

## **CHAPTER 1: INTRODUCTION**

### **1.1 Introduction**

Much of the literature on advanced capitalist democracies over the past two decades has painted a critical and pessimistic picture of advanced capitalism, and – closely linked – of the future of democracy in advanced societies. In this view, the advanced capitalist democratic state has weakened over time because of globalization and the diffusion of neoliberal ideas. With advanced business seen as major driver and exponent, this has led to liberalization, privatization, deregulation, and intensified global competition. In Esping-Andersen’s striking metaphor, it is markets against politics. This explains, *inter alia*, why there has been a rise in inequality (labor is weakened) and why this rise has not been countered by increased redistribution. If governments attempted such redistribution, the argument goes, it would cause footloose capital to flee. In Piketty’s hugely influential account, the power of capital to accumulate wealth is governed by fundamental economic laws which democratically elected governments cannot effectively counter. Democratic politics is reduced to symbolic politics; the real driver of economic outcomes is capitalism.

In this book we argue that the opposite is true. Over time the advanced capitalist democratic state has paradoxically become strengthened through globalization, and we explain why at length in this book. The spread of neoliberal ideas, we argue, reflects the demand of decisive voters from the middle and upper middle classes to fuel economic growth, wealth, and opportunity in the emerging knowledge economy. The “laws” of capitalism driving wealth accumulation are in fact politically manufactured. This was true to a large extent at the formation of advanced economies in the late 19<sup>th</sup> and early 20<sup>th</sup> centuries, but it is especially true in today’s supposedly borderless economy. Drawing on a wide literature in economic geography, in innovation studies and in management, we

explain how knowledge-based advanced companies, often MNEs or subsidiaries of MNEs, are increasingly *immobile* because they are tied to skill clusters in successful cities, with their value-added embedded in largely immobile highly educated workforces. As is standardly understood in contemporary economic geography, the topographical distribution of knowledge competences is of hills and peaks rather than of a flat earth. This reflects the combination of the importance of tacit knowledge (even if partly codifiable), and of the need for co-location in the generation of tacit knowledge. Educated workers co-locate in skill-clustered networks (which is valuable social capital) and therefore cannot be transported abroad, and companies cannot typically find alternative specialized knowledge competences elsewhere; thus in business school jargon ‘capital chases skills’. In the modern literature on knowledge-based MNEs, MNEs are seen as networks of increasingly autonomous companies, which get their value from the co-location with geographically differentiated skill clusters; and the payoff to the MNE derives from the complementarities which may be generated across the network from access to these differentiated knowledge competences.

In turn, skilled employees benefit both from this increased demand from FDI from abroad and also as a result of the knowledge complementarities from the FDI abroad of domestic knowledge-based MNEs. An even more profound benefit from globalization comes from specialization in advanced goods and services in the knowledge economy: the ICT revolution both decentralizes the level and multiplies up the number of groups capable of autonomous projects. This is the basis of specialization manifested in the great expansion of varieties traded across the advanced world. Rising inequality and increased poverty is a consequence of the government-sponsored shift towards the new economy and it is not effectively countered because the new middle classes are relatively secure and because the old middle classes are opposed to redistribution to the poor. Meltzer-Richard fails to provide redistribution or welfare benefits since median/decisive voters see themselves as contributors not recipients.

As noted, the national embeddedness of advanced capitalism is not new. We will argue that it goes back a long way and is fundamentally rooted in skilled workforces and a broad range of public and private institutions that promote investment in human capital and in new technology, together resulting in economic growth and prosperity. Central to the creation and continuation of this beneficial interaction between policies, institutions and investment is democracy itself. When the middle classes are educated and tied into the advanced economy, or have strong expectations that their children will be, they start to favor policies that promote growth, in part by forcing business to compete in international markets. Those with low or obsolete skills may not go along if they cannot see themselves or their children benefiting from advanced capitalism, and here we find a large audience for populist appeals. Our goal in this book is to present a new picture of the relationship between advanced capitalism and the democratic nation state that runs counter to the standard markets-against-politics perspective and explains the remarkable resilience of advanced capitalist democracies, from their beginnings in the early 20<sup>th</sup> century and through the arguably most turbulent century of human history.

## 1.2. The argument summarized

This book starts from what appears to us a major puzzle in political economy, though paradoxically one that the literature pay little attention to. This is the exceptional resilience of advanced capitalist democracies (in comparison to any other type of nation state in the last century or so). All the economies which industrialized in the nineteenth and early twentieth centuries were democratized by shortly after the end of the First World War; and apart from Germany and Japan in the 1930s and subsequent occupations they have remained advanced capitalist democracies ever since<sup>1</sup>. It is also true of the small number of newly advanced capitalist economies since the end of the Second World War (Italy, Israel, HK, Singapore, Taiwan, South Korea, Ireland): once they became

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<sup>1</sup> We see the primary driver of authoritarian regimes in the 1930s in Germany and Japan as private militias and the military; (in Austria under Dollfuss and Schuschnigg it was concern to keep out a Nazi incursion); this is discussed in Ch 2.

advanced capitalist democracies they have remained so (with the arguable exception of Hong Kong). While the correlation between per capita income and democracy is well-known (Lipset), and while the near-zero probability of rich democracies reverting to authoritarianism is well documented (Przeworski and Limongi), why this is so continues to be a black box.

What is particularly puzzling about this resilience is that it took place over arguably the most perturbed century in European recorded history (apart perhaps from the 5<sup>th</sup> century). In any case, a dominant theme in the book is how advanced capitalist democracies have responded to and shaped interactively two great technological regimes. The second industrial revolution (or the scientific regime) started in the mid-19<sup>th</sup> century and morphed into an organizational revolution of giant Chandlerian conglomerates, often described as the Fordist regime. And then the ICT or Information Technology revolution that followed ushered in so-called Knowledge economies. In addition to massive technological change, the advanced world has seen major wars, the end of empires, the rise and fall of communism, the rise of Asian manufacturing, and exceptional social, occupational and locational change. Most dramatically two deep financial crises led to prolonged depression and deep recession and slow growth.

The reader will be likely to read this book in the light of the present crisis. That is partially intentional. But from our perspective it is written in the light of the performance of the advanced capitalist democratic nation states, both as resilient and as having been responsible for the huge rise in living standards, decline in poverty and relative fall in inequality, as we will see in the next section.

Our initial motivation is to understand this striking resilience of advanced capitalist democracies. So a major concern has been to develop a broad model of advanced capitalist democracies to explain the resilience. We sketch key elements of this explanation here. We also see how this may help to solve several other puzzles about

advanced capitalist democracies, such as the continued variation in institutions and public policies despite the globalization of production.

The broad model developed in the book, we hope, goes some way to explaining this resilience, (as well as why particular periods are fragile – notably from very low growth and lack of access to necessary skills). By contrast to most other approaches, apart partially from Lindblom, we argue that there are powerful symbiotic forces explaining why democracy, the advanced nation state and advanced capitalism are generally mutually supportive, and have been so over this perturbed last century.

In fact, surprisingly, there are rather few ‘common’ models linking up advanced capitalist systems to democratic advanced nation states. Outside of Marxist works on capitalism and the state – Poulantzas, Miliband, Glyn, Streeck, Piketty, Lapavitsas (Miliband 1969, Jessop 1985, Glyn 2007, Lapavitsas 2014, Piketty 2014, Streeck 2014), there are a limited number of well-known approaches, most notably Hayek, Lindblom, Schumpeter (Schumpeter 1942, Hayek 1944, Lindblom 1977); in a somewhat different approach public choice theory; and in a quite different take, Przeworski and Wallerstein (Przeworski and Wallerstein 1982).

In common with Hayek, Lindblom, Schumpeter and Poulantzas, we see a strong state as necessary to promote successful innovation-oriented advanced capitalism, notably by enforcing competition on advanced capitalist companies (who would prefer protection and stable profits) and labor market rules to ensure workplace cooperation (against predatory unions). For both Hayek and Schumpeter, also Poulantzas, capitalism and social democracy are both enemies of such enforcement – capitalism because it eliminates monopoly profits and social democracy because it undermines monopoly wages. But in our model a central component is that the large skilled workforces of the advanced sectors of the economy, and the aspirational voters who seek to join these workforces, have interests aligned with the promotion and success of advanced capitalist

sectors, and are generally decisive voters. This contrasts with the general assumption in almost all this literature that democratic capitalism is a clash of interests between labor and capital.

Our approach, building on the alignment of decisive voters with the success of advanced capitalism, assigns a very different role to democratically elected governments, in which they play a central and activist role in an uncertain technological environment promoting change in their advanced capitalist sectors. This draws heavily on our academic background in the rich comparative political economy of advanced capitalism. From Shonfield, Chalmers Johnson, Wade, Berger, Dore and Zysman, (Shonfield 1968, Johnson 1982, Zysman 1983, Wade 1990, Berger and Dore 1996) through to neo-corporatism and the study of labor market institutions: Crouch, Schmitter, Lehbruch, the young Streeck, and Pontusson – (Schmitter 1974, Streeck 1987, Crouch 1993, Lehbruch 1993; Pontusson 2005), varieties of capitalism – Amable, Hall and Soskice, Iversen (Hall and Soskice 2001, Amable 2003, Iversen 1999), skill co-specificity and electoral systems – Iversen and Soskice (Iversen and Soskice 2001, Iversen and Soskice 2006) and Katzenstein’s seminal work on Small States (Katzenstein 1985), as well as the Regulation School (Boyer 1990), power resources theory and the welfare state – Korpi, Esping-Andersen, Rueschemeyer, Huber and Stephens (Rueschemeyer, Stephens and Stephens 1992), the developmental state (Weiss 1998, Block 2010, Mazzucato 2015), to Martin and Swank, and to Hall and Thelen and the historical evolution of institutions (Hall 1986, Thelen 2004, Martin and Swank 2008), a dominating concern of the political system has been analyzed as the effective organization and reorganization of their advanced capitalist sectors. This literature has also been concerned to understand heterogeneous socio-economic institutions across different advanced economies which underpin specialization of economic activities; a specialization we also seek to understand in this book. Given the scope for variety, advanced capitalist democracies evolve over time in response to technology and other shocks, and in turn reshape them; and they are embedded themselves in different electoral and legislative rules.

The most distinctive element of advanced capitalism in our approach has already been mentioned – the large skilled and educated workforces of the advanced capitalist sectors. Some of this has developed from comparative political economy, and much of this has developed from the literature on innovation (Dosi, Malerba, Nelson, Casper, Whitley). The skills of these workforces are tacit and co-specific both with each other and with company technologies (themselves codifiable and perhaps patented). Moreover, their tacit skills are generally learned from each other, in an over-lapping generation (OLG) logic. This implies co-location in work environments and/or skill clusters. This is widely recognized in the economics of agglomeration (Glaeser; Krugman), despite the role of the internet and global trade and finance, and it goes back to Fordist and earlier technologies. Quite generally it has pinned down advanced companies or their subsidiaries to the national environment where education and training takes place; the high value-added activities of an advanced company are thus generally tied down to this national or regional or local environment: advanced capitalism is geographically embedded and not footloose (irrespective of where the shares or patents are held). Knowledge-based multinationals (typically but not necessarily with core technologies in a particular national environment) may have many geographically embedded skill-intensive subsidiaries (Cantwell). It is only across the low-skill subsidiaries that MNCs can easily move between at low cost, leaving little rent to the countries they are in.

