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## Chapter 12

### Growth Strategies and Welfare Reforms in Europe

Sonja Avlijaš, Anke Hassel, Bruno Palier

#### 1. Introduction

This chapter ends our journey exploring the role of growth strategies and associated welfare reforms in the evolution of advanced capitalist economies. The key argument of this chapter is that welfare reforms are institutionally and politically linked to countries' growth strategies, i.e. their adaptations to the new eras of growth since the 1980s. Linkages between welfare systems and growth regimes (and economic activity more generally) are rarely made in the social policy literature. Usually, the main explanation for welfare state reforms provided by this literature refers to socio-demographic changes such as aging, entry of women into the labor market, and emergence of new social risks (Esping-Andersen 1999; Bonoli 2005; Hemerijck 2013). More recent research on the politics of the welfare state highlights changes in citizens' preferences for explaining welfare state reforms (e.g. Gingrich and Häusermann 2015). Here again, there is no link between welfare state reforms and national economic strategies. When welfare state reforms are linked to economic issues and policies, they are often portrayed as being imposed by generic global factors such as globalization, neoliberalism, and austerity, but not as mitigated by countries' institutional and political idiosyncrasies.

Yet, in practice, when welfare systems have changed (Hemerijck 2013; Palier and Hay 2017; Taylor-Gooby et al. 2017), their transformations have not been the same across all countries; they have not followed the same timing or the same logic, although the countries were exposed to the same exogenous, socio-demographic or economic forces of change. Why did the United Kingdom reform its pension system much earlier than Germany, despite the much stronger demographic pressure in Germany? Why did pension funds develop more in English-speaking and Nordic countries than in Continental and Southern Europe (Ebbinghaus 2011; Hassel et al. 2019)? Why did governments liberalize labor markets much sooner in English-speaking countries, and why did governments in Continental Europe only partially pursue this path, mostly affecting atypical employment (Emmenegger et al. 2012)? Why were social investment policies (i.e. policies aimed at investing in and mobilizing human capital and capabilities) taken up more fully in Nordic countries than in Southern or Eastern Europe (Morel et al. 2012)?

This variety might simply be explained by welfare regime path dependence. But we see significant variation in how the countries' reforms correspond to national institutional contexts: while some reforms fit the country's institutional legacy (path-dependent reforms), others do not (path-breaking reforms), as Thelen shows in her chapter (this volume) with the cases of Sweden and the Netherlands. Moreover, even if path dependency plays a major role in shaping the trajectory taken by changing welfare states, it does not explain why there have been reforms in the first place, or the specific content and timing of these reforms. Simple adjustment to demographic and social changes or to changes in individuals' preferences cannot explain the timing and content of the observed reforms.

In this final chapter, we rely on previous chapters of this volume and on other research on welfare state transformation to demonstrate that referring to national growth strategies helps in understanding welfare reforms. Our key proposition is that welfare system reforms are part of a government's economic growth strategy. Economic growth and job creation are key concerns for governments, since these are two goals for which the government is most accountable to its electorate. As presented in Chapter 1, all the actions taken in order to boost growth and job creation comprise what we call growth strategies. We do not conceive of growth strategies as a strategic plan of action, premeditated by a specific government, but as a trajectory of reforms that emerges over time through a series of trials and errors and interactions between policy-makers and electoral and economic pressures (see chapter 1). In that sense, growth strategies are not necessarily explicitly embedded in government policy discourse. Nevertheless, we argue that identifying and analyzing specific national growth strategies (as a pattern in a series of economic and social decisions) are necessary for understanding the content and timing of welfare state reforms. There are different ways to boost growth and jobs, and we contend that these differences explain a substantial part of the welfare system reforms that have occurred since the 1980s.

In Chapter 1, Hassel and Palier claim that five main growth regimes can be distinguished in contemporary advanced capitalist democracies. Working within these regimes (and sometimes in spite of them), governments in advanced industrialized European countries have pursued distinct strategies to generate growth in the post-Fordist era. In this chapter, we link these specific growth strategies to specific welfare state reforms:

- The high-quality manufacturing-based export-led strategy relies on wage moderation and on the protection of labor market insiders to maintain its international competitiveness, resulting in labor market and social protection dualization.
- The export of dynamic services strategy focuses on innovation and investment in a high-skill workforce to maintain product quality and develop new products and services. It requires financialization for promoting innovation capacity as well as social protection and social investment for developing a flexible but well-protected workforce.
- The FDI-financed export-led strategy attracts foreign investors with low corporate taxes and through specific social and educational policies that prepare the workforce for foreign investment. It relies on cost containment, but also on some compensation for the main "losers" of the strategy.
- The financialization strategy is related to the privatization and marketization of housing and pensions (but also education and other social services) to fuel the financial services industries.
- The publicly supported domestic demand-led strategy aims to stabilize employment and growth by keeping domestic demand steady through high minimum wages and social benefits.

Interactions between welfare system reforms and growth strategies are not automatic or purely functional. Reform attempts can have other goals (electoral, redistributive, coping with new social risks, and so on) and may create tensions between economic strategies, on the one hand, and social and political goals and interests, on the other. For the sake of our argument, the focus

of this chapter is on the theoretically proposed complementarities between growth strategies and welfare system reforms. In reality, however, some of the “ideal typical” welfare reforms (which would be compatible with a country’s growth strategy) may have been impeded in some cases, at least partially, due to electoral pressures, especially where the population has concerns about inequality or where the dynamics of electoral and party competition have trumped the economic growth agenda.

As we show in our empirical examples, there is no single mechanism connecting growth strategies and welfare reforms. The interaction between growth strategies and welfare system reforms can take place via at least three different mechanisms: i) the welfare system acts as an input for growth; ii) the existing welfare system is perceived as an obstacle to growth, so there is a need to reform, cut, or transform it to stimulate growth, and iii) growth takes place without positive redistributive impacts, so the welfare state is strengthened as a compensatory tool.

Evolving trajectories of growth and welfare regimes have made countries more distinct rather than similar over time. This becomes especially clear when we analyze the different mechanisms through which countries’ growth strategies have shaped welfare reforms. We show that when seemingly similar reforms of the welfare system are driven by different growth strategies, the design and properties of these reforms differ, as do their implications for the country and its citizens.

This chapter is divided into four sections. Section 2 theoretically links the five stylized growth strategies to welfare system reforms. Section 3 traces the proposed linkages between growth strategies and welfare state reforms empirically by mapping key reforms of the welfare systems in several European countries. Section 4 brings the discussion back to the politics of growth and welfare in capitalist democracies.

## **2. Growth strategies and welfare state reforms: the theoretical linkages**

Several chapters in this volume have identified exports and domestic demand as the two key drivers of economic growth (especially Baccaro and Pontusson; Picot; Scharpf). Hassel and Palier have shown in Chapter 1 that export-oriented economies rely on exporting high value-added services or manufacturing goods (of a greater or lesser quality), while domestic demand-driven ones can pursue stimulation of domestic demand via either private debt or wage and welfare benefits. All approaches have direct implications for welfare reforms. We start here by reviewing the basic connections between growth and welfare as they appear in various countries studied in previous chapters, before elaborating systematically the theoretical linkages between each growth strategy and the corresponding welfare state reforms.

When growth is driven by exports of high-quality manufactured goods, specialized skills of employees are a central element of the regime. For instance, it is well-known that in Germany these skills are provided by an efficient system of apprenticeship and vocational training, mainly financed and controlled by companies. Employers are dependent on the specific skills of their employees and have a keen interest in their willingness to participate in and support vocational training. But the employees’ specialization is not easily transferable to other sectors, thus employers aim to ensure job security and social security for their employees.

As manufacturing exports are price-sensitive, wage moderation is important (see Baccaro and Pontusson in this volume). This is even more vital in cases of foreign direct investment (FDI)-dependent economies, such as the Visegrád countries in Eastern Europe. Here, the economy needs to attract foreign investment, upgrade production capacities, and protect the skills of the manufacturing workforce in order to guarantee productivity (but without spending too much so as not to deter FDI with higher labor costs). This leads to the maintenance of specific skill formation systems inherited from the socialist era and compensatory social protection for the losers of the restructuring of manufacturing industry, at the expense of female labor force participation as well as broader social investment. The FDI-led export growth strategy can, however, instead rely on dynamic services-oriented foreign investment, along with the dismantling of old socialist industries, as in Baltic countries. The welfare reform is then to develop general skills among the population and subsequently social investment, at the expense of compensatory social expenditure.

High-tech goods and services are less price-sensitive and require a highly skilled and flexible workforce (Wren in this volume). Firms need to be able to generate new innovative activities with high value-added, for instance in financial services (as in the United States or the UK) or new tech companies (the Nordic countries or California). In this instance, the stability of jobs and activities may not be as central as in the previous cases.

When domestic household consumption plays a stronger role in driving growth, two typical scenarios emerge. First, household consumption can be driven by private debt as in the US or UK. In this case, the financial sector plays a vital role in economic growth. The privatization of education and social protection can contribute to this strategy by providing both market-based welfare to people and the opportunity for growth for the financial sector. Second, wages and public benefits can support domestic demand (as in Southern European countries, including France). Here, compensatory social benefits (what Beramendi et al. 2015 call “social consumption”) are key. In both these cases, the capacity to finance public debt and/or devalue the currency is crucial. Scharpf (this volume) shows how the Economic and Monetary Union (EMU) prevented the countries relying on domestic demand-led growth from devaluing their currency, leading to growing public debt. Today, these countries are under pressure to change their strategy and seek lower labor costs. Below, we call this the “competitive impoverishment” strategy, based on welfare state retrenchment and structural reforms.

Policy decisions are embedded in given economic structures and tend to buttress existing patterns of economic or sectoral specialization. However, they can also contribute to the transformation of growth regimes. For instance, financialization that sustains domestic demand can also contribute to the development of information and communications technology (ICT)-based sectors (Hassel and Palier in this volume), which in turn require an investment in higher skills (Wren in this volume). Thelen (this volume) shows how labor market reforms, as well as vocational training reforms, have accompanied bifurcation of the Dutch growth regime and diversification of the Swedish one.

In the sub-sections that follow, we present in a stylized way the main mechanisms through which the different components of welfare system reforms interact with one another and with growth strategies. By analyzing ideal-typical cases, we spell out an institutional

complementarities-based theoretical framework for understanding (in Section 3) how governments have used welfare policies and their interactions to (try to) stimulate growth.

We associate each of the five growth strategies with a typical set of changes in welfare policy that, combined, can be characterized as a more or less distinct type of welfare system reform. The five types of welfare state reforms are: dualization of welfare, social investment, fiscal and social attractiveness, commodification of welfare, social protectionism. We focus here on the main welfare policy arenas: the labor market, wages, pensions, housing, education (social investment), and social benefits (social spending). In practice, the different types of welfare system reforms do not have to be mutually exclusive, but some policies are incompatible. As we show, for example, increasing wages and maintaining high social benefits might conflict with a policy that focuses on wage moderation in order to foster the export of manufacturing goods.

## **2.1 Manufacturing export-based growth strategy and the dualization of welfare**

This growth strategy focuses on protecting traditional manufacturing industries in a context of globalization and deindustrialization, which requires maintaining the quality and productivity of the sector, while keeping prices low. The emphasis is on controlling labor costs via wage moderation (Johnston in this volume). As long as external demand compensates for the lack of domestic demand, wage moderation does not undermine growth.

Wage moderation and the preservation of quality in manufacturing labor is achieved through the protection of labor market insiders, close cooperation with manufacturing trade unions regarding investment and technology, and enhancement of skills through liaison with entities providing further or continuing education. Core workers in the manufacturing sector are promised employment protection in exchange for wage restraint and internal flexibility such as willingness to change jobs within the firm or variation in working time. As plant-level labor representatives prefer long-term investments and job security over short-term wage gains, local plant-level deals accumulate to shape sectoral policies of trade union wage restraint.

Since export capacity is key to this strategy, the real exchange rate is a central concern. Policies that might negatively affect the real exchange rate, such as accommodating fiscal or monetary policies and wage increases, are repressed institutionally and politically. These policy responses have repercussions not only for fiscal spending for education and childcare but also for labor market policies.

As demand stimulation is not an option, supply-side measures to reduce the reservation wage are introduced. The strategy also depends on the emergence of a cheap and flexible service sector, which makes domestic services affordable. Thus, dualization and supply-side labor market policies feed directly into the pattern of economic specialization (Palier and Thelen 2010; Hassel 2014). Companies use industrial restructuring to weed out less-productive service segments of the production processes from highly productive manufacturing ones. They thereby introduce an internal segmentation of their workforce and adopt changes in labor market rules that allow for a dualization of labor markets. The social partners, i.e. employers' and employees' representatives, tolerate the emergence of atypical employment and a low-pay

segment in other sectors, including in services, in order to save the manufacturing industry (Palier and Thelen 2010).

Other welfare reforms aimed at securing cost competitiveness are complementary to the manufacturing export-based growth strategy. Pension and health reforms aim to limit the increase in social contributions to constrain non-wage labor costs. With regard to housing policy, Reisenbichler (this volume) shows that conservative housing finance policies are designed to restrain demand and dynamic housing markets in order to keep down the cost of living, wages, and inflation. Dynamic housing markets are not central in such a growth strategy also because wage moderation further depresses the demand for mortgages and because central banks in these economies are mostly preoccupied with low inflation, price stability, and market discipline.

## **2.2 Exports of dynamic services growth strategy and social investment**

In the dynamic services-driven growth strategy, governments aim to boost the quality and innovation capacity of the business community in order to remain competitive in the knowledge economy. They invest in education and the (re-)training of the workforce, as well as human capital more generally. A certain degree of labor force flexibility is required to adapt the economy to innovation and change, as well as to external competitive pressures. At the same time, workers need to be able to switch sectors, while preserving or renewing their skills. Since skill and social protection cannot be provided through employment security (which is associated to an economy that is too rigid and unable to innovate), protection and the formation and renewal of skills are provided to all by the (welfare) state. This allows workers to concurrently invest in their human capital through publicly financed education and training schemes, while staying flexible in the labor market. Generous unemployment insurance also leads to a greater acceptance of risk, which enhances the workforce's capacity to cope with innovation (Boyer 2000, 6).

Therefore, social investment and social expenditure go hand in hand in this strategy, and they serve to boost labor productivity. Both factors, along with growing innovation, lead to wage expansion. Higher wages affect consumer behavior and stimulate domestic demand, which subsequently expands. Hence, this strategy allows for the combination of export-led and domestic demand-led growth.

This growth strategy requires that firms have access to venture capital which facilitates financialization. The welfare system can serve as a base for providing an expansion of finance, through either pension funds or the development of private, social, and educational services. While a highly developed welfare state lowers the demand for market-based tools for risk diversification through private insurance, privatization of social services might be pursued as part of the expansion of dynamic services.

Expanding financial markets help to facilitate innovation in the knowledge-based economy. While there are similarities between the dynamic services-based growth strategy and the financialization-based one described below, there is a key difference with regard to the role of the state. In the dynamic services-based growth strategy, the state foots the bill for education, social or health services, even though they can be provided by private firms, while

financialization is pursued as a complementary strategy. Furthermore, despite the growing privatization and marketization of pensions, the state provides universal minimum pensions that reduce the individual market-based risk that citizens face vis-à-vis their retirement income, while social partners (not private companies) own the pension funds rather than private companies (Anderson 2019).

The aim of housing policy in this strategy is to provide universal access to housing for workers. It is a form of social investment, along with education and childcare, since its main policy aim is to improve workers' quality of life and thus boost their productivity. While private providers are included in service provision, the government regulates the market for all citizens and allows them access to social housing, rather than limiting its intervention only to those below a certain income threshold. In that sense, the role of the state in the housing market is strong, even when financial markets participate widely. As Reichenbichler (this volume) underlines, a dynamic market for housing finance is not an impediment to the dynamic services-based growth strategy. Wage growth and the expansion of domestic demand and credit underwrite a dynamic housing market. This is in contrast to the manufacturing, export-based strategy, which is concerned with cost competitiveness of exports and therefore restraining wage growth.

