Equality Versus Efficiency?

Structural Reform, Inequality, and Economic Performance in Western Europe

Jonathan Hopkin & Mark Blyth
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Jonathan Hopkin
Department of Government
London School of Economics and Political Science
J.R.Hopkin@lse.ac.uk

Mark Blyth
Department of Political Science
Johns Hopkins University
Mark.Blyth@jhu.edu

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Abstract It is a commonly held view that economic efficiency is bought at the cost of inequalities in income and wealth, and vice versa. Our paper submits this view to empirical scrutiny by examining the relationship between economic efficiency, measured in terms of the liberalization of markets, and income inequality in Western Europe. We produce quantitative evidence that for the most part, higher levels of liberalization are correlated with lower, not higher, inequality in Western Europe. We then examine three cases of Western European countries with varying combinations of economic efficiency and inequality to show how there is no necessary trade-off between the two. We conclude that policymakers should be optimistic about the possibilities of combining good economic performance with a fair society.
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Introduction

Policymakers, political pundits, and even political economists, are much enamoured by the notion of ‘trade-offs.’ That is, while we may seek more of good ‘X’ to satisfy our desires, doing so necessarily implies a diminution in our consumption (or production) of good ‘Y’. For example, one of the most famous trade-offs of the post war era was the Philip’s curve, which purported to show an inverse relationship between the rate of change in money wages and prices (more prosaically, unemployment versus inflation) (Philip’s 1958). As such, any amount of a good purchased, such as lower unemployment, necessarily implied a trade-off in terms of higher prices. It should give us pause then that as soon as the Philip’s curve was declared an immutable fact of life, the curve, and the trade-off it implied, collapsed (Friedman 1975/1991).

The validity of theorized trade-offs may matter less than the conviction with which such beliefs are held by policy makers. Once such ideas become the ‘conventional judgment’ regarding economic affairs, to use Keynes’ term, they tend to become self-reinforcing (Widmaier 2004). Options are therefore limited by the trade-off, in large part, because policymakers believe the trade-off to be real. Path dependent policy making becomes a function of an ideational ‘logic of inevitability’ courtesy of the purported trade-off (Blyth 2001, Hay and Rosamond 2002).

In this regard, one particular trade-off seems particularly hard to shake-off. A little over thirty years ago, Arthur Okun famously wrote about Equality and Efficiency: The Big Tradeoff. (Okun 1975). As Kermit Gordon put it in the foreword to Okun’s book, “some economic policies designed to reduce the scope and magnitude of inequality weaken incentives to produce, and otherwise impair economic efficiency.” (Gordon in Okun: vii). Indeed, as Okun put it even more succinctly, economic “efficiency is bought at the cost of inequalities in income and wealth.” (Okun 1974: 51). Such a claim obviously has great resonance in the context of debates about the future of the European welfare state. For if, as many politicians, pundits, and political economists maintain, attempts by welfare states to reduce inequality necessarily impair economic efficiency, then in a era of globalization, the days of such states are surely numbered.

While the claim that globalization will inevitably bring about, if not the death of the welfare state, then its convergence on a more Anglo-Saxon residualist model have been subject to much scrutiny of late (Hay 2004, Mosley 2003, Swank 2002), we wish to tackle this issue in another manner. That is, we wish to contest the very notion of an inherent trade-off between equality and efficiency. Indeed, as we shall demonstrate below, some of the most egalitarian states in Europe are among the most efficient and some of the most unequal are among the most inefficient. Indeed, if there is an outlier case, it is precisely those states that combine efficiency and inequality. We argue that just like the Philip’s curve trade-off, the
notion of a trade-off between economic efficiency and equality rests more upon the conviction that ‘if it logically sound it must be empirically true’, rather than any actual investigation of the facts.

This notion of an equality/efficiency trade-off is perhaps the fundamental (unspoken) assumption underlying the common belief that the future of West European welfare capitalism revolves around a binary choice between Anglo-American style liberal market economies with small welfare states, on the one hand, and a continental European ‘social model’ where markets are more constrained by state intervention and welfare provisions are generous, on the other (Albert 1993, Hall and Soskice 2001). According to this reasoning, Western Europe must choose (or be forced to choose) between a coordinated and a liberal market economy, (CME or LME) trading off the benefits and costs of these two models. The benefit of the first is seen to be efficiency; the benefit of the latter, if it is seen as a benefit at all, is equality. The notion among some authors that one can obtain the ‘best of both worlds’ is implicitly rejected. If equality undermines incentives and thus limits efficiency, in the long run ‘equality as policy’ is unsustainable.

This paper contests the implicit trade-off that lies at the heart of such models. Building on the suggestive empirical findings of Hicks and Kenworthy (2003) and Sapir (2004, 2006), we argue that advanced industrial nations, and the combinations of equality and efficiency they produce, can be usefully analyzed in terms of a simple two-dimensional matrix that posits four possible answers to the purported efficiency/equality dilemma. These economies are assessed in terms of both equality - their welfare effort measured in terms of social outlays and levels of income inequality - and their efficiency - operationalized as their economic liberalism and market friendliness (microeconomic flexibility, regulation of markets, and degree of structural reform). The data show that there is no simple trade-off between efficiency and equality, and that different degrees of state intervention in the economy can co-exist with both high and low levels of welfare effort, and with varying degrees of success in combating inequality.

Our findings suggest two main conclusions. First of all, that while advanced industrial democracies may be constrained in their ability to fight inequality, there may be a greater variety of models available than has often

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1 Although Hall and Soskice are careful to argue that both Liberal Market Economies (efficiency) and Coordinated Market Economies (equality) both produce ‘good’ economic performance, and thus there is no necessary convergence on the Liberal model, each model trades-off efficiency and equality though its choice of coordinative institutions.

2 Hall and Soskice, as well as authors such as Iversen, make the case that one can have efficiency without giving up on equality, as is demonstrated in the case of Germany. However, given the current state of the German economy such a claim may in fact be increasingly hard to sustain.
been argued that can overcome this supposedly immutable trade-off. Second, that states that do in fact combine efficiency and inequality are more the exception than the rule. As such, Okun’s original trade-off may be another one of those economic truths that turn out to be more ‘true by conviction’ than ‘true by examination.’ Both points are illustrated by supporting accounts of three different examples of welfare capitalism in Western Europe.

