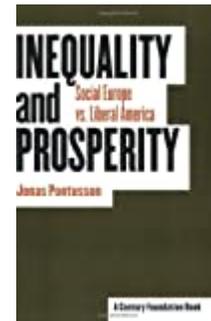




Jonas Pontusson. *Inequality and Prosperity: Social Europe vs. Liberal America.* Ithaca: Cornell University Press, 2005. xiv + 242 pp. \$19.95 (cloth), ISBN 978-0-8014-8970-9.



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The Impact of Institutions on Economic Performance and Equality in Liberal and Coordinated Market Economies

Jonas Pontusson's sweeping analysis probes whether institutions that promote income redistribution and employment protection reduce economic efficiency, economic growth and employment. In short, he contends that the relationship between these variables is not, as is commonly believed, by its nature negative. The impact of these institutions on the performance of economies and the redistribution of wealth within them would seem to depend on how institutions are structured and not simply on whether they exist. His telling observation is the fact that aside from the Irish case, there is no evidence that inequality leads to greater GDP growth per capita.

The first 5 chapters of this book present a wide array of statistical evidence that convincingly casts doubt on the widely held assumption that liberal market economies naturally outperform social market economies. In the first chapter he challenges the assumption that there is an automatic trade-off between growth and equality. In the second, he highlights similarities and differences not only between these categories but also

within them. In chapter 3, he contends that rising wage inequality is pervasive across both types of economies. In the following chapter he successfully demonstrates that social market economies do not naturally have higher unemployment rates than their liberal market counterparts. In chapter 5 he demonstrates how national systems of wage bargaining, combined with the proper monetary policy, can have positive effects on economic performance. Although the last four chapters of the book are interlaced with statistical evidence, they rely more on qualitative summaries of various institutions in liberal and social market economies. Chapter 6 summarizes how participation, employment security and skills impact performance in both of these types of economies, while the following chapter tackles the issues of welfare states and redistribution. In chapter 8 he contends that changes in welfare states in social market economies have often been cast incorrectly as retrenchment of the welfare state itself. Examining the details of the changes that have actually occurred makes clear that these changes were really mere adjustments in existing institutions. The final

chapter argues that the social market economies located on the continent of Europe should copy their Scandinavian counterparts and pursue more activist labor policies that focus on institutions to help job creation rather than on those that provide income support.

The author should indeed be praised for being able to tackle such a broad question in such incredible detail. He effectively demonstrates throughout the book that changes in Social Market Economies (SMEs) have not been as dramatic as they have been portrayed in some quarters. Contrary to popular belief, he argues that governments in these countries are reducing costs and fine tuning their institutions rather than abandoning them and embracing the liberal market model. Scholars interested in this broad debate as well as those interested in the details of differences in institutions will find this book incredibly valuable. In tackling this question he employs a wide array of statistics to probe whether liberal market economies (LMEs) by their nature outperform SMEs in terms of unemployment and economic growth.

The later chapters of this book in particular present excellent descriptions of the structure of institutions in SMEs. Regretfully, similar descriptions of these institutions in LMEs are lacking. Overall his discussion of institutions in liberal market economies is rather limited. He mentions throughout the book that LMEs are not as liberal as many observers believe, but does not demonstrate in any detail why this is the case. Passing references to differences in liberal market economies are never summarized or analyzed in any significant manner. This omission should not detract from the value of the book. The vast majority of work in this field, including the seminal work of Peter Hall and David Soskice, gives short shrift to institutions in liberal market economies.[1] By labeling such economies “liberal,” scholars tend to assume that institutions in these countries do not shape economic growth or inequality. Close examinations of institutions in such economies, however, clearly demonstrate that this is not the case. Although the author highlights the possibility that continental SMEs can learn from Nordic SMEs in terms of inspiring greater employment growth, he does not explore similar lessons that LMEs like the United States could learn from other LMEs like Ireland nor, for that matter, does he explore whether liberal market economies can actually learn something from their social market counterparts. This minor criticism should not detract from the excellent work done by this author but rather inspire others to pick up where he has left off.