### **2.3 FDI-financed export-led growth strategy and fiscal and social attractiveness**

There is a third family of export-led growth regimes in which exports represent a significant share of GDP (see Table 1.2 in Hassel and Palier in this volume), and for which Foreign Direct Investment (FDI) is an important source of capital and innovation. These are “FDI-led growth regimes” (Nölke and Vliegenthart 2009; Bohle and Greskovits 2012; Bohle and Regan 2019). The growth strategy seeks to make the most of the position of specific national sectors in the global economy and find a niche in the global supply chains of multinational firms. Specific fiscal and social policies are developed in order to attract these FDIs.

In order to attract FDI, governments implement specific industrial policies including low corporate tax rates, but also tax incentives and subsidies targeting these specific sectors. Fiscal exemptions and cash subsidies complement low corporate taxation in order to target the investment to a particular sector of specialization. Some countries aim to attract multinational manufacturing firms (such as German or French automobile companies in Hungary) while others may want to attract American high-tech companies, for instance in Ireland (Bohle and Regan 2019).

Low labor costs are obtained through comparatively low levels of public social spending and non-wage labor costs. Policies thus focus on the liberalization of labor markets and social protection, welfare state retrenchment, and privatization in order to increase social attractiveness for foreign investors. When implemented, this growth strategy usually entails a deep transformation of the economy towards the sectors which attract FDI and may produce losers (such as domestic firm owners, workers from other non-favored sectors, or low-productivity workers in FDI sectors). In these cases, some social compensation mechanisms are introduced (e.g. severance pay, early retirement schemes), which ensures political stability which is also important for foreign investors.



Depending on which sectors attract high FDI, education and social policies may also be used to positively reinforce the strategy in favor of either (medium-skilled) manufacturing specialization or (more or less dynamic) services. If a government wants to support firms' comparative advantage in manufacturing, the maintenance of social insurance and a medium-skill educational system is necessary, and a compensatory welfare system (which also allows compensation for the losers of restructuring, for instance through early retirement) is favored over broader social investment. In contrast, if the government wants to provide foreign investors with a general-skilled workforce in order to develop ever more dynamic services, educational and social investment is supported (at the expense of compensatory social insurance).

## **2.4 Financialization-based growth strategy and the commodification of welfare**

The financialization strategy uses the privatization and marketization of education and welfare (especially pensions and housing) to drive the overall financialization of the economy. This growth strategy relies on the residualization of public welfare and the rise of private social protection and education. Private welfare policies and access to mortgages encourage individuals to take responsibility for their own welfare through financial means. In the case of pensions, for example, while privatization shifts the responsibility for provision to private actors, financial services, and employers, marketization introduces market mechanisms into both public and private pension plans. Both reallocate retirement risks onto individuals and financialize their daily lives (Ebbinghaus 2015, 61; see also Engelen 2003; Hacker 2006; Langley 2008; Dixon and Sorsa 2009; Ebbinghaus 2011; Hassel et al. 2019).

In terms of housing, homeownership becomes the piggy-bank of the middle classes as a form of additional retirement income (or savings). Furthermore, as Reisenbichler (this volume) explains, higher rates of homeownership may increase public support for welfare state retrenchment because expenses related to homeownership lower the incentives of voters to support public welfare expenditure, especially when it comes to pensions.

Also, financial centers provide well-paid jobs for some and attract investors. The growth of real incomes, in combination with a greater supply of financial instruments and a greater demand for housing, spurs both credit- and income-driven consumption and thus stimulates domestic demand. Rising house prices in a growing economy boost the wealth effect of financialization as they contribute to the wealth of the homeowners.

Greater financialization also drives technological innovation in dynamic services and greater demand for human capital investment. Innovation, particularly through ICT, is fostered by high levels of venture capital and general skills, but these are subordinated to the financial sector. The financial sector is important not only in terms of employment and added value, but also as a means for facilitating and shaping the real economy. Finance-driven economies offer particular services to international investors, particularly investment and mutual funds. The effects spill over onto the high street as well: the housing market keeps driving the wealth effect of financial growth, and house price inflation is not controlled (Reisenbichler in this volume).

Low wages in low-skill service sectors, a result of labor market liberalization and weakening trade union power, serve to stimulate domestic demand for personal and consumer services (see Wren in this volume; Morel 2015). The significant wage discrepancy between high- and low-

skill service jobs also boosts the demand for (higher) education. The financialization strategy relies on the growing demand for education as an opportunity to reduce state funding for education and enhance, via educational loans, market access to education. This further fuels the financialization-driven growth model and increases competition, especially in the higher education sector.

Because of comparatively high rates of growth and a dynamic labor market, people are not exposed to long spells of unemployment, hence there is less demand for social protection. The fact that only a minimal safety net against poverty is in place favors the existence of a low-wage labor market, which boosts the productivity of highly skilled workers, as they can outsource many of their non-work-related responsibilities to cheap service workers (Morel 2015). At the same time, given that domestic demand is the key driver of financialization, the state protects low-skill incomes to a certain extent, for example, via income tax credits on earnings or a minimum wage, so that they do not end up having a negative effect on growth.

Therefore, the “beast” of financialization is fed through state retrenchment, privatization, and marketization of pensions, housing, and education, expansive wages, and the repression of social spending. These interactions create a cycle of economic growth and job creation, on the one hand, and a higher systemic risk from financial crises and growing wealth and income inequality, on the other.

## **2.5 Publicly financed domestic demand-based growth strategy**

The basis of this growth strategy is government support for households and companies in order to maintain domestic demand. The nature of this strategy is thus embedded in state spending. It can be complemented by the financialization-driven strategy, which further boosts domestic demand. It may be more difficult to combine it with manufacturing exports, for reasons of labor cost.

In the ideal type of domestic demand-driven growth strategy, a generous national minimum wage and generous compensation through social benefits (especially pensions) feed household consumption, while companies are supported via state involvement, devaluation, and some protection against foreign trade and investment that reduces competitive pressure on firms (Molina and Rhodes 2007). Traditional firms benefit, as they are met with relatively low levels of product-market competition because of protectionist policies, which allow them to offer high employment protection to workers and face little pressure to boost competitiveness. In order to compensate for the lack of price competitiveness in international markets, the state ensures currency devaluation. Firms are also not constrained by short-term profits, because the financial system is centralized and bank-based rather than driven by financial investors, which further accommodates high employment protection. The state is, in turn, left with few resources to invest in innovation, but is also discouraged from investing, as its key focus is to protect the situation of the traditional sectors.

A low degree of financialization is reflected in the low penetration of private financial markets into pension and housing provision and in the reduced support for investment in innovation and the knowledge economy, which would be facilitated through a market for new financial products and services (see Hassel and Palier this volume). The absence of strong competitive

pressure from global trade also discourages innovation, both at firm and state level, which exacerbates the vicious circle of pro-protectionist and anti-innovation policies (Capussela 2018).

The high level of employment protection, along with state protection of companies and their benefits, discourages workers from investing in their skills. This leads to low public demand for education, low enrollment rates in tertiary education, a weak and underfunded higher education system, weak vocational training, and no lifelong learning. A workforce with limited skills and education levels further limits the implementation of a high-skill and innovation-oriented industrial strategy. At the same time, an economy that is not based on knowledge and innovation does not demand these skills, which further undermines investment in human capital.

The decline of competitiveness leads to the shedding of labor in manufacturing and a further expansion of small firms in the service economy. Structural trends toward deindustrialization drive the dualization of the labor market. These structural pressures are reflected in the growing portion of labor market outsiders, i.e. flexible temporary and part-time contracts, which mostly affect new entrants into the labor market (younger workers). The growing precariousness of the labor force generates additional demand for non-employment-related social protection expenditures, while the public purse is being progressively depleted, as the country cannot find a sustainable engine for growth.

The domestic demand-driven growth strategy is entrenched and reinforced politically. State spending is electorally constrained and geared towards protecting the vested interests of pensioners and the wealthy, as well as labor market insiders who benefit from social protection. These groups are favored over youth, who are consequently unable to access well-protected jobs and face a faltering economy that does not demand high skills. In this context, we see a political reinforcement of the economic division between pensioners and the wealthy, on the one hand, and youth and the poor, on the other.

Being caught in this vicious circle of low growth and high state expenditure, the domestic demand-based growth strategy is least adapted to the new global drivers of growth (financialization and digitalization). For members of the Eurozone, export competitiveness is further undermined by the country's inability to devalue its exchange rate. Because of the Eurozone context, this growth strategy is also especially susceptible and non-resilient to systemic shocks such as financial crises, as well as to external pressures to maintain the stability of the EMU.

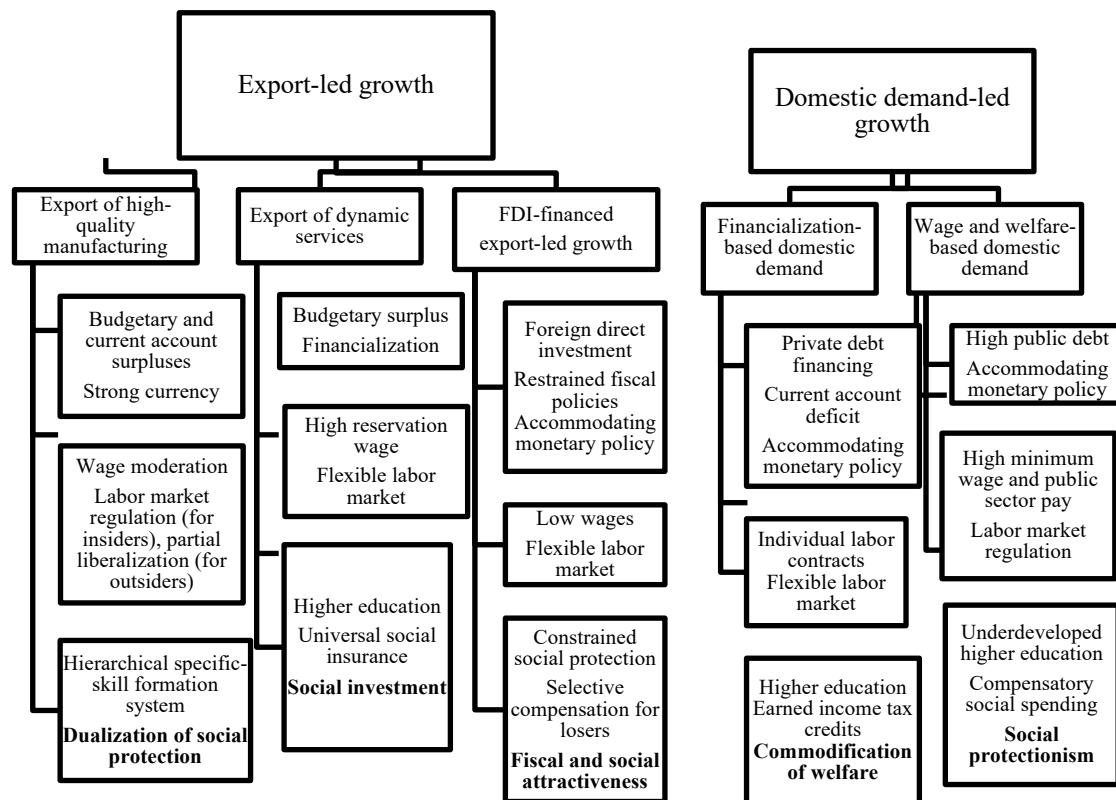
Within the eurozone, these pressures have led to an externally imposed, austerity-based agenda of "competitive impoverishment" (see Section 3.6). While the extent of the competitive impoverishment strategy has varied across countries, it is premised on the idea that the welfare state represents an impediment to growth and that internal devaluation of labor costs via deregulation of employment protection, reduction of minimum wages, and institutional weakening of unions and collective bargaining are necessary (see also Scharpf in this volume).

## 2.6 Overview of the five growth strategies

Figure 1 summarizes the growth strategies' various components and the welfare system reforms that tend to be associated with them. Within each strategy, we emphasize the main engine for growth (export manufacturing sector, dynamic services, FDI, financial services, or wages and social benefits). We also highlight the main macroeconomic policies (in terms of budgetary and monetary policies) and the associated welfare policies i.e. labor market, education, and social policies. As a result, we show the relationship between the five different growth strategies and five main types of welfare state reforms:

- (1) **Dualization of welfare.** Protecting medium and specialized skills, labor market regulation, and controlling wages, all policies favored by and favoring the manufacturing sector (to promote manufacturing exports as a driver of growth).
- (2) **Social investment** and expansion of higher education (to promote economic specialization in innovation, the digital economy, and higher education as drivers of growth).
- (3) **Fiscal and social attractiveness.** Attracting FDI through low corporate taxes and low labor costs, minimizing the cost of public welfare while compensating the main losers (developing higher education to attract high-tech FDI).
- (4) **Commodification of welfare.** Asset-based social policy, access to credit to bolster demand and consumption, privatization of health insurance and pensions (to promote financial services as engines of growth).
- (5) **Social protectionism.** Maintaining wage levels (minimum wages) and social spending despite deindustrialization to protect aggregate demand (to promote domestic demand as a driver of growth). This strategy may be turned upside down to “competitive impoverishment” under external pressure (as has been the case in the Eurozone)

**Figure 1: Welfare reforms in five distinct growth strategies**



### 3. Tracing the linkages through country cases

The empirical evidence presented in this section is mostly drawn from our own research and from secondary sources as well as other chapters in this edited volume. In the following case studies, we first examine the social policies adopted in Germany and how the dualization of the labor market occurred in support of export-oriented manufacturing. The analysis of the Nordic countries, specifically Sweden and Denmark, shows how they have combined social investment in human capital and education with innovation policies and financialization / privatization efforts. Then the cases of the Visegrád and Baltic countries are analyzed as (divergent) examples of how fiscal and social attractiveness policies that we associate with the FDI-led growth strategy have emerged and been implemented. Our survey of welfare system reforms in the UK serve as a case of commodification of welfare associated with the financialization growth strategy. Finally, we trace policies and reforms related to the domestic demand strategy in Southern Europe, especially in Italy and France.

#### 3.1 Manufacturing exports and the dualization of welfare in Germany

Since the 1980s, the German political economy has increasingly specialized in high-quality manufacturing exports as a strategy for economic recovery and growth. Maintaining and strengthening the export-oriented manufacturing sector has involved maintenance of plant-level cooperation, facilitation of technological upgrading, and reduction of labor costs in order to keep the real exchange rate low. Such a growth strategy has turned out to be a mixed blessing.

While it has preserved Germany's competitive edge vis-à-vis many other industrialized countries, it has also led to an increasing dependency on exports as the engine for growth. There has been no equally strong evolution of a domestic service economy beyond manufacturing-related services. By 2019, the share of exports in Germany's GDP was approaching 50%, while domestic demand has lagged behind other industrialized countries. Therefore, despite its size, Germany's growth strategy is that of a small open economy. This issue of export dependency has become increasingly important in light of the financial crisis of the late 2000s and global imbalances vis-à-vis Greece and the Eurozone, but also globally. At the same time, weak aggregate demand, which is an essential part of Germany's export-oriented growth strategy, both depresses domestic employment and endangers the still fragile construction of the Eurozone.

### *Export orientation during Fordism*

Germany's economy already started to focus on exports in the 1950s. The key was long-term wage restraint on the part of trade unions in the manufacturing sector, a feature already emphasized by the first president of the German Central Bank, Wilhelm Vocke, when he highlighted the role of exports for Germany's success in 1951 (Höpner 2019). Restrictive monetary policy also became a central element of the German export model, in particular after the 1975 oil shock (Scharpf 1991). The German government was also highly active in replacing the Bretton Woods regime with a European currency regime (the European Monetary System (EMS) in 1979 and later the EMU in 1999) in order to stabilize exports (Hassel 2003, 99). The Deutschmark (D-Mark) was deliberately undervalued and only reluctantly adjusted. Under the EMS, the D-Mark appreciated eight times between 1979 and 1992 (Höpner and Spielau 2015). This indicates that Germany did not follow a "traditional" Fordist model of domestic consumption-led growth, but was instead characterized by an export-oriented growth model very early on during the post-war period.

Welfare expansion took place primarily through social insurance schemes which privileged those in secure employment in manufacturing rather than through universal schemes. In the 1980s, early retirement, status-maintaining unemployment benefits for the long-term unemployed, and strong employment protection for workers on permanent contracts provided a buffer for workers against economic restructuring. These schemes were paid for by higher insurance contributions and relatively low wages, both of which helped the government deal with the restructuring of the coal and steel industries and later with reunification. Sectoral real-wage restraint paid off for the individual worker in the long run, even if an economic downturn would force them out of the labor market (into either unemployment or early retirement). Employers benefitted from coordinated wage-setting and investments in productivity-improving technologies.