Varieties of Capitalism, Worlds of Welfare, and Policy Choice

Recent work in comparative political economy has brought a much needed correction to some of the more sweeping claims about the sustainability of welfare states that characterized the debate in the early to mid-1990s. Many early contributions to this debate predicted dire consequences for welfare institutions as the internationalization of capital flows and the dismantling of trade barriers unleashed a ‘race to the bottom’ among Europe’s complacent and inflexible welfare states. Social democratic policies such as welfare entitlements, publicly funded services, and employment protection legislation would have to be rolled back if Western Europe was to ‘compete’ in the new global economy. Like some public policy equivalent to Gresham’s Law; good policy (efficiency enhancing) was going to drive out bad (equality enhancing). Such claims have been revealed to be over-blown however, and careful analyses of the realities of policy change under globalization depict a variety of responses dictated, in large part, by the different institutional arrangements governing politics and the economy in the advanced democracies (Hall and Soskice 2001; Crouch 2005; Thatcher, Hancké and Rhodes 2007).

Contrary to the convergence hypothesis, institutional constraints on welfare retrenchment appear decisive in determining the extent to which governments respond to globalization by cutting back social protection (Kitschelt et al 1999, Pierson 2001). Countries with majoritarian electoral systems, decentralized wage bargaining, federal arrangements and limited welfare states have tended to reduce social provision, while those with inclusive electoral institutions, centralized wage bargaining, unitary structures, and more encompassing welfare institutions have tended not to (Swank 2002). In other words, the countries that have cut back social protection in recent years have for the most part been those that had less generous welfare arrangements in the first place (Schmidt 2002). As such,

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4 Often these arguments are built on a fundamental misunderstanding of the nature of international trade; see Krugman 1996.
globalization has not simply forced the abandonment of anti-inequality strategies in many countries in a race to the bottom.

Similarly, extensive research on wage bargaining has demonstrated that both decentralized and centralized labor market institutions can contribute to economic efficiency, although ‘intermediate’ models are likely to be penalized by globalization (Garrett 1998, Golden, Wallerstein and Lange 1999, Iverson 1999). Centralized wage bargaining can keep income inequality low without sacrificing economic performance. Other research stresses the complex interactions between institutions, interests, and exogenous constraints, concluding that institutional divergence has actually increased in recent decades, in spite of, and in some ways because of, globalizing pressures (Franzese 2002). Finally, it has also been persuasively argued that many of the imperatives attributed to globalization are actually the result of other pressures, such as demographic and technological changes, and the shift in advanced democracies from a manufacturing-oriented economy to a services-oriented economy (Glyn 1998, Iverson 2001). In sum, dealing with these pressures does not have to mean the abandonment of attempts to maintain social cohesion (Esping-Andersen et al 2002).

Much of this work implicitly or explicitly draws on longstanding models or types of advanced welfare capitalism in order to make sense of the variety of responses to the problem of globalization and inequality. Most prominently, Hall and Soskice and their collaborators see these responses reflecting two broad types of institutional arrangements in advanced industrialized capitalism: liberal market economies (LMEs) and coordinated market economies (CMEs) (Hall and Soskice 2001). The crux of the ‘varieties of capitalism’ argument is that neither model is inherently more economically efficient, and both can harness their respective institutional comparative advantages to good effect in the unforgiving global economy. However, Hall and Soskice note that the coordinated market economy, with strong labor market institutions and generally more generous social provision, implies much lower levels of income inequality than is tolerated in the liberal market model. This school of thought has emerged as a powerful counter to the view that social goals will have to be sacrificed if advanced industrial democracies are to adapt successfully to globalization.5

These critiques of the ‘globalization as convergence’ thesis offer some reassurance and encouragement for supporters of Western European welfare states. However, in the public debate, the welfare state remains under heavy pressure. Part of the reason is the poor economic performance of the largest CMEs – Germany, France and Italy – over the past decade. These countries’ slow growth and higher levels of unemployment contrasts

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5 For a recent example of the standard view on structural reform in Western democracies, see Llewellyn et al 2003.
with the relatively stronger performances of Western Europe’s LMEs. International economic institutions and the financial press frequently draw on comparisons of ideal-typical LMEs (the US and UK) and CMEs (usually Germany) to argue the case for the increased marketization of economic and social life. Arguments about institutional complementarities notwithstanding, efficiency seems to be trumping equality, at least in the public and policy debate.

This discourse, however, rests, we argue, on a misleading dichotomization of economic models based upon the notion of a trade-off between efficiency and equality mentioned above. Although there is relatively little controversy over membership of the ‘efficient’ market liberal group of English-speaking democracies, the more egalitarian ‘social Europe’ alternative is more diverse. In fact, in much of the policy debate, the non-English speaking advanced industrial countries tend to be lumped together as market-averse welfare states, with sluggish growth and high unemployment brought about by well-meaning but wrongheaded equality-focused systems of social protection. Sweden’s generous social benefits, Italy’s state pension liabilities, Germany’s restricted shopping hours, and France’s insistence on ‘national champions’ are mixed together in the same Euro-sclerotic bag. This ‘continental corporatist’ model is then contrasted with the ‘Anglo-American’ market-based model: a ‘capitalist culture-clash’ in which the latter is usually tipped as the winner, since Okun’s trade-off ‘makes it so’.

Much of the debate surrounding globalization and structural reform, that is, what supposedly needs to be done to accommodate to it, has revolved around this choice, with proponents of structural reform arguing that European social models are unsustainable, and many on the left denying the need for any fundamental reform. Given continental Europe’s recent poor economic record, framing the debate in such terms places supporters of the welfare state in an unpromising position. However, this dichotomy conflates the degree of liberalization of economies with their approach to tackling inequalities, which are two analytically separate, and

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6 Ireland has posted the fastest growth in the EU, whilst the UK has outperformed the other large EU economies.