Despite Pontusson’s stated claim of comparing institutions in these two types of economies, it becomes abundantly clear by the end of the book that his real goal is to suggest a manner in which institutions in SMEs should be changed to adapt to new challenges. He contends that these economies can improve economic growth while maintaining a relative level of equality by pursuing activist labor market policies, namely by dedicating more resources to promote employability and less money to income support. An activist approach to labor markets helps people to find jobs and retain them while also helping specific disadvantaged groups. Such policies, he claims, can offset the negative effects of employment protection. Nevertheless, he believes that employment protection should be loosened somewhat to reduce unemployment.

According to his analysis, SMEs can not ignore the problem that high taxes, the coordination of wage bargaining and generous unemployment benefits tend to dampen job creation. A shift toward activist measures should reduce not only the duration of unemployment but possibly also the rate of unemployment. Although the reader might disagree with his particular suggestions for reforming SMEs, his idea of focusing on the impact of specific institutions on inequality and economic growth should be praised. Too often scholars in this field prefer to create binary ideal types without proceeding to examine the differences that actually appear when real cases are examined. It is important to examine not only how specific institutions impact inequality and economic growth but also the ways in which variations in these institutions affect these variables.

At the same time, Pontusson challenges the widely accepted notion that welfare states naturally undercut economic growth and living standards. He contends that in the 1960s and 1970s, evidence suggests that social welfare programs actually strengthened the performance of economies while also serving to redistribute wealth. The evidence for this correlation, according to his assessment, is rather mixed. His main contention is that aggregate levels of social spending do not automatically have a negative impact on the performance of economies. Instead, the potential negative effects associated with social programs would seem to be related to whether institutions promoting income redistribution and employment protection are offset by activist labor market policies that stimulate job creation.

Common wisdom regarding the impact of institutions on unemployment rates is also questioned in this

book. The author points out that unemployment rates were virtually the same across LMEs and SMEs from 2000 until 2003. Some SMEs have even shown consistently lower rates of unemployment than the average rate for LMEs. Moreover, labor markets do not need to be deregulated dramatically to improve employment prospects. Some social market economies have been able to reduce unemployment rates sharply without far-reaching deregulation. Nevertheless, job creation and the duration of unemployment still remain important problems for the majority of SMEs. In general workers who lose their jobs find it much more difficult to find new ones. At the same time, Pontusson points out that SMEs experience much less labor turnover. Firms do not simply dismiss workers at the first signs of difficulty, as is more common in LMEs. Therefore, unemployment rates tend to fluctuate more in liberal market economies than in their social market counterparts.

Similar observations can also be made about the performance of economies over the last few decades. The author marshals an array of statistics to show that if Ireland is excluded from data on economic growth, LMEs and SMEs grew at exactly the same rate in the last two decades of the twentieth century: 1.8 percent. Yet, countries in the OECD did not achieve this result in the same manner. The number of hours worked in the United States increased from 1990 until 2000, making it the leader in average annual hours of work across OECD countries by 2000. Economic growth in that country seems to come at the cost of not only an increase in the hours worked but, paradoxically, growing inequality as well.

Yet income inequality has grown in both LMEs and CMEs (coordinated market economies). At least a portion of growing inequality, apparently across OECD countries, can be attributed to de-unionization. Leaving aside the United States, unionization rates in LMEs are comparable to that in SMEs in the middle of the continent. Collective bargaining leads to more equality in wage distribution. However, coordinated wage bargaining in CMEs, that is, the setting of general wage levels across industries, was actually associated with better macro-economic performance in the 1980s and 1990s. Some of these states actually force all firms in a particular sector to adhere to general wage rates negotiated by unions and employers at the national level. The fact that these agreements usually cover all workers in a particular sector makes unions more likely to exercise wage restraint. The more workers covered by such arrangements, the more likely unions are to try to ensure

that rises in wages are connected to productivity growth. Workers in SMEs may be covered by collective bargaining agreements even if they are not members of a union. Consequently, the decline in unionization rates in these countries would not necessarily have a negative impact on inequality. Coordinated wage bargaining has actually been shown to be a mechanism for controlling inflation. Without this mechanism, LMEs are forced to rely on unemployment as a means for disciplining labor and dampening inflation. Nevertheless, central bank independence has a stronger impact on inflation than coordinated wage bargaining. Countries with both seem to have the best overall economic performance.