Some liberalization policies were introduced in the late 1980s. Public housing was gradually phased out through a change of law in 1989, which withdrew subsidies for social housing (Reisenbichler in this volume). The number of social housing units declined from almost four million subsidized flats in the 1980s to less than a million in 2020. A first step towards labor market liberalization was taken by deregulating temporary work agencies. In addition, pension reform was introduced, but was halted by the fall of the Berlin Wall.

### *The impact of reunification*

Reunification in 1990 was the toughest challenge to the German growth regime since the oil crisis in the 1970s that prompted stronger wage restraint. As it required massive public spending on the Eastern Länder, reunification took a major toll on the German economy. During the first two decades of reunification, about 4% of GDP or seventy to eighty billion euros were transferred from West to East Germany annually (Ragnitz 2009), funded through higher taxes (the solidarity surcharge), social security contributions, and debt. The collapse of the East German labor market during the 1990s was buffered by generous early retirement schemes, retraining, and large-scale labor migration from East to West Germany. While the funding of reunification was, in fact, a major boost to domestic demand, the government responded to increasing public debt, high unemployment, and low employment rates by encouraging export-led growth. Throughout the 1990s, manufacturing companies restructured their business models in order to remain competitive. They engaged in plant-level concession bargaining, in which employment guarantees were used to achieve wage restraint (Hassel 2014; Palier and Thelen 2010). This strategy of plant-level cooperation, while the government continued high levels of social spending, particularly in East Germany, was characteristic of the Helmut Kohl (1982–98) government of the 1990s.

### *Liberalization and attempted financialization in the late 1990s*

Economic pressure started to mount in the second half of the 1990s. The German export model was seen as exhausted. High social spending, low growth, and high unemployment dominated the public discourse. At the time, many policy-makers were actively considering a shift of the growth strategy towards a more liberal and Anglo-Saxon model. For instance, in the late 1990s, the Kohl government introduced several laws promoting capital markets. The government encouraged venture capital for new tech companies by establishing in 1997 a “new market”, modelled on the US Nasdaq. In addition, privatization of pensions and public housing were put on the public agenda.

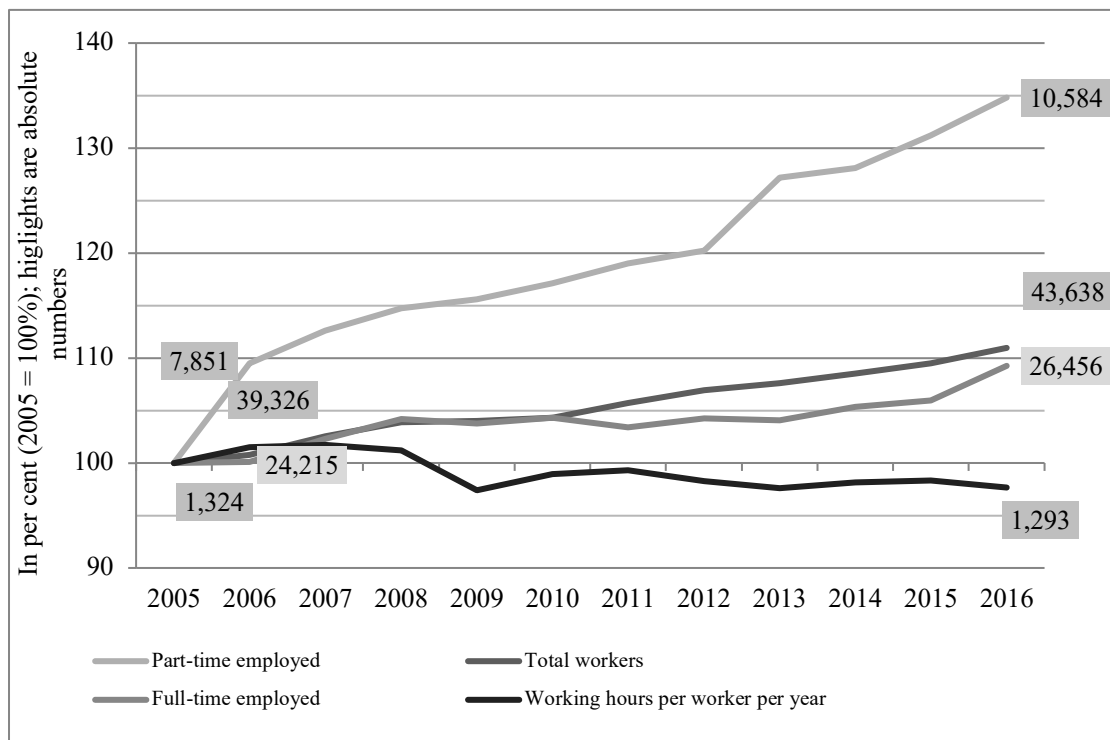
Pension privatization was driven by major concerns about the costs of aging and the impact of public pensions on labor costs. The Gerhard Schröder government (1998–2005) launched a new pension reform in 2001 that included both cuts to the public pension scheme and the possibility of compensation through subsidized private or occupational pension schemes (e.g. “Riester” pension) (Bonoli and Palier 2007; Naczyk and Hassel 2019). Reduced public spending on pensions would allow for stabilization of non-wage labor costs such as social insurance contributions, with a target of 20% of wages by 2020 and 22% by 2030. Publicly subsidized private pension schemes were introduced to compensate for cuts in public pensions, but they turned out to be a bad investment as returns were dismal. Only the occupational schemes that were negotiated by the social partners guaranteed top-up pensions; these were, however, only available in the manufacturing sectors and large firms. Consequently, pension privatization fed into the dualization mechanism – instead of financialization - and served mostly to compensate workers in the export sector for the public pension retrenchment, while the rest of the population received no compensation at all (Seeleib-Kaiser et al. 2012).

The most substantial policy reforms were the so-called Hartz reforms of 2003. Their aims were first, to lower the reservation wage in East Germany and, thereby, force the long-term unemployed to seek work; second, to cut the financial burden of high unemployment costs in both East and West Germany; and third, to increase the employment rate in general. The reforms cut the length of time a person could draw unemployment insurance benefits and introduced low means-tested benefits for the long-term unemployed. The line drawn between insurance-based benefits and means-tested benefits put manufacturing workers into the precarious position of looming poverty if they became long-term unemployed. As an effect, unions and works councils became even more focused on employment guarantees when negotiating with big manufacturing firms. The price for continued employment guarantees was an even stronger commitment to wage restraint (see Figure A1 in appendix which shows the development of labor costs after 1997 and the massive restraint in wages). The Hartz reforms also included a number of other labor market liberalization measures, reinforcing insider and outsider divisions on the labor market by further facilitating temporary agencies, contract work, unprotected mini and midi jobs, and the like (Hassel 2014; Palier and Thelen 2010).

*Renewed export strategy and the financial crisis*

From the moment the Hartz reforms were adopted, the world economy picked up and moved into a long economic upswing. Exports started to boom and unemployment started to fall in both East and West Germany. Despite massive criticism of the Hartz reforms and the collapse of the Schröder government in 2005, the German economy’s development overall was positive. As shown in figure 2 total employment increased by 10%, and in particular part-time employment took off.

**Figure 2: Employment and hours worked in Germany (2005-16)**



Source: Schulze-Buschhoff and Hassel 2018.

Note: Indexed in 2005, employment in thousands.



The development in the labor market reinforced the perception of almost all policy-makers that the export-based growth model was beneficial for all, in particular after the economy fared relatively well through the financial crisis of the late 2000s. Publicly subsidized short-shift working arrangements helped companies to weather the contraction of GDP in 2009, without shedding labor. Compared to the mid-1990s, the government's mood had completely changed by 2009. Since then export-led growth is well rooted in the policy community, despite the overall low wage growth and a large low-pay sector, which eventually led the government to adopt a minimum wage in 2015 from which point wages started to rise more in line with other countries in the Eurozone.

### *Digitalization and public investment*

Since the financial crisis, the focus of policy-making has shifted towards re-regulation of the labor market, expansion of childcare, and transition to the knowledge economy. Growing employment in high-skilled services depends on investment in higher education and an expanding female labor force. Both are areas that the German welfare state has not been used to catering for. Rather the opposite, women's labor market participation in full-time equivalents remains comparatively low, and the share of the population with a tertiary education degree is among the lowest in the OECD, with 31% of 25–34 year-olds having a tertiary degree, compared to 44% as an OECD average (OECD ilibrary 2019). However, public childcare for the under three year-olds has doubled over the last fifteen years from 18% in 2005 to nearly 38% in 2017 (OECD family database).

The challenge of the transition to a knowledge economy is exacerbated by the demographic change that has kicked in forcefully since the financial crisis. It is estimated that Germany's workforce will shrink by 5–10% by 2060 (Destatis 2019), an estimate that includes the rising numbers of immigrants. The shrinking number of young people induces labor shortages, in particular at the high end of the scale of skill distribution. These demographic changes also underline the urgency of offering full-time careers for working mothers and addressing work-life issues.

Several developments since the financial crisis can be classified as a “conservative” social investment strategy of the German government. These include path-breaking measures in the field of gender policy (female quota on supervisory boards; pay transparency norms), universal provision of early childcare, and the expansion and increasing flexibility of the tertiary education system. With regard to the latter, vocational training has increasingly intertwined with higher education, as vocational training certificates are now accepted as a substitute for entry exams at many universities, and many “dual degree” programs that combine vocational or on-the-job training and college coursework have been set up (Eichhorst and Hassel 2018).

### **3.2 Export of dynamic services and social investment in Sweden and Denmark**

Nordic countries are small, open economies, which were particularly affected by changes in the international economic environment of the 1970s and 1980s. During the 1990s, both Sweden and Denmark diversified their growth strategies towards innovative ICT-based services and privatized sheltered services. Denmark focused on environmental technologies, design, and

pharmacy, while Sweden entered the ICT-based and high-end services sectors (Dølvik forthcoming). As demonstrated by Thelen (this volume), Sweden's business groups responded to market pressures not by defending traditional strengths but by shifting resources into new sectors. In order to support the shift towards highly skilled, dynamic services, governments cut some compensatory social protection in favor of social investment policies. According to Baccaro and Pontusson (this volume), one important reason for the Swedish switch in growth strategy towards innovation and dynamic services was the size of the country's welfare state. Because of the Swedish public sector's large size and the importance of domestic demand, wage repression to maintain international competitiveness, like in Germany, was not feasible. This approach has led to a smaller current account surplus and an increase in household debt since the late 1990s and to higher growth rates in Sweden than in Germany from 1997 to 2015. In the case of Denmark, the diversification of the growth regime was underpinned by a substantial liberalization of financial markets, especially the credit market, which stimulated private household debt (Ibsen and Knudsen 2019).

#### *From retrenchment to social investment*

During the 1980s, both Sweden and Denmark experienced high levels of unemployment and high interest rates. At first, these countries tried to maintain full employment by creating public jobs, but this led to increasing public debt, which was difficult to finance. By the end of the 1980s, unemployment rates were increasing rapidly. For the first time, there was a public debate about the potentially discouraging effects of welfare generosity. When conservative governments came to power (in 1982 in Denmark and 1991 in Sweden), budget cuts ensued, which were intended to reduce the generosity of social insurance and, specifically, unemployment compensation. According to Korpi and Palme (2003), expenditures on social insurance programs declined substantially in both Sweden and Denmark between 1975 and 1995. Spending on unemployment insurance declined by 24.5% in Denmark and by 7.3% in Sweden, sickness insurance by 21.4% and 13.8%, and work accident insurance by 21.4% and 21.8%, respectively (Korpi and Palme 2003, 435).

Spending cuts and lower public employment not only helped the countries to pay off their debts, but also enabled collective investments to restart growth driven by technological innovation and higher skills. Thelen (this volume) analyzes in detail the changes in the educational system in Sweden that eliminated the more vocational two-year track system, so that everyone would stay in school until the age of 19, thus opening the path to university education for all. As Thelen shows, the country also made huge investments in ICT training and household equipment, as well as in upskilling-focused labor market policies to help workers shift from manufacturing to ICT-based dynamic services.

Labor market policies were also redesigned in the early 1990s in both Sweden and Denmark. A clear trend can be traced towards "activation" through various social expenditure measures: for instance, reducing the length and generosity of unemployment insurance benefits (especially in Sweden), increasing pressure on the unemployed to work, and providing retraining opportunities for acquiring skills in order to find jobs in new sectors.

Parties of the right initiated these policies in both cases. However, when returning to power, the Social Democrats in neither country questioned the cuts made in welfare policies, nor the trend towards marketization and activation. Instead, they increased emphasis on the necessity to invest in general skills to prepare the population for the knowledge economy and to improve work-life balance for families. In Europe, this has later been labelled a “social investment” strategy (Morel et al. 2012).

Denmark created its own trademark in labor market policies by developing the “flexicurity model”: “The model promotes high occupational and geographical labor mobility via low employment protection, compensated by generous unemployment benefits and ambitious active labor market policies aimed at skill improvement and activation for the unemployed” (Viebrock and Clasen 2009, 313). Among European countries, Denmark and Sweden spend the most on workers’ training, public employment services, subsidies for private sector jobs, and the creation of government jobs. These expenditures amount to approximately two percent of GDP in both countries. They also include large-scale early childhood education and care programs and have the highest rates of childcare attendance for children between one and three (Palier and Hay 2017).

The aim is an early and continuous investment in human capital for everyone to further academic and professional success, to accompany professional transitions, to allow parents to combine family and work responsibilities, and to favor high rates of labor market participation. The provision of high-quality childcare for all children also creates quality jobs for workers in these sectors. Parental leave reforms have added a specific number of months for fathers with higher income replacement rates.

Therefore, the Nordic countries’ adjustments to the welfare state went in the direction of boosting labor productivity in dynamic services via social investment policies and a reduction in the effect of moral hazards in social expenditures. While social spending in Nordic countries is still among the highest in the world, it has become more sustainable thanks to these reforms, as their social protection systems have managed to turn their social spending towards the education and mobilization of the workforce.

Steps to increase pension sustainability were also implemented early on, in 1991 in Denmark and in 1994 in Sweden, with the creation of a system of notional accounts in the latter. Furthermore, the countries have taken active measures to integrate growing numbers of immigrants into the labor force since the 1990s (Andersen et al. 2017, 96). These measures have indicated early efforts to tackle the adverse effects of aging, through pension reform, high net migration, and social investment (which focused on childcare and education). Nordic countries have some of the highest fertility rates in the European Union (EU) (between 1.7 and 1.9 children per woman).

Housing policy in the Nordic countries also illustrates a social investment-oriented approach, since housing is used to underpin and support worker productivity and decent living standards. Apart from public housing (some 20% of the total housing market), which is available to all citizens (in contrast to the UK, where eligibility is determined by means-testing), housing co-operatives have grown in importance (also around 20%). While the state regulates the entire housing market with some of the world’s most pro-tenant rent control laws, public, co-operative, and private housing compete freely in the market, thus enabling consumer choice

and increasing quality. The primary goal of housing provision is, therefore, not to feed the financial markets, as is the case in the UK, although financial markets are active participants in the marketplace (Turner Center 2017). The Swedish government also intervenes from the demand side by providing universal housing allowances at national and municipal levels. In that sense, there is no trade-off between household debt and welfare state expenditure in these Nordic countries, as is the case in the UK, because they complement one another. At the same time, and as Reisenbichler (this volume) points out, housing policies have served to boost private wealth in Nordic countries and thus have been some of the most important drivers of wealth inequality over the past few decades.

### *Privatization and financialization*

As Thelen and Wren (both in this volume) emphasize, many of the adjustments made in the 1990s in the Nordic countries meant an exit from medium-high manufacturing sectors and move upmarket into ICT and knowledge-intensive manufacturing and services. However, restructuring also occurred through the privatization of previously sheltered service delivery (not financing, which remains public), especially in the educational and social services. This was also a way for the main Swedish business groups (like the Wallenbergs) to diversify their activities and for governments to address the demand for choice coming from the electorate since the 1980s (Blomqvist 2004). Privatization of service delivery went particularly far in Sweden. In the early 2010s, Swedish private schools enrolled almost a quarter of the total student body at upper secondary level (Erixon 2011, 15). Since the beginning of the 1990s, the share of for-profit schooling has increased from virtually zero to 18-19% in Sweden (and to around 5% in Denmark) (Szebehely and Meagher 2018). Private, for-profit provision of public services became a prominent feature of the Swedish new political economy, especially in the education and care sectors (healthcare, childcare, and care of the elderly). This became a source of new activity for many corporations, but also triggered an increase in inequality, since wages increased slowly in these sectors while they skyrocketed in the ICT sector.