7 For a typical example see Robert Samuelson, ‘The End of Europe’ Washington Post, June 15th 2005, page A25. The recent demonstration in France over the proposed reforms to ‘first employment contracts’ has only added to the constant chorus of ‘Europe must reform’ voices. See Richard Bernstein ‘Political Paralysis: Europe Stalls on Road to Economic Change’ New York Times, April 14th 2006, Final, Section A, Page 8, Column 3.

politically very important, issues. The following account suggests the choice is far less stark than the rhetoric might suggest.

**Variation Within Varieties: Equality and Structural Reform**

The current orthodoxy amongst policy elites in western democracies – clearly outlined in the European Union’s Lisbon Agenda for improving Europe’s economic performance – suggests improving economic performance through the adoption of supply-side measures that favour investment and enhance the efficiency of markets. These recommendations are often accompanied by exhortations to curtail welfare programmes and reduce the role of labour market institutions in wage bargaining.

Analyses of what is broadly termed ‘competitiveness’ – the ‘set of institutions, policies and factors that determine the level of productivity of a country’ (Sala-i-Martin et al 2007) – suggests a wide range of performance within the group of advanced industrial states. Table One shows the findings of the Global Competitiveness Report for 2007-8 produced by the World Economic Forum (Porter, Sala-i-Martin and Schwab 2007). Predictably, the Anglo-Saxon liberal political economies perform well this ranking, with the United States top, the United Kingdom 9th, and Canada 13th. What is less obvious is that the high-spending welfare states of Northern Europe perform if anything better, with Denmark placed third, Sweden fourth, Germany fifth and Finland sixth. The European countries that perform less well are chiefly the Southern Europeans: Spain is 29th, Portugal 40th, Italy 46th and Greece 65th. This suggests that the relationship between social models and economic efficiency does not take the simplistic form envisaged in the ‘trade-off’ thesis.

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Figure One, which looks at the relationship between competitiveness and public sector size, illustrates this point quite clearly. For a start there is anything but a linear relationship between government spending and competitiveness; and to the extent that there is a relationship it runs in the opposite direction to that postulated by Okun (although it is very weak and
not significant). Instead there is a great dispersion around the two axes, with countries combining government spending and competitiveness in a variety of ways. There are competitive countries with large public sectors (Sweden, Denmark, Finland, Germany), and competitive countries with small public sectors (Switzerland, and to a lesser extent Norway). The less competitive European economies have both high (Italy, Portugal) and low (Greece, Spain) levels of public spending. In short, there is no pattern, except to the extent that the majority of European countries are located in the top right-hand quadrant, combining high competitiveness and a large public sector. The next section takes a closer look at the data in order to make sense of these relationships.

Figure 1: Public Sector Size (Government Expenditure) and Competitiveness (2006)

Sources: OECD in Figures 2007 (total government expenditure 2006)

Does Liberalization Mean the End of Equality?

Esping-Andersen’s ‘three worlds of welfare’ and Hall and Soskice’s distinction between LMEs and CMEs dominate scholarly discussion of the dilemmas of welfare capitalism. However, the way these typologies have been employed may have tended to oversimplify the range of choices available to national governments. Hall and Soskice’s work somewhat elides important variations in institutional arrangements amongst CMEs. Esping-Andersen’s work, on the other hand, has tended to be interpreted in terms
of a ‘league table’ of welfare state development, with social democracies having the best record in achieving social equality and decommodification, liberal welfare states having the poorest, and Christian democracies being placed somewhere in between.

However, viewing this typology as a ranking is misleading since it does not correspond to political economies’ ability to adapt to changing world economic conditions. Instead, as we shall see below, the best and worst performers in terms of inequality have proved equally adaptable to the pressures of globalization, whilst the middle-ranking Christian democratic welfare states have faced most difficulties. As we shall see, equality does not necessarily ‘crowd-out’ efficiency, while some states manage to combine inequality with inefficiency. In short, both of these typologies tend to adopt a linear understanding of variation which does not seem to capture the range of outcomes that can actually be observed.

Recent research has sought to move beyond this. Edwards (2003) uses cluster analysis to generate distinct welfare state groupings on the basis of Esping-Andersen’s data, and finds a partial confirmation of the ‘three worlds’ typology, with some data to suggest a ‘fourth’ world amongst Southern European states (also Ferrera 1998). Hicks and Kenworthy (2003) use principal components analysis to tease out the different dimensions along which welfare regimes can be distinguished, finding two orthogonal factors: one which they call ‘Socialist-Liberal’ which taps the extent to which welfare entitlements are universalistic and favourable to female labour force participation as opposed to means-tested and of limited scope; another they call ‘conservative’, which taps the extent to which welfare benefits are occupationally based and reflective of status differentials. Indeed, Hicks and Kenworthy’s analysis, based solely on variables relating to welfare provision, can be taken further with the help of a range newly available data on the regulation of economic activity. These data provide a number of measures of the extent to which advanced industrial states intervene in markets by regulating, channelling and constraining economic activity.

Testing the Trade-Off

The previous section suggested that apparently liberal policies can coexist with extensive welfare arrangements which curb inequalities. We therefore subjected indicators of welfare effort, and indicators of economic regulation, to closer scrutiny to examine the ways in which they interact. A principal components analysis was carried out on a range of variables tapping the extent to which governments intervene to regulate and control markets; what we call here a dimension of economic liberalism and ‘statism’ (see appendix). This analysis yielded a regression factor score that we deployed to generate an index of economic liberalism/statism (see Table Two).
The index confirms the picture found in the ‘competitiveness’ ranking in Table One. Whilst it is no surprise to find the UK well ahead in terms of the degree to which it has deregulated its economy, it is noteworthy that Denmark, Finland and the Netherlands are all placed towards the ‘economically liberal’ end of the spectrum, whilst Sweden is also in the liberal half. At the other end of the scale, the Mediterranean European countries have scores reflecting ‘economically illiberal’ or ‘statist’ institutions. These results show that in English-speaking Europe and in the smaller Northern states (with the exception of oil-rich Norway), business activity is mostly lightly regulated, with the state interfering relatively little in the economic decision-making of private actors. It is worth taking a look at the disaggregated data to comprehend what this means in practice. Analysis of financial markets, product markets, business conditions, and labor markets confirms that in many policy areas the CME group is divided between ‘liberal’ and ‘statist’ political economies, with the former being more similar to the LMEs than to the latter. For example, as Figure Two (below) shows, standard measures of financial liberalization group some of the most egalitarian welfare states (the Northern European social democracies) close to
the finance-friendly UK, whilst the conservative/Christian democratic welfare states tend to cluster towards the bottom of the scale.

