

## Round up the Usual Suspects!: Globalization, Domestic Politics, and Welfare State Change

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WHO killed the growth of the welfare state? Its seemingly inexorable budgetary, programmatic, and personnel growth in the 1960s and 1970s ground to a halt in the 1980s, accompanied by the mutilation of programmes and rising unemployment. Was it an external intruder—globalization of one sort or another? Was it an inside job—domestic politics and demography? Or, as public choice theory suggests, was death self-inflicted by a combination of producer and client groups? As if this richness of suspects were not problem enough, the identity of the victim is also uncertain. In fact, the central mystery in the relationship between globalization and the welfare state is accurately identifying the victim; it is a mystery of concept formation in which, prosaically, no one is quite sure which dependent variable matters and how it is changing. Spending levels? Policies? Institutions? Wage equality? Employment levels? National autonomy?

Two academic deformations of reality obscure the politics at the heart of this specific mystery. First, the richness of prior research on the formal or overt welfare state—systems of tax funded transfers and state provided or funded social services ameliorating life and economic risks for workers—provides a lamp-post around which enquiries naturally cluster, asking how ‘globalization’ has affected those programmes, but ignoring areas of darkness away from the lamp. Second, a profound normative bias favouring welfare in most welfare state research obscures the fact that not all welfare is for workers, that the welfare state was never simply an instrumental tool for advancing labour’s interests, and that ‘welfare’—understood much more broadly as ‘social protection’—was about sheltering all income streams,

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not simply wages, from market pressures.<sup>1</sup> Focusing only on formal welfare and workers' interests has led most analysis into a dead end discussion over whether globalization constrains 'national autonomy', as if in the absence of constraint the welfare state would not be politically contested.

In contrast, Polanyi's notion of 'social protection' encompasses a much broader conceptualization of 'welfare' as a shelter for workers and owners from the market. This broader conceptualization permits much more specific attributions of guilt in this case, using the traditional guides of motive, opportunity, and method (or more prosaically, interests, coalitions, and politics). Focusing on social protection shifts attention towards the ways in which the normal operations of the market and deliberate policy choices have eroded certain kinds of property rights, including those nested in the welfare state. Briefly (because the conventions of academic writing demand this now), most social protection after World War II was accomplished by sheltering the service sector (including and especially firms, not workers) from competition; the welfare state was relatively less important. The progressive deregulation and marketization of the service sector has displaced all this covert social protection onto the overt, formal welfare state. It is not the welfare state that has been killed but rather social protection.

The purpose of this essay is to rethink the whole globalization debate and create a more compelling attribution of guilt. So let us conform to the conventions of the mystery rather than academic genre, and survey the allegedly guilty parties before we turn to the victim. We begin with the time-honoured cry: 'Round up the usual suspects!' Was it SAM, ILSA, or RICK?

### 1. SAM, ILSA, OR RICK?

Most of the suspects in the debate over whether or not globalization did in the welfare state are arguments linking fairly broad pressures to equally uniform changes, and they typically cast conflicts over globalization as fights between capital and labour. But in all of these arguments, the traditional elements of motive, opportunity, and method remain under specified. Are there actors, who are they, and what are their preferences? Which global pressures matter, and—almost as important—from when? What are the intervening mechanisms turning pressures into policy preferences? After I collect all the suspects together into the parlour, you will see that the case against most of them lacks one of the three elements needed for a conviction. Only circumstantial or functional motives are present for most suspects. Causal chains linking the alleged murderer to the corpse are missing. And the variety of weapons is bewildering. In my interrogation I will pay particular attention

<sup>1</sup> One salient exception is Baldwin 1990.

to four issues. First, is the suspected cause in proportion to the alleged effects? Second, can the alleged cause be associated with a plausible set of actors (why do actors act; or how do changes in markets affect actors' interests)? Third, how well does the alleged cause explain the timing of actors' actions (when does it make them act)? Finally, does the alleged cause explain why actors see their proposed (and often realized) policies as plausible solutions to their problems? In this sense, I explicitly take up several challenges posed by Alt and his co-authors to show that while asset specificity is critical in the construction of interests, asset specificity is politically constructed and not an objective fact of economic life (Alt et al. 1996).

Below, I separate the suspects into three groups for interrogation. First, I deal with the obvious external suspects, the 'SAM' arguments about low-wage Southern competition, technological Advances, and Monetary policy constraints. SAM arguments generally correlate global changes to rising inequality, erosion of benefit levels, and heightened unemployment, but they typically lack a causal mechanism. Instead they substitute functional necessities for welfare state change or contraction; political actors are driven to retrench the welfare state regardless of preferences.

Then I turn to the domestic 'ILSA' arguments—Inflation control, Low Service sector productivity growth, and Ageing. ILSA arguments usually focus on the political difficulties in changing the welfare state, regardless of any necessity for change, and a strain of ILSA suggests that the welfare state is not really dead. ILSA arguments thus generally have better laid out causal mechanisms with better identified actors. Nonetheless, ILSA arguments also rely heavily on a functionalist link between cause and outcome that recasts the Malthusian tension between agriculture and industry as a tension between services and industry.

Both SAM and ILSA thus turn out to be rather unsatisfactory suspects, largely because they look at the formal welfare state, focusing on spending levels rather than institutional structure, and completely ignoring the sheltering of profits that was typical of the Keynesian 'golden era'. They both suffer from a species of functionalism that mistakenly treats an interdependent sequence of events as singular occurrences (i.e. 'Galton's problem'). Finally, they are both weak on method—it's difficult to construct a causal mechanism linking the alleged weapon to the ultimate outcomes.

Consequently, I finally turn to 'RICK'—property Rights, Income streams, and Coalitions, to solve the mystery. RICK arguments link the fear or reality of market and political destruction of actors' property rights (and thus streams of income) to actors' policy preferences for the welfare state understood in its broadest possible form, as social protection, or shelter from market forces. RICK arguments recast the 'external' versus 'internal' dichotomy as a question of market forces to make a tighter case linking motive, opportunity, and method. Constable! Bring in SAM!

## 2. SAM

The SAM arguments share a common causal effect. Increased trade and financial mobility at the global level correlate with rising income inequality and unemployment (A. Martin 1996). In the first two arguments, this puts fiscal stress on welfare states designed for economic ‘fair weather’. In the last, even though some welfare states might be able to handle at least some economic bad weather, financial internationalization constrains monetary policy, preventing expansionist policy in pursuit of lower unemployment. In all three, actors directly translate globally derived fiscal pressures into cutbacks; no motive for institutional changes can be traced in these models.

While the correlation between rising unemployment and fiscal stress is clear, the greatest reductions in formal welfare have occurred largely in the countries with relatively low unemployment rates—the USA, Britain, and New Zealand—not highly unemployed Continental Europe. This suggests the viability of the welfare state rests on political rather than financial foundations, and suggests that SAM arguments lack a causal mechanism for automatically translating economic shocks into cutbacks. Moreover, each of the advanced technology and monetary constraint arguments has a variant that assumes that the welfare state can be expanded despite greater international integration. What do the SAM arguments specifically claim?