While Nordic countries have followed the global trend of growing inequality, partly due to tax and benefit cuts in the 1990s, their Gini coefficients and poverty rates remain among the lowest in the OECD today (Andersen et al. 2017, 92). In effect, the wages of low-skill workers have fared relatively well in Sweden over this period, also due to a high demand for private services by middle- and high-income households and a broader union presence (see Wren and Thelen, both in this volume).

Nevertheless, while both countries have accommodated financial service providers in their economies, the state has acted as a strong regulator of private service providers in education, housing, and pensions especially in Sweden. Since the welfare state has served to feed dynamic services and innovation-oriented economies (see Baccaro and Pontusson in this volume), there was no extinction of public financing of welfare services. Thus, although there has been a proliferation of private providers, the state continues to foot the bill and is supposed to ensure equality and universality in access to public and social goods and services. This makes the Nordic states rather distinct from the UK model, which has allowed a deterioration of public services along with a deregulation of pricing in private markets (Hood and Dixon 2015).

Both Sweden and Denmark have also liberalized their financial markets to support the financing of innovative start-ups and firms in the ICT sectors. Financialization in Denmark has been stronger, especially in pensions and housing. In fact, Denmark has the highest share of private pension contributions and benefits in Europe through a fully funded pension system governed by the social partners (Figure A2 in the appendix). Denmark also relaxed constraints on the credit market, leading to a mortgage boom.

Reisenbichler (this volume) argues that Nordic countries adopted financialized housing policies as a way to liberalize financial markets and boost private wealth because firms were less concerned with wage restraint. There are, however, differences between Denmark, which allowed unsustainable levels of household debt to mount up during the 2000s, and Sweden, where the government has been more cautious concerning the accumulation of household debt. In 2010, the Swedish government capped mortgages at 85% of a property's value and introduced requirements to amortize on loans, while pursuing an expansionary monetary policy to boost consumption (Jansson 2013; also see Baccaro and Pontusson in this volume on the increasing role of domestic demand after the financial crisis in Sweden). Swedish policymakers did not prioritize financial services' profits over macroeconomic stability and their accountability to voters. We argue that, in general, financialization is not a dominant strategy in the Nordic countries, but is complementary to the dynamic services strategy which emphasizes productivity and human capital formation.

After 2008, welfare reforms in Sweden and Denmark diverged. The Great Recession had a greater impact on Denmark, due to a self-inflicted financial crisis that led to seven years without economic growth. The main cause was the pegging of the Danish crown to the Euro and the excessive liberalization of credit, which forced internal devaluations to manage demand shocks, and thus greater pressure on welfare and wage policies (Andersen et al. 2017). By contrast, Sweden's growth rate after 2008 was among the highest in Europe (*idem*).

The situation in Denmark was aggravated by a stigmatization of recipients of social assistance linked to an increasingly anti-immigration discourse. Moreover, the low economic growth, provoked by too much liberalization, led to even more radical market-oriented solutions to fix the faltering economy (Andersen et al. 2017, 105). Denmark saw severe public spending cuts after 2010, although spending remained relatively high in comparison to other European economies. The country thus partly preserved its traditionally social democratic inclination despite significant cuts since it continued to have a high degree of inclusive and universal provision of state-financed welfare services and active support for the unemployed, along with an increasing emphasis on activation and some discrimination against migrants.

In the Nordic countries, there were considerable political and social conflicts related to immigration, and newly emerging political cleavages played a more important role in policy decisions than economic pressures did. For example, the 2011–16 reduction in public spending in Denmark would not have been politically imaginable only a few years before. In the Swedish context, public discontent over privatization of welfare services, their quality, and profits made by the private sector from taxpayers' money have been a source of vibrant national debate (Andersen et al. 2017, 95).

Given the stable macroeconomic environment and budgetary surpluses, some repairs to social protection have started in both countries. For example, Sweden raised the unemployment level

of benefit ceiling significantly in 2015, while the Danish 2014 labor market reform relaxed eligibility conditions for unemployment benefits (Andersen et al. 2017, 106).

### **3.3 FDI-led export growth and fiscal and social attractiveness in Eastern Europe**

One can distinguish between three types of countries in the EU which adhere to the FDI-led export growth strategy: Ireland, the Visegrád group (the Czech Republic, Hungary, Poland, and Slovakia), and the Baltic countries (Estonia, Latvia, and Lithuania). The Irish case has been extensively covered elsewhere (Regan 2012; Regan and Brazys 2018). In this section we focus on Eastern Europe. While there are several commonalities between the Visegrád and Baltic countries (low corporate tax, low labor costs, labor market flexibilization, and privatization to attract FDI), the two sets of countries also exhibit differences in labor market, educational, and welfare reforms which complement their specific drivers of export-led growth (manufacturing versus dynamic services). The FDI-led reindustrialization growth regime in the Visegrád countries relies on a Bismarckian type of welfare system, which predominantly consists of work-related compensation and cash benefits, while the Baltic trajectory of services liberalization and an ICT and knowledge-oriented growth regime pursues a social investment-oriented welfare state (Avlijaš 2020; Avlijaš forthcoming).

The foundation of the socialist growth model in Eastern Europe before 1989 was rapid industrialization underpinned by substantial welfare provisions for workers. Besides full employment and decent pensions in the context of centrally planned economies, Eastern European states provided universal healthcare and education, as well as subsidized housing. The region, therefore, experienced substantial socio-economic progress and welfare state development in the decades following World War II, amid authoritarianism and the absence of political competition. Following the economic and political crises since the 1970s and the demise of socialism in 1989, Eastern European countries embarked on the historically unprecedented transition to capitalism.

Along with the concurrent transition to democracy, major institutional reforms took place on the road to capitalism. Redistribution, which was a non-issue during socialism, began to dominate both the economic and political agenda in the context of privatization of publicly owned resources and new political competition. A new social contract had to be defined, which would affect both domestic and international stakeholders (e.g. foreign investors and the EU). The dominant perspective on welfare reforms during the early years of transition was mainly influenced by Janos Kornai's notion of the socialist state as a prematurely born welfare state (Szelenyi 2011). This approach implied that the supposedly overly generous welfare provisions from the socialist era needed to be reduced and possibly privatized in order to stimulate growth and allow Eastern European countries to recover from the transitional recessions that they were experiencing. Rapid liberalization was thus imposed from the onset of transition as an "obvious" solution to numerous practical economic challenges and employed as a tool for market-driven growth via privatization and trade openness.

Dramatic privatization of housing also took place across Eastern Europe in the context of the highly deregulated financial markets, the foreign takeover of the banking sector, and the massive inflow of credit to households. Domestic policy-makers supported these trends during

the 2000s as part of their general growth strategies of attracting foreign capital, especially in the Baltic countries. The trend was further reinforced as a way to keep social peace by boosting household wealth in the context of worsening labor market conditions (Bohle 2013).

Amid these economic liberalization-driven processes, there was also a Polanyian social countermovement at the domestic level (Bohle and Greskovits 2012). Pro-welfare state constituencies in Eastern Europe were stronger than in Western Europe, due to their welfare state legacy. The retrenching of existing social programs was politically difficult, and anti-reform voting emerged (Vanhuysse 2009, 56). An important question for policy-makers was how to ensure domestic political stability and reduce protest while implementing the liberalizing reforms imposed by the international discourses and pressures. The liberalization discourse and the domestic political conflicts over redistribution interacted in shaping the outcomes of welfare state reform in the region. These interactions produced a fiscally constrained, pro-social investment-oriented reform agenda in the Baltics and a fiscally constrained, pro-social compensation welfare state in the Visegrád region.

The literature has widely acknowledged that the Baltic and Visegrád countries have followed different trajectories of capitalist development since the early 1990s (Bohle and Greskovits 2012; Feldmann 2006; Nölke and Vliegenthart 2009). These different trajectories were path-dependent on the initial choices that the countries made, but they also reflected the ways in which foreign investors shaped economic developments in each of the regions.

#### *The Visegrád FDI-financed manufacturing export growth strategy*

The Visegrád countries (the Czech Republic, Hungary, Poland, and Slovakia) pursued reindustrialization, which was driven by FDI (coming mainly from Germany, Austria, France, and the UK) as the key source of capital and innovation. According to Bohle and Greskovits (2012), these four countries capitalized on their specialization in automobiles, machinery, and electronics industries during late socialism to transform their economies “into one of Europe’s largest transborder clusters of complex-manufacturing export industries” (p.138). By offering subsidy packages and tax incentives to foreign investors and already removing market entry barriers during the early 1990s, these countries outcompeted the rest of Eastern Europe (the Baltics and South East Europe) in attracting most of the FDI. For this reason, Nölke and Vliegenthart (2009) refer to them as dependent market economies, ie economies that are dependent on FDI for sources of capital and innovation.

Since labor market attachment in the context of reindustrialization served as the primary basis for welfare eligibility, post-socialist Visegrád welfare states returned to their pre-1945 Bismarckian path (Vanhuysse 2009; Cerami, 2010). The countries provided social compensation to the losers of economic restructuring in the form of unemployment benefits, pensions, and early retirement opportunities to ensure political support for their growth strategy. Cash benefits dominated the welfare state agenda in the Visegrád countries. However, while politically necessary, such large welfare state expenditures, along with generous subsidy packages to foreign investors, came at the cost of significant fiscal strains, especially in Hungary and Poland, which faced extreme early retirement booms (Bohle and Greskovits 2012; Vanhuysse 2009). The early retirement schemes resulted in strong pensioners’ constituencies

that directed resources away from youth-oriented policies (Vanhuyse 2009, 59). The fiscal situation was further exacerbated by the recessions that the countries experienced during the initial transition, as well as by regional tax competition to attract FDI (and thus low tax revenue), and by the requirement of the EU's Stability and Growth Pact to maintain low budget deficits.

Due to rapid liberalization, trade openness, and a high dependency on foreign capital, export-oriented price competition became the basis of the growth strategy. However, given the relatively high educational attainment of the population that was inherited from socialism, reindustrialization was based on technological upgrading and middle- and high-skilled, rather than low-skilled jobs. Therefore, while the restructuring of the economy required a flexibilization of the labor market, the need to preserve workers' skills has led to the preservation of a certain level of employment protection, which is why there is no "race to the bottom" in employment relations despite strong competitive pressures.

While productivity gains were achieved through substantial labor-shedding, these "losers of transition" were protected with severance pay and early retirement packages, policies which, as noted earlier, put further pressure on the welfare state. This has also created a path dependency so that social protection expenditures on pensions have remained high and politically salient, making it difficult to redirect state resources into youth policy, social investment, and educational reform, as well as upgrading towards higher-quality products or switching to dynamic services. A market for private education has, however, emerged, since the relatively better-paid jobs in multinational firms encourage workers to invest in their skills, offsetting some of the negative effects of low state investment in education.

Financial markets have been dominated by foreign investors and predominantly focused on achieving short-term profits. This increases pressure on firms to shed labor and weaken employment protection to remain price competitive. At the same time, the financial sector offered market-based tools for risk diversification through private insurance, reducing the pressure for the state to increase its provision of social protection.

### *The FDI-financed dynamic service export-led growth strategy in the Baltic countries*

The Baltic countries have built a different regime of foreign capital-dependent, post-socialist capitalism. Their strategy relied on rapid liberalization and macroeconomic stabilization to attract foreign capital into high-value service sectors, such as banking, telecommunications, and real estate. The strategy depends on both price and quality competitiveness and is centered not only on exports of high-value services, but also on substantial domestic consumption of telecommunications, finance, and retail.

As Bohle and Greskovits (2012) explain, just after the fall of their socialist regimes, the Baltic countries pursued an agenda of macroeconomic stabilization, extreme openness, and rapid liberalization of services, which resulted in a high influx of FDI in banking, logistic services, and real estate. Given that they pursued a concurrent agenda of nation-building following their secession from the Soviet Union, they also had a political interest in deindustrialization, as it served to weaken the position of ethnic Russian capital and labor, which had dominated Baltic



industries at the onset of the transition (Avlijaš forthcoming). They also opted for the rapid introduction of national currencies and pursued national monetary independence.

This was done in a quest for international creditworthiness and legitimacy (Bohle and Greskovits 2012, 105). Alongside the liberalization of services, the Baltic countries also pursued an internationally competitive ICT and knowledge-oriented growth agenda, notably by using public procurement (Avlijaš 2020; Lumiste et al. 2007; Runnel et al. 2009). Low levels of employment protection and the increasing flexibilization of the workforce encouraged workers to invest in general skills that are easily transferable between firms and sectors of the economy rather than in specific skills. This state-led development of the highly dynamic service economy required the expansion of tertiary education. Educational expansion and reform, along with the digitalization of education and public services, were recognized as essential inputs for the Baltic growth model, and, between 1995 and 2015, the countries were among the highest spenders on education in the EU (Avlijaš 2020). Such an approach to economic development, most conspicuously in Estonia, resulted in the establishment of human capital-oriented social investment policies in the region.

Since the Baltics were as severely fiscally constrained as the Visegrád countries due to their initial transitional recessions and their strict adherence to macroeconomic stability, they redirected public resources away from direct cash compensation towards future-oriented social investment policies. This course was feasible since the high flexibility of the workforce, along with high employment rates and relatively high education levels, reduced the demand for social protection. Moreover, a foreign-owned financial sector with low ownership concentration offered market-based tools for risk diversification through private insurance. Also favoring this course was the political context in which the large Russian-speaking minority, the biggest “losers of transition”, were effectively marginalized, and any political conflict surrounding reforms was transformed into an ethnic one (Bohle and Greskovits 2012, Avlijaš forthcoming). Thus, as the Baltic countries pursued their burgeoning social investment agendas, they were able to significantly cut social spending on cash benefits to compensate the losers of transition, which led to their characterization as “disembedded” neoliberal states (Bohle and Greskovits 2012).

#### *Eastern European responses to the 2008 financial crisis*

The 2008 crisis had an extremely negative impact on Eastern European GDPs, which dropped by up to 20% in some countries, due to their high exposure to international financial markets. The Baltic countries resorted to steep austerity measures, which severely impacted the less privileged parts of their populations, but allowed them to avoid external devaluation and preserve their middle-class and foreign business interests. For example, Estonia, which was among the worst hit countries by the 2008 crisis, avoided external devaluation, which would have burdened its indebted middle class and its transnational banks. Instead, the government resorted to severe austerity, with large wage cuts in the public and private sector, lay-offs, and further retrenchment of welfare programs, all of which disproportionately hit the lower-skilled and welfare-dependent parts of the population. The austerity program was effective within a year, allowing Estonia to join the Euro in 2011, which enabled both its households and banks to restructure their debts under more favorable terms (Bohle 2013).

The Visegrád countries, in contrast, appear to have resorted to a mixture of political populism and economic policies that aimed to restore their national economic independence and a quiet continuation of subsidies for FDI in manufacturing, in tandem with the noisy politics of social compensation for pensioners and middle-class families (Bohle and Greskovits 2018). Using the example of Hungary, Bohle (2013) shows how the newly elected Hungarian Prime Minister, Victor Orbán, committed to restoring the country's financial independence by introducing taxes on financial services and pushing costs onto banks and away from their customers, limiting housing repossessions by banks, renegotiating debt burdens for many debtors, and a series of other anti-financial, capital-oriented measures. But his government continued to support FDI in manufacturing industries (Bohle and Regan 2019). Thereby they averted evictions and a major mortgage crisis, but at the price of international reputational damage to the Hungarian government.

These trends indicate that neither of the two regions has made a U-turn in their dominant growth strategies since the 2008 crisis. If anything, the Visegrád countries have strengthened their focus on FDI-driven industrial upgrading by reducing government support to the FDI-driven development of finance and other dynamic services and entrenching the welfare agenda of social compensation at the expense of social investment. By contrast, the Baltic countries have increased their support for dynamic services and financialization-oriented economic activities, as well as their commitment to investment in human capital at the expense of social compensation for losers of these reforms.