**Figure 2: Banking Sector Regulation (2003-2005)**

![Banking Sector Regulation Graph](image)


A similar picture emerges regarding product market regulation and barriers to entry. In Figure Three, the UK – the poster child of economic efficiency in Western Europe – fails to outperform the Northern European social democracies in removing barriers to the entry of new businesses, with Denmark, Finland, Norway and the Netherlands all enjoying lower start-up barriers.

Finally, even in the controversial area of labour market flexibility (Figure Four), there is a striking degree of variation amongst Western European States. Although the UK stands out here for its low employment protection and light touch regulation of the labour market, Denmark matches it despite maintaining a large public sector and highly developed labour market institutions.
It is therefore overly simplistic to equate ‘liberal’ economic institutions for market regulation with minimalist approaches to the public sector. Moreover, as we shall see below, the notion that greater economic liberalism is necessarily associated with inequality and poverty, and that liberalizing reforms will therefore engender greater social injustice, is also not supported by the data.
What Does This Mean For Inequality?

There are a number of difficulties involved in drawing firm conclusions on this point. First, many of the liberalizing reforms measured in this data are relatively recent, and may bring about changes in levels of inequality which have not yet been detected in the available research. Thus, we could be seeing convergence but with an equality lag. Second, the strong impact of encompassing labour market institutions on inequality is well documented (Wallerstein 1999). Countries lacking such institutions may find that liberalizing reforms have stronger effects on levels of inequality than on countries with such institutions. Third, inequality can have an independent causal effect on welfare arrangements. There is, for instance, some evidence that high levels of inequality make it less likely that income support programs will be established (Moene and Wallerstein 2002). However, a preliminary look at the data does suggest at least that there is no linear relationship between levels of inequality and the position of political economies on the ‘liberalism-statism’ spectrum.
Figure 5 plots European countries against their levels of income inequality (measured by Gini coefficients) and their position on the liberalism/statism spectrum. A curious pattern emerges from this analysis. The highest levels of inequality are found in the United Kingdom, the clearest example of an LME in Western Europe, with Ireland, another LME, also having above average inequality. However, the other examples of high inequality are to be found in the ‘statist’ CMEs of Greece, Italy and Spain. The remaining CMEs are to be found in the bottom left quadrant, combining low levels of inequality with relatively high scores for economic liberalism. This suggests a three-fold typology that has some resemblance to Esping-Andersen’s ‘three worlds’: a statist form of CME found in most of Catholic Europe and Greece, a more liberal form of CME found mostly in Northern Europe, and few economically liberal LMEs.

The Estimated Household Income Inequality Data from the University of Texas Inequality Project offers similar findings to the LIS: the latest year for which data is available for Portugal (1989) places that country as the second most unequal of our group of 15 countries (Switzerland being excluded from this data set), after Greece.
This suggests two things: that ‘inequality plus inefficiency’ may be far more common that is often admitted, and conversely, that ‘efficiency plus inequality’ may be far rarer than is commonly acknowledged. Okun’s trade-off purports to show that to get efficiency, the price paid is inequality. What Western Europe in fact shows is that one can have inequality without any corresponding ‘trade-up’ in efficiency, and one can have equality with efficiency. Indeed, we find that the purported trade-off between equity and efficiency is only credibly identifiable in a small number of Western European cases – basically Ireland and the UK – which combine liberal economic institutions with relatively high levels of inequality. Statist economic institutions with high levels of inequality, and liberal institutions with low levels of equality, are far more common in Western Europe. In the aggregate, efficiency and equity appear to be complementary, whilst the norm predicted by the Okun trade-off thesis turns out to be the outlier. 10

The next section illustrates these claims by examination of representative examples of each of the three ‘types’ identified above. The case of Sweden, the paradigmatic Nordic welfare state, is taken first to show how efficiency and equality are not necessarily in conflict. One can, it seems, have the best of both worlds if the correct institutional adaptations are made. Next we discuss the United Kingdom, a (relatively isolated West European) case where efficiency has trumped any commitment to equality. However, although in this case Okun’s trade-off is confirmed, we show how the policy choices made in this case were neither inevitable nor necessary, calling into question once again the logic of the trade-off. Finally, the case of Italy is examined to show how a state can exhibit both tenuous commitment to equality and little concern for efficiency. These discussions are followed by some tentative conclusions.

Three Worlds of Income Inequality: Efficiency and Equality Revisited

Equality and Efficiency: The Scandinavian Social Democratic Model

Coming on the heels of a precipitous economic collapse in the early 1990s where real GDP declined by 5 percent between 1990 and 1993, and total unemployment (registered unemployed plus training places) reached 12 percent, the Swedish social democrats (SAP) returned to power in 1994. However, far from repudiating the liberalizing policy stances that may have

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10 Given the trade interdependencies of Ireland and the UK, these two cases could be considered a single economic unit. Combine this with the historical uniqueness and financial openness of Switzerland and the liberal and unequal cases are indeed outliers.
in fact engendered the crisis of the period\textsuperscript{11}, the SAP sought to further structural reform in the areas of pensions, labour markets, and social welfare provision, while adhering to a market-conforming macroeconomic framework. The wheels, it seemed, were finally coming off the Swedish welfare wagon and equality was, however regretfully, being traded-in for efficiency.

Weakened public finances led to reductions in public as well as private employment, and in response to such pressures, the government began a program of deregulation and privatization that eventually encompassed postal services, telecommunications, domestic aviation, electricity, and the rail network. Further microeconomic reforms, such as the 1993 competition law that restricted anti-competitive behaviour, and incremental changes to labor market regulation to encourage flexibility and part-time work, were made throughout the decade.