A second implication is geographical specialization. Specialization is deeply embedded in innovation-oriented activities. Again, this follows both from the literatures on comparative and international political economy; and also on the innovation literature including that on national systems of innovation (Nelson). Geographically embedded skills and specialization in turn lead to a second symbiosis, namely that each advanced nation in general derives complementarities from trading and capital mobility with other advanced economies. Thus advanced nations gain from globalization with other advanced nations, at least in the advanced sectors. This then is a game of strategic

complementarities. In our broad model the greater the specialization, the greater the value the community of advanced governments gain from each individual advanced economy: hence the symbiosis between the advanced nation state and the extent of advanced globalization. A hegemon may be important in protecting an advanced economy from military threats by non-advanced economies; but it is not relevant within the community of advanced economies.

The co-location and co-specificity of skilled workers, enabling and enabled by specialization, are in turn what endow the nation-state with power, and in democracies this power is used to improve the lives of a majority by creating the institutional conditions for innovation, skill formation, and growth, and by responding to demands for social insurance and sometimes redistribution. This then implies another strategic complementarity, or symbiosis, between democracy, the advanced nation-state and advanced capitalism. Democratic parties and politicians that successfully promote the prosperity and welfare of a majority will be rewarded by winning elections, and the majority will be skilled workers who are keen to see the advanced sectors of the economy thrive.

Spelled out in greater detail below, we thus see our broad approach going some way to explain the resilience puzzle.

It also explains, we believe, five related puzzles which we elaborate below: The first is the middle income trap and why so few countries have developed into advanced capitalist democracies after the Second World War. Second, why a thoroughly integrated world economy has not undermined the existence of different forms of advanced capitalist democracies – since their institutional differences cause and is caused by distinct patterns of specialization. Third why democracy reinforces advanced capitalism when it is widely thought to cause “decommodification” by majoritarian demands for policies that undermine markets in the name of equality. Fourth, and related, it goes a long way as will



be seen in Chapter 2 in understanding the distinct paths to democracy of the different advanced economies, and the limitations of generic arguments such as Acemoglu and Robinson (2005). Finally, it helps us understand why advanced democracies, despite generating prosperity and greater income equality than most non-advanced countries, have not responded to rising inequality since the late 1970s. Closely related is why ACDs have given rise to populist political movements that oppose the very elites that grow out of the knowledge economy as well as open borders and the prosperous cities and the live-and-let-live values that they give rise to. But first we sketch our basic argument.

### 1.3. Our ACD framework approach

Our broad thesis is that a relatively simple framework model of advanced capitalist democracies (ACD) evolved over a long period of time, at least over the last century – from roughly the end of the First World War by when all the early industrialisers had become democracies. In summarizing this framework more closely than above, we attach central importance to the *symbiotic* relationship between five core elements:

#### 1.3.1. The role of the strong nation state

We follow many analysts before us (for example Poulantzas, Hayek and Schumpeter, among the major theorists of advanced capitalism from quite different political perspectives (Schumpeter 1942, Hayek 1944, Poulantzas 1973)) in paying close attention to the central role of the state in putting and maintaining in place key necessary conditions for the operation of advanced innovation-oriented capitalism. The state can be thought of having four sets of tasks:

- (i) Imposing on business the requirement that product markets are competitive; this is a key requirement for there is considerable evidence that competition (so long as not too intense) is a precondition for innovation. It requires a strong state to impose competition because businesses prefer protected

markets with low risk and high profits which they share with politicians. The first country to emerge as a modern capitalist economy, Britain, did not take off until the rampant rent-seeking and corruption characterizing the political system up until the end of the 18th century was eliminated (Papa 2011).

- (ii) Imposing on labor the requirement that businesses are allowed the right to manage and to cooperate with management. If labor is too powerful, it may prefer to control production. Thus a strong enough state is needed to organize labor market rules to prevent this.
- (iii) In addition to these rules of the game, the third role of the state is to invest in a range of public goods, especially in the area of education, training and research. Here the problem for the nation state is that, if advanced capitalist companies are mobile they will take the benefits of these investments and locate elsewhere. Thus the benefits of knowledge generated in the nation state need very broadly to remain there.
- (iv) Finally the state needs to negotiate out through the political system and interest groups how advanced capitalism and the state need to reset rules and reinvest in response to shocks (Fioretos 2011).

### 1.3.2. Aligned interests of decisive voters with advanced capitalism

Why should a strong enough state behave in these market-enhancing ways? If capitalism is politically strong it will be tempted to demand protection from the state, and a state will be tempted to make bargains with it. Advanced capitalists will exchange profits with the state for protection and the quiet life. Poulantzas saw this as a fundamental problem facing capitalism. Arguably most brilliant of Marxist theorists of the 1960s to 1980s, his regional theory simply posited that the state had the ‘function’ of maintaining a

competitive environment; this both geared business to innovation, and prevented businesses from collective action such as investment strikes because of the collective action problem that they were competing against each other. This approach may appear slightly mystical, but it showed how Poulantzas was aware of the problem. Hayek was equally aware of the need to impose competition requirements on businesses if they were to compete. His concern was with democracy: he believed that voters as workers would vote for protection to guarantee their jobs. And Schumpeter was equally aware of the problem and thought that advanced capitalism would lead to corporatism and an end to a competitive environment, or that voters would choose socialism.

We take a quite different position. Along with Lindblom (Lindblom 1977), we argue that governments pursue policies supporting advanced capitalism in the nation state because the electorate, or at least decisive voters, punish governments which don't. We argue that they do so because a large number of voters see themselves as benefitting from advanced capitalism, whether directly as employees or as aspirational voters: thus we take a different line to the standard view of political economy that the interest of workers is opposite to those of capitalists.

Within advanced capitalist democracies, political parties need to build up reputations as effective economic managers: that is to say, they need to build up a reputation for maintaining and where necessary changing the product and labor market rules (mainly, competition and labor market cooperation) and the public infrastructural investments (education, skills, research, universities) necessary for innovation-oriented capitalism. We can think of these as electable parties.

An important question is what ensures a majority, or decisive vote, for these policies and parties. Who are these voters?

First, there is a large vote from employees in advanced capitalist companies. Advanced capitalism has required since the second (or Scientific) industrial revolution from the last third of the 19<sup>th</sup> century, a large skilled and educated labor force, co-specific and collocated with the technology of the company in question (Thelen 2004; Goldin and Katz 1998). It is often wrongly thought that the knowledge of the company is a technology which can be codified and patented; but almost always that technology is co-specific with the tacit skills of the workforce. The level of skills and education is relative to the prevailing technology, but management has always had to secure the cooperation or motivation of the labor force in the sense that there are significant hiring and firing costs. This is as true of semi-skilled workers under Fordism (they could easily stop the line, and replacing them involved both strikes and significant retraining costs, especially if training new workers required the tacit cooperation of existing semi-skilled workers) as of contemporary software engineers. Thus we can think of this skilled workforce as gaining rent from advanced capitalism above the competitive market value of their skills. In one form or another this aligns the interest of the skilled worker with advanced capitalism. Because advanced capitalism is skill-intensive this electorate is very large.

Second, the aspirational vote has a particular relevance in relation to advanced capitalism. By contrast to status ordered societies, *growth* in the demand for skilled and educated labor is core to the idea of advanced capitalism as a result of technological change (Goldin and Katz 2009). Hence, while aspirational individuals, parents and families have always existed to some extent, it is particularly associated with advanced capitalism. Even if parents may not themselves be skilled they can aspire to their children being skilled, which is equivalent to upward intergenerational mobility. Thus the aspirational voter has interests aligned with the success of advanced capitalism.

### 1.3.3. Specialization and location co-specificity

This is perhaps the most novel element of the argument, and it underpins the symbiosis above between decisive voters and governments promoting the framework rules and

infrastructural investments needed for advanced innovation-oriented to function effectively.

A critical and major empirical assumption we make about advanced capitalism is that (at least since the Scientific Revolution) it has been skill-intensive. That is an empirical assumption, and Braverman argued to the contrary that the microprocessor would see a fall in skill-intensity (Braverman 1998). That has not happened so far in the advanced sectors; it has arguably, as in Asian manufacturing, turned what had been advanced sectors in the Fordist era into less skilled sectors today. We will discuss different future scenarios depending on the nature and trajectory of future technological developments in the conclusion. In the contemporary world advanced capitalism is built on a large skilled labor force. More than 42 percent of 25-35 year olds today graduate with a tertiary degree in the OECD (compared to 26 percent among 55-64 year olds), and the far majority of those who do not still acquire a higher secondary degree and can expect their own children to go to university. Almost 80 percent of the working-age population in contemporary OECD countries have at least a higher secondary degree (OECD, Education at a Glance 2016)

Not only is labor skill-intensive in the advanced sectors, those skills are tacit (ie difficult to codify) and co-specific with other skilled workers, and also co-specific with the relevant technology even when the technology is itself is codifiable and thus (generally) patentable. This in turn implies that the skilled workforces of advanced companies are co-located and have to work physically together. The great Chandlerian companies of the Fordist era typically had huge plants or connected sets of plants – the advanced plants of their era - which housed the skilled workforce, often from sophisticated manufacturing through to research and development. Many find it surprising that co-location has increased in the knowledge economy, despite the internet. This is often today in the form of skill clusters, so that knowledge is geographically distributed, and both workers with

the relevant skills and knowledge-based companies wanting to tap into the relevant knowledge area have strong incentives to locate there.

This is then a picture of the value-added of companies being constituted by their skilled workforces. Because whole workforces are extraordinarily difficult to relocate (especially to another country), and because the training costs of relevantly skilled workforces abroad, advanced companies (or their subsidiaries) are relatively immobile.

This is consequential for how we understand modern capitalism. First, the common view of footloose capitalism makes little sense in relation to advanced companies, or at least the knowledge-based part of advanced companies. This is different to the behavior of MNEs in non-advanced countries. It is different to financial assets, including the ownership of companies. And it is different to the ownership of patents. But even if the technology or discovery is codifiable, it is typically co-specific with skilled workforces. In the substantive sense of the value added of its knowledge, advanced companies are relatively immobile.

Second, these collocated and relatively immobile workforces are generated both by economies of scale and scope. In the scientific revolution and increasingly under Fordism this required collocation in vast plants covering multiple interlinked activities gaining great economies of scale and also frequently of scope. It also took the form of smaller skilled companies carrying out interrelated activities. And it typically included many high value-added service sector activities, as skill clusters do now. And both in the past and now it has required differences, major and minor, across advanced nation states in knowledge competences.

#### 1.3.4. Strategic complementarities and institutional heterogeneity

Because of nationally-rooted specialization in an integrated world economy the advanced capitalist democracies are engaged in a game of strategic complementarities.

Globalization between them increases the payoffs from the game, as opposed to constraining domestic political choice or suborning the democracy of the advanced economies.