*Southern Discomfort*

The low-wage southern competition argument sees the spectacular rise in foreign direct investment (FDI) flows to the newly industrializing economies (NIEs) after 1970 as a search for relatively cheap and literate workers and links this to declining demand for relatively expensive unskilled labour in the OECD. Adrian Wood argues that southern competition alone accounts for a loss of at least 9 million OECD manufacturing jobs, equivalent to about two-thirds of *Euroland’s* total unemployment in 1998. Similarly, William Cline argues that trade and immigration together account for between 20 and 25 per cent of the observed increase in US wage inequality (Wood 1994: 167; Cline 1996).<sup>2</sup>

Southern competition has two alibis though. First, FDI still disproportionately flows between rich countries relative to either LDC population or purchasing power parity adjusted gross product as a share of total world product (UNCTAD 1993). Second, even if NIE growth displaced OECD

<sup>2</sup> I will not discuss rising wage inequality at length, because wage compression was never a core goal of most formal welfare states.

workers, NIE imports created growth in the OECD that in turn could have provided a window for redistribution towards those workers. Net of internal flows, industrializing Asia's share of world merchandise imports doubled to 18 per cent, 1985 to 1995 (OECD 1998*b*: 207). And in the USA, Clinton expanded the tax expenditures for the poor and tried to expand the formal welfare state to encompass health care. In some of the smaller European countries like Denmark, exogenously driven prosperity in the 1990s translated into increased rather than decreased transfers to persons. Southern competition at best explains the weakness of demand at the bottom of the manufacturing labour market. It does not provide a sufficient explanation as to why cutbacks are the natural political response to rising unemployment and inequality or why welfare institutions were restructured.

### *Advanced Technology*

Southern competition's alibi in part rested on the fact that most FDI flows are intra-OECD. Does this throw suspicion on technological advances that facilitated rising intra-OECD competition by lowering transaction costs for management at a distance? Dani Rodrik (1997) provides an argument complementary to the southern competition argument, while abjuring any causal connection between welfare recision and globalization. He argues that increased mobility for goods producing capital has also increased the elasticity of demand for labour across the entire labour market, thus causing stagnant real wages in the USA and more generally the OECD. But Rodrik makes no causal connection between this rising demand elasticity and the crisis of the welfare state. In fact, Rodrik ends by making a partly normative, partly practical argument that globalization implies an even greater need for welfare, lest the unexpected political consequences of globalization undermine the market system as a whole. So while he sees global changes as more consequential than other economists, he obviously thinks these changes do not constrain the provision of welfare. Still, Rodrik provides a point of entry for a broader argument as yet unexplored by economists.

Most FDI does flow to and from rich countries, although the stock of FDI there has fallen from 79.3 per cent of all FDI in 1990 to 68 per cent in 1997 (UNCTAD 1998). One of the less surprising aspects of FDI in manufacturing is that foreign firms generally have higher labour productivity than local firms. (Less surprising, because absent such an advantage, local firms would necessarily out compete foreign investors.) In the six largest OECD economies, on an unweighted basis, the ratio between assets and employment for inwardly investing manufacturing firms at the beginning of the 1990s was 1.6 (versus a nominal economy-wide ratio of 1), suggesting higher capital intensity and lower than average direct employment from FDI (UNCTAD

1993: 5).<sup>3</sup> FDI has carried more efficient production norms from each OECD economy into the others, causing job losses as domestic firms adapt to higher productivity levels or simply exit the market. North–north competition via FDI thus may be responsible for job losses on the same order of magnitude as southern competition, and moreover losses of well paying jobs in steel, autos, and electrical machinery. While wage rates for these kinds of jobs are not affected (as in the southern competition argument), the volume of jobs is reduced. Still, even cast this way we lack specific links between the erosion of manufacturing and service jobs and changes in the welfare state. Most job losses would have occurred in the late 1970s and 1980s, precisely when welfare became politically contested. Why didn't job losers and those afraid of losing jobs demand and get more welfare the way they demanded, and quite often got, more trade protection (see also Iversen, in this volume)? Clearly asset specificity (here job-specific skills) induces a preference for trade policy. But this simply reinforces the tenuous nature of the link between globalization and welfare state changes. This leaves only monetary mechanisms as a suspect in this group.

### *Money Madness*

The financial internationalization argument is similarly straightforward and similarly lacks any direct connection between economic shocks and welfare states' problems. Andrew Martin (1996) summarizes these arguments clearly in order to dismiss them, showing that they all argue that rising financial capital mobility systematically biases macroeconomic policy in favour of deflation. Because countries with floating exchange rates and no capital controls can only make monetary policy operate through the exchange rate, efforts to expand the economy by lowering interest rates only lead to imported inflation and capital flight as the exchange rate falls. Policy makers thus operate under an asymmetrical constraint when faced with unacceptably high unemployment. Whatever their preferences, they can only deflate their economies. Fair weather welfare states thus lack the national autonomy to make any reasonable policy response to rising unemployment.

Geoffrey Garrett rather clearly but perhaps too cavalierly has dismissed this argument, pointing to the absence of significant fiscal and capital tax policy convergence among OECD countries (Garrett 1998*a, b*). Garrett supplements his critique with a positive argument. He argues that social democratic policy makers can deploy powerful supply-side policies, particularly centralized collective bargaining and low relative unit labour costs, to attract capital (see also Boix 1998).

<sup>3</sup> Put differently, because FDI accounts for 20% of manufacturing capital stock, manufacturing employment is roughly 7.5% lower in these OECD countries, an effect similar in magnitude to the losses Wood identifies.

Garrett is clearly correct in dismissing financial integration as a serious challenge to national 'autonomy'. He also correctly criticizes the globalization literature for its obsession with convergence. But he draws the wrong conclusions from the absence of policy convergence, at the policy levels he studies anyway. Logically, the absence of convergence does not demonstrate an absence of effect. Arguments about globalization are ultimately arguments about markets, and markets produce variation. Markets produce winners and losers; different strategies can succeed. Garrett also misconstrues what is at stake because he poses the 'globalization' problem as one of national autonomy in the face of external constraints, rather than asking what autonomy might be used for. He poses the problem this way because he assumes that workers and capital each have internally consistent preferences regarding formal welfare. The left uniformly wants redistribution and the alteration of market outcomes and the right the reinforcement of those outcomes (Garrett 1998*b*: 7). This assumption obliterates any political contestation around welfare inside each camp.

This is a crucial error, because one implication of recent work is that centralized bargaining and large welfare states are an unstable combination because of the way that greater competitive pressures in the international market create conflicts over relative wage levels inside the labour movement (Swenson 1989; Pontusson and Swenson 1996; Iversen 1996). Empirically, the connection between centralized bargaining and capital flows is weak: correlating Garrett's rankings of labour market centralization against FDI inflows and outflows yields coefficients of 0.13 and 0.09, respectively. Garrett does not test whether capital flowed to countries with highly centralized bargaining during the period he studied, 1981–92. This is an odd omission considering that Sweden, which he regards as highly centralized, suffered the second largest outflow of FDI of any OECD country those years, at 2.7 per cent of GDP, only partially offset by well below average inflows running at 0.7 (OECD 1995*e*: 75).<sup>4</sup> So while Garrett correctly dismisses much of the financial mobility argument, he too elides the politics surrounding welfare state change.

Financial and productive capital clearly are more mobile now, but the causal chain linking increased mobility to changes in the welfare state is weak, particularly with respect to the connections between interests, politics, and policy outputs. All three sorts of SAM arguments ultimately depend on two assumptions: that rising unemployment is a sufficient explanation for a weak fiscal basis for the welfare state and that in turn politicians automatically

<sup>4</sup> The Netherlands, a traditional capital exporter, had the largest outflow at 2.9% and Britain the third largest at 2.6%. The unweighted OECD average outflow was 1.1% of GDP; the average inflow 0.9%.