Macro-economically, the objective of price stability was enshrined as the number one policy priority, and the Riksbank acted throughout the decade without regard to domestic economic conditions. Similarly, the state adopted, in the 1996 state budget, a target of a two percent budget surplus to be achieved over the business cycle tied to a three year nominal expenditure ceiling (where overruns in one budget area must be met with reallocation of existing revenues). At the same time, marginal tax rates were slashed. The fact of these reforms suggests a profound transformation of the Swedish political economy, while the results of these reforms on Swedish business, and the overall macro-economy, have been dramatic.

From 1993 to 2000 “industrial production rose by about 60 percent, equivalent to annual growth of about seven percent.”\textsuperscript{12} Similarly, the services sector grew from 48 to 60 percent of the economy from 1990-2000, a significant part of which is growth in the IT sector where Sweden has emerged as world leader and investment hub for global business. Given this new pro-business environment, Sweden performs well in international comparison of enterprise demographics. Though enterprise birth rates are marginally higher in the UK than in Sweden, other large welfare states, such as Norway and Denmark, have higher enterprise birth-rates than all other LMEs. Once established however, Swedish enterprises survival rates “are consistently higher than those recorded in other countries” (Schror 2004: 3). In fact, the death rate of enterprises in LME’s such as the UK is almost double that of Sweden. Given this, it is hard to make the claim that such an environment is bad for business.

This picture is further enhanced by international comparison of labour productivity and unit labour costs. Looking at output per employed person in manufacturing, and taking 1992 as the baseline year (index value 100),

\textsuperscript{11} Those being badly timed credit market deregulation and tax reform plus an incredible currency peg.

\textsuperscript{12} Swedish Institute, Fact Sheets on Sweden, FS 1 ab Qad (May 2001) p. 2
LME’s such as the US and the UK racked up impressive gains in productivity (index values of 185.6 and 142.5 respectively) between 1992 and 2004. However, this same Bureau of Labor Statistics (US) time series shows Sweden having more than doubled its labour productivity in constant dollar terms over the same period to an index value of 242.6. Unit labor costs in manufacturing tell and even more interesting story. Taking 1992 as the baseline and 2004 as the terminus, we find that while the US had some success in reducing unit labor costs (from 100 to 87.9), the UK’s unit labour costs actually increased from (from 100 to 121.1). Meanwhile Sweden’s unit labor costs plummeted by over forty percent in real terms over the same decade (from 100 to 57.4).

Given these institutional, policy, and performance transformations, it is tempting to conclude that the Swedish model, and its emphasis on equality, has gone out the window. Equality must have been traded off given these efficiency enhancements? Yet to conclude this would be a mistake. First of all, as noted above, in comparison with LME’s, Sweden’s Gini coefficient has hardly moved in the past three decades. Whereas the US’s Gini increased from 0.301 in 1979 to 0.368 in 2000, and in the UK the Gini moved from 0.270 in 1979 to 0.345 in 1999, Sweden’s went from 0.215 in 1975 to 0.252 in 2000; a smaller increase in inequality over a longer period of time from an already low baseline. In fact, Sweden today is still far more equal than the UK was thirty years ago. When one considers that unit labor cost reductions (listed above) tend to increase inequality, the US seems to have traded-in a great deal of inequality for a little more efficiency, the UK has traded-down a great deal more inequality for less efficiency, and Sweden has maintained equality with no trade-off in efficiency. Indeed, efficiency and equality in this case really do seem to go hand in hand.

Therefore, in this case at least, the issue of structural reform engendering Okun’s trade-off, as is commonly painted, is in fact much more complicated than the simple ‘liberalization -> inequality’ equation would allow. Reforms in Sweden have certainly occurred. Indeed, in the core areas of welfare transfers public pensions have put more emphasis on the link between contributions and benefits; private spending on pensions is up; hospitals can and have been privatized; a voucher system has been introduced into the secondary education system, and private school subsidies have been passed by the Riksdag. Yet having said all this, it is less anti-egalitarian than it sounds.


For example, private school pupils account for only seven percent of the eligible school population (Svennsson 2004: 14). On pensions and unemployment benefits, while changes were made to replacement rates, overall “the generosity of Swedish social security was on average the same in 1998 as in 1980” (Lindbom 2003: 178). In fact “the unemployment benefit was [even] more generous [than formerly].” (Ibid). Spending on private health and retirement certainly has increased, as have means tested benefits, which implies more markets and less equality. However, this too is misleading since the proportion of the population covered by such benefits has actually increased, in large part due to immigration. As Lindbom argues, increased expenditure on social assistance is not the result of less universalism and more liberalism. Rather, it is the opposite case where benefits cover more people who need more assistance and who were not part of the older, narrower, regime (Lindbom 2003: 182).

Furthermore, while taxes were cut in the early 1990s, they were raised again in the latter half of the decade when the regressive nature of the 1990 reforms became apparent (Steinmo 2003: 40). Once Sweden recovered from the collapse of the early 1990s and began to run a surplus in 1998, as well as paying down the national debt, the government increased spending on child support and other benefits. As Prime Minister Persson said to the SAP Congress in Sundsvall the previous year “healthcare, social services and schooling come before tax cuts,”15 and indeed they did, consistently.

In sum, while there has been structural transformation in the Swedish welfare state, it is simply not the case that such transformations are inevitably inequality increasing. Despite efficiency enhancing measures being implemented from early 1990s on, Sweden remains a social democracy with a large public sector, generous social benefits and public services, and low levels of inequality. As Steinmo puts it “The Swedish model (which comprises corporatist decision-making institutions, solidaristic wage policies, and perhaps even the ‘politics of compromise’) may well be dead. But the ambition and political support for a largely egalitarian polity with a very large welfare state and the taxes to support it live on quite healthily today.” (Steinmo 2003: 42). Contrary to expectations then, marketization and liberalization, which undeniably has occurred in Sweden, does necessarily lead to greater inequality. Okun’s trade off seems conspicuous by its absence.

\textit{Okun Confirmed? The Anglo-Saxon Liberal Model}

In contrast to Sweden, the United Kingdom is the clearest example in Western Europe of a political economy that has embraced liberalizing

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15 Quoted in Keesings Record of World Events on line edition.
structural reforms without managing to cushion the effects of liberalization on the social fabric. Yet this seeming conformation of Okun’s trade off in fact rests upon a series of contingent political choices rather than any logic of inevitability. As such, even the confirmatory case rests upon less than secure foundations.