In Chandlerian companies in a Fordist regime free trade and freedom of foreign direct investment movement are both important, as they are in knowledge economies. In knowledge economies, as knowledge competences become more decentralized, so knowledge-based MNEs become more like networks of autonomous subsidiaries with complementary knowledge competences.

In both cases there is a political incentive to promote globalization across the advanced economies; but it is arguably more important in the contemporary world. There are several implications of this insight:

*A. The political power of advanced capitalism is unlikely to be strong.*

Advanced capitalist companies need to operate in an international competitive environment in the advanced democracies. That makes it difficult to solve the collective action problems (such as mutual punishment) needed for carrying out for example an investment strike, as well as sharply reducing the temptation to do so. Even in coordinated systems, business action against a government is both costly and limited to areas like training, technology transfer and wage restraint where they are unlikely to want to follow disruptive activities.

Equally, as we have seen, since companies are relatively immobile geographically, it limits both actual exit and the credibility of exit threats. The critics of capitalism are right

that footloose capital constrains what states can do; it is just that advanced capitalism is not footloose. Thus we find the idea thoroughly unpersuasive that advanced capitalism has suborned the autonomy of democracy through globalization, and is responsible for austerity, poverty and cutbacks in redistribution and the welfare state.

*B. Redistribution and the welfare state is democratically decided for better and (often) for worse*

In understanding inequality before and after redistribution and the policies towards the welfare state in advanced societies there is consequently little mileage to be gained from focusing the political power of advanced capitalism; in advanced democracies (though not elsewhere) it is weak. Instead, for understanding ‘bad’ outcomes, the focus should be on three aspects of advanced democratic systems: First, that the winners from advanced economies are typically the decisive voters – they choose re- and in some measure also pre-distribution; they or may not make those choices to compensate the losers, in particular not the poor. Second, that ‘rules of the democratic game’ differ as one moves from consensus PR based systems to majoritarian ‘winner takes all’ systems (Iversen and Soskice 2006); and further still to the porous American system in which primary elections and semi-disciplined parties enable money to buy outcomes (Hacker and Pierson 2010). Third, the level of political information among the electorate exacerbates bad outcomes (Iversen and Soskice 2015). In understanding the problematic of inequality and poverty in the advanced world it is to these aspects of democracy that we will look, and it is to these aspects that critics of contemporary politics in advanced democracies should focus.

*C. A key underlying condition for a democratic system to support heavy investments in education and research infrastructure is their geographical immobility.*



Geographic immobility relates to the rents of skilled workers and the alignment of their interests with advanced capitalism. It also critically explains the logic behind the heavy infrastructural investments needed to support advanced capitalism in the first place. For if it could be taken abroad (as companies could do in the absence of the tacit skills of the domestic workforce and their co-specificity with company technology), then incentives for governments and voters would collapse.

In the following we develop our argument further by applying it the six puzzles we identified above: the resilience of ACD; the middle income trap; democracy strengthening advanced capitalism; the rise of democracy, persistent varieties of capitalism in an age of globalization, and the lack of response to rising inequality.

#### 1.4. The resilience puzzle

The first and most remarkable puzzle is the persistence and resilience of advanced capitalist democracies over arguably the most perturbed century in European recorded history (apart perhaps from the C5th): The advanced capitalist countries which had industrialized in the late 19th and early 20th centuries had all become democracies by shortly after the end of the First World War. And apart from the Nazi regime from 1933 until 1945, and occupations in the Second World War and under the Soviet Union, they have remained advanced capitalist democracies ever since<sup>2</sup>.

Modernization theory, especially in the form proposed by Lipset, imply that economic development will lead to democracy, and that once established in rich countries democracy will be stable, and Preworski and Limongi lend much empirical support the

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<sup>2</sup> We do not include Italy in this analysis before the Second World War, since it had only a limited number of advanced sectors in relation to the size of the economy. The authoritarian regimes of Dollfuss (1932 to 1934) and Schuschnigg (1934 to Hitler's Anschluss in 1938) were primarily designed to prevent a Nazi take-over; (Dollfuss himself was assassinated by a Nazi follower in 1934).

notion that advanced countries are unlikely to backslide into authoritarianism. But like the modernization literature in general, they do not offer much of an explanation. Besides, an influential literature now exists on the fragility of advanced capitalist democracy, indicated most recently by the title of Streeck's book, *How will Capitalism End?* This is rooted in the Marxist (or alternately Hayekian) notion of a deep contradiction between capitalism and democracy that must eventually be resolved in the demise of one or the other. But to us, the big, but unasked, question is "Why are advanced capitalist democracies so resilient?"

As noted above, a key theme in the book is therefore how advanced capitalist democracies have responded to and shaped interactively two great technological regimes. The second industrial revolution (or the scientific) regime started in the mid nineteenth century and morphed into an organizational revolution of giant Chandlerian conglomerates, often described as the Fordist regime. And then the ICT or Information Technology revolution that followed ushered in so-called Knowledge economies. In addition to massive technological change, with a starting point of 1920, the advanced world has seen major wars, the end of empire, the rise and fall of communism, the rise of Asian manufacturing, as well as financial crises and prolonged slow growth, and exceptional social, occupational and locational change.

These shocks are not only externally imposed on advanced capitalist democracies. There is a dynamic logic to innovation-oriented advanced capitalism, as Kaletsky noted (Kaletsky 2010): innovation requires radical risk-taking, and highly correlated expectations and widely commonly underestimated risks especially after prolonged periods of stability can lead to financial crises (see also Minsky 1986). Major innovations, especially technological regime change, produce great benefits but at great risk of eventual financial crisis; financial crisis spills into prolonged deep recession or very slow growth. The financial crises of 1873, of 1929 and of 2007-8 all precipitated the downside of a prolonged cycle. Moreover technological regime change has major

social, locational and occupational consequences which can be divisive and disruptive; and the combination of economic and social change can generate major political pressures (as at the contemporary moment).

This is of course the fundamental dilemma of advanced capitalism: innovation and productivity growth are central to raising living standards (as well as reducing inequality and leading to democracy); but key to such growth are investment decisions based on future expectations by private entrepreneurs taking high risks in a competitive environment. It is for this reason that we attach so much importance in this book to the question of why advanced capitalist democratic nation states have been so resilient.

There are five basic elements in the answer:

1. Outside war, in pre-existing advanced capitalist democracies, we argue that the parties (and or their leaders) who get elected to power have a reputation for taking measures needed to promote the advanced sectors of the economy. They do so because that is a valence strategy across decisive voters, who are both the skilled and educated workers in those sectors and aspirational voters who want themselves or their children to gain access to those sectors. Because there is much uncertainty in this and often experimentations, mistakes will be made; but this rules out what Hayek and Schumpeter feared, namely reducing competition legislation and making corrupt deals with business exchanging protected markets for shares of profits; it also rules out adopting socialist policies, or acquiescing in labor market legislation endangering cooperative behavior by giving unions too much power.
2. The fact that the educated and skilled workforces constitute a necessary component of the value added capital of the advanced sectors, supplying the tacit skills co-specific with codified (and patentable) knowledge, as well as being

broadly geographically immobile, implies that governments will continue to invest suitably heavily in education, skills, university and research infrastructure.

3. Both the immobility of their value-added workforces implying absence of an exit threat, and the imposition of competition policy imposing costs on collective action by businesses (eg investment strikes) against government, make the political power of advanced capitalism as a whole weak. Hence they pose no threat to the implicit bargain between governments and skilled workforces to promote advanced capitalist sectors.
4. Since this is true across advanced capitalist democracies, advanced globalization as a result of specializations across the advanced capitalist democracies is a small-N network externality game (of strategic complementarities). Hence advanced globalization increases the network value of each advanced capitalist democracy, enabling individual governments to pursue the institution building strategies they see as necessary (in for example maintaining or modifying individual varieties of capitalism).
5. Since the educated and skilled workforces benefit from the effective performance of the advanced sectors, and as skilled workers with co-specific skills are most effectively unionized, they would be unlikely to take industrial action against labour market rules supportive of advanced sectors.

### 1.5. The middle-income trap puzzle

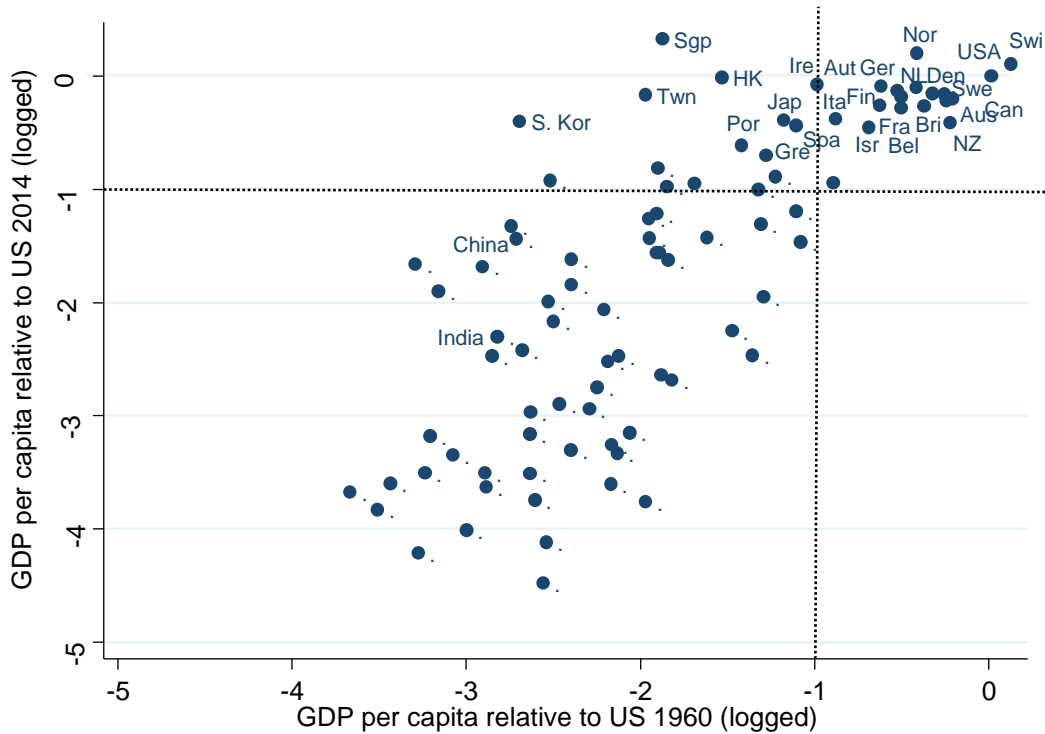
A related fact is that the group of advanced democracies has only been slightly expanded since their rise in the nineteenth century. The distribution of world income has become

marginally more equal since the 1980s, but this is virtually all due to the rise of a few populous poor countries to ranks of middle-income economies, notably China and India; not the rise of middle income countries into the high-income group. For a more than a century, entry into the advanced group has only occurred in the instances of Singapore, South Korea, Taiwan and Israel. This is illustrated in Figure 1.1, which compares the GDP per capita across the world relative to the US in 1960 and 2014. The graph includes all countries with a population of at least one million in the latest version of the Penn World Tables, except oil exporters, which do not have major advanced sectors.