TABLE 1.1. *Net change in selected expenditures and fiscal deficits, OECD 18, 1980s–90s (% of GDP, – indicates a fall in spending or deficit)*

Net change in	1980–3	1983–9	1989–93	1993–6	1980–96
Total UE expenditures	0.94	–0.37	1.11	–0.38	1.30
Total social expenditures	1.70	0.20	3.60	–0.70	4.80
Total debt service expenditures	1.40	0.10	0.30	0.10	1.90
Total expenditure	3.60	–3.20	5.20	0.10	5.70
Total taxation (1993–5 only) (Reference: 1970–9 = 4.8 %)	1.10	1.50	0.20	0.20	3.00
Fiscal deficit	2.44	–3.71	4.16	–4.07	–1.18

*Source:* OECD, *Employment Outlook*, 1997; OECD, *National Accounts Statistics*, various dates.

translate external constraints or rising fiscal stress into welfare state cut-backs (or in Garrett's case, costlessly ameliorate constraints). Certainly rising unemployment raised the relative cost of welfare (tax revenues are down, spending is up); moreover, the Continental welfare states responded to higher unemployment by shifting labour market losers into early retirement and disability programmes, magnifying the fiscal stress. But in most economies the cost of deferred wages—i.e. normal health and pension expenditures—runs at roughly five times the cost of unemployment insurance and early retirement schemes. Absolutely the latter cannot account for the increase in public sector deficits in the last ten years or the twenty years before that. From 1980 to 1996 active and passive unemployment outlays for the eighteen rich OECD countries rose on average by only 1.2 per cent of GDP to 2.97 per cent (OECD 1997a). Both unemployment expenditures and fiscal deficits oscillated up and down in response to the business cycle.

But as Table 1.1 shows, factors besides the direct cost of rising unemployment expenses drove the evolution of fiscal deficits. Pro-cyclic unemployment increases surely aggravated deficits, but secular increases in other areas drove the long-term evolution of fiscal stress. Health and old age pensions are the major cause for rising government spending, and thus presumably for fiscal stress. Cumulating deficits and debt service also loom larger than unemployment expenses by the end of the 1980s. As high real interest rates arguably cause both unemployment and high debt service costs, this seems a more appropriate locus for enquiry than unemployment alone.

SAM's second assumption also seems implausible. Much rational choice theorizing about the behaviour of politicians would suggest that in the face of rising demands from their clients they would choose to expand welfare services and transfers, particularly since the interest rate penalty for doing so was not overwhelmingly large. Layna Mosley finds that the financial penalty for running fiscal deficits is a modest 5 basis points (0.05 per cent) on domestic currency debt for every increase in the deficit of 1 per cent of GDP

in OECD countries (Mosley 1998: 20–1; Garrett 1998a). In the Continental welfare states where unemployment has risen the most and been persistently highest, the fewest cutbacks have occurred. All SAM arguments thus need to connect the kind of external economic pressures they posit to a fleshed out political mechanism. They need to connect interests and preferences to policy outcomes, or in other words, to find not just opportunity but also method and most importantly motives for actors. Perhaps, though, the weak case against the external SAM arguments is irrelevant; maybe it is ILSA who fits the frame better.

### 3. ILSA

If it is difficult to pin this killing on SAM, the external intruder, perhaps ILSA the maid did it. Most murder after all is domestic. Perhaps Inflation control, Low Service sector productivity growth, and Ageing account for changes in the welfare state. The former argument is most associated with Ton Notermans, the latter two with Paul Pierson.

#### *Inflation Control*

Notermans argues that the institutional structures governing post-World War II economies were erected in response to the deflation of the 1930s and consequently were biased towards inflation (Notermans 1999). These institutions naturally could not effectively contain the inflation that emerged in the 1970s, and this inflation forced politicians everywhere to dismantle those institutional structures. Full employment policies, credit market regulation, discretionary monetary policy, and, of course, the welfare state all fell by the wayside. At this point, Notermans's argument becomes symmetrical to and incorporates parts of the SAM financial mobility argument: unemployment rises, no policy response is possible, the welfare state encounters fiscal difficulties. Greater central bank autonomy imposes a domestic constraint on full employment, but capital market and foreign exchange liberalization are external constraints operating in the same way.

Notermans's domestic version of the monetary policy constraint argument at least has the virtues of starting from actors trying to cope with the problems they face, rather than starting from an actorless system imposing constraints, and it also opens up the institutional aspects of the post-war welfare state to scrutiny, unlike Garrett's depoliticized account. But like all the domestic suspects, Notermans's account suffers from a fundamental methodological problem, known as 'Galton's problem', which makes it difficult to sort out logically where constraints on policy really originate. Francis

Galton critiqued Edward Burnett Tylor's explanation for the presence of similar sets of cultural practices in Pacific Island societies (Hamel 1980). Tylor argued that these sets of practices represented functional responses to similar problems in all these societies, and that these practices could reasonably be compared as independent occurrences of the same phenomenon; for statistical purposes, they could be considered independent events. Galton, however, noted that there was a competing, equally plausible logical possibility: that these sets of practices had originated in a single spot and diffused to all the other societies rather than springing up independently. Since the odds of independent multiple emergence are low, Occam's razor favours the external causal argument. Thus, arguments that claim that efforts to change a parallel problem, here inflation-prone institutions, invariably lead for functional reasons to parallel sets of changes to those institutions, cannot eliminate the possibility that these changes originated in one country and diffused to others. Here the likely suspects, aside from those raised in SAM, would be events like the unilateral decision by the US Federal Reserve Bank to raise interest rates in 1979, or, less plausibly, the deliberate propagation of a policy line by elites acting in concert (Gill 1990).

The only suspect immunized against Galton's problem is Ageing, to which we now turn.

### *The World According to AARP*

Clearly people who are living longer, retiring earlier, and demanding more medical care are a growing proportion of all OECD economies' population. It could be argued that ageing has an external component: heightened competition in world markets creates more stress, leading to early retirement. While the Continental welfare states routinely use early retirement to clear labour markets, I do not think I can find a district attorney in the world who would take that one to court. So let us code ageing as a purely domestic suspect for changes in the welfare state.

Paul Pierson (in this volume) has made the strongest case for this.<sup>5</sup> Pension and health spending (much of which goes to old people) amount to two-thirds of government spending in the EU. The secular increase in pension and health spending from 7.1 per cent of OECD GDP to 14.3 per cent in the period 1960 to 1990 is significantly larger than the (cyclic) rise in unemployment expenditures. Moreover, virtually all OECD countries have initiated a debate about or actual policy reforms in old age pensions. These range from tinkering with benefit formulas and eligibility criteria (as in the USA) to wholesale changes like a shift from defined benefit to defined contribution

<sup>5</sup> Garrett similarly argues that 'the crisis of the social democratic welfare state is a demographic crisis, not the product of market integration' (Garrett 1998b: 21).

plans (as in Sweden) or the creation of mandatory private pensions (as in e.g. Australia). Still, in most countries, these changes are much more consequential fiscally for the future than for now. Only in Britain and in New Zealand has an ongoing fiscal deficit triggered large immediate changes in the indexation formulae and led respectively to slower growth or declining spending in the short run. Worries about an ageing population, Japan perhaps excepted, are worries about the future. So the causality here is backwards: it is hard to see how ageing led to efforts to change the welfare state in the 1980s. The crippling fiscal stresses are over the horizon, and the pension policy reforms made in the 1980s were efforts to head off a crisis that had only limited spillovers into other welfare policy arenas. On the other hand, health care expenditures, including long-term care for the elderly, have been rising, and these are labour-intensive services. Perhaps slow service sector productivity growth has simply priced welfare out of the market?

#### *Violating Baumol's Law*

Paul Pierson and others have deployed Baumol's law as a cause for fiscal stress in the welfare state (Pierson, in this volume). Baumol argued that services would become progressively more expensive relative to physical goods because of low productivity growth in services and because wage increases from more productive sectors would inevitably flow on to the service sector. Baumol noted that the labour itself was the object of consumption in much of the service sector, and thus that productivity increased only slowly. Baumol assumed that wage increases in what he called the progressive (manufacturing) sector inevitably flowed over to the constant productivity (service) sector. In turn, labour-intensive welfare state services would become increasingly more expensive, imposing high levels of fiscal stress that ultimately force choices not only between welfare and other goods but also among different categories of welfare spending.