The Thatcher and Major governments of the 1980s and 1990s carried out important liberalizing reforms in financial, product and labour markets. In the financial sector, an already lightly regulated banking and investment industry was deregulated further, fuelling a significant expansion of financial services, which became the motor of the British economy. In product markets, reforms to the retail sector and the Thatcher governments’ enthusiastic championing of the European single market contributed to further liberalization and the phenomenal growth of the service sector. As Coates (2002: 160) put it, so many people worked in banking and retailing by the year 2000 that Britain had genuinely become, by then, “a nation of shopkeepers.”

In labour markets, significant reforms had a direct and lasting effect on social cohesion. A series of legislative measures to undermine the position of trade unions, in combination with a rapid and extensive restructuring of the British industrial sector, skewed industrial relations in favour of employers and reduced the role of collective bargaining in the determination of wages. All of this occurred against a background of exceptionally rapid deindustrialization. UK manufacturing employment fell from 35 percent of the total labor force in 1960 to just under 12 percent in 2005 (OECD 2005, 2006). As Wells has observed, UK manufacturing shed employment at an unprecedented rate. In the 1980-82 recession 27 percent of the 1979 manufacturing labor force disappeared (Wells 1989: 25). Furthermore, as Matthijs notes, citing OECD data, “this process continued under New Labour, with just over 3 million jobs left in the sector by 2005” (Matthijs 2006: 22). Reforms to the welfare system moved in a similarly restrictive direction, reducing the real value of welfare benefits, limiting entitlement, and de-indexing the state pension system from inflation.

The consequences of these changes have been far-reaching. On the one hand, proponents of structural reform can point to the United Kingdom’s comparatively good growth performance in the 1990s and early 2000s as evidence of the effectiveness of market-friendly liberalizing measures. In particular, the higher than average percentage of the active population in employment is often attributed to the increased labour market flexibility resulting from the Thatcher reforms. On the other hand, these changes have been accompanied by an extraordinarily rapid increase in income inequality. In 1979, the UK had a Gini coefficient of 0.27, lower than France and only slightly higher than Germany. By 1995 the UK Gini coefficient had reached 0.34, a level matched only by the United States and Italy amongst advanced industrialized nations. Moreover, as noted above,
despite its ‘flexibility’, as noted above, UK unit labor costs have actually risen while inequality deepened.

Indeed, under the New Labour administration of Blair, the picture has actually worsened, despite the much lauded ‘redistribution by stealth’ and welfare reforms the party has undertaken. As Shephard (2003: 4) puts it, “Since Labor came to power the Gini coefficient has increased once more… Income inequality over the past two years [2000-2002] has been higher than in any other period covered by our data [1979-2002].” Labour’s tax increases, which have in part rested on indirect taxes on products such as fuel, cigarettes, and alcohol, are disproportionately paid for by the very people who are being redistributed to, which is probably why the government’s own recent surveys of inequality find at best, ”no consistent trend since the start of the 1990s” in income inequality (Lakin 2004: 2). The United Kingdom thus stands out for the dramatic rate of increase in inequality, since the other two ‘most unequal’ states, Italy and the United States, had higher levels of inequality at the beginning of the data series.

The UK also shows starkly the potential costs in terms of social inequality and cohesion of an aggressive and uncompromising approach to structural reform. Political choice is critical here. Where the Swedish SAP sought to craft institutions that maintained equality, the Thatcher, Major, and even the Blair governments have been quite open about not buffering inequality since it is seen to harm ‘incentives’. Yet without the kinds of buffers to social inequality present in the Northern European CMEs, such as equalizing public services and pensions, social benefits with high replacement rates, and centralized wage bargaining, liberalizing reforms can cause a rapid deterioration of social cohesion. Despite the UK’s relatively good recent performance in terms of employment and growth (net of manufacturing costs), its level of income inequality remains stubbornly high, exceptionally so by the standards of Western Europe. In sum, one can have market reforms that do indeed lead to greater inequality, but this tends to occur most in societies where the political commitment to a policy of egalitarianism is absent, and most often, where inequalities were higher to begin with. This case suggests then that Okun’s trade-off is only ‘real’ to the extent that policymakers see it as desirable in and of itself.

\textit{Inequality and Inefficiency: Italy and the Mediterranean-Statist Model}

The countries where the ‘statist’ model of regulation of financial, product and labour markets is strongest are France, Greece, Italy, Spain and Portugal. These countries also have more substantial state holdings in the economy than most other European countries. One of the most interesting features of this particular model of state-market relations is that,

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\footnote{16 For an assessment of the effects of this type of regulation on employment see Esping-Andersen (1996).}
Despite the apparently ‘social’ justifications often presented for maintaining state interventions, it has a poor record in securing social objectives. For example, the Luxembourg Income Study data set – the most commonly used in comparative studies of inequality does not include Portugal, but it does reveal that Greece, Italy and Spain both have relatively high income inequality by Western European standards (see Figure Five).

Spain has the second worst income inequality after Britain, and Italy and Greece are joint third worst. In short, the available data suggests that Mediterranean-Statist political economies suffer from particularly high levels of household income inequality. Here we draw on the Italian case to illustrate the implications of such economic institutions for equality and efficiency. Italy is perhaps the most extreme case of the Mediterranean-Statist model, which allows us to bring into sharp relief the potential for particular types of state interventionism to have inequitable and inefficient implications.

The quantitative measures of market regulation analyzed earlier reinforce more qualitative evidence that the Italian economy remains, despite some privatization and supply-side reforms undertaken in the 1990s, very heavily constrained by legalistic state intervention (Signorini 2001, Alesina and Giavazzi 2007). Regulations and backdoor protectionism restrict free competition in a range of sectors, such as city-center retail, travel and transport, public utilities, and housing. Italy also retains a significant state presence in industrial production and services through state-owned or part-owned companies. These features make Italy one of the least ‘marketized’ economies in the advanced industrialized world (Giavazzi 2005).

