smaller islands from where they did not want to move." Under such

[11] Allsopp (1983), Table 3.4.

conditions, the threat of unemployment no longer disciplined wages. Memories of high unemployment faded as the postwar generation of workers aged and retired. The Soviet threat was perceived as less immediate, removing one incentive for labor and capital to pull together. And with the weakening of the Bretton Woods System and its breakdown in the early 1970s, inflationary expectations lost their anchor.

These problems were exacerbated as the postwar wave of Fordist mass-production methods gave way to more skill-intensive science-based technologies and flexible specialization (what European observers refer to as diversified quality production), increasing the demand for skilled workers, who attempted to "liberate" themselves from centralized bargaining and wage directives and pushed for higher wages. But given the expectation of wage equalization, the resulting "wage drift" filtered down to the ranks of unskilled, who used the leverage they possessed as a result of the operation of multi-layered bargaining and solidaristic wage policies to push up their earnings as well. Inflation was unavoidable in this setting.

This shift in the composition of labor demand in manufacturing, combined with the failure of relative wages to adjust, caused less-skilled workers to be pushed off into the service sector.[12] But since productivity growth in manufacturing outstripped productivity growth in services, some of the less skilled workers who now comprised the bulk of the labor force in services found themselves priced out of work.[13] In this manner, what had previously been an effective means of overcoming distributive conflict and creating a broad base of support for

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[12] See Appelbaum and Schettkat (1995).

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

wage restraint now generated wage pressures and problems of unemployment. This struck at the heart of the postwar model which had been premised on the notion that equality, jobs, and productivity growth went hand in hand.

Governments responded to the consequent unemployment by increasing their spending to sustain demand. They responded to breakdown of wage moderation by encouraging further centralization of negotiations. Unions were promised increased health and unemployment payments and larger social security stipends as the quid pro quo for restraint. Public spending as a share of gross domestic product rose from 24 per cent in 1967-69 to 30 per cent in 1974-76.[14] While the growth in spending as a percentage of GDP had been rapid in the 1960s, its expansion was even faster in the 1970s (see Figure 1). It was particularly dramatic in the Netherlands, Denmark, and Sweden, where public spending was tied to the expansion of transfer payments and social programs.

This strategy worked best where the institutions of corporatism and centralized wage bargaining were most advanced.[15] Fiscal expansion and accommodating monetary policy stimulated employment rather than inflation, given agreements by the unions to restrain their wage demands. Where private-sector employment growth lagged, governments supplemented it with increases in public employment or early retirement schemes. In Austria and Sweden, these policies combined to keep unemployment at a remarkably low 1.7 and 2.0 per cent of the labor force in 1973-79. In Germany, where the unions similarly restrained wages but macroeconomic stimulus was less (due to the strong anti-inflationary predisposition of the Bundesbank and

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

[15] Typically, in the smaller European democracies. See Katzenstein (1984, 1985).

deficit reductions by capital-market-constrained state and local governments), unemployment still averaged less than 3 per cent. By comparison, in countries like Britain, Italy and France, where corporatist institutions were less well developed and more difficult to reinforce, demand stimulus tended to aggravate inflation instead of reducing unemployment (as shown in Table 2).

Consequently, when Europe's economy was exposed to the second OPEC oil-price shock, it became more difficult to apply the same shopworn formula. Additional demand stimulus now threatened to aggravate an already serious inflation problem. Having already held wages below inflation for some years, unions were loath to continue doing so. Public payrolls having been expanded significantly in the previous recession, budgetary burdens were now heavier, leaving less room for increases in public spending. As can be seen from Figure 1, public spending stagnated in most countries in the 1980s, and in some it actually declined. Considering that the dependent population -- retired people, the unemployed, and the disabled -- grew everywhere, the 1980s clearly marked the end to, and in some cases the reversal of, the postwar trend. It also marked the end to the "social democratic-Keynesian cooperation" that had contained European unemployment in the 1970s.[16] Adjustment to the second oil shock consequently proved more difficult than adjustment to the first. Between 1973-79 and 1979-85, unemployment rates Europe-wide rose by half again and in some countries, like Belgium and the Netherlands, more than doubled.