### **3.4 Financialization and commodification of welfare in the United Kingdom**

The UK was a leader among the advanced economies in adjusting to growing manufacturing competition from emerging countries by shifting to financial services as the new national engine of growth and swiftly shutting down extractive and manufacturing sectors of its economy. The conservative Thatcher and Major years (1979–97) were famously marked by a large-scale privatization of the British economy, including partial privatization of pension schemes (more general privatization was desired by the neoliberal governments, but it was not politically feasible, see Pierson 1994), as well as extensive privatization of social housing and deregulation of the housing market. The increasingly liberal and residual character of the British welfare state continued to be reinforced even after the end of the conservative era, since subsequent Labour governments continued to focus on reducing the cost of the welfare state and increasing its efficiency. Market mechanisms in social welfare provision continued to increase (especially in healthcare and pensions) and the selectivity of welfare policies grew, while the promotion of workfare measures accelerated, along with growing labor market flexibility (Palier and Hay 2017). This welfare state retrenchment trend has accelerated even further since the onset of the global economic crisis, following the austerity-driven agenda of the Tory government which came to power in 2010. While the general trend in UK welfare state reform since the 1980s has been towards reduction, some rebalancing of welfare state spending could be observed during the 2010s as the government attempted to mitigate the negative impact of the financialization-driven growth strategy on consumption capacities of low earners via, for example, income tax credits on earnings or basic pension.

### *Privatization of welfare*

When it comes to specific welfare policies that have been adopted since the 1980s, pension privatization is an important area. While conservative governments were unable to completely privatize the basic and complementary public pension systems during the 1980s (Pierson, 1994), they reformed public pensions by introducing price indexation of the basic pension level, reducing the guaranteed replacement rate of the public complementary pension, SERPS) and favored the expansion of private pension funds by proposing to those having a public complementary pension to “opt out” from public schemes and benefit from quite attractive fiscal exemptions if they did so (Bonoli and Palier 2000). As a result, the UK is among those countries with the highest private pension contributions and benefits in the OECD, together with other countries which have pursued the financialization growth strategy and those which have pursued the export of dynamic services growth strategy (Figure A2 in the appendix).

The Thatcher government also eased access to credit for the middle classes during the 1980s and created a new constituency of homeowners by introducing a national “Right to Buy” (RTB) policy, which consisted of selling public housing to private tenants. The RTB policy was the largest single example of privatization in the UK in the period from 1980 to the mid-2000s (Disney and Luo 2017). This policy particularly benefitted low- and middle-income groups who purchased homes cheap and benefitted from the skyrocketing prices afterwards. Given the growing marketization of retirement schemes, housing served as an additional source of savings for retirement.

Housing privatization also went hand in hand with the deregulation of the UK housing finance market and opened the mortgage market up to much greater competition. This increased the supply of mortgages and reduced their price, which fueled the newly emerging appetite for house ownership among the British middle class and reinforced the country’s growth model. As Reisenbichler (this volume) explains, the housing market has been an important transmission channel for monetary policy in the UK because lower mortgage rates lead to higher housing demand and house prices, which in turn stimulates bank lending and household consumption in the wider economy. The expanding housing market also fueled financial product innovation, which made access to mortgages easier for the poorer and less creditworthy households. Buy-to-let mortgages were one such innovative financial product that emerged in the financial services during the 1990s.

The significant wage discrepancy between high- and low-skill service jobs boosts the demand for (higher) education. Individual investment in human capital grew in importance, since it improves the potential for access to high-paying jobs in financial services, where decentralized wage-bargaining could not impose any collective levers on wage growth. In parallel, workfare measures were adopted for low-income groups. A continuous decline in the level of unemployment benefits went along with growing pressure on beneficiaries to return to the labor market. The unemployed lost the most from the welfare state reforms during the Thatcher and Major eras (Bonoli and Palier 1998).

### *Targeted social investment and the financialization of education under New Labour*

Instead of stopping the privatization and financialization trends of the previous neoliberal governments, the Blair government (1997–2007) introduced mostly correctives and added a new component to it in the form of social investment. In other words, Blair’s “Third Way” after 1997 continued to promote the highly financialized, dynamic services-driven model of growth for the UK, while directing a portion of its proceeds into social spending and social investment. According to Taylor-Gooby et al. (2017), New Labour started off with a “cautious expansion of state provision through social investment” (p. 51), which included educational investment in low-performing regions, subsidized childcare, introduction of the national minimum wage (in 1998), and expansion of means-tested welfare and means-tested tax credits for those on low incomes.

In order to ensure that the unequal income and wealth effects of the financialization-driven economic growth would not start to impede growth via faltering domestic demand, working tax credits and other efforts to support the consumption of low earners were developed. The expansion of public social services also served to lift incomes of the bottom quintile of earners. The Blair and then Brown governments regularly increased and expanded income tax credits on earnings to boost the consumption capacities of the low earners.

Blair was very clear about the necessity of promoting investment in human capital, as it was deemed crucial for success in the new dynamic and financial services-driven economy. However, the chosen means to that end continued to be market-based. The Blair era was indeed characterized by a government-encouraged marketization and financialization of the higher education system. Following half a century of direct government funding for universities and direct student support via state maintenance grants, tuition fees were increased in 1998. Subsequent governments have further retrenched state funding, allowed the cap on fees to be raised, and removed restrictions on student numbers and the limit on fees for foreign students (Viña and Hale 2016). The retrenchment of state funding for education in a context of growing demand for education increases the marketization and financialization of access to education, especially via educational loans. This approach to the expansion of tertiary education is therefore different from the one in the Nordic countries, where private providers have also been introduced but the state has remained responsible for financing.

While New Labour did not dismantle the RTB housing policy, no new stocks of social housing were built, creating very long waiting lists. In the 2010s, the UK has the lowest level of peacetime house-building since the 1920s, and the chance of owning a home in the UK has more than halved in twenty years (Bennett 2017). The benefits of the RTB policy for homeowners have been further buttressed by an unregulated rental market with high prices. This has created a strong constituency of homeowners that is heavily and increasingly skewed against youth and towards older generations who purchased housing during the Thatcher era. The fact that no progressive land value tax has ever been introduced has further reinforced inequalities in the housing market and strengthened the wealth effect of housing for the older generations who accessed affordable housing during the Thatcher era at the expense of the young. Between 1995 and 2016, the average (median) ratio between the average house price in the region where a young adult lives and his/her annual net family income doubled, from 4 to 8 (Cribb et al. 2018). Affordability has thus become a growing problem over time.

The absence of new social housing has fueled the mortgage market and, along with growing salaries for some, has resulted in most of the new housing stock being bought from private owners at market prices. In summary, while the government initially encouraged homeownership through privatization of its stock of social housing, the construction of social housing was discontinued, while the demand for housing at market prices went up. This was fueled further by growing salaries and increased access to financial instruments such as mortgages to finance these purchases. Furthermore, the UK has seen a growing financialization of housing, whereby it is treated as a commodity to invest in and a means to accumulate and deposit wealth, rather than a place to live.

### *Further public retrenchment feeding private welfare since the 2008 crisis*

A conservative turn in New Labour policies took place during the later 2000s, and their final years saw a partial loss of the social inclusion gains from the early 2000s, as the government failed to adjust the means-tested benefits to the cost of living after 2007 (Taylor-Gooby et al. 2017, 53), except for the pensioners. In 2010, in the wake of the financial crisis, the Tories came to power with an austerity-driven political platform aiming to balance the budget, reduce access to welfare, and activate those who were not participating in the labor market. Several benefit cuts and freezes have been introduced since 2010. The government raised the value-added tax, which affected the poorest the most, as they consume the highest portion of their income, and it raised income tax thresholds, which hit unemployed people and low-wage workers without children the hardest. While subsidized childcare for 15 hours per week was preserved, the overall costs of childcare skyrocketed between 2010 and 2015. Austerity measures also included significant cuts to the budgets of local councils, which are mostly responsible for providing social services (Taylor-Gooby et al. 2017, 56). The post-Blair years, therefore, saw a significant cut in social spending and, in that sense, a continuation and acceleration of the Tory policies from the Thatcher era. Given that these policies were administered in the wake of the 2008 economic crisis, the highly flexible UK labor market has seen a boom over the last few years in the most precarious forms of employment such as zero-hour contracts (contracts without guaranteed hours) and agency work. According to data from the UK Office for National Statistics,<sup>1</sup> zero-hour contracts peaked at 2.1 million in 2015, following which they saw a slight drop.

When it comes to housing, UK government measures in the aftermath of the 2008 crisis dampened the impact of the crash and recession on the housing market. The £15.5 billion worth of public schemes that were introduced in 2013 to support homeowners in the aftermath of the crisis (Jenkins 2013) indicates the growing importance of housing in the UK financial services-driven economy.

The Tory government also looked for ways to maintain the consumption capacity of low earners to stimulate domestic demand, but as cheaply as possible. The government thus argued that working tax credits, which were introduced as wage top-ups from public revenues, cost the state too much. They, therefore, tightened the eligibility criteria for tax credits in 2016 and increased income tax thresholds, while introducing a national living wage for those above 25 years of

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<sup>1</sup> Accessed at <https://www.ons.gov.uk/> on 9 May 2019.

age, which is higher than the national minimum wage. They also banned employers from having an exclusivity clause in the zero-hour contracts, which likely explains why unit labor costs in the UK grew substantially less during the period 2009–17 than during 1997–2007 (see Figure A1).

The Cameron government (2010–16) also implemented several changes in the pension system. Along with legislative provisions that have raised retirement age thresholds and that have encouraged employees to work past their retirement age, retirement saving requirements in employer-sponsored, private pension schemes were increased. In 2012, an “automatic enrolment” into pension funds was put in place for every salaried worker, in order to increase the number of people having a personal pension fund. In 2016, a flat-rate state pension was also introduced, that is aiming at merging the basic pension and the complementary public one to a flat rate basic state pension in the future. It will take decades to come into full effect, as current employees continue to benefit from the state scheme that they are already entitled to. These changes to the pension system have shifted a larger portion of the retirement burden onto employers and private pension providers. Pensioners’ incomes rely more and more on private pension funds: while 44.5% of mean income of retired households came from private pensions and annuities in 1977, it was 82.1% in 2017 (Office for National Statistics 2018, 15).

Due to uneven access to supplementary pensions that contributed to increase poverty amongst the elderly during the 1990s and early 2000s (Ebbinghaus 2019), governments have also made sure that the level of basic public pensions would be increased and sustained. The Blair government’s decision to peg public pensions to earnings instead of inflation has been strengthened by the Brown government (with a mechanism of “triple lock” that guaranteed an increase of public pension of at least 2,5% per year) and maintained by the Tory governments. This has ensured the consumption capacities and political support of pensioners by enhancing their incomes, while concurrently benefits for the working-age population were cut.

The post-financial crisis years have also seen further cuts in public spending on higher education, which resulted in an unprecedented level of financialization in the higher education sector, as universities went to financial markets to obtain funding by issuing bonds. In fact, between 2010 and 2016, government grants to English universities halved from £8 billion to £4 billion per academic year, while income from tuition fees tripled between 2005 and 2015 (Viña and Hale 2016). In other words, weakening government support has pushed universities towards greater competition for students and towards international capital markets, which have an interest in them because they are deemed as rather safe investments. As Hale (2018) writes in the *Financial Times*, UK universities are a “popular target of investment for US pension and insurance money seeking long-term projects. Lloyds estimates that more than £3 billion has been borrowed by UK universities since 2016 on capital markets, with around half of that coming via private placements”.

### **3.5 The fate of wage-led growth and social protectionism in Southern Europe: from public debt to “competitive impoverishment”**

France and Italy were clear examples of wage demand-led growth regimes typical of Fordism (Boyer 1979 for France; Baccaro and Pontusson 2016 for Italy), despite the existence of some

export sectors (such as French “champions” and Northern Italian firms). Since the 1980s, these countries have been stuck in the Fordist growth model, being able to neither grow nor transform into new ones. Their “consumption-based welfare systems” (Beramendi et al. 2015) guaranteeing a high level of compensatory benefits, such as unemployment allowances and generous old-age pensions, are key to sustaining their domestic demand-led growth. Italy has been an example of “permanent stagnation” since the 1990s (Baccaro and Pontusson in this volume), while France has continuously failed to become an export-led economy (Culpepper et al. 2006). Before 2008, membership in the Eurozone secured relatively low interest rates that sustained a public debt-led growth. Since then, these two countries have pursued a competitive, low cost, and austerity strategy that only leads to poor growth (Johnston in this volume), further deindustrialization, difficulties in developing new, high-skilled dynamic services, massive unemployment (especially for youth), and low labor market participation. The other Southern European countries (Greece, Spain, and Portugal) benefitted greatly from EU accession in the 1980s, and then, like Italy and France, from the Euro before the 2008 crisis. Since 2010, however, all of them have been deprived of the possibility of running a domestic demand, wage, and welfare-led growth regime, after the EU imposed a more or less stringent “competitive impoverishment strategy”, which we introduce at the end of this section.

*Italy: permanent stagnation and the impossibility of reforming the welfare state*

The Italian economy has been characterized by low expenditure on R&D, technological and organizational regress, and weak competition in domestic product markets (Capussela 2018). The large stock of public debt contributed to the country’s inability to invest in new technologies and R&D. Italian firms have been growing more slowly and have been less innovative than those in other European economies. They have also declined in average size and productivity since the late 1980s. While none of these constraining factors on the economy is new in the Italian context, their importance has strengthened over time given the new global challenges that have emerged (Capussela 2018).

Italy has made repeated failed attempts to reform its model and boost its competitiveness since it prepared to join the Euro in the mid-1990s (Hassel 2006). The contribution of net exports to growth was in fact negative from 1994 to 2007, and the share of ICT and services in exports declined. The decline of the wage share continued throughout the 1990s and the early 2000s (Baccaro and Pontusson 2016). As Italian exports are price-sensitive, these industries failed to make important gains in world markets. According to Baccaro and Pontusson (2016), this is due not only to Italy’s specialization in labor-intensive manufacturing and the growing global competition in these industries, but also to the negative effect of Eurozone membership which further reduced the ability of Italian exporters to compete on price. At the same time, the growth of household consumption has been supported by a significant expansion of credit since the country adopted the Euro, albeit starting at low levels (Baccaro and Pontusson 2016).

In the context of this low, and at times negative, growth, Italy has been stuck in a vicious cycle of having to control public debt and stimulate domestic demand with ever-scarcer resources. Due to the externally imposed fiscal constraints, first by the EMU and, after the crisis, by the ECB (Sacchi 2016), political conflict has revolved around the external push for fiscal cuts and domestic resistance to them. The Italian population refused to accept impoverishment because

of international competitive pressure, and the Italian government did not accept to restrain domestic consumption.

Because neither side has pushed for it, Italy has not redirected any substantial social expenditures towards new social risks or social investment, except for some slight improvements in childcare policy (Kazepov and Ranci 2017). Spending on old-age and survivors' pensions as a percentage of GDP is the second highest (after Greece) in Europe,<sup>2</sup> while spending on family policy, education, and active labor market policy is much lower than in other EU countries. Some more recent efforts to boost female labor force participation and increase access to childcare, especially via the expansion of private childcare service providers, have partially fallen through, as their increased privatization had led to a deterioration in service quality (Kazepov and Ranci 2017).

### *Welfare reforms in a stalemate*

In this context of push and pull factors for fiscal cuts in order to boost international competitiveness, we find a myriad of both passed but afterwards abandoned welfare state reforms in the spheres of pensions, labor markets, and education policy.

Already in the 1990s Italy tried to reform its pension system under fiscal pressure of the Maastricht criteria and implement a notional account system (as in Sweden). These reforms were delayed through very long phase-in periods (Ronchi and Vesan forthcoming). However, following the 2008 crisis, especially with the Fornero pension reform of 2011, the shift to defined contributions accelerated, along with the elimination of early pensions and further increases in the retirement age (Agostini and Natali 2016).