In financial markets, although the 1990s saw some consolidation, Italy has a limited stock market and a highly fragmented and politicized banking sector. Direct state interventions in financial markets, for instance, tariff ceilings on insurance services were only lifted in the early 1990s, has hindered the development of open market competition in this sector. Although recent reforms have made it easier for consumers to shop around for financial products, Italian banking services remain relatively consumer-unfriendly, and the blocking tactics adopted by the Bank of Italy to protect the sector from foreign competition have allowed anti-competitive practices to survive legislative challenges.17

Of course, some regulated financial sectors can be a source of economic efficiency when combined with constructive bank-company relationships providing ‘patient capital’ along the lines of the Rhenish model. However, in the Italian case the reliance on coordination rather than competition does not seem to have brought such positive results. The politicization of financial institutions and lack of transparency therein have in some cases bordered on the kind of ‘crony capitalism’ characteristic of

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17 Seen most clearly in the ABN-Amro Antonveneta case in 2005.
some developing countries. Furthermore, the poor functioning of the financial system can be linked to the decline of the flexible and innovative industrial sectors of the ‘Third Italy’ in the face of intense competition in international markets (Giavazzi 2005).

In terms of its product markets Italy has the most restrictive regulation of entry in Western Europe, with complex and bureaucratic procedures for starting new businesses (see Djankov et al 2002) and a variety of regulations restricting entrepreneurs’ freedom of action. Examples of this abound, but current debates have cited cases of burdensome regulation of markets leading to high prices, low efficiency, and vast monopoly rents for well-positioned market participants (Giavazzi 2005). Clearly much of this regulation has its roots in longstanding institutional arrangements (related by Djankov and his colleagues to factors such as legal origin), and the intricate nature of Italy’s legal system stands as a constant through Italy’s recent periods of economic growth and stagnation. Such restrictiveness has high costs, hindering the full development of the service sector, which in comparable western economies has proved the major source of employment growth. It also has distributive consequences, shifting resources towards relatively inefficient parts of the economy with little scope for productivity growth, such as small-scale retail and legal services, which also enjoy tax advantages. In comparison with the UK and Sweden, Italy’s unit labour costs increased (100 to 144.6) from 1992-2004 while its productivity remained stagnant (100 to 103) over the same period. At the same time Italy’s Gini coefficient increased from 0.306 in 1986 to 0.346 in 1998. In short, product market regulation has anti-competitive as well as inequalitarian consequences, depressing both efficiency and equity.

Finally, while Italy has relatively regulated labour markets, some parts of the labor force face a very deregulated environment, in particular the substantial numbers of workers in the black and ‘grey’ economies, as well as increasingly large numbers of new entrants to the labour force dependent on temporary contracts. However, some parts of the labour force are relatively protected both by legalistic provisions and by practices of collective bargaining, which is reflected in Italy’s inflationary levels of wage growth, even during the lean years since the country’s entry into EMU. The labour market also promotes both inefficiency and inequity given the inability of collective bargaining (except for short, exceptional periods) to

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achieve encompassing coverage and secure pay increases consistent with maintaining competitiveness.20

Moreover, the job protections offered to the more privileged sectors of the workforce impede rapid adjustment of the labour market (Esping-Andersen 1996). As Lindert (2006: 247) notes, while such employment protection laws must take some of the blame for European unemployment in general, it seems to be the case that Italy is a place where such effects are particularly strong. Meanwhile, the patchy coverage of unemployment insurance further impedes labour market clearing. In sum, the structure of the Italian labor market has failed to ensure equitable wage growth or an efficient allocation of resources, contributing to both economic decline and increasing inequality. In contrast to Sweden’s ‘big state’, Italy’s tradition of state interventionism has become a drag on growth at the same time as it fails to address inequalities.

Italy is certainly the most dramatic case of the failings of the ‘statist’ model, and it has performed comparative poorly in terms of efficiency and equality even compared to the other ‘statist’ cases. This analysis should therefore only be extrapolated to the other European countries with great caution. France, which shares some features of the ‘statist’ model, has some of the same problems, but its performance in terms both of macroeconomic indicators and inequalities has been comparatively better. The Southern European new democracies are in a different position, with lower levels of productivity but with lower wage costs, which have helped them to take advantage of the opportunities provided by the single European market and the dramatic monetary easing resulting from the entry into the single currency.

However, all these economies to some extent share the problems of weak job growth and low overall levels of employment (Bermeo 2000), patchy and excessively selective welfare provision (Ferrera 1998, Boeri 2000), and regulatory measures which have the effect of shielding inefficient producers of goods and services from competition. They also, with the exception of France, display high levels of economic inequality. In the Italian case in particular, statist policies and institutions appear to combine the ‘worst of both worlds’ by acting as a drag on efficiency whilst doing little to deal with inequality.

Conclusion

This paper has attempted to show two things, and to tentatively suggest one more. First, it has sought to demonstrate empirically that neither globalization nor liberalization necessarily leads to a race to the

20 Such outcomes place Italy squarely in the worst-case ‘intermediate’ category of wage bargaining, in which substantial sectors of the labor force are able to force inflationary wage growth and externalize the consequences (Garrett 1998).
bottom where ‘bloated’ welfare states are doomed to fail. Instead, we have argued that significant market-conforming reforms can be undertaken in such political economies without necessarily giving up on equality. In order to demonstrate this we examined the degree of structural reform, financial liberalization, labor market flexibility, the regulation of entry, and the degree of legalistic intervention relative to existing levels of inequality in the set of European advanced industrial states. We found that, in contrast to much of the conventional wisdom, the evidence suggests that significant ‘business friendly’ structural reforms are not always accompanied by high levels of inequality. In fact, those states that were most unequal to begin with were precisely those that became comparatively more unequal under conditions of globalization (also Swank 2002). This applied both to LMEs and to what might be termed the Mediterranean-Statist ‘variety of capitalism’. In contrast, the ‘most likely victim of globalization,’ the Scandinavian welfare state, has shown itself to be quite adaptive and able to undertake a variety of reforms, that while changing the form of the model, do not (thus far) significantly alter its content. There is, in sum, a tendency in the literature to conflate liberalization and welfare state retrenchment while the two are distinct concepts, and distinct outcomes, which need to be measured separately. Inequality is not an inevitable price to be paid for efficiency in the global economy.