The constraints on policy responses at the national level were further tightened by rising capital mobility. As early as 1959 the restoration of current-account convertibility had made it possible to evade capital controls by exploiting "leads and lags." Moreover, as governments

[16] The phrase is from Scharpf (1991).

moved away from the harsh financial control of the immediate postwar years and adopted more market-friendly forms of financial regulation, it became more difficult to stop capital flows at the border. And inflation which eroded real interest rates gave finance an even stronger incentive to seek more remunerative opportunities abroad. An unintended consequence of the policies with which governments met the first oil shock was thus a rise in capital mobility which constrained the policy independence of national central banks and limited the scope for using interest rates to encourage investment. The experience of the first Mitterrand Government in 1981-82 is only the most dramatic instance of a more general phenomenon.

The late 1970s and early 1980s was also the period when the European welfare state "overshot." The intention was to alleviate distributive conflict and induce wage restraint by expanding the government's commitment to future welfare spending. But this "deferred wage" strategy reflected and reinforced, rather than solved, problems of short-termism and distributive conflict in the labor market. Nonwage labor costs soared as governments shifted the burden of financing social benefits onto employers, rendering firms reluctant to hire and undermining their international competitiveness.[17] Generous unemployment benefits and disability pay insulated the unemployed from pressure to search for work. All this rendered labor markets less flexible. And the recipients of governments' largess soon became formidable opponents to those who sought reform.

There is a sense, in other words, in which the seeds of the continent's subsequent difficulties were planted by these efforts to use the welfare state to reinforce the social contract.

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

Public employment soared as governments expanded their payrolls in response to rising unemployment. Tax rates and public debts soared as governments sought to finance the consequent wage bill and to expand solidaristic social transfers.

VI. Decentralization and Reform

By the 1980s, then, it was clear that the postwar growth model required updating. Public debts had exploded in Belgium, Ireland and Italy, raising questions of sustainability (again, see Table 3). Unemployment rates shot up and showed no sign of coming down, creating worries about social stability.

Looking to the American success with job creation, greater labor-market decentralization was the obvious response. By allowing wage differentials to develop, it promised to accommodate the demand for skilled workers generated by the spread of post-Fordist technologies and to stimulate service-sector employment growth. Employment growth in turn promised to boost payroll tax revenues and cut outlays on unemployment compensation and disability, helping to solve the fiscal problem. The pressure for decentralization consequently was greatest in countries where centralization had historically been the highest, and not surprisingly decentralization came first in those countries most committed to price and exchange rate stability and integrated into international capital markets. Belgium and the Netherlands shifted to industry-based bargaining systems in the 1970s, followed by Denmark in the 1980s and Sweden in the 1990s.

But greater labor-market decentralization would work only if governments at the same time succeeded in putting in place supportive institutional arrangements. Unlike the situation in the US, governments in most European countries could not hope to undermine the power of unions to a point where they could simply rely on competitive labor markets. Instead, where centralized bargaining and continuous consultation between the peak associations and government could no longer be relied upon for wage restraint, there was a pressing need to anchor inflationary expectations — to signal the unions that monetary policy would be non-accommodating, implying that excessive wage demands would mean additional unemployment and not just inflation — by adopting an exchange-rate commitment and giving the central bank the independence to pursue it. While the exchange-rate commitment generally came first, in the 1980s, and the central-bank independence followed only in the 1990s, the two were nonetheless part of the same larger process. In addition, a credible commitment to exchange-rate stabilization and monetary non-accommodation presupposed a solution to the fiscal problem; otherwise, central banks might come under pressure to inflate as a way of rescuing governments from their debt difficulties. Pegging the exchange rate would only bring interest rates down toward German levels and reducing debt-service costs if fiscal excesses were at the same time eliminated. But this had to be done in a way that did not fray the social safety net and create insurmountable resistance to greater labor market flexibility. The only European example of a radically confrontational strategy designed to undermine the power of the unions is the UK, where it was possible only by virtue of the existence of a majoritarian political system and a divided opposition.