Again, there are arguably four countries that have made the transition: Taiwan, S. Korea, Singapore, and Israel. This ties into our argument since in each case powerful governments were deeply committed to becoming advanced capitalist countries; Taiwan, S Korea and Singapore were semi-authoritarian so were unconstrained by democratic considerations; the Israeli government tied up the development with advanced capitalist sectors into defense concerns. In each case, governments were powerful enough to impose competition (in different ways). And when these countries became democracies, there was a powerful electoral lobby for advanced capitalism.

Although the cutoff point of one log point (about 38%) of the relative per capita income of the US is arbitrary, the group of advanced countries is tightly clustered in the top-right corner and is the same today as it was in 1960, with the exceptions of the East Asian tigers. Indeed, if we go back to the early 20<sup>th</sup> century all the rich, industrialized countries were to be found among the same small group of countries. The difficulty of breaking into this exclusive club is known in the economic literature as the “middle income trap” (e.g., Kharas and Kohli 2011). Eichengreen et al. (2012) have persuasively argued that the key barrier is the creation of large knowledge-intensive sectors sustained by internally-driven innovation. It is precisely existence of such dynamic, skill-intensive sectors that define advanced capitalism as we use it in this book. This is true today as it was at the turn of the previous century.

Figure 1.1. Income per capita relative to the US, 2014 versus 1960.



Source: Penn World Tables, version 9. Excludes countries with populations under one million, and economies based on oil production.

In fact, if one considers the distribution of the world population, the share who lives in rich democratic countries has *declined* since WW-II, and the total number of people living in these countries has barely risen. Paradoxically, in the face of this evidence most of the recent work on globalization has focused on the concern that rich countries might fail in global competition with “low-wage” countries and decline into the middle income group. But no country has suffered this fate, and the gap to middle income countries is stable. Simply put, there is no convergence; whether viewed from above or from below.

Our framework explains the middle-income trap at least in part:

1. The advanced capitalist democracy requires (*ab initio*) a strongly organized government with both the ability and the incentive to impose the relevant labor and product market rules as well as build the requisite education and research infrastructure. The incentives for non-advanced governments to do so are not likely to be fulfilled since they will have strong incentives to do protectionist deals with companies; or wish to control the companies in the first place; or with natural resources to exploit. Post-1945 exceptions were initially strongly-organized states with effective bureaucracies, an absence of natural resources, and a need for the resources to maintain a powerful military – Singapore, South Korea and Taiwan. Israel is a related case in point, where the electorate understood the military need. But absent that special case, and absent initially large skilled and educated workforces supportive of advanced sectors, there is no democratic incentive on governments to behave in this way (Doner and Schneider 2016).
2. The professional social networks and skill clusters do not generally exist to create the capacities and requisite knowledge to build innovative companies with the necessary marketing and financial linkages with other companies and the relevant markets (themselves nearly always in advanced capitalist democracies). Israel and Taiwan were able to benefit from social networks and skill clusters composed of returnees and also between networks strung between them and Silicon Valley (Saxenian 2007); Singapore and South Korea from MNEs; and in all cases rapid build-up of skills and research. These now constitute skilled and educated electorates supportive of government promotion of advanced capitalism. But it is only the rare cases where governments had the relevant incentives, connections and capacities (Breznitz 2007).
3. The democratic institutions necessary to support advanced capitalism are mostly absent. First, there has to be government support for broad-based public investment in education (and a range of supporting institutions that we discuss

later), and this in turn requires disciplined political parties that are preeminently concerned about their reputation in a political system where governments must continually appeal to electoral majorities. Reputation-based political parties are also necessary for the government to be sufficiently independent of local strongmen and business interests to ensure that they will not allocate resources or restrict competition for short-term political support. Such democratic institutions failed to emerge in most countries, in part because of strong clientilistic networks.

From this we can begin to understand why it is so difficult for middle income countries to join the rich camp. Unlike the neoclassical notion that technology is available to every country, it is in fact embedded in immovable national workforces. Advanced technologies therefore have to be built from within, and for middle income countries to acquire this capacity requires two simultaneous revolutions: one economic and another political. The economic revolution is that firms have to abandon their current product market strategies and make major investments in new technology, at the same time as the supply of highly skilled workers expands dramatically. The latter requires a political revolution since politicians have to free themselves from both educated elites who have no interest in such a major supply shock, and from clientilistic networks of existing producers and their dependent workers who want to remain protected. Competition is a requisite for technological progress, but it can be the death kneel for many middle-range producers that have to confront global competition. Moreover, because mid-range technologies rely on easily replaceable skills, any attempt by governments to impose costs or demands on business can be met by exit. So unlike advanced capitalism, the nation state in middle income countries is generally weak and short-sighted, while capital is strong.

### 1.6. The puzzle of democratic politics strengthening capitalism

It is natural to think that democracy and capitalism are on a collision course. One is based on a principle of equality (“one person one vote”) while the other is based on a principle



of market power (“one dollar one vote”). Esping-Andersen captured this tension succinctly in the title of his 1985 book “Politics Against Markets”, and it underpins the entire power resources approach to capitalist democracies. So why does democracy not undermine markets, leading to divestment and capital flight?

The first reason is that a majority of voters wants to see advanced capitalism succeed. They derive their prosperity from the success of the advanced sectors, and they therefore have an incentive to support parties that promote the advanced sectors using a variety of policies, including exposing business to competition as a means to spur innovation and growth. These policies are market-enhancing, and therefore entirely compatible with the success of capitalism as a system, though not individual companies, and they typically garner broad cross-class support. In advanced countries with large skilled workforces democracy promotes capitalism.

When the threshold into a modern economy is passed, the mutually beneficial, and reinforcing, relationship between advanced capitalism and government takes the following form:

Governments provide and/or underwrite an *institutional framework* which enables advanced sector companies to develop and carry forward their comparative advantages – we see the provision of the conditions in which advanced capitalism can flourish as a central function of advanced governments. This institutional framework covers a wide range of areas, which notably include education, vocational training and higher education, technology transfer and innovation systems, regulation of skilled labor markets and industrial relations, corporate governance and markets for corporate control, those aspects of the welfare state relevant to advanced capitalism (its insurance but not redistributive functions), trade, competition and intellectual property policy, and the macroeconomic regime.

Politically, what sustains the equilibrium is a large electoral constituency of educated workers attaching importance to the competence of government parties in managing the institutions promoting successful advanced capitalism. This constituency is supplemented in multiple ways by those who are not direct beneficiaries of advanced capitalism: there is a wide aspirational community of families concerned that their children (or they themselves) can access these advanced sectors; and there is a wider set of service sectors whose prosperity depends on the success of the advanced capitalist system. Specifically:

The electability of parties requires that they are credibly seen by this broad electorate as having the competence to manage and promote advanced capitalism. In our perspective, the possession of this competence is a valence issue across parties, (while redistribution and other policy issues may be partisan). Thus we will argue that there is a symbiosis between democracy and advanced capitalism in advanced societies. So long as the constituency of actual or aspirational direct or indirect beneficiaries of advanced capitalism is large enough that it includes enough decisive voters, then there will be pressure on governments to promote the conditions for the success of advanced capitalism.

Our key assumption is that that constituency is big enough in the advanced economies. And if governments successfully promote these conditions then that constituency is reinforced. Thus under these conditions there is a symbiotic relation between democracy and advanced capitalism.<sup>3</sup>

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<sup>3</sup> We will argue below that if, counterfactually, innovation-oriented capitalism had not been intensive in human capital, but required a small educated workforce, and say large uneducated workforces, then society might very well have been quite differently organised, with military dictatorships and so on. Advanced capitalism has labour requirements quite different for example to resource-based capitalism.

One element of institutional frameworks that needs highlighting is the one governing industrial relations and the power of unions. This gets to the core of the relationship between capitalism and politics. First, as with all other aspects of the institutional framework, governments (and the political system more generally) can only impose legislatively feasible frameworks; in the UK neither the early 20<sup>th</sup> century Liberal government nor the 1950s Conservative government could have legislated against unions had they wished to, because decisive voters were respectively skilled and semi-skilled workers. But Thatcher did this in the 1980s and Blair accepted her legislation because they did not face this electoral constraint, and because they saw this as benefitting the innovative capacity of advanced capitalist sectors. Second, disciplined industry unions and employee representation within the company have been integral to competitiveness in skill-intensive export-oriented manufacturing industries in coordinated capitalism and hence part of the relevant institutional frameworks. This was not always the case, and it only holds when companies see cooperative unionization as a better alternative in managing highly skilled employees with autonomous responsibility than individual wage/career structures and/or company-based social protection. This highlights another point:

The development, maintenance and modification of institutional frameworks is neither simple nor transparent nor typically consensual. There is nearly always conflict when major changes occur since the interests of some particular groups will be damaged. In coordinated economies organized interests have greater negotiating rights and therefore play a greater role in the process of change in institutional frameworks, while in liberal and majoritarian countries governments may simply impose decisions against the will of business (as Thatcher did in eliminating collusive agreements in finance or ending protection against hostile takeovers) let alone against unions. Our contention is that governments of advanced nations – often after long processes of consultation, argument and sometimes open conflict – generate institutional frameworks which effectively

promote comparative institutional advantages, given the pre-existing patterns of know-how and coordination.

In exchange, the economic success of advanced capitalist sectors cashes out in many ways for governments, from electoral success to military resources; governments of all political colors therefore are concerned to build appropriate institutional frameworks, sometimes conflictually – so long as they remain electorally and politically successful. To a far greater extent than recognized in the literature, governments and mainstream political parties are concerned with their medium and long-term viability, and voters reward parties for sustained good economic performance. Political parties represent distinct interests, especially in multiparty PR systems, but they also serve as bridges between the present and the future which enable voters and companies to thrive.<sup>4</sup> This does not mean that parties have no incentives to pursue short-sighted policies, but rather that such policies come at a cost in terms of lost reputation. When the economic gains from far-sighted policies are sufficiently large – in the context of an advanced economy -- the costs of reputation from short-sighted policies are correspondingly large.

The exchange between business and governments has many benefits for advanced capitalism, but it is far from maximizing the interests of capitalist companies. Their basic strategic interest at any given moment is in protected markets in which they can make secure profits with minimal and low-risk investment. That, however, is against the interests of governments who are concerned *inter alia* with tax receipts, value added and productivity, competitiveness and exports, skills and innovation and the provision of sustainable high value-added employment. Again, it is possible that some politicians are unconcerned with these issues but instead with personal enrichment, but we argue that it

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<sup>4</sup> This is also true in macroeconomics where there is little empirical support for the notion that governments in advanced countries engage in massive and frequent manipulation. In past literature the absence of political business cycles in the real economy has been explained by the limited capacity of governments to affect real economic outcomes. But today most leading economists believe that monetary and fiscal policies can have large short- and medium-term effects; yet governments do not appear to take advantage of this power for short-sighted electoral purposes.

was an element of the co-evolution of the political systems of our countries (i.e. those with advanced capitalist sectors) that this incentive was minimized. Thus:

A critical element of the institutional frameworks which governments with advanced capitalist sectors (and thus sectors capable of innovation) provide is some requirement on companies that they compete in domestic and/or export markets in order to incentivize them to innovate.