Baumol's law nicely delineates the contours of some of the political struggles that occur in and around the welfare state, allowing us to pinpoint the correct suspect with more certainty. But Baumol's law embodies a relatively static view of the supply side of the market, and takes for granted the political foundations for wage parity. In essence, by assuming that productivity levels in services are more or less fixed, Baumol presents a neo-Malthusian argument in which labour-intensive services rather than the supply of land (and thus agricultural output) is the limiting factor, but in which services simply price themselves out of the market rather than causing mass starvation. However the history of markets is a history of efforts to overcome precisely the kinds of limiting factors and shifts in relative prices Baumol predicts. What distinguishes recent service sector and welfare state reorganization (NB: reorganization, not cutbacks) are attacks on both of Baumol's

limiting factors: a pervasive introduction of managerial, organizational, and information technologies that increase productivity; and changes to collective bargaining regimes that delink Baumol's progressive and constant sectors and prevent rapid cross-sectoral transmission of wage gains.

Service sectors like retail and wholesale distribution, transportation, power generation, and telecommunications are important later in this mystery, and there productivity has risen quite rapidly, leading to declining rather than rising prices. (Indeed, declines are often built into regulatory structures as CPI-X pricing formulae.) In Canada, for example, productivity in three of these four sectors rose faster than productivity in the goods-producing sector in 1981–91 (MacLean 1996: 8, 18). But let us put them aside to address directly two core welfare services: health and education.

Health and education are precisely the kinds of services Baumol had in mind in the second part of his article when he predicted the collapse of municipal socialism. In each, labour costs generally amount to 60–85 per cent of operating expenses, and in each we can see both his underlying dynamics at work and efforts to reverse them. Put aside both purely technological productivity gains (e.g. endoscopic surgery requiring fewer personnel and fewer hospitalization days) and technologically driven price increases (e.g. bioengineered pharmaceuticals). Wages in the health sector generally have risen, most strongly for doctors, contributing to a real 450 per cent increase in health care costs from 1967 to 1998 in the USA (Federal Reserve Bank 1999: 8). Why hasn't the normal operation of supply and demand caused entry into the market for provision of medical services and gradually eroded doctors' price premium? Cast as a production problem, why hasn't the market generated close but cheaper substitutes for doctors, or otherwise 'Taylorized' doctors' work practices to strip out (expensive) labour?

Actually it has. In the USA one major thrust of HMO-ization and large group practices has been imposition of strict controls on doctors' use of time. This rationalization of the production process also involves limits on doctors' incomes, with salaries replacing fees and the implicit profit stream in fees being captured by the practice or the HMO. Both organizations have also begun substituting nurses and near-doctors for doctors. So too have universities, where the substitution of expensive tenured faculty with contingent workers has gone even farther.

Clearly, like Marx's prediction of a falling rate of profit, Baumol's law describes a tendency rather than an absolute condition. There is considerable room for rationalization, and precisely because of the operation of Baumol's law considerable pressure to rationalize. While Baumol's law pretends to describe a universal law, perhaps the only universal law in market economies is that when relative prices shift sharply in favour of one kind of input to production, market actors have a powerful incentive to economize or find substitutes. This is precisely what US HMOs (and the employers that

favour them) and universities (with much more success) are doing. The differences in outcome are not explained by the irreducible labour content of the service but by the degree to which producers have overcome collective action problems to defend their wages and conditions. This is even clearer if we look outside the USA at professionals in other societies—weakly organized US pharmacists are now essentially wage employees; well organized German pharmacists retain considerable control and enjoy better incomes. So at least part of the service sector's lower productivity is political in origin. It rests on the ability of specific groups of producers to use collective action to defend work norms.

The diffusion of wage gains from Baumol's progressive to constant sectors also rests on political, not market mechanisms. Baumol finessed politics by simply assuming that progressive sector wage increases would translate into rising prices, carrying constant sector wages and prices with them. But Baumol's argument reflects the conditions of the period in which he wrote (1967). In this period wage dispersion fell markedly, cross-sectoral wage links were pervasive, and many markets were characterized by mark-up pricing by firms possessing some degree of oligopolistic power (Goldin and Margo 1992). This led to rising progressive sectoral wages and their transmission to the constant sector. But in perfect product markets, productivity increases lead to declining prices, rather than rising wages. In perfect labour markets, wages would decompress and wage gains would not automatically flow from sector to sector. Quite the opposite: the more labour the progressive sector sheds, the greater the supply and lower the price of labour in the constant sector. While the present period by no means has perfect markets, they more closely approximate that condition than when Baumol wrote.

What then does Baumol's law tell us? Lower service sector productivity clearly is implicated in the cost problems of and fights over the welfare state, particularly in efforts to reorganize production practices and change collective bargaining patterns. Can we indict this simple internal suspect?

No. Oddly enough, Baumol's law provides two incentives to look once more at external suspects. Baumol's law is simply an American inversion of the standard Scandinavian inflation model (the EFO model). In the EFO model, exposed sector (i.e. progressive sector) wages are constrained by world market prices while sheltered sector (constant sector) wages are not. The only way to prevent inflation in the service sector from pricing the exposed sector out of world markets is to assure that sheltered sector wages rise in line with exposed sector wages. Baumol's law thus logically predicts conflicts similar to EFO's: between the traded and non-traded sectors, between progressive and constant sectors. This means that Baumol's law has to be somewhat silent on the question of internal versus external assailants. EFO after all, is a model about global constraints on local choices. Second, the wide dispersion of service sector productivity and remuneration across OECD

countries both confirms that Baumol's law has worked its way out in very different ways in different societies, and also creates conditions for extensive arbitrage by firms that can also constrain service sector prices.

Two political considerations temper Baumol's prediction of ineluctably rising absolute or relative services prices. First, as in manufacturing, rising relative wages and prices in services are a function of the structure of production, the wages associated with particular jobs, and collective action by producers. Baumol's law does not work automatically because all of these are inherently political in nature. They are fights over the constitution and defence of property rights and their associated streams of income through collective action. Second, the differential evolution of Baumol's lawlike price pressures provides strong motives for one set of actors to translate the global constraints they experience into local politics. And this suggests that we turn to the suspect who has been sitting quietly in a dark corner so far: RICK—property Rights, Income streams, and Coalitions.

#### 4. RICK

One of the problems pinning the rap on the internal and external suspects above is that if you misidentify the body, it is harder to understand both motive and method, that is to say, the reasons actors transform economic pressures into policy choices and the specific causal mechanism linking pressures, interests, policy preferences, and policy outcomes to a discernable welfare state corpse. Much of the confusion about the relationship between global (and internal) markets and welfare comes from a professional deformation of reality in which academics focus closely on the formal welfare state as an instrument of redistribution only towards workers. Consider the conventional wisdom about politics and about the appropriate dependent variable encapsulated in Garrett's (1998*b*: 7) 'broad' definition of the welfare state:

The most important distributional cleavage in the industrial democracies has long been those who support the market allocation of wealth and risk—the natural constituency of right-wing parties—and those who favor government efforts to alter market outcomes—the left's core base of support. The welfare state—broadly construed to include not only income transfer programs such as unemployment insurance and public pensions but also the provision of social services such as education and health—is the basic policy instrument for redistribution.

Why does the right automatically favour market allocation and the left redistribution? Why is the formal welfare state the only mechanism for redistribution? The astounding thing about the so-called 'golden era', after

all, was not widespread recourse to formal welfare by those in the labour market or even the deliberate (if only occasional) use of expansionist monetary policy. The astounding thing about the golden era was stable employment, wages, and investment across all sectors, and predictable access to deferred wages after retirement. States created this stability in reaction to the exposure of virtually all life chances and income streams to the logic and volatility of the market in the long nineteenth century during Polanyi's Great Transformation. They did so not only to benefit workers, and workers alone were not the only actors who benefited from and campaigned for redistribution and stability (Polanyi 1944).