While each country had to solve these problems in its own way, the European Monetary System, the Single Market and the Maastricht Treaty contributed to the process. To be sure, the implications of European integration have been complex, even contradictory. For some it has been a way of introducing the chill winds of competition and intensifying the pressure to deregulate and eliminate the excesses of the welfare state, while others see it as a way of halting the race to the bottom. Be that as it may, integration has clearly supported labor market decentralization. By eliminating capital controls and making realignments more difficult, the Single Market solidified the exchange-rate commitment and the credibility of the non-accommodating monetary policies needed to restrain wage demands in more decentralized labor markets. By making central bank independence and fiscal retrenchment conditions for qualifying for monetary union, the Maastricht Treaty reinforced the credibility of that macro-policy stance. And the advent of monetary union itself, which hands the reins of monetary policy to a European Central Bank with unparalleled independence, has removed residual doubts about the new orientation of monetary policy.

VII. Adaptation and Political Will

The successful cases of reform in the 1980s and 1990s have received much attention. Denmark eliminated its unsustainable fiscal deficits and at the same time ignited rapid economic growth. The Netherlands reformed its welfare state and reduced its unemployment. Sweden and (to a lesser extent) Germany decentralized wage bargaining, although significant improvements in economic performance have yet to materialize.

In Denmark, wage negotiations were significantly decentralized starting in 1981 in response to pressure from engineering firms and skilled workers.[18] Peak-level bargaining was superseded by negotiations between sectoral associations and their union counterparts. Ancillary

[18] See Iversen (1996).

reforms were pushed through by a center-right coalition government that came to power in 1982. Capital markets were liberalized, requiring the krone to be more firmly pegged to the Deutschmark, which helped to reconcile greater-labor market decentralization with wage moderation. The budget deficit was eliminated, reinforcing the authorities' anti-inflationary credibility; the turnaround in the full-employment primary budget amounted to 10 per cent of GDP, of which 3 per cent was accounted for by reduced government consumption and the bulk of the rest by increases in taxes (net of transfers). Consumption grew rapidly, driven in large measure by massive wealth gains in securities and one-family houses, but the most impressive response was the investment boom: business investment rose at an average annual rate of 13 per cent between 1983 and 1986.[19] That so much of the response took the form of investment plausibly reflects the attractions of a more decentralized and flexible labor market.

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

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[19]For details, see Giavazzi and Pagano (1990).

The result has been a halving of Dutch unemployment and, in the 1990s, steady economic growth.

In Sweden there was a longer lag between labor market decentralization and the adoption of complementary macroeconomic policies. Metal-workers and their employers -- again the obvious opponents of wage compression -- began negotiating separate agreements in 1983, followed by other sectors. A significant increase in wage dispersion soon resulted. But notwithstanding the government's continued efforts to orchestrate negotiations and moderate the rate of wage increase, there was a tendency as the labor market became more decentralized for wage restraint to break down. The Riksbank's traditional policy of accommodating wage increases did not deter this -- to the contrary. A first attempt to institute a hard currency policy by linking the exchange rate to the EMS lacked credibility owing to Sweden's high unemployment, large budget deficit, and weak banking system and came apart in the currency crisis of 1992. A second attempt, initiated once Sweden had put its banking crisis behind it, was more successful. The authorities cut the budget deficit and strengthened the independence of the central bank, which adopted an explicit policy of inflation targeting.

Austria and Germany offer another interesting set of paired case studies. In Austria the negotiations determining the distribution of wage increases had never become as centralized as in other small European countries, although some coordination of plant- and sectoral-level negotiations was carried out by the Trade Union Federation. While exceptional wage increases for particular groups of employees still had to be approved by the Parity Commission (representatives of the Trade Union Federation, the Chambers of Agriculture, Commerce and Labor, and the government), these were regularly authorized on grounds of strong demand or short supply. Evidence of rising wage dispersion suggests that even this modest effort at labor-market-wide coordination has come to exercise less influence over time.[20] Wage dispersion in Austria is now strikingly high, as high as in the United States by some measures. But the country's close economic ties to Germany meant that its monetary policy was closely keyed to that of the Bundesbank, avoiding any erosion of wage and budgetary restraint.