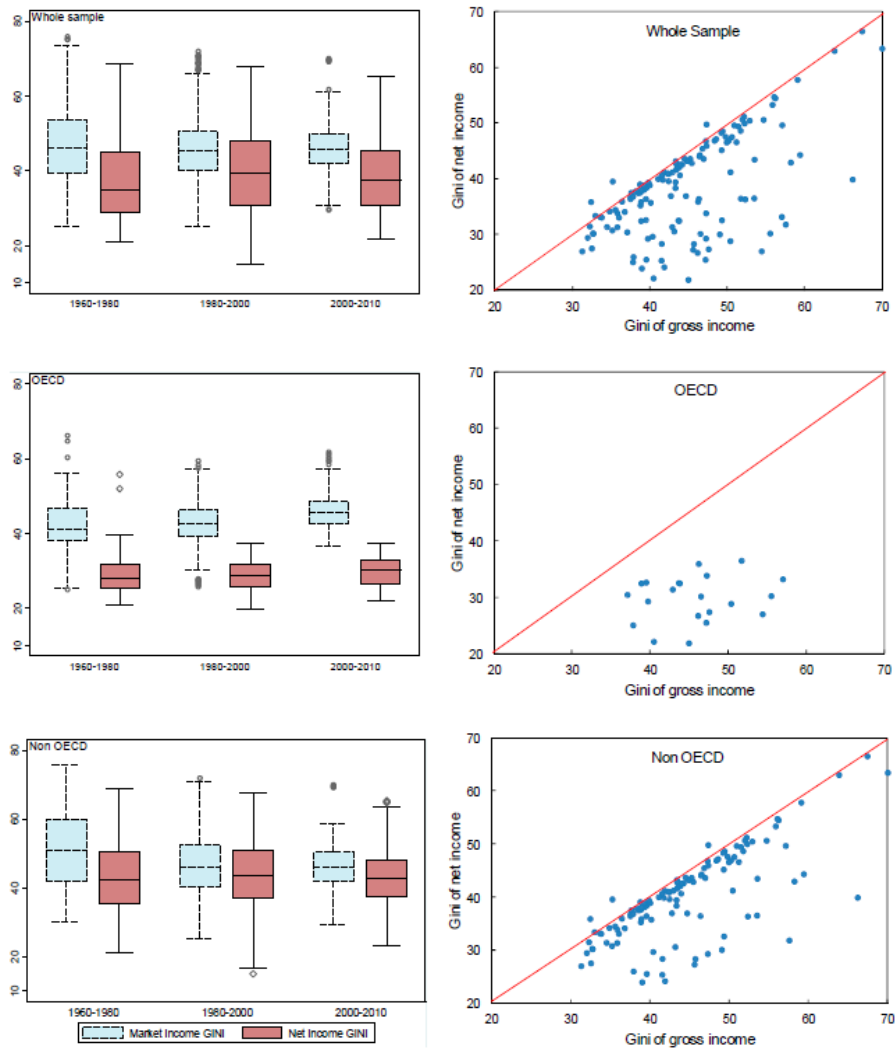
By contrast to Marxist arguments we do not see political systems setting the frameworks which capitalists would have chosen. On the contrary, the institutional frameworks of the advanced countries forced capitalists to compete and take risks rather than guaranteeing them safe and high returns on their capital. These national frameworks (in different forms) both supplied the public goods necessary for innovation, and imposed the competitive incentives to generate innovation. The political basis for these policies were educated workers and aspirational constituencies.

But within these broad efficiency mandates, governments have considerable discretion to tax and redistribute as they see fit since they are not constrained by capital mobility. Indeed, advanced democracies tend to be more redistributive compared to both non-democracies (where governments have little incentive to redistribute) and to non-advanced democracies (where governments have little discretion to redistribute). When governments in advanced democracies do little for the poor, as is often the case, it is not because they are constrained by capital but because, we argue, majority coalitions do not support such policies. Because poverty is concentrated in the low-skilled sectors there are no guarantees that democracy will produce redistribution.

Still, people in the lower half of the income distribution fare better in advanced democracies in relative terms than non-advanced countries, whether democratic or not, as

very clearly illustrated in Figure 1.2. Lower inequality is especially evident for net income, after taxes and transfers, reflecting higher levels of redistribution in advanced countries compared to other countries. Greater redistribution is partly a reflection of the role of middle classes in demanding a share of income through the democratic system, partly a result of democratic coalitions that include representatives of lower classes, and partly it is a reflection of the role of social insurance as a complement to skill-intensive production, as we discuss in greater detail below. But it also reflects the strengths of the state to redistribute, which is largely missing in low- and middle-income countries (democratic or not). These differences are very stable over time.

**Figure 1.2. The distribution of income in advanced democracies compared to non-advanced countries.**



Source: Ostry et al. (IMF Staff Discussion Note 2014).

## 1.7. The puzzle of the rise of democracy

The historical parallel to the question of how democracy can co-exist and indeed reinforce each other is how democracy emerged in the first place. Contemporary dominant theories of democratization by Boix (2003) and Acemoglu and Robinson (2005) assume that the establishment of democracy provides a commitment to each side (as it were, to rich and poor) that from then on redistribution would be based solely on democratic processes. But it is not clear why that commitment is credible; and in many non-advanced economies democracy has been overturned or subverted or put at risk.

Next, neither theory gives a role to advanced industrialization in democratization. This contrasts with the most plausible reading of Lipset (Lipset 1960; and see Wucherpfennig and Deutsch 2009). Lipset's measures of what might be thought of as a proxy for advanced capitalism (industrialization, urbanization, wealth and education) is not only strongly correlated with democracy but also with the stability of democracy. Why have explained why this is so, and the question is then how it shapes our understanding of the origins of democracy.

There are clearly pre-democratic forces pushing forward advanced capitalism. This is true for the advanced countries that emerged before the Second World War, and it is true for those that emerged after the war. They were all characterized by an authoritarian regime strong enough to impose a set of rules and invest in research and education infrastructure and to have a (non-democratic) incentive to promote advanced capitalism. Under those conditions, skilled and educated workforces are built up, generally in Chandlerian corporations in the case of the early industrialisers (Thelen 2004). These workforces, with skills co-specific with each other and with the company's technologies, are then central to the value-added of the company.



Once the transition to democracy has occurred, the sustainability of the system depends on these skilled workforces because a) they want the system of advanced capitalism to continue, since their market income depends on its market success, and b) they have the organizational capacity to block or render a return to authoritarianism very costly. By contrast to Boix's condition that capital be mobile to prevent expropriation, the ("functionally equivalent") condition is that these skilled workforces support the system of advanced capitalism. By contrast to Acemoglu and Robinson, the non-reversibility of democracy does not lie in the institutions themselves but in the organizational capacity and economic importance of skilled workers.

This then explains the conditions for democratization in advanced capitalist systems: the skilled workforces with their co-specific skills will eventually be well-entrenched enough to have the bargaining power to impose democracy on governments. And non-democratic governments – promoting advanced capitalism – will eventually accept democracy, since these skilled workforces also wish to promote it. As advanced capitalism promotes the number and bargaining strength of skilled workers, democracy becomes highly stable.

As we explain in detail in Chapter 2 advanced capitalist democracies did in fact not all develop from worker-pressure in non-democratic advanced capitalist states. In the United States and the UK, as well as Australia, New Zealand and Canada democracy was elite-imposed (Collier 1999). In our interpretation, this happened because a modernizing elite – though in very different ways in the US on the one hand and in the UK and its settler colonies on the other – wanted to minimize the influence of conservative landowning or plantation owning classes who were opposed to the education and modernization needed to build an advanced capitalist system. In the UK and the settler colonies it was designed to bring skilled workers into the class of decisive voters diminishing the role of landowners in the Lords and other upper houses, as well as in local governments. In the US the Republican ascendancy of the late C19th in effect permitted the conservative

plantation-owning Southern states, hostile to industrialization, to opt out of the development of advanced capitalism in the North.

## 1.8. The puzzle of varieties of advanced capitalism in an age of globalization

A large literature, mainly in economics, has been devoted to the idea that there is a single optimal way – a best practice -- of organizing economies to pursue growth or maximize GDP. At various stages especially in the 1980s and 1990s, the OECD, the World Bank and the IMF propagated these beliefs, sometimes referred to as the Washington Consensus. (A confusing factor is that there has been as a great increase in regulatory systems over the same period, covering the growth of complexity, uncertainty, environmental and safety issues. To the extent that we can separate these out at the moment.)

It might have been expected that advanced capitalist democracies would have seen convergence, especially in corporate governance, labor market rules, as well as institutions playing roles in training and in technology transfer. Moreover advanced companies face broadly similar conditions in international product and financial markets, and with respect to overseas direct investment. But that has not generally been the case, despite major relaxation of government rules in the last quarter century and despite the fact that companies are free to move (Hall and Soskice 2001). In fact, although corporations are now organized with greater flexibility and are more decentralized, each advanced capitalist democracy has remained different to each other: some advanced capitalist democracies are closer to each in broad variety of advanced capitalism terms, but there are many institutional differences between even Denmark and Sweden. As already noted redistribution and welfare states, while they have changed over time, remain different across advanced capitalist democracies. These institutional differences

are for the most part at national level. In particular there is a great difference in knowledge competences and patterns of specialization across, but also within, countries.

Our approach is quite consistent with these differentiated patterns, even in a global world in which financial markets are competitive and capital movements are unconstrained. These results are of course widely known (Garrett 1998, Swank 2002), but our approach makes them reasonably clear to understand.

1. The first key point is the limited mobility of skilled knowledge-based workforces in the advanced economies. Companies can seldom move a whole skilled workforce, for many reasons: social networks get fractured; the skilled workforce has typically significant bargaining power, and would resist attempts to be moved to a less costly environment where for example social protection is more limited. Nor can they usually replicate the skills of the workforce elsewhere because training in tacit skills depends largely on new employees working with existing ones who can impart the tacit knowledge. Nearly always companies or skilled educated employees depend on other companies or other facilities (including research) in the area.
2. Not only can the company not move, but it also cannot credibly threaten to do so. More generally, as noted above, advanced capitalist companies are weak politically since the state impose competitive product market rules: competing against each other they cannot easily solve the collective action problem of threatening to penalize the state. Hence advanced capitalist companies (even if they should want to do so) cannot force the state to lower corporation taxes or limit redistribution or cut back welfare states. Nor by the same token can they force states to change rules governing varieties of capitalism.