Polanyi's counter-movement after all was about sheltering 'productive organization' from the market. The welfare state is a fiscally visible and expensive modality for providing social protection. But budget financed services and transfers are not the only modality for social protection. After the 1930s states provided social protection—and achieved redistribution—through a wide variety of instruments: trade protection, minimum wages, centralized collective bargaining, product market regulation, zoning, the delegated control over markets to producer groups, and, of course, formal welfare states. The essential feature these all share is that they disconnect or buffer income streams from market outcomes, whether those incomes take the form of wages, employment, or profits. Welfare state analysts call this de-commodification, but golden era de-commodification was not limited to welfare services and transfers. Regulation of the service sector, which created a broad range of property rights for workers and owners (including the state as an owner), de-commodified substantial chunks of capital.

Analysts of the formal welfare state have traditionally preferred to view welfare entitlements as 'social' rights, and there are important reasons for doing so (Klausen 1995). But welfare state related streams of income are also property rights. Welfare state socialization of various life and economic risks created property rights to streams of income from the state, as in the case of defined benefit pensions or disability pensions; by the same token tax-sheltered defined contribution pensions can create a property right if the tax expenditure is linked to the contribution.<sup>6</sup> Similar property rights were constructed outside the formal welfare state after World War II.

These property rights took different forms. The service sector, the source of most post-war employment and employment growth, contained the most expensive and important property rights related to social protection whether expressed as public ownership or regulation of the service sector. These property rights guaranteed stability for wages, employment, and, for regulated

<sup>6</sup> Even in the pre-child-tax-credit USA, welfare-related tax expenditures (health, pensions, housing, and the earned income tax credit being the largest) already amounted to almost half as much as formal line item budget spending (Howard 1997: 26).

private owners, steady revenue and profit streams. State regulation dampened or eliminated competition by segmenting markets for services such as telecommunications; road, rail, and air transport; power and water generation and distribution; and retail distribution. These four sectors amount to one-third of most OECD economies and a significant source of producer costs in the manufacturing sector.

Consider how investor-owned power generation utilities in the USA were sheltered from the market. The state offered firms territorial monopolies, access to tax privileged equity capital, and regulated rates of return in order to induce firms to make highly asset-specific investments. In turn firms offered workers stable employment at predictably rising wages linked to the utility's equally predictable expansion of its assets in an environment in which the price of electricity was also predictable. (Workers for state-owned utilities often got the even greater stability of civil service status.)

Because services were sheltered from market pressures, much wider productivity differentials developed internationally across service sectors than in manufacturing, where the GATT permitted increased competition. This can be seen in a simple measure of the relative dispersion of productivity levels in the OECD-19 economies around 1990. If we index US productivity at 100 and rank everyone else accordingly, and then calculate the standard deviation of productivity levels in manufacturing and four critical service sectors, we get 16.1 for manufacturing, 15.8 for telecommunications, 21.1 for retail distribution, 26.8 for electricity generation, and 57.1 for air transport (calculated from Pilat 1996: 107–46). The large dispersion of productivity levels around the mean (i.e. a larger standard deviation) indicates that historically there was much less market pressure to conform with best practice production norms. By 1992, progressive deregulation and privatization in telecommunications unleashed market pressures that essentially eliminated any differences between this service and manufacturing. But in the other three sectors considerable divergences remained.

Because the best data measure productivity after the deregulation wave of the 1980s, we can only surmise the degree of pre-deregulation slack. But in telecommunications, some useful proxies are the 60 per cent reduction in the cost of British and French telephone service after market liberalization or the drop in the share of telecommunications employment in the OECD from 0.81 per cent in 1982 to 0.67 in 1992. Similarly the electricity, gas, and steam sector shed 17.4 per cent of its labour force in the EU-12 post-deregulation, and deregulation of the industrial electricity market in the EU led to a halving of prices for medium-size industrial consumers (Héritier and Schmidt 2000; *Financial Times*, 19 Feb. 1999). Most productivity studies agree that the most significant factors explaining productivity differences in services are government ownership and regulation of labour and product markets (McKinsey 1992; Pilat 1996).

The degree to which regulation created property rights for capital and labour becomes visible in the problem of stranded costs that emerges when states move to deregulate. Stranded costs are the characteristic feature of the regulated service economy and an important clue in our mystery, because they are specific investments, by both capital and labour, that make sense only in a regulated environment. Specificity arises as much from the structure of regulation as from the more objective factors Oliver Williamson (1995) delineates. For example, stranded costs are investments utilities made, using borrowed money, in anticipation of stably rising demand and regulated rates of return on the capital invested. Subsequent deregulation and free market entry ‘strands’ this investment, saddling existing firms with above average capital costs and lower rates of return than new entrants. Worse, as the income stream this investment generates shrinks, its market value falls. While this term is used specifically for the electricity generation industry and the problem is most acute there, it inheres to most services. Deregulated telephone service in the USA created a long legal battle over whether network owners could charge new entrants the ‘historic’ (i.e. stranded) cost of creating their networks or only the incremental cost. Analogously, in labour markets, states rewarded civil servants’ investment in non-transferable, job-specific skills with guarantees of stable employment. Consequently, states have either bought out civil servants when they privatized state firms or explicitly voided their property rights.

What about the parts of the service sector Baumol fretted about? In more labour-intensive services states’ delegation of market control to producer groups solved their collective action problems by allowing them to use selective (dis-) incentives to protect quasi-property rights around specific investments in human capital. As noted above, doctors and lawyers used collective action to restrain entry to their markets, restraining access to training and licensing, and controlling advertising standards, fees, and the definition of jobs allowed to paraprofessionals. Delegated control is typical of but not unique to the professions. Bo Rothstein has shown how Swedish farmers could not control output, and thus prices, collectively until the state delegated taxation power to the Farmers Association, permitting it to impose selective disincentives on overproducers (Rothstein 1991; see also Tilton 1996).

The degree to which the service sector was sheltered, its economic weight, and the salience of stranded costs suggests we need a new autopsy report. The welfare state is not dead. The corpse here is actually social protection delivered through the service sector, and its death has led to intense conflicts around the remaining major source of social protection, the formal welfare state. Fights over retaining or removing social protection—insulation from market outcomes—lie at the heart of welfare state politics in the 1980s and 1990s. Thus, posing the question as ‘globalization’ versus domestic causes—external intruders versus household suspects—and using the welfare state

as the dependent variable misconstrues the motives for the crime. Fights over property rights constructed through state delegation of power to producer groups or state-regulated market segmentation naturally have a substantial domestic component, because deregulation can differentially benefit actors in the same sector even when 'foreign competition' per se is absent. What matters are groups' specific preferences for and political efforts to achieve discrete policy changes around those property rights.

But this discussion has thrown up a new suspect. Perhaps, as the earlier Baumol/EFO discussion suggested, fights over social protection are really fights between traded and non-traded sectors over issues that extend beyond trade protection? Certainly the IPE literature based on Heckscher–Ohlin and Ricardo–Viner models assumes this (Frieden and Rogowski 1996). But the traditional cleavage between traded and non-traded is misleading, as is the emphasis on opportunity costs understood as a loss of potential income for the traded sector. Misleading, not wrong.

The distinction between 'traded' and 'non-traded' is misleading for three reasons. First, all too often it is simply understood as manufacturing versus services. But in many sectors 'internal' competition is the source of market pressures on firms. That is, firms in cognate fields bypass or evade what were always incomplete systems of regulation to capture some of the rents that regulation generated. Thus, non-bank financials invaded banks' territory; paralegals offered cut-rate uncontested divorces; courier and package services eroded postal monopolies; postal monopolies invade each other's markets. All upset delicate balances in which producer groups sought rents for their own aggrandizement while politicians used them to cross-subsidize what were seen as socially desirable services. So an analysis dichotomizing traded and non-traded sectors misses important dynamics leading to deregulation and, of course, attacks on the formal welfare state.