Comprehensive labor market reforms towards deregulation were adopted, first by the center-left government in 1997, then by the center-right in 2003 (Ronchi and Vesan forthcoming), and again in 2012 (Fornero labour market reforms). Their goal was to diminish unemployment and labor market dualism by reducing protection against dismissal that permanent employees enjoyed (i.e. increasing flexibility) and promoting new types of labor contract (short term without justification, permanent contract with easier firing possibilities, etc.). Governments have also intervened with short-term policies to cushion the population from rising unemployment, such as expanding existing short-shift working arrangements after the 2008-9 shock (Vesan and Pavolini 2018). Yet, cuts to unemployment benefits and employment protection were more severe than efforts to prevent the rise in unemployment (Guillén and Pavolini 2015). Despite the professed intention of these reforms, the labor market has become increasingly dualized, particularly between age groups, where older workers still benefit from the more protected contracts, while young people are increasingly exposed to temporary contracts.

### *Consumption rather than investment*

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<sup>2</sup> 16.5 % in 2015 for Italy, 17.8 % for Greece and 15% for France, while the EU average is 12.8%, Eurostat data. Accessed on 6 May 2019. [https://ec.europa.eu/eurostat/statistics-explained/index.php/Social\\_protection\\_statistics\\_-\\_pension\\_expenditure\\_and\\_pension\\_beneficiaries](https://ec.europa.eu/eurostat/statistics-explained/index.php/Social_protection_statistics_-_pension_expenditure_and_pension_beneficiaries)



When it comes to education policy, Italy has lower tertiary educational attainment than most EU countries. Education policies were subject to retrenchment throughout the 2000s, in stark contrast with the general European trend. Most cuts came with the education reform adopted between 2008 and 2010 under the center-right Berlusconi government, which reduced expenditure for both compulsory and university education (Ronchi and Vesan forthcoming). Italy's underinvestment in education reflects the structure of its economy and labor market, which does not demand skilled labor and hardly invests in innovation and R&D (Kazepov and Ranci 2017). Because Italy has been going in the opposite direction from most advanced economies where the demand for skilled labor has been growing, it has not prepared for the knowledge economy. Moreover, those with high skills have difficulties to find jobs, and economic returns to their skills are very low, resulting in the problem of overqualification, which has further reduced incentives for both individuals and the state to invest in human capital (Kazepov and Ranci 2017).

We find no evidence that there has been a paradigmatic shift towards finding new sources of growth for the country. On the contrary, most of the few resources available for welfare expansion went to “short-term employment incentives, tax credits and, to a lesser extent, consumption-oriented benefits (unemployment benefits and, later on, the new, residual, minimum income scheme), which extended income support to categories that were previously left aside the Italian welfare system, such as young labor market entrants and the poor” (Ronchi and Vesan forthcoming, 10). These were all efforts by the government to maintain domestic demand via household consumption.

After seven years of stagnation, Italy returned to low growth (half of the Eurozone average) in 2014 with a supportive fiscal policy that “relied on waivers or flexible interpretations of EU rules” (Capussela 2018, 2). Following this long recession, average real disposable income is still a few points below its 1995 levels (Capussela 2018, 2). Recent political developments in Italy (the domination of radical, anti-EU, and anti-migrant parties) illustrate the political danger of imposing austerity, welfare cuts, and wage moderation on a country that relies on domestic demand-led growth without organizing any transition to a different growth regime. In this volume, Johnston shows the negative results of wage moderation in this context, and Scharpf analyzes the political risks of such a strategy. At the time of writing, initiatives by the “populist coalition” government (2018–19) had been leaning towards income maintenance and compensatory welfare, such as the implementation of a minimum income scheme (the so called basic income promoted by the Five stars movement) and revalorization of pensions.

### ***France: failed attempts to become an export-led growth economy***

France is an interesting example of a failed attempt to switch to an export-led growth regime, while being restrained by the (institutional and political) legacy of the domestic demand-led one. The turning point starts in the 1980s, reinforced in the 1990s by several attempts at welfare retrenchment, and culminates in a series of policies to lower firms' labor costs. Lowering the cost of labor is still the cornerstone of French economic policies. Governments seek to enhance firms' external competitiveness via internal deflation, but without damaging domestic consumption (supported by a relatively high national minimum wage and generous social benefits). Most of the French growth strategy towards bolstering export capacity is thus based

on cost reduction and is in reality a low-cost strategy that relies on dualizing welfare system reforms.

### *Trying to become an export-led growth economy without harming domestic demand*

Traumatized by the double failure of Keynesian reflation plans (in 1974 and in 1981), French governments have changed their growth strategies to promote external “competitiveness” in the French economy. In 1982, the socialist government adopted a “policy of rigor” (austerity), especially by freezing welfare benefits (Palier 2005), and adopted a strong currency policy in 1983 (Culpepper et al. 2006). The 1980s were marked by industrial restructuring that was buffered by early retirement pension schemes and generous unemployment benefits as well as outsourcing and off-shoring (Palier and Thelen 2010). Reducing the size of the manufacturing workforce was meant to increase productivity and competitiveness. Compensatory measures were very costly and were financed by both an increase in social contributions and budget deficits. The looming of the Euro, however, imposed limits on deficits and inflation. French governments have since then been trapped in a double bind: on the one hand, they try to follow the German path of rescuing the manufacturing sector via internal devaluation, but, on the other hand, they know that wage decreases or even stabilization and cuts in social benefits hurt growth and increase unemployment since the economy is mostly driven by domestic consumption.

Indeed, the French growth regime relies much less on exports than on domestic consumption, as is indicated by the almost permanent deficit of the current account <sup>3</sup> and by the low share of exports in GDP (around 30% of GDP in 2018, see table 2 in Hassel and Palier in this volume). Household consumption is maintained by a relatively generous wage policy, in particular through the minimum wage. However, since the late 1980s, many economists and employers’ representatives have complained about the cost of labor and have pushed governments to lower non-wage labor costs (Palier 2005, chapter 7; Carbonnier et al. 2016). Since net wage moderation risks stunting growth and triggers social unrest, non-wage labor costs have become the target of the economic strategy of French governments, implemented through incremental and partial welfare retrenchment and many exemptions to employers’ social security contributions.

### *Ambivalences of the wage policy*

In France, wages have continuously risen since the 1960s, in both exposed and sheltered, public and private sectors. The median net wage (gross wage minus social security contributions) of full-time, full-year, salaried male workers increased in real terms by about 15% from 1976 to 2010 in private and public firms. From the mid-1980s to 2007, individuals and households enjoyed gains in their disposable income of 30% and 23%, respectively (Askenazy and Palier 2018). Since 2008, wage increases in France have even been higher than productivity increases (Askenazy et al. 2013).

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<sup>3</sup> An exception is the 1990s, mostly explained by German reunification, when rising domestic demand in Germany boosted the French current account.

As analyzed by Höpner and Lutter (2018) and Scharpf (this volume), France (like other Southern European countries) lacks the capacity for wage coordination, which is instrumental for wage moderation. On the contrary, French industrial relations led to a wage push in all sectors, notably because unions are organized in national confederations and have their strongholds in the public sector. Wage rises in the private sector are supported by a relatively high national minimum wage that enjoys strong political support. Any attempt to reform it has led to strong social protest.<sup>4</sup> In France, the minimum wage is perceived as the best tool to limit an increase in inequality, and it has indeed been working (OECD 2015). The minimum wage usually rises faster than average and median net wages (Askénazy and Palier, 2018). It is thus used as a tool to increase consumption, especially amongst low-income groups, and to limit wage inequalities in France.

However, French governments have tried to decouple minimum wage increase from inflation and limit the once traditional “coup de pouce” (push-up) aimed at boosting consumption. The last big push-up was in 1981 (a 10% increase of the minimum wage). However, there were also a number of minor “political” push-ups when new presidents and prime ministers took office (1995, 1997, 1998, 2001, and 2012). In the public sector, the evolution of wages is strongly contested. The “point system” (*point d’indice de la fonction publique*) that is used for calculating public servants’ wages has hardly followed inflation and has been frozen for some years. However, wages in the public sector have, in reality, increased through the “normal” upgrades associated with career advancement (in terms of grade and age).

However, the rise of taxation over this period has eroded the purchasing power of wages incomes (Askenazy and Palier, 2018). Total taxation rose from 30% of GDP in 1960 to 45% in 2017 (*ibidem*). More than half (55%) of total taxation (including social contributions) goes to the social insurance system (of the rest 30% go to the state budget and about 15% to local governments). While income tax is relatively limited in France (less than half of the households pay it, and it has been regularly reduced), there have been continuous increases in social contributions (paid by employees) and even more increases in local taxes (financing social assistance) and in consumption taxes, such as those on tobacco, alcohol, or soft drinks (earmarked to finance healthcare) and on gas and gas oil. The rise in the taxes on gas and gas oil in late 2018 triggered the *gilets jaune* – yellow vest mobilization.

### *Labor market and welfare reforms*

France has gone through many labor market and welfare reforms since the 1990s (see e.g. Palier 2000, 2005, 2010; Hassenteufel and Palier 2016) aimed at reducing the overall cost of the welfare system, while protecting the core workers and activating those at the periphery of the labor market (Palier and Thelen 2010). Ultimately, these reforms have contributed to a dualization of the labor market and the welfare system (Palier and Thelen 2010; Seeleib-Kaiser et al. 2012).

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<sup>4</sup> Attempts to reform the minimum wage have always been strongly contested on the street, especially in 1994, when the government tried to create a specific (lower) minimum wage for youth, and in 2006 when a ‘Contrat Première embauche’ would have allowed firms to hire new entrants to the labor market at a lower level than the minimum wage. Both attempts were abandoned due to massive demonstrations.

As in Germany, during the late 1970s and the 1980s, France used insurance-financed welfare benefits to implement its first response to the end of Fordism, i.e. dealing with industrial restructuring via labor-shedding, generous unemployment allowances, and early exit policies (including putting the age of retirement at 60 in 1982). The aim was to save the industry by relieving it of part of its workforce. However, in the early 1990s, the EU context introduced new constraints. During the 1990s, all welfare reforms were made in the name of the introduction of the Euro and the defense of French competition in an open economy (Palier 2005, 2010). The goal was not to dismantle the welfare system but rather to rescue it through reforms. The logic of the reforms has always been the same: to reinforce the Bismarckian contributory mechanisms (one needs to pay more social contributions and for longer to be entitled to the same social insurance benefits) so that insiders bear less of the burden of the reforms than those who are unemployed or in atypical jobs. For outsiders a different welfare state has developed, consisting of means-tested benefits, income tax credits on earnings, and activation of unemployment insurances (Palier 2010).

These efforts at retrenchment have never been able to stop the growth of social expenditure, only to reduce its rate of increase. Despite dozens of reforms throughout the 1990s, 2000s, and 2010s, according to OECD socx data<sup>5</sup>, public social expenditure went from 24.3% of GDP in 1990 to a peak of 32.2% in 2014 (down to 31.2% in 2018). Since the 1990s, France has had the most expensive welfare state in the world. These expenditures have been triggered by old-age pensions,<sup>6</sup> healthcare,<sup>7</sup> and unemployment insurance. The French welfare system remains mostly a social consumption one.

However, not all workers can benefit from it, since changes in labor market policies have given a boost to atypical employment (Palier and Thelen 2010). Policies of labor market flexibility at the margins were aimed at developing low-paid jobs in the sheltered service sector and thus providing manufacturing and high-skill services with cheap outsourcing opportunities, a capacity to adjust the size of the workforce to economic conditions (with a rise in short-term contracts), and a relatively cheap domestic service environment. Since the 1990s, there has been a succession of changes in labor law including the Macron ordinance of “*loi travail*”, adopted in 2018, that eased the use of atypical work contracts (Palier and Thelen 2010; Askenazy and Palier 2018). Trends at the end of the 2010s show an increase in very short-term contracts<sup>8</sup> and non-standard employment so that more than a third of the working population did not have a permanent work contract.

France has put in place a system that allows—and actually encourages—the development of low-paid jobs, while keeping the net hourly wages of these workers close to those of other workers. This occurs through the application of the minimum wage to all sectors (with only few exceptions), salary grids in industry agreements, which cover the vast majority of workers, an

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<sup>5</sup> [https://stats.oecd.org/Index.aspx?datasetcode=SOCX\\_AGG](https://stats.oecd.org/Index.aspx?datasetcode=SOCX_AGG), accessed on February 24, 2020.

<sup>6</sup> The standard of living for pensioners has continued to increase to an income of €2,049 per month in terms of per unit of consumption in 2013—almost equal to that of the working-age population (€2,062) and higher than the standard of living for the whole population (€1,946) and especially young people aged 18–24 (€1,671) (COR 2015) It has remained above the standard of living of the active population since then.

<sup>7</sup> Health spending increased from 8% of GDP in 1990 to 11.5% in 2014 and has since then remain around this level.

<sup>8</sup> Since 2015, at least 4 million people are hired on a fixed-term contract of less than one month each quarter. About half are on contracts of less than one week (Askenazy and Palier 2018).

earned income tax credits (*prime d'activité*), and specific social benefits for workers with very few hours of work (Askenazy and Palier 2018).

While these welfare and labor market reforms resemble those of Germany and were indeed inspired by the German example, which is prominent in the French economic debate, there are four main differences with Germany which are linked to the political priority to preserve French domestic consumption. First, in contrast to Germany, welfare expenditure has not diminished, and wages have increased during the 1990s and 2000s. Second, the reforms have been much less abrupt than the German ones (especially under Schröder); they have merely contributed to reducing the rate of increase of social expenditure, not shrinking it. Third, the rise in atypical jobs has not been accompanied by a sharp increase in working poverty as in Germany, thanks to a general minimum wage and specific subsidies. Fourth, the state spends much more money in France than in Germany to support the changes, especially to compensate for the general exemptions in social contributions and to finance low-paid job creation.

### *Lowering labor costs while maintaining consumption capacities*

In order to protect businesses from carrying the burden of the expensive, consumption-oriented French welfare system, all governments since the early 1990s have continuously intervened to indirectly lower the cost of labor, i.e. to lower the level of social security contributions, especially for the low-paid (before exemptions, social contributions account for 60% of the firm's cost of labor). Both conservative and socialist governments have pursued this strategy (Askenazy 2011; Carbonnier et al. 2016). They first aimed to compensate for labor costs that minimum wages represent for firms employing people in low-skilled jobs. Over time, the social contribution exemptions have increasingly concerned higher wage levels, with the CICE (*credit d'impôt pour la compétitivité et l'emploi*, a tax credit for firms, calculated at a percentage of payroll, created in 2013 and worth 20 Billion € per year) reaching all wages up to 2.5 times the minimum wage. Institutionalized by Macron in 2019 as a permanent reduction in employers' social contribution, the very name of this measure (literally “tax credit for competitiveness and jobs”) encapsulates the French growth strategy: reduction of labor cost to improve firms' competitiveness and boost job creation!

Not only French firms are able to benefit from these social contribution exemptions and tax credits, but private households are too, if they employ someone for domestic tasks like cleaning, home help, childcare, or elder care. France has created many (bad) jobs in these areas (around 1.23 million, according to Carbonnier and Morel (2018)), supported by many (inefficient) tax credits that are contributing to further crowding out French investment capacities.

This strategy of lowering labor costs is extremely costly for the public purse, since social contribution exemptions are compensated by the government budget (financed by other taxes). With an overall cost of around €50 billion per year (Carbonnier et al. 2016), this tax and social contribution exemption strategy is increasing the public deficit and debt without triggering strong growth or the creation of good jobs. Yet, it continues to be the main economic instrument used by the government to boost firms' competitiveness. The French economic strategy is, thus, more a low-cost strategy than anything else.

### *A low-cost strategy*

Despite governments' aims of supporting the competitiveness of manufacturing industrial sectors (and more recently of "French Tech"), there are few institutional changes that positively enhance such capacities. France has been able to develop neither an efficient apprenticeship and vocational training system nor a co-decision organization of corporate governance that would generate high-quality manufacturing nor a wage coordination system that would allow for wage moderation, also indispensable for a manufacturing export-led strategy.

As for dynamic services, France is able to create good jobs in some sectors (banking, luxury) but lacks the basic institutions needed to pursue an inclusive social investment strategy. The number of children under three in formal childcare is now well below the German one (Collombet et al. 2017). Despite a will to "democratize universities" since the late 1990s, France still lacks an efficient university system that provides high general skills to all, since it remains strongly elitist (Chevalier in this volume). The distribution of literacy and numerical proficiency is among the most unequal in the OECD (close to Southern Europe, according to Programme for International Assessment of Adult Competencies data).