3. Most important, companies want to specialize. This has taken very different regimes: The collocated skilled and educated workforces of the scientific and Fordist regime were used in the organizational structures of giant Chandlerian conglomerates in their pursuit of economies of scope and scale to capture particular markets (Chandler 1990). The IT revolution with decentralized skill organization massively encouraged further geographical specialization as companies sought to capture lucrative niche markets and became entirely dependent on local networks of highly educated workers.
4. A key implication is that advanced capitalist democracies will have an incentive to support globalization, at least relative to the sectors in which the economies specialize. But this does not mean that globalization then suborns democracy as in a Marxist account. The opposite is the case – for each advanced country benefits more from globalization the more specialized advanced countries are drawn to the table. In this sense, it is a classical strategic complementarities (or network externalities) game.
5. Finally note that this is reinforced in a world of knowledge-based MNEs. Together with the geographical immobility of these sophisticated innovation-oriented research, development and production clusters, the impetus for nation states to encourage the globalization of FDI by knowledge-based MNEs is clear. Pushed by the immobility of knowledge and the benefits of accessing via FDI complementary knowledge based in other advanced countries, the autonomy of the advanced state is enhanced. Knowledge-based MNEs increasingly become networks of semi-autonomous innovation oriented subsidiaries, enabling core MNEs to tap into relevant complementary knowledge competences (Cantwell and Mudambi 2005).

All this enhances the power of the individual advanced capitalist democracy: for the specialization of each advanced state is desired by the others.

## 1.9. The puzzle of rising inequality without redistribution

The most vocal contemporary exponent of the structuralist interpretation of the rise in inequality is Piketty (2014) who attribute rising inequality to a set of “laws” that govern capitalist accumulation, most notably the idea that capital is rising at a faster pace than output,  $r > g$ , implying a higher capital-output ratio ( $\beta$ ) over time. But this is not in fact a law derived from first principles, or any kind of economic theory, but rather a summary (expressed through a Cobb-Douglas production function) of the evolution of wealth and income in a particular historical period, largely from 1970 and onwards. In this period -- but not, say, in the previous 100 years -- there has been a sharp rise in income and wealth inequality. The inequality  $r > g$ , and a rising beta neatly describe these trends, but they do not explain them.

We see rising income and wealth inequality instead as a function mainly of technological change and choices made by politicians trying to satisfy the demands from middle class constituencies. Skill-biased technological change is a well-established driver of income inequality, with a clearly-articulated economic logic. Because ICT technology substitutes for semi-skilled, routine tasks, while it complements high-skilled non-routine tasks, demand drives up relative wages of the high-skilled (Autor, Levy, and Murnane 2003; Autor, Katz, and Kearney 2008). Yet, even here politics is essential because the SBTC thesis only speaks to the demand side, and the supply of skilled labor is heavily influenced by government policies, in particular spending on higher education (Goldin and Katz 2007).

Democratic politics is even more important in explaining wealth accumulation. If we assume that the middle and upper-middle classes are the most important constituencies in successful governing, we must ask what these groups want. Clearly, they want to become wealthier, and a large portion of the wealth that Piketty assigns to capital is in fact in the form of housing and pension funds, which are also owned in large numbers by middle

and upper middle classes. Surely they see an interest in policies that help increase the value of these assets, and politicians of all stripes obliged from the 1990s onwards by making it easier to own real estate and to build up pension funds (Popa 2016). Indeed, as we show in detail in this book, the entire reconfiguration of financial, educational, and regulatory institutions in the 1990s and 2000s was induced by politicians eager to satisfy the demands from those who stood the best chance to benefit from the emerging knowledge economy. Especially those in the rising cities were richly rewarded by higher housing prices, better education, and ballooning private pension funds.

But if the democratic state is powerful and advanced capital weak, why was rising inequality from the 1980s not accompanied by increased redistribution? Most agree that it was not in a majority of countries. There are two parts to this puzzle; one is about the top half and one is about the bottom half. At the top end there is no doubt that financialization of the economy, coupled with the extraordinary fortunes made by entrepreneurs in the new high-tech sectors has stretched the income distribution, as documented by Piketty and others. But it is a mistake to think about this as a zero-sum game. In the most extreme case of rising top-end inequality, the US, data from the Internal Revenue Service show that the share of tax revenues paid by the top 1 percent has risen from about 20 percent in the early 1980s to nearly 40 percent in the 2000s. The latest figures released by the IRS is for the year 2014 and show that 39.5 percent of federal tax income revenues were paid by the top 1 percent of earners, while 19.9 percent came from the top .1 percent.<sup>5</sup> The bulk of total tax revenues, 71 percent, were accounted for by the top 10 percent of earners. The average tax rate paid by the top 1 or 10 percent has not changed much from the 1980s to 2014 – there was a slight drop in the 2000s that was reversed under Obama -- so this dramatic increase in top-end shares is driven by rises in top incomes. Still, high incomes are the main funders of the major middle-class programs such Medicare, Social Security, and public higher education. If rising inequality is driven by the transition to the

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<sup>5</sup> Individual Income Tax Rates and Tax Shares, Internal Revenue Service Statistics of Income, <http://www.irs.gov/uac/SOI-Tax-Stats-Individual-Income-Tax-Rates-and-Tax-Shares>.

knowledge economy, the middle and upper-middle classes have benefited, either directly through the market or indirectly through the welfare state.

But across most advanced democracies there has been no or little effort to address rising low-end inequality. We argue that the reason for this lack of government responsiveness is declining political support for expanding redistributive social programs in the middle and upper-middle classes – and the unwillingness of even the lower middle classes to redistribute to the poor. Underpinning this shift is a breakup in an alliance between skilled and semi-skilled workers, which characterized the postwar industrial economy, and the rise of new middle- and upper-middle classes of high-educated. Only where there are strong political-institutional incentives to include representatives of the weak in government coalitions have policies been responsive to rising inequality and insecurity. It is not only the poor being left behind, but also the old middle classes who had their heydays under the Fordist economy.

As we set out in more detail in Chapter 3 major underlying cause of the challenge to the postwar consensus over the welfare state was the decline of Fordist mass production since the 1970s, and the concomitant shift towards knowledge-intensive production. These changes have severed previously strong complementarities in production between skilled and semi-skilled workers. Deindustrialization contributed to this process by gradually segregating many low- and intermediary-skilled workers into insecure, often part-time or temporary, service jobs. The combined effect of new technology and deindustrialization has been a divergence in employment security and income between core and peripheral workers (Kalleberg 2003), with the college-educated in much more secure positions.

The increase in inequality and labor market dualism have been subject of a rich literature in recent years, most notably Rueda (2005; 2008), Thelen (2012), Rehm (2009; 2011), Rehm, Hacker, Schlesinger (2012); Hacker et al. (2013); Margalit (2013); Emmenegger et al. (2012); and Wren (2013). A key question in this literature, and indeed for our entire

understanding of the role of democratic politics in redistribution, is the extent to which governments have stepped in to compensate and assist workers who have been adversely affected by deindustrialization and technological change.

In past work, we have argued that in multi-party PR systems where each class is represented by its own party, there is an incentive for the middle-income party to ally with the low-income party because the size of the pie to be divided rises with the wealth of those excluded from the coalition. Majoritarian systems with a center-left and a center-right party are different because with incomplete pre-election commitment, the middle might end up with fewer benefits and higher taxes under a center-left government dominated by the left, whereas lower benefits are likely to be partially offset by lower taxes if the right dominates in a center-right government.

The qualification to his logic is for PR systems with strong Christian democratic parties. Following Manow (2009) and Manow and Van Kersbergen (2009), if parties under PR represent more than one class it opens up the possibility for governing coalitions that excludes both the left and right. The historical example is Christian democracy because these parties represent multiple groups, including skilled workers, technicians, and upper-middle class professionals and managers. These parties do not need to win elections by appealing to the “median voter”, as in majoritarian systems, but by allowing group differences to be bargained out inside the party they end up closer to the center where they can often govern with “pure” center parties, shunning compromises with the left.

In addition to these coalitional dynamics, however, we need to consider the effects of the reconfiguration of interdependencies in the economy; what we have called location co-specific assets. The Fordist economy not only tied together skilled and semi-skilled workers in the production process and in the industrial relations system; it also made them natural allies in government. This is because they were exposed to the same industrial business cycles, and while layoffs were concentrated among the semi-skilled,



trained workers with non-transferable skills were vulnerable to the same risks. These groups therefore had a common interest in unemployment and income insurance (including transferable pension and health benefits).

The knowledge economy has upended this relationship. Semi-skilled workers have largely lost their foothold in the dynamic sectors of the economy and are increasingly segmented into precarious low-end jobs in social and personal services, delinked from their erstwhile peers in industry. Some hang on to jobs in industry, but these have been declining rapidly. Instead, a new web of interdependencies have emerged in the urban centers of the new knowledge economy, organized around those with higher education. Workers with high school degrees and secondary vocational training in the old manufacturing cores are left out of this new economy, and many have fled traditional center-left parties, which are increasingly chasing the emerging urban, educated middle classes with liberal, cosmopolitan views. Many in the old middle classes have instead thrown their support behind populist parties on the right, which promise to restore the status of the old industrial (mostly male) skilled workforce while retaining core elements of the old welfare state. Immigrants, who are a core part of the disenfranchised or demobilized precariat, are left out. This new divide is not identical to the “insider-outsider” conflict identified by Rueda and others because many of the “insiders” in that story are in fact the losers in the new knowledge economy, even as “outsiders” fare worse. It is far closer to the rise of a new “cultural” (or “libertarian-authoritarian”) dimension in politics, which has been convincingly documented by Kitschelt (1995), Häusermann (2010), Oesch (2012), Kriesi and Pappas (2015), and others. These authors also show the close connection of attitudes on this new dimension to education, occupation, and location. In chapter 5 we interpret their findings from the political economy framework developed in this book, with a strong emphasis on the role of education and educational institutions. As it turns out, populist values are everywhere far more prevalent among those outside the urban centers without the skills to compete in the knowledge economy and little hope that their children will be able to, and the size of this

constituency is strongly dependent on national educational institutions and the extent to which they facilitate intergenerational mobility.

From our perspective what blocks redistribution to the lower half is not economic constraints, but political. Redistribution towards the vulnerable sectors does not involve the institutional framework that supports the advanced sector of the economy. This institutional framework covers a wide range of areas, including higher education, technology transfer and innovation systems, corporate governance and markets for corporate control, trade, competition and intellectual property policy, and the macroeconomic regime. All governments have an interest in effective institutional frameworks: this is not generally an area of partisan division even though it accelerates the shift to a more bifurcated electorate. But redistribution towards the poor and lower middle classes, and in general the protection of workers in the vulnerable sectors, is not part of the institutional framework of advanced capitalism. What makes advanced democratic capitalism resilient is the continued expansion of education and opportunity in the advanced sectors for the new middle and upper middle classes, who ultimately prevail in politics. Only in extreme crises like the 1930s is there a serious risk that populism grow so widespread that the foundations of both capitalism and democracy come under attack. Nonetheless the cleavage between traditional mainstream parties, especially on the center-left, and rising populist parties is the most salient political division in the knowledge economy. In fact it illustrates the political logic of advanced democratic capitalism and why it is so resilient.