The integration of unions into the decision-making process of firms in SMEs is often criticized by observers in liberal market economies as limiting the speed at which firms can make decisions. Although this criticism may be accurate, the direct involvement of workers in this process also improves the flow of information in the firm and legitimates the activities of the firm in the eyes of workers, thereby lowering rates of absenteeism. As my work on the introduction of a lean production program by a German conglomerate in its facilities in the United States and Germany shows, the identification of workers with the firm that co-determination engenders proves critical to the success of best practices that require employee involvement. Without this type of participatory framework, workers are reluctant to take on new responsibilities and actively work to diagnose and solve problems, two key activities required of workers in firms purporting to practice lean production.[2]

My work on lean production in the United States has further demonstrated that co-determination, while slowing the actual speed at which decisions are made, also serves to ensure that people within a firm are committed to the particular goals resulting from the decision-making process. Without this commitment, top executives are unsure whether their decisions will actually be implemented. Consequently, firms without co-determination require more policing and monitoring. This latter point can possibly explain why, as Pontusson observes, the elimination of co-determination is generally not on the agenda of business people in SMEs. The contrary would seem to be the case. Such laws were actually strengthened under the Schröder government in Germany. While the author claims that co-determination is possible in LMEs even though it is not legally mandated, this is technically not the case for the United States. Section 8(a)(2) of the National Labor Relations Act in the United States actually prohibits firms from involv-

ing workers in their decision-making processes.[3]

The degree of employment protection varies across countries. While it is indeed stronger in SMEs than in LMEs, it is also stronger in social market economies in southern Europe than in social market economies in central and northern Europe. Nevertheless, no statistical evidence suggests that employment protection per se naturally causes higher rates of unemployment. Countries like Austria, Norway and the Netherlands have relatively strong employment protection laws but nonetheless have relatively low levels of unemployment. Employment protection may make it more difficult for people to find jobs but it also reduces inflows into unemployment during economic downturns. Nevertheless, a strong correlation has been found between employment protection and the duration of unemployment. It has also been shown to stunt job growth.

While the downside of employment protection seems clear, the upside should also be highlighted. In evaluating the costs and benefits of such protection scholars have to keep in mind the traditional trade-off between efficiency and job creation. Although less employment protection may lead to greater job creation, it also seems to lead to a lower overall efficiency within an economy. At least a portion of the greater efficiency apparent in countries with job protection can be attributed to the fact that people in such countries tend to hold jobs for longer periods. The longer one works in particular firm, the more proficient, and therefore efficient, one becomes. At the same time, employment protection provides the basis for the generation of trust, motivation and loyalty. Workers are willing to make firms more efficient and firms are willing to invest more in the skills of their workers when workers are motivated and feel loyal to their employers. Nevertheless, Pontusson contends that it is difficult to measure the benefits of employment protection accurately. The same could be said of attempts to measure the benefits of not having employment protection.

As mentioned above, the author seeks to evaluate the impact of institutions on equality and economic growth without arguing that SMEs have to abandon them. He does, however, suggest ways to counterbalance the negative impact which some institutions have on economic performance. The author contends that most SMEs need to shift funds from income support to employability and employment promotion. This shift is necessary because such policies serve to counteract some of the adverse effects that high taxes, union wage setting and generous unemployment benefits have on the creation of jobs.

Shifting funds in this manner would seem to reduce not only the duration of unemployment but quite possibly its rate as well.