In Germany, resistance to decentralization was stronger. Reunification led the 16 sectoral unions, seeking to prevent the emergence of a low-wage *Mezzogiorno* in the east, to push for the incorporation of workers in the five new *länder* into existing national wage rounds. Limited wage differentials between east and west were permitted, with these expectation that these would be closed in a few years.The reality of low relative labor productivity in the former German Democratic Republic translated this policy into high rates of unemployment in the east, encouraging workers and employers to develop ways of circumventing national agreements. The problems in the German economy have also been manifested by a lack of wage restraint in the west, which can be understood as a breakdown of macroeconomic coordination. Thus, unification was followed by a politically popular, but economically unsustainable, fiscal expansion that prompted the Bundesbank to drive up interest rates and unemployment. By adopting an unsustainable fiscal stance, premised on Kohl's promise that unification would be costless, the government in effect jeopardized the virtuous interplay between wage and monetary policies, thereby decoupling unions' wage demands from economic outcomes. The experience underscores the importance of having a macroeconomic regime that supports the smooth functioning of the wage-bargaining system.

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[20] See Guger (1998).

In Britain, macroeconomic coordination through concertation broke down in the late 1970s, setting the stage for a decade of neo-liberal reform and monetarism. Unlike the coordinated wage bargaining systems of northern Europe, however, the government could and did not rely on the self-discipline of strong (but fragmented) unions. Instead, it directly attacked the legal and organizational base of the unions through legislation (especially the Employment and Trade Union Acts), privatization of unionized public services, and abolishment of minimum wage regulations. Elsewhere in Europe, including Italy, the move towards more decentralized wage bargaining and greater flexibility in labor contracts was not accomplished by similar attempts to break the backs of the unions. While the macroeconomic regime was everywhere altered in a non-accommodating direction, some governments have sought to enlist the support of unions for a proliferation of flexible, part-time and fixed-term labor contracts. Where successful, the Netherlands being a case in point, this mixture of macroeconomic discipline and negotiated flexibilization of labor markets has boosted employment without the political confrontation and gross inequalities accompanying the neo-liberal strategy in Britain.

An essential question is what makes some governments seemingly do "the right thing" while other do not. A potentially fruitful approach to this question would allow for the existence of interactions between economic policies and labor market institutions and model shifts from one equilibrium to another as resulting from a political contest between governments and organized interests with opposing institutional preferences. If we think of the 1980s as a shift from a "Keynesian centralization" equilibrium to a "monetarist decentralization" equilibrium involving changes in both government policies and wage bargaining institutions, it is not hard to imagine that this transition took different forms in different countries depending on the relative strength of the actors. In some cases, entrenched interests seeking to preserve existing institutions and policies may have prevented their governments from adopting the necessary reforms (as in Belgium), while in others the government may have genuinely believed that it could rekindle the postwar compromise and breathe new life into old institutions (as in Sweden in the 1980s).

VIII. Conclusions and Implications

In this paper we have provided a bird's-eye view of the institutional determinants of 20th-century economic performance. We have emphasized the importance of institutions for the operation of the market economy -- in our case, institutions affecting labor markets, although the point is more general. As we have shown, European labor relations provide a particularly powerful illustration of the point. Economic growth after World War II was based on Fordist technologies. Manufacturers merely had to import technologies of mass production from the United States and to apply to them substantial inputs of capital and semi-skilled labor. The institutions of solidaristic wage bargaining developed after World War II were ideally suited to these tasks. They eased potentially divisive distributive conflicts and delivered wage moderation, which in turn supported high investment.

The wage compression that was a corollary of their operation was of little consequence for production so long as the dominant industrial technologies remained such that European firms relied on a relatively homogenous labor force. But as the backlog of technologies was exhausted and developing countries emerged as new competitors in many of Europe's old industries, Fordist mass production inevitably gave way to diversified quality production which relied more on highly-skilled workers and less on brute-force inputs of capital and labor. Increasingly the centralization of bargaining and the compression of wages became impediments rather than aids to growth. Downward pressure on the relative wages of highly-trained workers made it difficult for manufacturing firms to attract and retain the skilled labor they required, while upward pressure on the wages of the less skilled gave rise to widespread un- or underemployment. Employment problems were exacerbated by the difficulty of generating a sufficient number of jobs in low-skilled and labor-intensive services where productivity growth lagged that of manufacturing. In response, labor relations in several European countries haltingly moved toward greater decentralization, but only in the face of political resistance.

If our first message, then, is the importance of institutions, our second is the need for institutional adaptation. Assuming as we do that growth will rely even more in the future than in the past on rapidly-changing, science-based, skilled-labor-intensive technologies, countries with centralized labor-market institutions will have to move still further in the direction of decentralization. Because most European countries cannot rely on market-based solutions as in the US, coordinated wage bargaining will continue to be important for cost competitiveness, but to capitalize fully on new technologies and changes in the types of labor they require, countries will have to accept wider and more variable wage differentials. Whether Europe in particular can accommodate these demands, given its egalitarian norms and communitarian values, will help to determine whether it is able to re-establish a full employment economy in the 21st century.