### 1.10. Contrasting our approach to existing literatures

In political economy there is a long tradition for analyzing the interplay of markets and politics, but while it offers a nuanced view of politics, it substitutes a detailed understanding of the organization of firms, production, and labor for broad notions of “markets”. The modern literature on voting behavior in the advanced democracies or

political parties or electoral systems or the operation of legislatures or even economic policy-making and the welfare state talks little of the world of advanced capitalism or organized business or multinational companies. By contrast, firms and how they are organized are often at the center of analysis in business schools, industrial economics, and business history, but this literature rarely considers the role of political institutions: governments, political parties, electoral systems, and voters. The Marxist tradition, and some of the work inspired by it, considers structural constraints on democratic politics, and this is what leads it to erroneously conclude that the nation-state is weak and capital strong. Precisely the opposite, we argue, is the case.

A left critique of capitalism has long engaged some version of the above questions. In one form or another, it has argued that capitalism captures the political system and uses it to produce or underwrite an unequal distribution of property and incomes. The Marxist theory of the state sees the latter as representing the interests of capital ('the executive committee of the *bourgeoisie*' in Marx's phrase); it takes its most sophisticated early form in Poulantzas (1973; 1978), later taken up by Block (1977), Wright (1979), and Jessop (1982), and in the more instrumentalist version of Miliband (1969), where senior judges, civil servants, and politicians share schools, universities, gender, ethnicity and therefore interests with capital. Lindblom (in *Politics and Markets* 1977) argues that voters can only demand of elites what 'elites are prepared to give them', and envisaged business as successfully imposing its demands on voters; in this approach governments comply with business demands fearing that otherwise business will engage in investment strikes, thus worsening economic performance and hence government re-electability (see also Block)

In Przeworski and Wallerstein (1982) there is a compromise between capital and labor, and the terms of this compromise can be seen as the main source of variation in Power Resource Theory (Korpi 1983, 1989, 2006; Esping-Andersen 1985; 1990, Stephens 1979; Huber and Stephens 2001). This perspective suggests that political outcomes are a

function of the strength of business and its political allies relative to labor and its allies, as captured in Esping-Andersen's celebrated title *Politics against Markets*. Esping-Andersen is well aware that there are more than two classes, and that much depend on alliances across classes, but at the end of the day the key outcome is the degree of decommodification, which is a measure of the strength of the state versus the strength of the market.

More recently, writers from a wider left tradition have critiqued the subordination of politics to advanced capitalism: Hacker and Pierson (2011) do so in relation to the extraordinary inequalities of the U.S. and the stagnant incomes of middle-class America. For Simon Johnson the great investment banks, with close links to successive administrations, caused the financial crash. Streeck (2009; 2011), in an explicitly Marxist vein, attributes to advanced capitalism what he sees as the collapse of Durckheimian solidarity in the German political economy and its convergence on the Williamsonian instrumentality of the U.S. after a struggle which democratic politics was doomed to lose. Susan Strange predicted the hollowing-out of the nation state by the growth of huge multinationals. For Rodrik (1997) globalization, especially low-wage competition and the ability of companies to locate wherever they want, now threatens the foundation of the welfare state. Glyn's *Capitalism Unleashed* (2007) offers a *tour de force* of the political economic history of the last four decades and argues that advanced capitalism – with the continuing support of the state – has had adverse economic consequences on distributional outcomes (the share of profits, income inequality, the welfare state) as well as unemployment and financial stability. Central to all these arguments is the claim that advanced capitalism has neutered or bought-out or taken-over or suborned democratic politics to act in the interests of advanced capitalism<sup>6</sup>.

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<sup>6</sup> What exactly are these mechanisms is seldom fully explicated. In the more Marxist approaches, there is a hint of reification of capital – that the political superstructure has the function of supporting capitalism. An institutional perspective is that big business is powerful enough politically to force governments away from what they otherwise would have chosen in responding to electorates. A version of this, repeated below in public choice theory, is that of the political market in which politicians votes are for sale. A different type of argument is that the straightforward operation of markets constrains more or less sharply what governments

No one has drawn out the political implications of this perspective more succinctly than Wolfgang Streeck, a sociologist, and Thomas Piketty, an economist. According to Streeck “[m]ore than ever, economic power seems today to have become political power, while citizens appear to be almost entirely stripped of their democratic defenses and their capacity to impress upon the political economy interests and demands that are incommensurable with those of capital owners” (2011, 29). Streeck reaches this gloomy conclusion in a section called “political disorder,” which refers to the notion that democratic politics has been reduced to symbolic protest politics because there is simply little left that governments can do: “No government today can govern without paying close attention to international constraints and obligations, including those of the financial markets forcing the state to impose sacrifices on its population.” (p. 26).

Piketty attributes this defeat of democratic pressures for redistribution to the dark inner workings of the capitalist system, which concentrates output in the owners of capital. Defining “capital” very broadly to mean not only the means of production, but to include *all* property such as pension funds and real estate, he shows that the share of capital in total output has risen more or less continuously from the 1970s, resulting in very small and very rich upper class while ordinary people (“labor”) suffer. Indeed, Piketty suggests that the tendency for capital to grow faster than output ( $r > g$ ), measured in this manner, can be understood as a “law” of capitalism (not unlike laws of accumulation claimed by Marx). Piketty offers no analysis of democratic politics, but the implicit assumption is that labor and the state are too weak to offer a serious counterweight to capital, which then drives down wages and escapes taxation. It is a deeply structuralist argument – there

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can do. An implication is that these constraints tightened as markets liberalized in recent decades. And an argument advanced forcefully is that governments were constrained against expanding public expenditure by the liberalization of financial markets.

are no agents or choices to be made and elected governments are relegated to the sidelines.

There is also a right critique of democratic capitalism, in public choice theory and in the Chicago School. In this critique politicians are rent-seeking. For the politician the financial cost of awarding protection to an economic group is virtually zero, and different groups may bid for protection thus raising the cost to them of doing so. The real cost is economic inefficiency as a result of price distortions, and a transfer of resources from capitalists to politicians and from consumers to producers. Such “redistributive coalitions” imply a switch in investment from the real economy to investment in politicians and the regulatory agencies put in place to restrict competition and raise prices (Buchanan and Tullock 1962; Brennan and Buchanan 1980; Peltzman 1976; Stigler 1971; Krueger 1974; Olson 1982). In the words of Robert Bates: “Public choice theorists divided the world into two spheres: the sphere of choice, where markets ruled, and the sphere of coercion, where the powerful governed. In the one, exchanges were voluntary and generated welfare gains. In the other, the powerful extracted involuntary transfers; while one person might gain, it could be at the expense of another. Liberty thrived in the one realm; tyranny threatened in the other.”

Particularly for economists the attraction of public choice theory is a well-articulated and rational-choice based institutional model of politics, quite in contrast to the left critique. It also reverses the left perspective on globalization because restrictions on trade are seen as a form of inefficient rent-seeking (Magee, Brock, and Young 1989). Still, there are points of tangency with the left critique – notably, corrupt politicians and the loss of welfare for the majority. Also, the two approaches agree – from opposite ends of the political spectrum – that democracy and capitalism are at loggerheads. Hayek wanted to sacrifice democracy to save capitalism; Streeck is advocating the opposite. For both critiques the interaction of capitalism and politics is *dysfunctional*.

In this book we take a very different approach as outlined above. To us capitalism and democracy are both necessary for prosperity, and rising inequality in the rich world is ultimately a consequence of – or one might say failure of -- democracy, not capitalism. As with the left critique we want to explain the current worsening of poverty and the lot of low-skilled and semi-skilled workers in many developed nations; as with the right critique we want to explain the ties between organized business and politicians. But we also want to understand the persistent power and dominance of the advanced nation state – forecast away by globalization theorists. We want to explain what we see as the extraordinary resilience of the institutions of advanced capitalism and of democracy over the last century in developed nations. In sharp contrast to the critique of democratic capitalism as dysfunctional, we see a fundamental and mutually beneficial relationship over long periods of time between advanced capitalism and democracy – specifically between the advanced capitalist sectors of developed economies and their governments.

A central feature of the organization of both capitalism and politics from the industrial revolution to the present day is that advanced capitalist sectors, despite ample opportunities to invest globally, are largely confined to the developed economies; and both advanced capitalism and politics are largely nationally organized in these economies. We argue that the relationship between advanced capitalism and politics has been responsible for raising the standard of living of the mass of the population in the developed world – from the pervasive poverty of the mid-19<sup>th</sup> century to widespread contemporary affluence; but, in a fateful consequence to which we return later in the book, the state-economy relationship has also been responsible for confining that widespread affluence to the developed world. Our argument is about advanced capitalism, not about developing countries.

Advanced capitalism has been directly beneficial because it has been responsible for most of the technological and organizational change of the past two centuries in the developed world. Governments of advanced countries, concerned to promote these changes, have

provided or underwritten the institutional frameworks seen as necessary to generate comparative advantages. Critically for organizational and technological change, and against the interest of capitalists to create protected and low-risk markets, governments have also imposed the requirement of competition, domestically or internationally, on their advanced sectors. Competition has been central both to stimulate innovation and efficiency, and to limit monopoly profits.

Secondly, advanced capitalism has provided a continuous flow of investment in capital, infrastructure, and, above all, labor, despite much lower cost alternatives in low and middle-income countries. Governments have facilitated this by providing the necessary institutional infrastructure and a stable and predictable macroeconomic environment based on political parties with a concern for reputation, despite short-term electoral temptations to inflate and borrow on the future.

Finally, for much of the postwar period advanced capitalism, with its requirements for skilled and semi-skilled employment, has further raised real wages through facilitating unionization (often unwillingly) and needing to set efficiency wages; and the political system responding to electorates has underwritten this as well by raising reservation wages and by providing a general education system to sustain a productive workforce.

For this general equilibrium to work – for the symbiosis to be sustainable -- we submit that advanced capitalism is politically weak. Contra the left critique, advanced capital cannot easily relocate beyond national borders in response to redistribution, and contra the right critique, it cannot escape competitive pressure within national borders by buying off politicians. Unlike both critiques, democratic politics is the main guarantor of prosperity in advanced countries, and when large numbers of people are excluded from sharing in this prosperity it is again a problem with democracy, not with capitalism.



Within the national boundaries that business cannot escape, the main actors are knowledge-carrying companies of advanced capitalist sectors and their workers<sup>7</sup> in which most of their knowledge is embedded, together with the political parties and governments of the advanced countries in which the advanced sectors are located.

### 1.11. Conclusion: Coevolving Systems

In this concluding section we summarize the main elements of our approach and the implications for the study of politics and capitalism.

1. *The primacy of the democratic state.* The central idea in our basic theory of the relationship between politics and capitalism is that advanced capitalism is driven and maintained by national governments who are concerned about the long-term competitiveness and strength of their national economy. Governments are comprised of leading politicians, typically with careers within a political party, whose concern for economic strength largely derives from the long-term economic concerns of party supporters – determining whether they vote or abstain or even switch party adherence; hence feeding back into their future careers directly and via the support from lower level party politicians. Economic strength in turn increases the capacity of government in a wide range of areas, and from this leading politicians also benefit. Thus we see the framework of advanced capitalism being conditionally promoted within the political framework of relatively long-lived parties with overlapping generations of politicians and supporters as well as – critically – potential voters with equally long-term and often loose party identification to whom a well-functioning economy is of great importance. Political promotion of the framework of advanced capitalism is conditional on its being consistent with winning elections.