The French case demonstrates the incompatibility between wage-led and manufacturing export-led strategies. Since its policies do not help to create enough good jobs or strong growth, France continues to finance its publicly subsidized, low-cost strategy through public debt. It is trapped in a low growth, low employment, low skill, high public expenditure, and high public deficit and debt circle, gradually getting closer to its Southern European neighbors. It has, however, been able to avoid a debt crisis and has, thus, eluded the drastic "competitive impoverishment" strategy that has been imposed by the EU on Portugal and Greece and partly on Spain and Italy.

### **3.6 The EU-imposed "competitive impoverishment" strategy**

As demonstrated by the study of Germany and France in this chapter, the wage and social benefits-based domestic demand-led growth regime is quite incompatible with a manufacturing export-led growth regime. As explained by Scharpf in this volume (see also Hassel 2014; Hall 2014; Höpner and Lutter 2018; Iversen and Soskice 2018; Johnston and Regan 2016), the differences between the two growth regimes are at the core of the explanation of the Eurozone crisis. Before the crisis, Southern European countries benefitted from low to negative real interest rates and from the credit ratings of the Eurozone as a whole, so that they could finance their domestic demand out of debt (more private in Portugal and Spain, more public in Italy, France, and Greece). However, inflation, wage increases, and the emerging credit bubbles led to a deterioration in competitiveness compared to their Northern counterparts, and, once the crisis struck, they had no instruments of their own (i.e. devaluation capacities) to deal with it. In parallel, Northern European Eurozone countries seemed to grow in the exact opposite direction: they organized low inflation and wage stagnation (and thus lower growth than in Southern Europe) during the first years of the Euro. They undertook major structural reforms of their labor markets and pension systems and managed to contain, and even decrease, their public expenditure from 2000 to 2007. They thus increased their competitive advantage in comparison to their Southern counterparts. With the Euro, there is no exchange rate adjustment mechanism to counterbalance this advantage. What seemed at first glance to be an economic

and social convergence between the core and periphery (the periphery, with higher growth, was catching up to the center) actually resulted in increased competitiveness in the Northern countries and diminished competitiveness in the Southern countries. Most Northern countries recovered quite rapidly from the crisis (already in 2010) and then were in the political position to impose their own views at the European level.

### *The new Euro regime as an export-led growth regime*

From 2010, the governance of the Eurozone started to change. Many decisions created a more coercive environment in the Eurozone: the adoption of the Six-Pack (in 2011), the fiscal compact (2012), and the Two-Pack (2013). National budgets, and thus details of welfare policy reforms, became the subject of scrutiny with strong potential for the EU to intervene (De La Porte and Heins 2016, 18–19).

The Six-Pack introduced the Macroeconomic Imbalance Procedure (MIP), which aims to monitor in detail the evolution of each EU economy. The 14 “headline indicators” of the MIP reveal the kind of growth strategy the European Commission pursues,<sup>9</sup> which includes a balanced budget, low unemployment rates (including youth and long-term), and a high participation rate in the labor market. The MIP also observes the evolution of nominal labor costs, private sector debt, house price developments, financial sector liabilities, the current account balance, and the real effective exchange rate. Taken together, these indicators reflect the “normal” situation of a manufacturing export-led growth regime (low public deficit and debt, limited increase in labor costs, potentially positive current accounts) more than anything else. In practice, the MIP represses instruments of domestic demand-based growth regimes, either through private debt, house price increases, and financialization or through wage boosts and public deficits. Even though the Commission adopted a “social investment package” in 2013, there is little sign of active monitoring of the indicators proposed therein along the same lines as the MIP.

As Scharpf (this volume) demonstrates, the implementation of these economic control policies within the Eurozone aims at compelling the domestic demand-led growth regimes to become compatible with manufacturing export-led ones in a “forced convergence” process: “The main emphasis is on reducing unit labor costs in order to improve international competitiveness – and thus to achieve export-led economic growth.” The goal however is not to help the Southern countries to become export-led growth countries themselves, i.e. to invest in specific skills or to develop wage coordination, but rather to make them abandon their previous practices which favor domestic-oriented sectors and domestic demand-driven growth. Southern European countries are expected to become cheap enough to become competitive (i.e. to sell cheap products abroad, attract foreigners with tourism, and attract FDI to develop some industrial activities). This entails a long phase of decline and impoverishment, hence our label: “competitive impoverishment” strategy. This is not a passive strategy (waiting to become poor to become competitive), but it supposes an active welfare state reform agenda to destroy the institutions and practices linked to a domestic demand-led growth regime.

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<sup>9</sup> [https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/macroeconomic-imbalance-procedure/scoreboard\\_en](https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/macroeconomic-imbalance-procedure/scoreboard_en).

### *Welfare retrenchment and structural reforms to implement the competitive impoverishment strategy*

The reduction of unit labor costs to improve international competitiveness is at the core of the competitive impoverishment strategy. It implies both immediate cuts in public expenditure and more structural reforms to avoid any risk of an increase in unit labor costs in the future (Scharpf in this volume). Under the pressure of EU institutions, there have been waves of such reforms in Southern Europe since 2010. One channel was applied to all EU countries, namely the excessive deficit procedure (EDP). The other more stringent and intrusive channel was through Memoranda of Understanding (MOU) between the Troika (European Commission, European Central Bank, and International Monetary Fund) and the indebted countries that needed a bailout (such as Greece, Portugal, and partly Spain but also Cyprus, Hungary, Ireland, Latvia and Romania or). Italy also implemented some of these structural measures under the Monti government in the context of implicit conditionalities (Sacchi 2016).

As of mid-2011, 24 EU member states were subjected to the EDP. All countries had to control their budget deficit, inflation, and public expenditure. However, the policies implemented in order to achieve this had a much stronger impact on Southern countries. In the first place, their deficits and debts were much higher (so they had to implement harsher adjustment plans). Second, implementing austerity measures on domestic demand-led growth regimes has a much harsher effect than applying them to an export-led growth one (where wage moderation and balanced budgets are already part of the strategy).

The measures adopted since 2010 by European Union governments have been mainly of three different types: wage-freezes for civil servants (and cutbacks in their numbers in MOU countries), privatization (especially in MOU countries), and social policy reforms. A number of countries reduced unemployment benefits (Portugal, Romania, Denmark, Ireland, the UK, Spain, and Greece) in an effort to activate the unemployed. Several countries also restricted unemployment claimants' rights to refuse an offer of employment (Spain and the UK), and several measures were adopted that increased labor market flexibility, notably affecting workers with open-ended contracts (Spain, Italy, Portugal, and Denmark). Some governments also reduced the public share of health expenditure, with such measures being imposed on Greece, Ireland, and Portugal as a condition for receiving aid within their MOUs. Budget consolidation plans also included pension/retirement reforms. Spanish and Greek reforms introduced cost-containing measures in a new calculation of their pension formulas as laid out in their MOUs. In Southern Europe (and the UK and Denmark), cuts have also been made in education and family policy expenditures (Palier et al. 2018).<sup>10</sup>

Whereas the impact of cuts has been limited in most Northern and Eastern European countries, Southern European countries suffered in many ways from such budgetary measures and structural reforms: Greece lost a quarter of its GDP between 2008 and 2016, Spain had no growth during the same period, Italy almost none, and Portugal only 3.39% (Scharpf in this volume). Moreover, while other countries rapidly recovered their capacity to invest in their own

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<sup>10</sup> For an overview of the main decisions concerning welfare system reforms in Southern Europe see Guillén and Pavolini (2015, the whole special issue); Pavolini et al. (2016) for Italy and Spain; and Theodoropoulou (2016) for Portugal and Greece.



growth strategy, Southern European countries lost their capacity to boost growth and jobs through domestic demand, while not having the means to invest in any other strategies. There is growing divergence between Northern and Southern Europe in future oriented national social investment expenditure in the realms of health, education, family policies (like childcare), and (upskilling) active labor market policies (Palier et al. 2018). As a result, in Southern European countries, there are high levels of youth unemployment and a high number of Neets (neither in employment, education, or training), as well as a high number of well-educated youngsters leaving these countries (Lafleur and Stanek 2018).

#### **4. Conclusions: the politics of growth and welfare reform in advanced capitalist countries**

This chapter has illustrated how in European countries the dominant growth strategy has interacted with and shaped welfare state reforms. Analyzing the linkages between welfare states and growth strategies helps us to understand why welfare state reforms have been undertaken and their timing and content. While we do not pretend to provide a full explanation of welfare state reform trajectories, our account expands on the existing welfare state literature by answering why welfare state reform takes place even when it is politically costly.

We are now at the end of retracing the journey taken by capitalist growth regimes since the 1980s. The post-war era of welfare capitalism ended with the dissolution of the Bretton Woods system and the oil crisis of the mid-1970s. Since then advanced industrialized countries have undergone a constant process of economic restructuring. In line with other comparative political economy research (Crouch and Streeck 1997; Hall and Soskice 2001; Beramendi et al. 2015), we show that, despite common challenges, policy responses and reform trajectories have remained diverse.

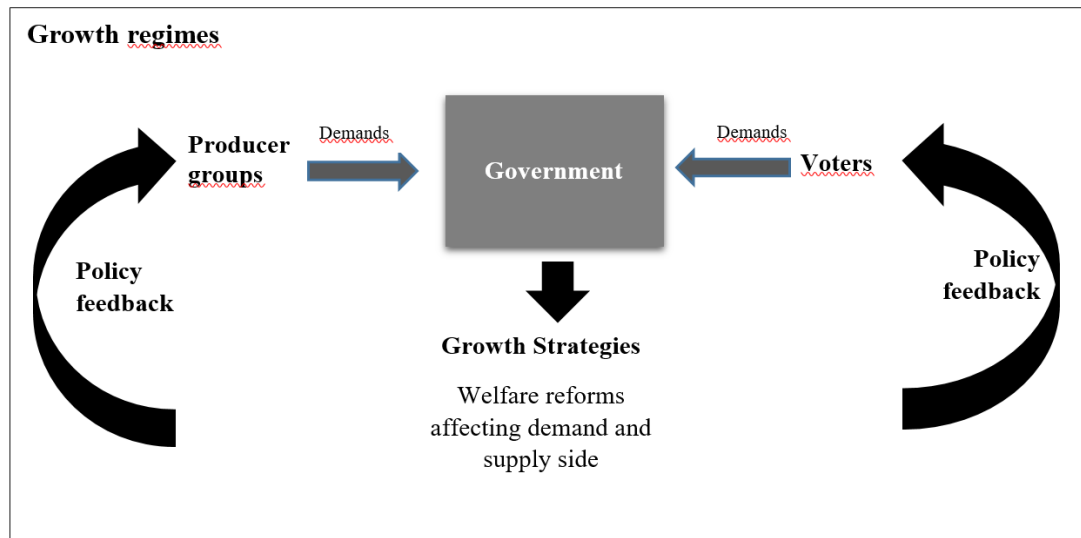
With this volume we have taken a step towards understanding why these trajectories of change have varied across countries and which mechanisms and drivers have shaped them. To address these questions, some authors emphasize the electoral process, including the changing composition of the electorate and their policy preferences (Beramendi et al 2015), while others focus on producer coalitions or social blocs and institutional legacies (Baccaro and Pontusson 2019). Some authors argue that there is a kind of division of labor here: electoral politics are dealing with very salient issues (“loud politics”), e.g. redistributive issues resulting from welfare state reforms, while business and producer groups deal with much less salient issues (“quiet politics”), such as economic policy issues (Culpepper 2010). By underlining the strong connections between welfare reforms and growth policies, we argue that one cannot just separate these two worlds of politics. There is a need to better understand how they interact. Like Hall (this volume), we argue that both processes work in tandem, or, as we illustrate below, in alternation.

To the current debate, we add the importance of governments’ actions and their growth strategies. Policy-making by governments does not take place in a black box, automatically following demands of the electorate (through parties) or those of dominant social blocs. In reality, governments are sandwiched between the demands of voters, on the one hand, and preferences of producer groups, on the other (see Figure 3; **Error! No se encuentra el origen**

**de la referencia.**) These demands exert pressures, which can even go in opposite directions, but also give governments a pivotal role in shaping the evolution of capitalist economies.

As this volume shows, governments' growth strategies are key to understanding how growth regimes evolve. We end this chapter by focusing on the politics of such strategies and propose a model illustrating how both producer groups and electoral politics matter in shaping these strategies.

**Figure 3: The politics of growth and welfare reforms**



We start by emphasizing the key role of producer groups on growth strategies and, henceforth, on welfare state reforms, but then underline the political feedback (sometimes backlash) that these reforms may trigger, thus implying more noisy electoral politics in the process.

*The key role of existing regimes and producer groups in shaping growth strategies and welfare reforms*

Government performance is measured against a country's economic growth and job creation. As the literature on economic voting has convincingly established, good economic performance contributes to electoral success of incumbent politicians. The review of the literature by Lewis-Beck and Stegmaier (2015) established that governments are held accountable for economic performance in terms of outputs such as employment and income growth. Iversen and Soskice (2019, 164) maintain that the electorate, in particular the middle classes, expect and ensure that the governments they elect focus on prosperity and prompt governments to pursue an efficient growth strategy (in our terminology, not theirs).

As the economic vote is a key predictor for electoral success, it continues to guide policy-makers. However, different governments choose different roads to that end. Suitable policies are context-specific and not universal. Chapters in the second part of this volume demonstrate that, when looking for clues as to which strategies are the most suitable for boosting growth and employment, governments take the interests of national producer groups into account.

Producer groups with the most leverage tend to be firms and organized interests in the most productive or the most relevant parts of the economy. In manufacturing-based economies, such as Germany, they comprise business and labor communities in engineering, the car industry, and pharmaceutical industries. In finance-dominated economies, they are located in the major financial centers, as, for example, the City of London in the UK. In France, they represent the interest of French-based multinationals, such as the automobile industry, luxury groups, and supermarkets (Carrefour). In Southern Europe, the most relevant business communities might be state-run enterprises or those that are protected by the state.

Economic growth and growth policies are confronted with the interests and power politics of the business community. Employment, innovation, and productivity take place overwhelmingly in private companies, in interaction with public research and innovation policies. The business community, therefore, has an important stake in how policies that affect them are implemented. There is a reciprocal and mutual dependency between business and state interests, but business elites pursue their own economic interests rather than the general public's (Amable et al. 2019; Culpepper 2010; Hacker and Pierson 2010; Skocpol and Hertel-Fernandez 2016). Typically, producer groups exercise political influence quietly, away from the media (Culpepper 2010).

Martin's chapter in this volume underlines the variety of business interests depending on growth regimes, but it also shows how the organization of business interests mediates and shapes the policy process regarding social and other policies. The degree of coordination, including macro-level concertation, and the degree to which the business community is able to present coherent preferences to governments make a key difference in policy outcomes. The business community's ability to forge alliances with trade unions and other civil society actors influences the framing of policy issues. Thelen's chapter in this volume demonstrates the key role of producer groups in forging growth strategies.

While business groups in the dominant sector(s) tend to have privileged access to governments (and to media), we do not assume that they always have the upper hand. In fact, business interests and government priorities may not coincide. However, we do expect government policy-making to take into account the demands of the dominant business community and their strategies to cope with economic and welfare restructuring.

Obviously, many other factors beyond the production regime and their representatives (producer groups) matter as well. Electoral rules, political institutions, political parties, and external events, as well as ideology and values, can lead policy-makers to adopt growth strategies that are not necessarily in line with the growth regime. However, in the medium to long run, we assume that the production regime will play an important role in influencing growth strategies, independent of the political configurations and institutions. The French case illustrates how much the legacy of an existing growth regimes weighs on the capacity to switch to another one.

The preference of the dominant sector informs policy-makers as to what the priorities of economic and social policies should be to protect, rescue or revive the existing growth regime (see also Iversen and Soskice 2018). As already demonstrated by Swenson (2002) and Mares (2003), and confirmed in this volume by Martin, these preferences do not always favor welfare retrenchment and liberalization. For example, in some contexts, social protection can serve as insurance for investment in skills, which business might support. In other contexts, business

may favor public investment in higher education in order to develop general skills of the workforce. Martin in this volume analyses the variation of business preferences for welfare reforms that depend on the kind of business community that is dominant. In some cases, workers in key industries might support business preferences, especially since both typically benefit from the economic specialization process. Such cross-class coalitions are sector- (or country-) specific and largely focused on or coming from the dominant sector in the economy.