The levels of skill across LMEs and SMEs vary quite dramatically. Social market economies have a higher level of skills, measured in terms of literacy scores, than their liberal counterparts. The productive potential of a country may actually be limited by a shortage of workers with useful skills. Nevertheless, the author does not examine why some CMEs are inherently better at producing workers with a relatively high level of skills compared to other economies. Although Pontusson points out that the advent of globalization may actually require firms to employ workers with higher levels of skill, he does not seek to explain how differences in training systems produce different results. Instead he provides a basic overview of the structure of training systems in SMEs and LMEs.

Research on the impact of skills on the ability of firms to implement lean production in the United States and Germany demonstrates that lean production programs require workers with a relatively high level of skills. If firms do not have such workers, companies can not empower them and realize fruitful teamwork between managers and workers as imagined by this type of production. Since the skills of workers and managers are relatively similar in Germany, firms in that country would seem to have little difficulty in implementing lean production. Such production programs prove more difficult in LMEs like the United States, in which the disparity of skills between workers and managers is much larger. Since lean production has been proved to increase overall productivity in firms, it is important for firms to have the resources needed to implement them. Otherwise, economic growth can come at the cost of squeezing labor rather than through programs that actually improve productivity.[4]

If scholars solely examine social spending levels, it appears that the welfare state has actually grown across all OECD countries from 1980 until 2001. Yet, this fact masks the growing dependence of a greater number of people on the services of the welfare state. Hence, spending on social welfare programs is actually slowing as an increasing share of populations across these countries depends on them. In general, welfare spending is not growing sufficiently to keep up with the needs of the elderly, unemployed and the working poor. Regretfully, changes in the mere terms by which benefits are distributed have often been touted as reform and misrepresented as some-

how shrinking the welfare state. Changes in the provision of social welfare have actually been incremental in nature or perhaps have involved the overhaul of specific social programs. The core components of postwar welfare states remain intact, even enjoying strong support in public opinion polls. Despite some evidence of convergence, a wide array of diversity persists in institutions across OECD countries.

Pontusson recognizes that welfare states are indeed being challenged by an increasing number of retirees. Instead of abandoning the welfare state and moving toward a more “liberal” model, he suggests that governments reduce incentives for people to retire early while simultaneously inducing more women to join the workforce. The former would prevent jobs from merely being shifted from one group to another while the latter would be a means for increasing welfare funds without having to wait for a growth in population, which, if it were to occur, would take many years. The author recognizes that wage compression, employment protection and payroll taxes inhibit growth. For him the question is the extent to which these policies need to be relaxed to boost economic growth. He wants to keep wage protection because it puts pressure on firms to improve efficiency and produce products with greater value-added. The best means for boosting growth, according to his analysis, would be to liberalize employment protection somewhat and shift payroll taxes to income taxes. He believes that SMEs should converge on the Scandinavian model because it promotes activist policies of in education and job creation instead of just economically sup-

porting the unemployed. Although his suggestions are well argued, one should be careful not to relax employment protection too much, as it provides the basis for loyalty and trust, key elements for enabling firms to improve productivity through new organizational models such as lean production.

This book has indeed paved the way toward reexamining the links between economic growth and inequality. What is now missing is a careful examination of how firm behavior is actually affected by institutions and how their behavior in turn effects the overall level of inequality and growth in any economy. The first step toward such a goal should be a careful examination of how institutions actually affect firm behavior in so-called “liberal” market economies. Such a study would shift the debate from one which compares reality (SMEs) to an abstract model (LMEs) to one which recognizes that economies in the twenty-first century are indeed, at least in the developed world, embedded in a wide variety of institutions.

Notes

[1]. Peter Hall and David Soskice, eds., *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (London: Oxford University Press, 2001).

[2]. Daniel Friel, “Transferring a Lean Production Concept from Germany to the United States: The Impact of Labor Laws and Training Systems,” *Academy of Management Executive* 19 (2005): pp. 50-58.

[3]. Ibid.

[4]. Ibid.

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