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<sup>7</sup> ‘Workers’ is used as a catch-all term to include professionals, technicians, as well as skilled workers on the shop floor.

A central element of the institutional framework is the requirement that advanced sectors are exposed to competitive export and/or domestic markets in effect to force companies to innovate. This goes against the interests of capitalists, who want to create monopolies and to reduce risk, but business has limited ability to pressure governments to adopt its preferred policies for two basic reasons: (i) Advanced companies are domestically anchored, so they cannot threaten exit. (ii) Companies are set up as independent to compete and make profits, so that their collective voice is limited. We have underscored the role of coordination across companies in coordinated market economies or of their buying into the political and regulatory system in the US, but these fundamental institutional weaknesses of capitalism remain. (iii) With a high stock of location co-specific investment and long-term oriented politicians, the gains from, and opportunities for, rent-seeking are limited.

This political weakness of advanced capitalism extends into all areas outside the institutional framework. In particular advanced capitalism has no impact on decisions over redistribution and poverty, the protection of the low-skilled including their unionization and the operation of low-skilled labor markets. These issues are determined by majorities or coalitions in legislatures. Whereas political positions on institutional frameworks are non-partisan, positions in these other areas are likely to be partisan. It is true, of course, that business opposes redistribution, but it has no credible way to threaten exit or disinvestment because it depends and thrives on the infrastructure of location co-specific assets that is embedded in advanced sectors of the economy. Massive redistribution where such threats would become credible are not in the interest of politicians who largely cater to the winners of the transition to the knowledge economy, who have no interest in such redistribution.

2. *Political economies are spatially anchored.* Our argument explains how institutions (especially overlapping generations of knowledge bearing companies and workers) remain within the same *space* over long periods of time; indeed how knowledge – which

should in principle be almost costless to move – remains in particular locations. Unlike most work in the comparative political economy literature but in line with that of business history, the knowledge-bearing company of advanced capitalism is seen as the carrier of technical, market and organizational ‘know-how’ across time but within a national or more narrowly defined space. We model such companies as complex webs of locational co-specific assets embedded in overlapping generations of employees.

Knowledge-bearing companies range from great long-lived multinationals to short-lived high-tech start-ups in agglomerations of such companies. High-skilled workers share know-how embedded in locational co-specific assets with other workers in companies, but they also share social locational co-specific assets with families and friends and colleagues, frequently in high skill agglomerations in the major cities. As noted above in our quotation from Ha-Joon Chang, networks of highly-skilled employees of any size cannot be moved geographically by companies without great cost. High-skill agglomerations are nearly always defined within the advanced nation state and generally within a narrow area. If companies want to access the know-how of an agglomeration they have to set up subsidiaries located in the agglomeration; this is a major motivation for the spread of MNC subsidiaries across the developed world in pursuit of complementary technologies (Cantwell, Kummerle). In addition, companies and their employees operate within institutional frameworks covering technology transfer, universities and research institutes, training systems, industrial relations, and corporate governance. We argue that these forces reinforce agglomerations and generate centripetal pressures at local, regional and national level. In these senses we describe advanced capitalist sectors as domestically-anchored. Thus methodologically we see our work – micro-founded in complex spatially-defined webs of co-specific assets – as tied to the economics of geography and specifically the economics of agglomerations and social networks.

If advanced companies are the spatially-defined ‘people-carriers’ of know-how over time, political parties are the spatially-defined ‘people-carriers’ of their interests. Precisely because interests are locally embedded, political parties representing these interests have to be as well. This is why the communist dream of an international labor movement has largely remained unfulfilled. Yet, the effective representation of interests is by no means straightforward. Parties face two problems in particular: first, they have to balance narrow firm-based interests at the local level with broad sectoral and class interests at the national level; secondly, they have to balance the long-term representation of interests with the short-term temptation to use public policy to buy votes. Much of the economic success of advanced democracies is owed to the fact that political parties have managed this balancing act by building strong national organizations and by cultivating a reputation for responsible, far-sighted government.

This fortuitous development, we argue, is rooted in the coevolution of advanced capitalist institutions and advanced democratic institutions. The emergence of national industries in the early 20<sup>th</sup> century, and the concomitant development of a centralized labor movement, prompted the development of national political parties, which in turn provided much of the regulatory infrastructure for the continued growth of advanced national firms. In countries that transitioned to proportional representation, parties were closely tied to distinct interests and electoral markets became segmented with limited inter-party competition for votes. Where electoral institutions remained majoritarian, investment in human capital was concentrated in the urban middle classes, which came to dominate national politics. Yet, there are important variations within each political system. Federalism accords greater representation to regional interests, and presidentialism fosters weak parties that give large firms and local interests a greater say over public policies.

3. *The system of representation underwrites the economic system.* The institutional patterns of both advanced capitalism and of (usually) democratic politics have varied across the advanced nations but with stability over time. In particular, coordinated

capitalism has been associated with negotiated political systems and liberal capitalism with competitive political systems (Martin and Swank forthcoming). There have been relatively stable differences within these broad varieties, as between the centralized British and decentralised American political system, and associated differences in their institutions of capitalism. Other notable differences are between Sweden, Germany and Japan.

In our model the stability of these institutional patterns reflects the nature of investments which advanced companies have made given the degree of protection afforded by the political system, and the concern of governments to maintain a political system supportive of the comparative advantages of companies. The clustering of coordinated market economies with consensus political systems, and liberal market economies with majoritarian political systems, follows directly from our logic of the set of rules and understandings governing the production and maintenance of skills and their insurance. Yet we want to underscore commonalities. Whatever the set of rules and understandings, its framework is underwritten by the democratic political system. This is what sets advanced capitalism apart from non-advanced countries; whether democratic or not.

4. *Wage coordination and welfare states secure co-specific assets.* Union centralization and/or coordinated wage bargaining plays a major role in our argument in determining the equality of the earnings distribution. For us this derives from the different nature of skills in different varieties of capitalism. Groups of workers are strong when they can credibly threaten to hold up employers. This is a consequence not of employment or skills per se—employers can in principle replace workers with general skills at low cost—but of skills that are costly to replace and whose withdrawal is costly to the employer in lost production. Thus *co-specific* skills cause particular problems for employers; and for employers to invest in them, they need the assurance that wages will be set *outside* the company, whether across the industry or more widely. Otherwise they

risk holdup by their skilled workers. Hence, employers support disciplined unions and industry or economy-wide bargaining.

Workers with co-specific assets also have an insurance need for strong unions and coordinated wage bargaining. The reason is that they face a similar holdup problem by employers since it is difficult for them to employ their skills elsewhere, and they also face the risk that their skills could be made obsolete by technological change. So just like employers, they need to know that the return on their investment in co-specific assets is safeguarded. Hence we see coordinated wage bargaining and social protection as stemming in part from an insurance need for co-specific asset investment by both employers and workers in coordinated economies.<sup>8</sup>

In part wage compression reflects the relative power of workers with different skills. When skilled and semiskilled labor are strong complements in production, even small groups of workers have the capacity to cause serious interruptions in production. Semiskilled workers in that situation become *de facto* co-owners of specific assets (specialized machinery and skills), and they gain bargaining power as a consequence. The most prominent example of this logic is the rise of Fordist mass production, where interruptions anywhere in the assembly line could shut down the entire production process. Not surprisingly, we argue, this is a period with falling wage dispersion across countries. Conversely, the end of Fordism in the 1980s was associated with a rise in wage inequality as the complementarities between semiskilled and skilled workers unraveled.

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<sup>8</sup> Reinforcing this is the fact that in coordinated economies, employers and unions have the capacity to resolve the negative externalities of uncoordinated bargaining on inflation or competitiveness, because otherwise higher unemployment is needed to stabilize inflation or the real exchange rate. They also have a shared interest in doing so.

5. *Globalization strengthens the state.* Finally, our model of national governments choosing institutional frameworks to promote their own systems of advanced capitalism leads to a reinterpretation of common views of globalization.

In our analysis globalization is not capitalism unleashed but the choice of advanced national governments in response to the collapse of Fordism as a competitive organizational technology and the onset of the information technology revolution. Eliminating barriers to trade and capital mobility is seen to promote the interests of their advanced sectors – both to enable domestic multinationals to access complementary foreign technologies and markets requiring customization, and to enable foreign multinationals to access their national technologies and markets<sup>9</sup>. They are not, we argue, threatened by footloose multinationals, still less by political coordination of foreign multinationals. Indeed, protectionism in the 1930s came on the heels of the hitherto most globalized economy, and it happened because of domestic pressure for social protection in the face of mass unemployment, and against the interest of big capital.

The welfare state has since assumed the role that trade protectionism once disastrously filled, what Ruggie calls embedded liberalism, and globalization has come in response to the endless search of advanced country governments for greater prosperity. Trade facilitates specialization in lines of production in which companies have a comparative advantage because of the institutional framework. Trade therefore also entrenches and facilitates cross-national differences in institutions, and this is reinforced by foreign direct investment. We see more tendencies toward convergence in non-traded, low-wage service sectors where flexibilization of labor contracts is a common trend in the past two decades. Still, most evidence confirms that there have not been races to the bottom in redistribution or corporate tax rates (Swank 2002). Moreover, in all these cases

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<sup>9</sup> Governments are interested in the strength of their advanced sectors and not just their domestic multinationals. The UK and US governments are keen to attract to German and Swiss banks to Wall St and the City.

differential outcomes are determined in our analysis by domestic political coalitions. Thus we conclude that it is to be expected that governments of advanced countries with strong advanced capitalist sectors are the dominant powers in the contemporary world: not the EU, nor multinationals, nor transnational standard-setters, public or private.

6. *The transition to the knowledge economy has transformed the party system.* There is a rich literature on the de- and re-alignment of electoral politics and party systems across advanced democracies (Kitschelt, Kriesi, Hausermann), which shows that the traditional left-right dimension has been complemented by an increasingly salient cross-cutting “cultural” dimension. Positioning on the two dimensions are closely tied to occupation and location, and we provide a political economy explanation for these linkages. Broadly speaking the knowledge economy has produced a large number of highly-educated people, most of whom reside in the urban centers. As we have argued, these centers are hubs for economic and social networks based on co-specific assets, and they are the engines of economic growth. People who thrive in this new economy typically support the entire institutional infrastructure that underpin the knowledge economy – most obviously investment in schools and education, but also public goods such as libraries, parks, culture, neighborhood development, and social services that make the urban space an attractive and secure place to live and work. Ethnic, sexual, and cultural diversity is largely seen as complements to a thriving economy, and the extensive opportunities for forming social networks with like-minded do not require conformity to any particular norm set.

Those with lower education, working in occupations outside the advanced sectors, and typically residing in smaller towns or stagnating suburbs, by contrast, see little advantage of policies that are advantaging the urban centers, and they generally oppose ethnic-cultural diversity, which is seen as a threat to their own conformist life styles and a source of competition for scarce jobs and welfare benefits. This does not supplant the distributive cleavage in democratic politics, clearly, but it does add a spatial dimension to



that cleavage and it does mean that there is now a large constituency for populist politics concentrated among those whose skills, occupation, and past are closely connected to the old and disappearing industrial economy.

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