Second, the distinction between traded and non-traded is misleading because few commodities or services are naturally 'non-traded' in the sense that economists meant when they designated services and goods that cannot enter into trade. Economists' classic non-traded service, the haircut, obviously does not cross-borders. But if the structure of regulation permits franchised extensions of multinational (or non-local but domestic) firms to compete with local firms, then parts of the haircut production process are traded. Franchisees' management system, access to liquid capital markets and branding are traded, though the haircut itself cannot cross borders. If significant components of the haircut production process are traded, then few sectors enjoy the natural protection economists talk about. Even domestic mail has become 'traded'; the Dutch Post remains for German customers avoiding high local postage costs (Héritier and Schmidt 2000).

The issue of opportunity costs is also misleading. IPE analysts have invoked opportunity costs in order to provide a micro-foundation for actors'

interests and willingness to participate in collective action. Clearly, firms competing in world markets and buying relatively expensive regulated domestic inputs would rather buy cheaper inputs. For them higher domestic costs represent lost profits. And certainly for cognate firms invading regulated firms' territory opportunity costs loom large as the difference between their low (unregulated) cost of production and the high (regulated) price represents additional profit.

But the absolute losses to the firms benefiting from deregulation are not simply losses of income, but rather the destruction of their stranded investments. Deregulation devalues the capital stranded in regulation-specific investments. Consider again the old style barber, making a location and relationally specific investment. This investment was rational when price regulation, zoning, or licensing kept franchisers out of the market. Franchisers/franchisees' investment by contrast is much less specific because the brand travels in a way that a local barber's does not. The same analysis could be made of the considerably larger stranded investments in electricity generation, water systems, or telecommunications. These sectors have seen considerable cross-national investment (\$50 billion in 1998) and contestation for market share subsequent to de-monopolization and/or privatization; they have also seen significant devaluation of investments which were rational to make under a regulated market but cannot generate revenues in a competitive market. As Alt and Gilligan have shown, divergent specificities inside the traded sector (and presumably the non-traded sector as well) mean that the traded sector itself has quite heterogeneous and often unpredictable preferences regarding trade policy (and by extension deregulation and the formal welfare state) (Alt and Gilligan 1994).

The important distinction is not between traded and (the very small number of truly) non-traded sectors, then, but between firms (and employees) that made large specific investments secured as politically generated property rights and firms which either did not, or which had such investments liquidated in prior rounds of deregulation. By looking at the benefits some groups accrue from these property rights, and by looking at the kinds of costs imposed on other groups by a given group's property rights, we can understand fights over welfare and social protection much better. We can construct a much stronger causal chain linking motive and method. As a first cut, suppose we overlay the traditional cleavage between capital and labour with a redefined cleavage between the kinds of firms typically enjoying shelter from market forces and those exposed to markets.

Broadly speaking, by sorting out what are really a large assortment of heterogeneous groups into these four categories we can see that 'welfare state' politics has shifted from primarily being the politics of redistribution among classes which Garrett identifies to being a politics in which groups also try to protect or expand their politically constituted property rights, which is to

say partly over the degree to which they are exposed to domestic and international market forces. Sectors/firms already exposed to market pressures deliberately seek to impose market disciplines on sheltered sectors/firms to expose them to competition and so bring down their own cost of production. Sectors/firms still enjoying property rights sheltering their stranded investments try to retain insulation.

Doing this reveals that political conflicts around the welfare state are not solely about aggregate spending levels in the formal welfare state. Fights also centre on institutional changes bringing markets into the formal welfare state and especially into the mechanisms which guaranteed social protection in the service sector. Conflicts are about the specific burdens and benefits that the public sector, the welfare state, and regulation place on specific actors because of their position in the market, and because of different vulnerabilities that different degrees of investment specificity create. Fights over the formal welfare state necessarily involve fights over informal forms of welfare, such as tax expenditures, 'corporate welfare', professional privileges, regulated monopolies, and delegated authority, or in other words, RICK. Below I will briefly sketch out these different group's motives, opportunities, and methods in fights over the property rights created by social protection to show why these fights do not produce policy convergence.

## 5. MOTIVES, OPPORTUNITIES, AND METHODS

The SAM and ILSA arguments all tend to argue that the welfare state should be changing in roughly the same ways. They all argue that welfare is 'too expensive' and thus that welfare spending should be shrinking. If all welfare states (or all forms of social protection) did change the same way, the case for a functionalist argument would be stronger, although with reasonable doubt remaining as to the internal versus external question. However welfare states are not changing the same way, nor is spending shrinking everywhere (Pierson 1994). Analysts of the public sector discern four emerging models in public administration (Peters 1998). And those building on Gøsta Esping-Andersen's work, like Torben Iversen and Anne Wren, see three major types of response to the emergence of a service economy (or put differently, to the working out of Baumol's law) (Esping-Andersen 1990; Iversen and Wren 1998). Patterned responses suggest an underlying political logic. The public administration studies are content to describe these patterns; Iversen and Wren supply a description based on quantitative analysis, link their argument to Esping-Andersen's rather than advancing a causal mechanism. I intend here to obtain a conviction by tracing out different groups' interests in order to trace out policy preferences and causal mechanisms in the transformation

Policy preference in italics	Firms / producers	Labour
Sheltered Streams of income secured by property rights created by collective action or (producer) regulated markets	<i>Limited neoliberalism</i> Traditional (labour-intensive) Service sector State-owned firms and/or regulated monopolies with stranded costs New self-employed and the old professions Farmers	<i>Responsive state</i> Public sector unions in health, education, and social services Unorganized workers in traditional services Construction unions
Exposed Streams of income secured by (transient) technological advantages	<i>Neoprotectionism</i> Large export-oriented firms, MNCs, franchisers Agri-business and food processing State-owned firms' own management?	<i>Social protectionism</i> Private sector industrial unions Public sector unions in goods (not service) producing firms

FIG. 1.1. Cleavages over social protection

of social protection. I will show that RICK orchestrated a conspiracy containing SAM and ILSA. The latter two arguments are not wrong. They are what Hempel called non-rival explanatory sketches lacking fully fleshed out causal mechanisms.

Figure 1.1 lays out the two cleavages identified above, some typical interest groups, and labels for policy syndromes (in italics) in order to trace the connection between motives (interests), policy preferences (methods), and outcomes in fights over social protection. This figure lays out the positions of organized interests and not voters. Like the traditional IPE literature (and Stein Rokkan) I assume votes can be bought; the critical step in the expression of interests as policy lies in the interactions of interest groups and parties seeking the resources they need to win elections. Although the populations in the four cells are fairly heterogeneous in terms of the economic activities they pursue, they are homogeneous in terms of the kinds of property rights and market pressures they confront. As in Helen Milner's analysis of trade preferences, I assume that firms in the same sector but with diverging market positions can express diverging policy preferences (Milner 1988). Conversely firms producing different things can have the same policy stance because they share similar kinds of property rights.

#### *Interests and Policy Preferences: Sheltered Firms and Producers*

Sheltered firms and producers enjoy streams of income anchored in property rights whose strength reflects government enforced collective regulation

of their markets, guaranteed monopolies, or other politically generated barriers restricting competitive entry or market contestation. These firms or producers made 'regulation' specific investments that were viable given entry barriers, regulated prices, and other devices securing or raising their rate of return. This explains their ferocious defence of the regulations that shelter those immobile investments and their efforts to bolster income streams when those defences fail. These producers and firms pursue an ensemble of policies we can label a 'limited neoliberal' position because it emphasizes the elimination of government and regulation outside of product markets. At the same time it abjures the reform of government or the dismantling of the political supports for their own collective action. Maximally, they want social protection for their capital and no one else.