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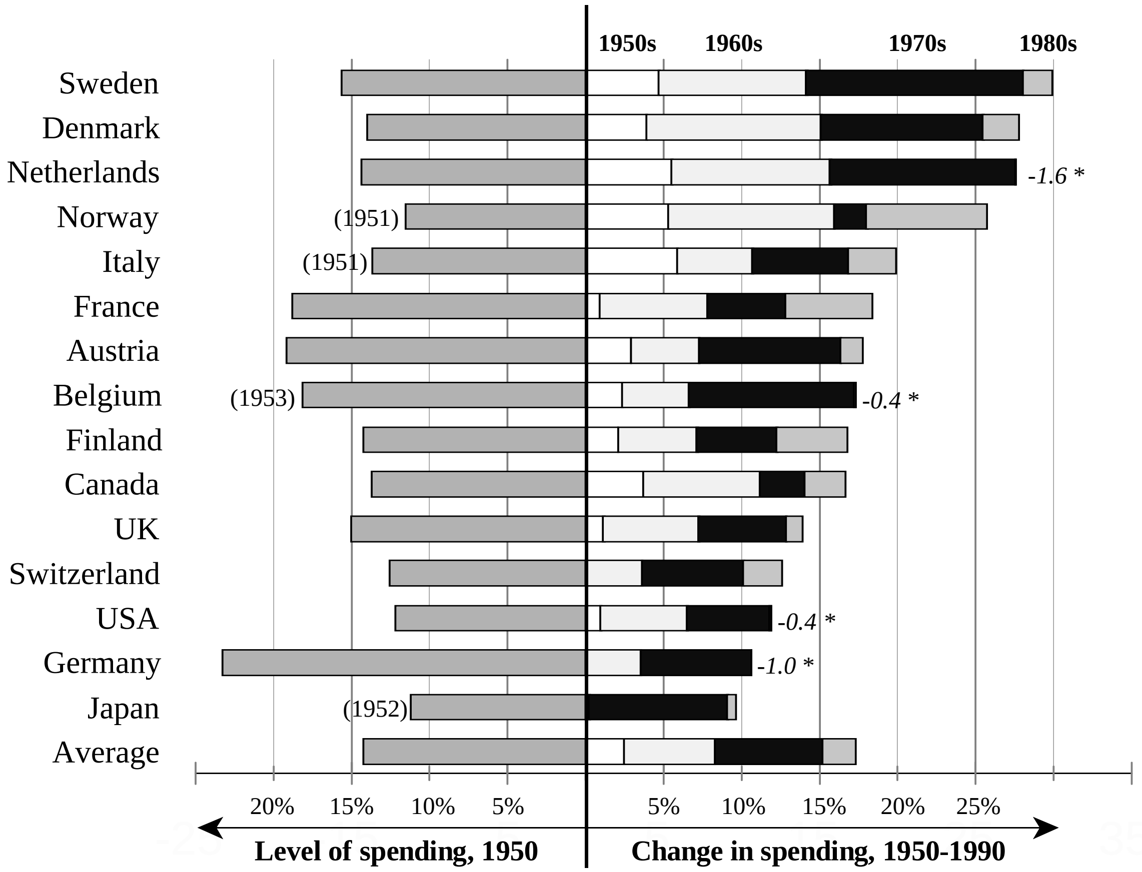
FIGURES AND TABLES

Figure 1.
Public spending as percent of GDP, 1950-1990.



* Negative change in the 1980s

Note: Figures are total government spending as percent of GDP, net of militaty spending.

Source: Cusack (1991).