However, even within the context of a specific welfare and growth regime, the social policy response to promote growth that is in the interest of producer groups might trigger political contestation. Such was the case when, in 2003, the Schröder government in Germany introduced wide-ranging, business-friendly labor market and welfare reforms as a reaction to low growth and high levels of unemployment. While analysts continue to dispute the real effect of the reforms on growth and employment, labor market activation lowered the reservation wage and contributed to wage restraint, which in turn bolstered the export-oriented growth strategy and contributed to job creation in the service sector.<sup>11</sup> The reforms however also contributed to the development of low paid jobs and in-work poverty. In the end, Schröder's Social Democrat government was not rewarded for its reforms, and the party was punished badly in the polls for their choice. The example shows that growth strategies might be adopted in the interest of dominant producer groups or for electoral reasons (jump-starting growth and reducing unemployment), but the choice of reform is not obvious, nor is it clear that incumbent governments will benefit from undertaking welfare reforms in pursuit of their chosen growth strategies.

An even more telling example of political backlash to the implementation of a growth strategy is to be found, of course, in Southern Europe, where reforms implemented in the name of growth and EMU without voters' consent have led to electoral discontent. Governments that side with producer groups at the expense of important voter segments might be punished at the polls or experience fierce reactions. Governments are, therefore, pressured from both sides: producer groups and voters. The demands of the two sides might overlap (for instance a demand to protect key industries), but might also clash. How the literature of voters' preferences in welfare reforms can inform us about how governments might respond when adapting growth regimes is the focus of the next sub-section.

### *The electoral challenge*

Hall's chapter in this volume points out that the most important feature of electoral politics is the structure of political cleavages. Cleavage refers to those issues most salient to electoral politics and the alignment of social groups along them. "Cleavage structures evolve in response to changes in the size and socio-economic position of specific social groups, which are affected by economic developments, and in response to changes in the appeals mounted by political parties" (Hall in this volume).

Hall analyzes the rise of female employment as a key new political cleavage, as women's position in the labor market is determined in particular by family-friendly policies and childcare

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<sup>11</sup> See Krebs and Scheffel (2013), Dustmann et al. (2014) and Bofinger (2017) for different assessments.

opportunities. While growth strategies during the era of liberalization beginning in the 1980s encouraged female employment, working women in turn started to demand better childcare (Hall in this volume). Morgan (2013) shows that since the late 1990s, important family policy reforms were introduced in Germany, the Netherlands, and the UK because party leaders needed new constituencies and thus feminized their party structures to attract female voters. Women working within the parties had played an important role in hatching or lobbying for these reforms. Such reforms were slow to materialize in Austria and Italy due to the absence of similar electoral dynamics. In a more general sense, as demonstrated by Beramendi et al. (2015), “investive” policies are demanded by service sector workers, who are often female. Low-skilled manufacturing workers, on the other hand, prefer “consumptive” social policies (Beramendi et al. 2015). Political parties regroup around these new cleavages and present their choices to the electorate in competition for votes.

How do these new cleavages influence growth strategies? The policy cleavage around investive versus consumptive social policies partly mirrors the five types of growth strategies and welfare state reforms identified in this chapter. When dynamic services are favored, social investment comes to the fore, and when manufacturing sectors are key, one is more likely to find a predominance of protective social policies that feed consumption.

In the context of financialization and very flexible labor markets, policies that allow or encourage an individual to invest in general skills is likely to be favored. Financialization leans more toward investive policies, as it gives access to credit to fund private education, including early childcare education. People investing in their own human capital through market mechanisms would likely prefer low social expenditure and easy access to credit and choice (through diversified private offers). These correspond to typical neoliberal proposals that New Labour kept on board to attract and keep upper middle-class voters. In the Nordic countries, the dynamic service strategy is directly related to investive policies in education and public educational spending. This strategy is very likely to be supported by the educated middle class. In the Nordic countries, educated people in interpersonal service occupations represent about a quarter of the workforce and therefore a good portion of the voting public, whereas the same group remains far below 10% in the Southern European countries (Beramendi et al. 2015).

The manufacturing export-led strategy pursues wage moderation and lower labor costs, while keeping labor market insiders protected. It is more related to consumptive policies, which on their own do not feed into a reduction of labor costs, but rather the opposite if they raise social contributions and the overall taxation of labor (the labor wedge). This is why dualization occurs, where only the most protected workers continue to have access to both public and private “consumptive” social insurance. Core workers in the manufacturing sector are promised employment protection in exchange for wage restraint and increased internal flexibility. Outsiders tend to work in low paid service jobs with low levels of protection (Emmenegger et al, 2012). Wage moderation and the preservation of quality in manufacturing labor is thus achieved through protection of labor market insiders, close cooperation with manufacturing trade unions on investment and technology, and enhancement of skills through liaisons with further education entities. Kapezov and Ranci (2017) have convincingly demonstrated that there is no political interest (nor actually any economic interest) in investive policies in Italy (and this could be generalized to other Southern European countries).

Overall, the electoral cleavage between the new (educated) middle class and the old middle class (routine-based jobs in both manufacturing and services) (Beramendi et al. 2015) also partially overlaps with the policies that are frequently employed in different growth strategies. The areas of overlap are particularly easy to detect in the strategy of dynamic service exports, which focuses on public investment in education. Here a positive feedback process can be identified in which more employment in the services sector bolsters demand for social and educational services, which then promotes further investment in the knowledge economy. By contrast, the manufacturing export-led strategy, which tends to privilege the old middle class working in the favored industries, focuses on consumptive social policies and social protectionism and contributes to their self-reinforcement (sometimes up to the point of exhaustion, as in Southern Europe).

Electoral cleavages can reinforce growth strategies, but do not automatically do so. In the Nordic countries, pursuit of the chosen growth strategy and welfare policies has not been hampered by electoral cleavages since the preferences of producer groups and other voter groups tend to coincide. Yet, electoral cleavages might cancel each other out or conflict with each other, thwarting governments' efforts to introduce reforms. This is what took place in Italy, when both the Monti (2011–13) and the Renzi (2014–16) technocratic governments tried to promote social investment against the interests of producer groups and the majority of the electorate (Kapezov and Ranci 2017).

For us, however, the main electoral dimension of the process lies in the political feedback effects that growth strategies and their associated welfare reforms might trigger. Indeed, these feedback effects can reinforce electoral cleavages or even create new ones. Changes in welfare systems made in the name of growth strategies have left large groups of the electorate less protected than before and forced them into insecure jobs. More labor market insecurity and less social protection have in turn given rise to more demands for social protection. For example, unions pursued the introduction of a statutory minimum wage in Germany after labor market deregulation contributed to the rise of the low-wage sector and was met with criticism by the electorate. One could also interpret the emergence of UKIP in the UK, and henceforth Brexit, as well as populist movements in Southern and Eastern Europe, as a countermovement to the growth strategies that had been implemented before.

To recognize the two sides of the politics of growth – producer group preferences and electoral cleavages – can thus help to understand increasing levels of voter alienation with government policies. Many policies by the center-left governments of Tony Blair in the UK, Wim Kok in the Netherlands, and Gerhard Schröder in Germany during the 1990s and early 2000s were based on the belief that “good” welfare reform policy would serve the middle classes and generate growth and jobs. These policies included labor market liberalization, activation, and social investment. They were often accompanied by welfare cuts and the conditionality of transfer payments for the unemployed, which parts of the electorate did not appreciate as “good”.

*Political salience as a determinant of path-dependent versus path-breaking reform trajectories*

Another important aspect of welfare reform is the salience and visibility of social policies. The dependence of large parts of the electorate on social policies and the importance of path-dependent developments in welfare reforms stand in contrast to many policies that interest the business community such as corporate governance reforms or the regulation of financial markets. As Culpepper (2010) has convincingly argued, the power of business varies between policy areas. The business community is particularly powerful with regard to economic policy issues, which receive low media attention and are decided on in informal settings. The higher the salience of an issue and the more formal the institutional arena governing it, the greater the likelihood will be that business will have to build alliances with other actors. While the business community might be tempted to shift the arena from high to low salience and from formal to informal venues, other – civil society or party – actors will do the opposite. For these other actors, the framing of an issue as high salience and governed by formal policy processes is advantageous for winning policy battles. The political battleground is, therefore, dependent on the framing of an issue and the definition of the venue for contestation.

The dynamics of policy-making when pursuing growth strategies can be illustrated with the example of German pension reform (see Naczyk and Hassel 2019). Before implementing the Riester pension reform, the Schröder government had envisaged opening up the German market for pension funds to bolster private pension mechanism and to strengthen capital markets in Germany, thereby inducing financialization as a growth strategy. The government had prepared legislation to set up defined-contribution plans for private pensions with no guarantee of returns. This would have contributed to a more finance-led growth path in the German economy. The plan, however, failed as the government wanted to link the introduction of such plans to cuts in existing public pensions that allowed the opponents – mainly the insurance industry and some segments of organized labor – to thwart their introduction (Naczyk and Hassel 2019).

Naczyk and Hassel (2019) argue that pension reforms remained a technical issue as long as policy-makers kept the introduction of pure defined-contribution plans separate from cuts in public pensions. In an environment of “quiet politics”, opposition to pension reform is harder to mobilize than it is for highly salient pension cuts. When – as in the German case – defined-contribution plans were presented in combination with retrenchment, the pension reform package became much more politicized and allowed arguments to be heard in the public debate about the threats to actual pension payouts posed by the volatile portfolios of pure defined-contribution plans. The visibility and threat of pension cuts put strong pressure on politicians, compelling them to commit to safe and adequate pensions (Naczyk and Hassel 2019).

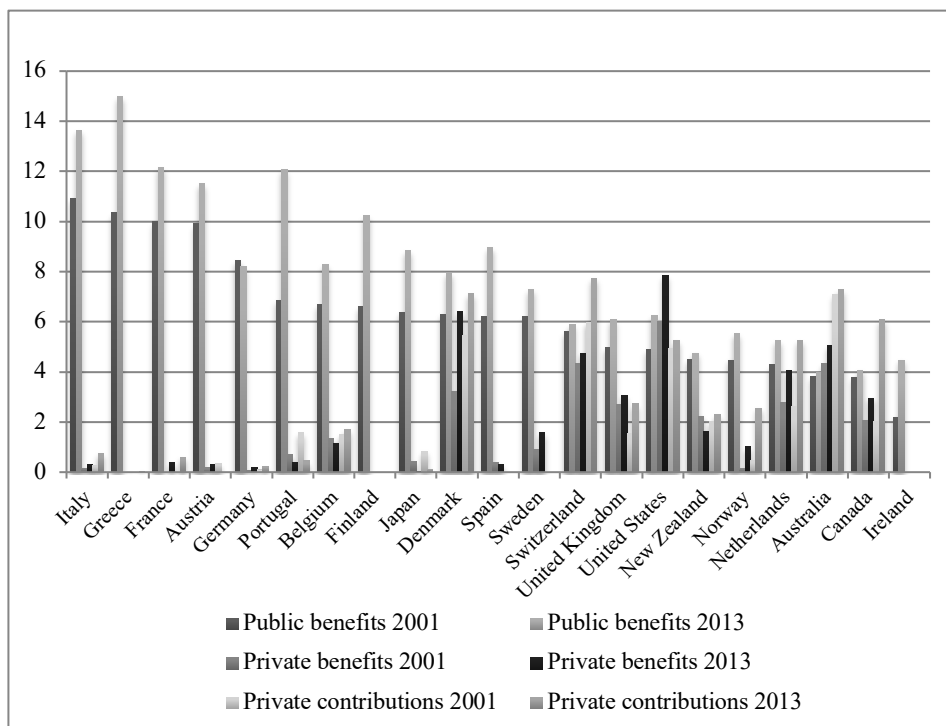
In other words, growth strategies that rely on welfare reforms are situated in the highly salient and contested arena of the politics of welfare reform, rather than in the hardly visible arena in which policies for business are determined. The stickiness of the welfare state also prompts strategies that correspond to the existing welfare and growth regime. Path-breaking reforms are much harder to achieve and sustain politically. We, therefore, argue that, in the context of long-established welfare and growth regimes, the dynamics of the policy process, situated between the quiet politics of business regulation and the noisy politics of welfare reform (and social policy preferences of changing electorates), largely determine the capacity of governments to effectively pursue their growth strategies. Governments have no choice but to mediate between quiet and noisy politics; policies will inevitably trigger responses and feedback loops from both producer groups and voters.

We finish this chapter by noting that, throughout our analyses of national growth strategies, we hardly came across the issue of climate change in the various growth strategies we studied. In their search for growth, most governments have neglected the environmental issues that seem to contradict or hinder that quest. However, in a context of global warming and climate change, traditional patterns of growth will be increasingly questioned, and strategies for green growth are likely to be sought. The climate crisis will force governments to change course, either to control emissions or to cope with the effects of climate change. As climate change will pose great costs on all governments (and the people they govern), growth strategies will have to adjust with regard to, at a minimum, transport and energy systems. Here, we expect to see a distributive impact across the board, with new, potentially quite noisy political dynamics emerging.



## 5. Appendix

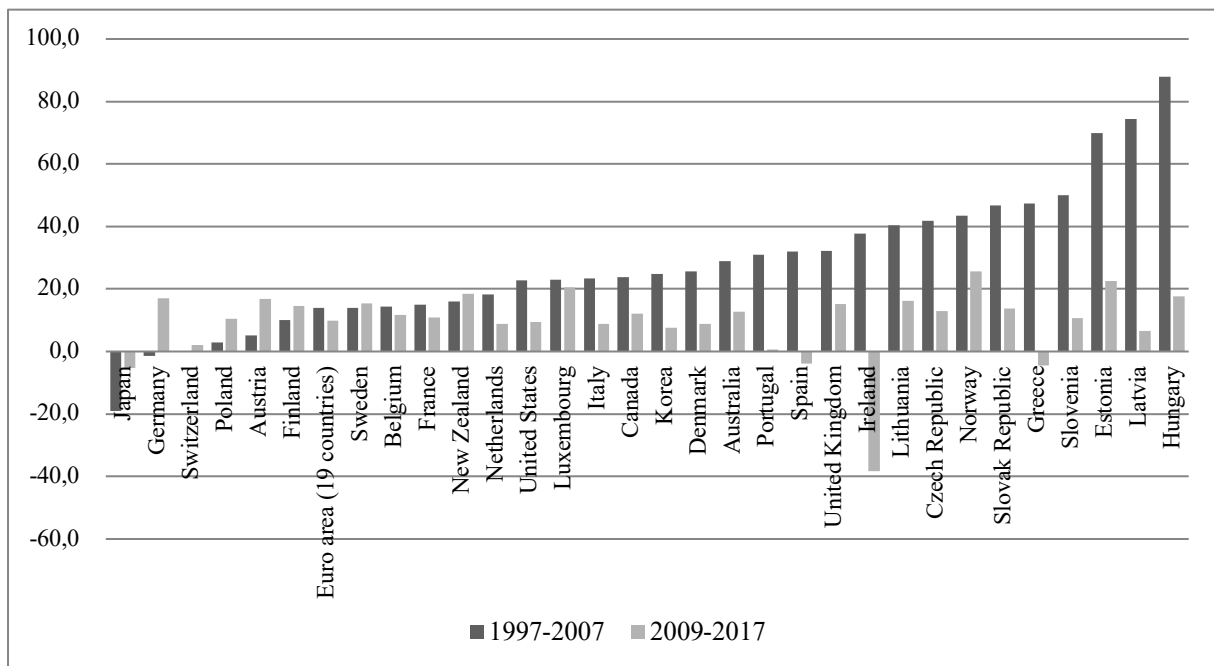
**Figure A1 - Spending on public/private pensions and contributions to private pension plans as a % of GDP, 2001 and 2013**



*Sources:* Hassel et al. (2019). OECD SOCX; OECD Global Pension Statistics

*Notes:* data for private benefits in France (2001), Greece (2001) and Ireland (2001 and 2013) are missing; data for private contributions in France (2001), Ireland (2001 and 2013), Spain (2001 and 2013) and Sweden (2001 and 2013) are missing. For Sweden's private benefits, data were retrieved from OECD.data (2005 benefits for 2001).

**Figure A2 Change in unit labor cost, selected OECD countries, 1997–2017**



Source: OECD Dataset: Unit labor costs and labor productivity (employment-based), total economy; quarterly change. Data extracted on 05 Sep 2018 07:12 UTC (GMT) from OECD.Stat

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