Sheltered firms' and producers' problem is the intrusion of franchised competitors into previously fragmented and localized markets, and the erosion of barriers to entry that had been supported by collective action. Here I use franchise not only in its common meaning, but also in its older meaning to indicate any firm given licence to operate in a given sector, for example firms bidding for the right to operate a public water system. Franchisers have access to cheaper, more liquid pools of capital because franchisees back them in capital markets; have management strategies using relatively less skilled, cheaper labour, or in utilities, more efficient use of underlying assets; and are branded. Franchisers' investments thus are less asset-specific and risky because they use branding, capital (or information) market access, and management strategies to re-segment markets for undifferentiated goods when political segmentation is removed. Examples of this intrusion include the rise of paraprofessional real estate conveyance firms in the legal market; foreign direct investment (or bidding) in newly opened public utilities; or the replacement of traditional fee for service medical practice by HMOs and investor-owned practices.

Sheltered firms' and producers' relatively greater investment risk (what Frieden and Rogowski misperceive as opportunity costs) explains their ferocious pursuit of reductions in labour costs, personal taxes, and regulations aside from those protecting their product market. Continued regulation and taxation in markets invaded by franchised competitors threatens the very existence of stranded investments, not just the rate of return on those investments. As Tversky's prospect theory tells us, people are generally much more sensitive to losses than to gains (Kahneman and Tversky 1979). Moreover, the gains deregulation creates for producers when they behave as consumers are pretty meaningless if they suffer enormous reductions in their stream of income or have lost their entire investment and are forced out of business.

Sheltered firms and producers also prefer to shift regulatory control out of the state and down to their own organized interest groups. For smaller

firms, the fixed costs of regulatory compliance cannot be spread over large and stable revenue flows, so the choice is to contract out for them (at a high cost) or simply evade them (risking legal penalties). Studies of Australian firms have shown that these costs are not trivial, amounting to 4 per cent of turnover and equivalent to 32 per cent of profits in five sampled industries (OECD 1998b: 128).<sup>7</sup> Delegation reinforces the ability to use selective (dis-)incentives for collective action in defence of property rights, while minimizing regulatory costs. A partial exception to this pattern is state-owned utilities, where it is the state's capital and not investor capital that is at risk.

Sheltered firms typically prefer the wholesale elimination of publicly socialized health, education, and labour market risks to lower their tax burden. (Except of course where they live off that sector, as in health.) Individuation of risks allows sheltered firms to pass social costs onto larger firms that face organized labour and so must provide a wide range of benefits to buy labour peace. Lower income taxes enable the owners and managers of sheltered firms to purchase 'welfare goods' tailored to their needs, and to maintain a socially defined standard of living in the face of increased competition. In terms of the broader public sector, smaller scale sheltered firms and producers also prefer wholesale privatization of (relatively expensive) public services and deep budget cuts to fund accompanying income tax cuts (since they receive much of their return as what the tax system considers 'income').

The limited neoliberal policy syndrome is most strongly expressed where private ownership in the service sector survived the regulatory impulses of the Great Depression, where financial markets permitted 'deviant' unregulated firms to capitalize themselves more easily, and where individuals can easily purchase insurance against life and economic risks. In short, it is strongest in the Anglo-Saxon welfare states. In this sense Esping-Andersen is quite correct about the importance of programme design in institutionalizing the welfare state's political support. By stamping out private service provision and pricing private service sector employment out of the market, the 'social democratic' welfare state drastically reduced the electoral base for this policy syndrome by lowering the rate of self-employment by 40 per cent relative to the four Anglo-Saxon economies.

#### *Interests and Policy Preferences: Exposed Firms*

Exposed firms' income streams depend on their property rights in transient technological advantages for the goods and services they produce. These

<sup>7</sup> Similarly, French small business owners (including, naturally, a hair salon) are registering their firms in Britain to avoid taxation on proprietor's income, with savings amounting to 30% of owners' gross pay (*Washington Post*, 16 Apr. 1998, A23).

property rights are not as dependent on collective action or political support. But exposed firms faced quite significant threats of technological leapfrogging, shorter product cycles, and falling prices—deflation—for their products and services as competition intensified in the 1980s and 1990s. All of these factors reduced the potential rate of return on a given investment in R & D or process technology improvements. Looking at price pressures helps explain the timing of political efforts at deregulation and welfare state restructuring. By the late 1990s disinflation had turned from a largely sectoral phenomenon into an economy-wide problem verging on deflation. Simultaneously, these firms felt increased pressure to conform to international rates of return, as financial deregulation broke open illiquid local markets and increased the incentive to diversify into global markets (Germain 1998; Verdier 1998). Downward pressure on prices and profits thus ran headlong into rising expectations about profitability. Disinflation made it harder for exposed firms to accommodate price increases from both sheltered and exposed suppliers. So exposed final producers reacted by transmitting downward price pressures to their parts suppliers. For example, the major US automobile assemblers imitated Japanese norms and began demanding annual 5 per cent price decreases from their global parts networks. Exposed firms want to impose the same sorts of productivity expectations on their public sector and other sheltered suppliers. But this could not be done to public monopolies without first destroying these monopolies' legal standing by introducing competition, and through a pervasive reorganization of the public sector to make government more business-like and responsive to competitive pressures.

Like the original progressive movement in late nineteenth-century America, this 'neoprogressivist' model emphasizes depoliticized and efficient government, and it attacks much 'corporate welfare' (i.e. sheltering) just as the progressives attacked urban machines' patron-client welfare networks. Exposed capital thus is the strongest advocate for the 'new public management' model of public sector reform, involving real wage disciplines, results-oriented management, budgetary transparency, and true costing (Schwartz 1994a). New public management does not involve the wholesale programme of deregulation, privatization, and public sector staffing cuts that sheltered firms prefer. Instead it aims at lower costs via higher productivity and via the professionalization and insulation of the state, and at making public sector actors behave more predictably and more like private sector actors who are susceptible to cost reduction pressures. Large exposed firms prefer predictability, because predictability allows them to maximize the return they get from taking targeted risks.

Substantively exposed firms seek increased public sector productivity because they directly and indirectly consume a wide range of public services. Most firms in this sector either face organized labour or value a stable, skilled

labour force as a competitive resource. They thus view dismantling the welfare state and desocialization of risks as something that will raise their labour costs rather than reducing them, as a comparison of the incidence of health costs in Canada and the USA shows (C. J. Martin 1995a; Giaimo 1998). Exposed firms thus see fiscal discipline as a way to put a hard budget constraint on public producers, a way to attain better credit ratings, and a way to stabilize tax levels, rather than a way to finance tax reductions in individual income tax levels. Fiscal discipline improves the state's credit rating and thus indirectly firms' own rating and borrowing costs. Exposed firms prefer broad-based sales taxes whose regressivity does not affect their upper management, and whose rebate-ability improves their position in export markets. In short, exposed firms prefer to fix the state's service production rather than eliminate it.

#### *Interests and Policy Preferences: Exposed Labour*

Exposed labour, like sheltered producers, has a variety of property rights constituted through successful collection action. Most of these rights are secured via the socialization of individual and economic risk, so this group has good reason to prefer a continuation of the welfare state. At the same time, this group faces exactly the same pressures their employers face from falling prices. Falling prices (and heightened competition) puts continual pressure on workers to improve productivity in order to pre-empt any effort by employers to threaten or actually to flee to lower wage regions (as Rodrik and Wood suggest), and to moderate their wage demands to prevent their firms from failing (as Swenson suggests). Exposed sector unions fear that wage pressures emanating from organized sheltered workers will induce their workers to take wage positions detrimental to their long-term employment. But exposed workers also consume public sector services that represent socialized risks, and prefer that to individualized and market-based risk.