Table 1
Output, Employment and Labor Productivity, 1950-69
(Annual percentage compound rates of growth)

Country	Output (GDP at 1963 f.c.)		Employment		Output per person employed	
	1950-1952 to 1958-1960	1958-1960 to 1967-1969	1950-1952 to 1958-1960	1958-1960 to 1967-1969	1950-1952 to 1958-1960	1958-1960 to 1967-1969
Austria	5.7	4.5	0.4	–0.2	5.3	4.7
Belgium	2.5	4.5	0.2	0.6	2.4	3.8
Denmark	3.2	4.7	1.0	1.2	2.2	3.4
Federal Republic of Germany	7.5	5.1	2.2	0.3	5.2	4.8
Finland	4.3	4.6	1.0	0.9	3.3	3.7
France	4.3	5.5	0.0	0.7	4.4	4.8
Ireland	0.8	4.0	–1.6	0.1	2.5	3.9
Italy	5.3	5.5	0.7	0.2	4.6	5.3
Netherlands	4.5	5.5	1.1	1.2	3.4	4.3
Norway	3.0	4.9	0.0	0.6	3.1	4.3
Sweden	3.6	4.5	0.2	0.4	3.4	4.1
Switzerland	4.0	4.4	1.4	1.8	2.6	2.5
United Kingdom	2.4	2.9	0.5	0.4	1.8	2.5
Industrial western Europe	4.5	4.7	0.8	0.5	3.6	4.2
Greece	5.6	6.3	0.9	1.0	4.7	5.3
Portugal	4.0	6.1	0.4	0.0	3.6	6.2
Spain	5.2	7.0	1.0	0.6	4.1	6.4
Turkey	5.1	5.2	. .	. .	. .	. .
Yugoslavia	6.4	6.1	0.5	1.1	5.9	5.0
Southern Europe	5.3	6.3	. .	. .	. .	. .
Southern Europe ex. Turkey	5.4	6.6	0.8	0.7	4.6	5.8
Bulgaria	6.4	7.4	0.7	0.4	5.7	7.0
Czechoslovakia	5.7	4.8	1.0	1.3	4.7	3.5
German Democratic Republic	7.1	4.5	0.7	0.1	6.4	4.4
Hungary	4.1	5.5	1.2	0.7	2.9	4.8
Poland	6.2	6.0	1.7	1.9	4.4	4.0
Romania	6.3	8.0	1.4	0.4	4.8	7.6
Soviet Union	8.3	6.9	1.9	2.1	6.3	4.7
Eastern Europe	7.6	6.5	1.7	1.7	5.8	4.7
United States	2.8	4.6	0.5	2.1	2.3	2.4

Source: Eichengreen (1999).

Table 2.
Unemployment in Selected European Economies,
1973-1979 and 1979-1983/85

	Average annual unemployment rate	
	1973-79	1979-85
Austria	1.7	3.0
FRG	2.9	6.0
United Kingdom	1.7	10.3
Sweden	2.0	2.7
Belgium	5.8	11.6
Switzerland	0.4	0.6
France	4.3	8.0
Italy	6.5	9.0
Japan	1.8	2.4
Norway	1.8	2.4
Netherlands	4.5	10.3

Source: Scharpf (1991).

Table 3

Debt and Deficits, 1981-1988 (% of GDP, General Government)

	1981			1988		
	Debt	Deficit Total	Primary	Debt	Deficit Total	Primary
Europe-10	40.6	3.8	1.4	58.7	2.9	- 1.8
Belgium	75.7	12.6	4.8	126.5	5.9	- 4.5
Denmark	39.3	6.9	1.6	62.5	- 1.0	- 8.5
Germany	32.7	3.7	1.4	44.7	0.8	- 2.0
Greece	28.8	11.0	7.9	73.6	12.8	3.2
Spain	18.2	3.9	3.1	47.7	3.2	- 0.3
France	24.6	1.9	- 0.1	36.5	1.7	- 1.1
Ireland	76.8	13.4	6.8	118.6	5.1	- 4.3
Italy	58.5	11.3	5.2	94.1	9.9	1.0
Luxemburg	13.6	3.6	2.7	10.0	- 5.6	- 6.7
Netherlands	45.9	5.5	1.0	78.5	4.5	- 1.5
Portugal	37.1	9.2	4.1	72.2	6.1	- 2.4
UK	52.3	2.6	2.4	48.6	- 1.2	- 4.7
USA	37.1	1.0	0.7	51.5	1.7	0.3
Japan	57.1	3.9	2.5	68.3	- 0.2	- 2.8

Note: Gross debt/GDP ratios. The primary budget deficit excludes interest payments. A minus (-) sign denotes a surplus.
Source: Dornbusch and Draghi (1990).