Exposed thus labour prefers to reorganize the public sector and welfare state to impose fiscal and wage disciplines on it, but without a recision of public services. Like exposed firms, exposed labour prefers welfare state reorganization to dismantling, but it also prefers continued public ownership to privatization and open private-public competition. To the extent that productivity gains are not forthcoming in the public sector, exposed workers have strong incentives to band together with exposed firms to break wage parities with Baumol's constant sector and /or the public sector.

This ensemble can be called 'social progressivism.' As with the neoprogressivism of exposed firms it emphasizes the more business-like, new public management model, but it diverges by preferring continued socialization of a broad range of risks and a relatively higher level of public spending, ownership, and service provision.

*Interests and Policy Preferences: Sheltered Workers*

Sheltered workers have a wide range of politically constituted property rights. Generally they enjoy not only the socialization of individual and employment risks that exposed workers enjoy, but they also enjoy significant shelter from market pressures on wage levels and long-term employment. This group fears the de-segmentation of labour markets that previously supported wages and conditions above a 'natural' market level, particularly for the many unskilled workers in this group. De-segmentation occurs when private sector wage disciplines replace public sector norms (through privatization or wholesale changes to collective bargaining regimes) or when licence-based barriers between different labour markets disappear. Consider efforts to remove civil service status from Deutsche Telecom workers, or franchises' substitution of low-wage hair cutters for licensed and experienced cutters, or hospitals' substitution of LPNs for RNs. Sheltered labour thus prefers a stable or growing budget for the public sector, to prop up demand for labour, and a continuation of licence-based barriers inside labour markets. By the same token they oppose anything more than incremental, internally driven reorganization (if any) of the public sector, and any attacks on the continued socialization—i.e. de-commodification—of risks. In effect, they seek to shelter labour markets from world market prices much as sheltered firms seek to shelter their stream of profits from franchisers. The primary method is a public sector with entrenched work norms and rules, and large enough to soak up excess (unskilled?) labour. Aside from direct beneficiaries, who anyway are almost always concerned only about their own specific income stream, this is the largest status quo constituency in the welfare state debate.

In its most positive and forward-looking formulations, this strategy tries to overcome the management problems associated with a bureaucratic welfare state in order to generate continued public support for the public sector (Rothstein 1996). It is a 'high road' strategy for the public sector, emphasizing high-quality services at, of course, high costs, and trying to occupy a market niche different from the low-cost, low-quality US welfare model. The political strategy here tries to retain the support of middle-income voters (or firms) by offering high-quality services, and then using cross-subsidies to also provide high-quality services to poor people. The political strategy here also tries to inculcate a set of values centred on social citizenship; not everything has a 'price'. Consequently, this strategy focuses much more on client service than on NPM style production efficiencies; thus it is a responsive state strategy. Only public sector labour unions possess enough organization to implement this strategy, because most private service industries have fragmented and volatile labour forces. However unionized private sector service workers in regulated product markets are also conscious defenders of their 'local welfare state', i.e. the secure employment conferred on them by sectoral regulation and market segmentation.

## 6. WHO DID IT?

Initial perceptions about the murder of the welfare state were erroneous. There are more guilty parties than most investigations allege, and the corpse is not the formal welfare state but rather the covert provision of social protection for both capital and labour through service sector regulation. RICK organized the way SAM and ILSA impinged on established forms of social protection. Because RICK shows more precisely how different internal and external pressures matter, indicting RICK overcomes the dispute about internal versus external causes, and shows why a debate about 'autonomy' is misplaced. Our composite suspects SAM and ILSA are neither wholly innocent, nor totally correct. As Hempelian non-rival explanatory sketches, they describe pressures that at least some actors feel. But these sketches impute tropism, automatic reactions, to actors' responses to market pressures. RICK provides a better underlying basis for actors' behaviour, showing why different actors react differently to the same pressures, why actors react at all to those pressures, and why more is at stake for some actors. Looking at the differential erosion of property rights, and the income streams they secure, permits us to generate a more robust causal mechanism that encompasses the causal effects on which the SAM and ILSA sketches are based.

RICK permits us to construct a stylized causal argument that runs like this: in the OECD area, states and collective actors suppressed and contained market pressures on income streams through a regulated service sector and formal welfare state during and after the 1930s. But the incomplete suppression of the market following the Great Depression allowed some firms, mostly in the USA, to generate new competitive strategies that eluded regulatory restraints in the late 1960s. As these actors searched for higher profits in banking, telecommunications and other public utilities, transportation, and retailing they provoked successive waves of deregulation in the USA in the late 1970s and early 1980s. Established, regulated firms either joined the clamour for deregulation (to survive) or exited the market. Competitive markets in the USA generated a range of new production strategies and organizational formats for franchisers and other firms that put new competitive pressures on firms outside the USA.

At the same time deregulation was occurring, the US Federal Reserve Bank shifted to a policy of disinflation, removing mark-up pricing as a plausible strategy for firms in the market. Deregulation in the USA and the Fed's commitment to disinflation set up the dynamics described above, in other countries. On the one hand, regulated firms sought deregulation for their own protection. They could not respond to increasingly plausible customer threats of exit; telecommunication regulation unravelled most quickly because 'call-back' services made exit easy. On the other hand, the Fed's commitment to high real interest rates also made it increasingly important for both exposed firms

and the state to push from sheltered sectors into the market. High interest rates made it increasingly expensive for states to simply subsidize state-owned firms given an environment in which operating losses had to be capitalized as public debt. Exposed firms of course faced 'opportunity costs' from continued subsidization of sheltered firms, and so pressed for the elimination of some local forms of social protection and the adaptation of the formal welfare state, just as they had in the USA. Depending on how groups packaged their policy proposal and coalesced with other groups, different flavours of welfare state reorganization and service sector deregulation emerged.

This process did not force states to eliminate the welfare state and did not generate political coalitions with uniformly 'neoliberal' policy preferences (i.e. a preference for a smaller, residual welfare state). Instead most states chose to reformat the welfare state around market forms of regulation. But the survival of most formal welfare state programmes should not obscure the essential disappearance of social protection in the broad service sector as deregulation and privatization thrust millions of workers and thousands of firms into the market. So the broad welfare state was murdered, even though the narrow, formal welfare state survived.

Thinking about the globalization-welfare state question as a problem of markets and social protection thus allows better answers about the timing of change; allows us to locate the sources of change in discrete political decisions in one country (solving Galton's problem); allows us to understand how external and internal changes in markets affect the interests of internal actors; allows us to understand the variety of motives (interests) underlying actors' policy preferences; allows us to understand why actors see certain policy proposals as plausible solutions to their economic problems; and allows us to understand policy proposals spanning different areas as discrete packages.

Here then, are the main points emerging from the interrogation: globalization and the erosion of the welfare state really should be understood as the erosion of politically based property rights and their related streams of income, and as reactions to that erosion. Actors with different kinds of property rights put forward policy prescriptions derived from those different property rights in fights over social protection, the public sector, and the welfare state. A strong case can be made that the causal mechanisms leading to the erosion of social protection find their origin first and foremost in the USA, rather than in markets bubbling up spontaneously everywhere. As in the nineteenth century, the (re-)emergence of markets was planned by market actors and states that stood to benefit from the destruction or reconfiguration of a range of property rights created in the 'golden era' of the Keynesian welfare state. And should we be shocked, *shocked* to find markets going on here? Hardly. As Marx, Weber, and Simmel observed at the turn of the century, once started, markets are extremely difficult to suppress. The wonder is that we enjoyed such a long and beautiful friendship with social protection.