Second, and analytically, to the extent that typologies remain useful, we argue that the over picture of welfare state demography is still better captured by Esping-Andersen’s ‘three worlds of welfare capitalism’, in which LMEs (liberal welfare states) are contrasted with two kinds of CME: the Scandinavian social democratic welfare state, and the Mediterranean-Statist model. This outcome pertains since economic reform, often portrayed as a one-way street towards free market capitalism, is actually far more compatible with the institutions of the social democratic welfare state than is generally acknowledged. The Northern European social democracies have managed to combine market-friendly regulation of key areas of the economy with high levels of state spending, which permit generous welfare provision and public services 21. As we have seen, despite significant reforms being undertaken in such states, the relatively good economic performance of this group of economies through the difficult period of the 1990s and into the new century was not achieved at the expense of social solidarity. Economic reform does seem to improve economic performance, but nations can choose whether or not to accompany a liberal market regime with a decommodificatory welfare state. One choice does not necessarily negate the other.

21 Indeed, the World Economic Forum’s ‘Competitiveness Report’ for 2004 found that Finland, Denmark and Sweden – all high-spending social democratic welfare states – were more ‘competitive’ than even the United States (‘US Still More Competitive than EU’, Financial Times, 27 April 2004, p.2).
Finally, we hope that this analysis contains some hopeful lessons for Social Democratic parties throughout of Western Europe. Social Democratic parties in Christian democratic welfare states can, in principle, liberalize their economies and maintain high standards of welfare provision. Similarly, Social Democratic parties in liberal welfare states such as the UK can aim to expand social provision without necessarily undermining the functioning of markets. Hopefully then, European social democrats can both defend equality and respond to the need for great economic efficiency without simply denying that change has taken place or by simply accepting an increasingly tired neoliberal orthodoxy. Okun’s trade-off may be alive and well in a handful of liberal political economies, but it remains conspicuous by its absence elsewhere in Western Europe.
Appendix

Principal Components Analysis:
Fifteen variables included. Extraction method: principal components, select one factor.
Factor scores method: regression. Full results available on request.

Variables:

Labour Market Regulation Fraser Institute 2005 (Area 5B score)
Data for 2005 generated by Fraser Institute, [http://www.fraserinstitute.ca/; http://www.freetheworld.com/]. See Gwartney and Lawson et al 2007 (Ch.1) for a full description. Fraser Institute’s index of government regulation of labour markets (Area 5B) awards higher scores to countries with least restrictive legislation on employment relations.

Credit Market Regulation Fraser Inst 2005 (Area 5A score)
The Fraser Institute’s index of government regulation of credit markets (Area 5A); awards higher scores to countries with least restrictive regulation of financial and credit markets.

Competition Domestic Banking Fraser Inst 2005 (Area 5Aii score)
The Fraser Institute’s index of government regulation of domestic banking (Area 5Aii); awards higher scores to countries with least barriers to entry in the domestic credit market.

Banking Barriers to Competition OECD/WB 2003
This variable measures the degree of restriction on competition in the banking sector, and is taken from the OECD/World Bank database, de Serres et al (2006).

Banking Regulation OECD/World Bank database 2003
This variable measures banking regulation, and is taken from the OECD/World Bank database, de Serres et al (2006).

Fraser Institute Entry of New Business 2007
The Fraser Institute’s index of barriers to entry of new businesses in product markets (Area 5Cii); awards higher scores to countries with lowest barriers to entry.

Starting Business Procedures (number) WBI 2008
Data for 2006-7 generated by the World Banks’ Doing Business project, [http://www.doingbusiness.org/]. See World Bank (2008) for a full description of data. This variable records the number of administrative procedures required in order to open a new business. For methodological details see the Doing Business project website [http://www.doingbusiness.org/MethodologySurveys/StartingBusiness.aspx].

Starting Business Time (days) WBI 2008
This variable records the number of calendar days it takes on average to open a typical new business. For methodological details see the Doing Business project website [http://www.doingbusiness.org/MethodologySurveys/StartingBusiness.aspx].

Starting Business Cost (% of income per capita) WBI 2008
This variable estimates the average cost as a percentage of per capita income of opening a typical new business. For methodological details see the Doing Business project website (http://www.doingbusiness.org/MethodologySurveys/StartingBusiness.aspx).

Starting Business Min. capital (% of income per capita) WBI 2008
This variable estimates the minimum capital (as a percentage of per capita income) an entrepreneur needs to put up in order to open a new business. For methodological details see the Doing Business project website (http://www.doingbusiness.org/MethodologySurveys/StartingBusiness.aspx).

Dealing with licences time (days) WBI 2008
This variable estimates the average time required to complete arrangements for licensing a new business in calendar days. For methodological details see the Doing Business project website (http://www.doingbusiness.org/MethodologySurveys/StartingBusiness.aspx).

Difficulty of Hiring Index WBI 2008
This variable measures legal restrictions on hiring workers on the basis of 3 criteria. For methodological details see the Doing Business project website (http://www.doingbusiness.org/MethodologySurveys/EmployingWorkers.aspx).

Rigidity of Hours Index WBI 2008
This variable measures legal restrictions on working hours on the basis of 5 criteria. For methodological details see the Doing Business project website (http://www.doingbusiness.org/MethodologySurveys/EmployingWorkers.aspx).

Nonwage labour cost (% of salary) WBI 2008
This variable measures all social security payments and payroll taxes associated with hiring an employee, expressed as a percentage of the worker’s salary. For methodological details see the Doing Business project website (http://www.doingbusiness.org/MethodologySurveys/EmployingWorkers.aspx).

Global competitiveness index 2007-8
The global score for each country case from the World Economic Forum’s Global Competitiveness Report 2007-2008. (Porter, Sala-i-Martin and Schwab (2007). The score seeks to measure ‘competitiveness’, defined by the study’s authors as ‘the set of institutions, policies and factors that determine the level of productivity of a country’. These include institutions, infrastructure, macroeconomic policy, education, healthcare technology and the efficiency of product, financial and labour markets. For methodological details see the WEF website (http://www.gcr.weforum.org/).

Other Data

Income Inequality
Gini coefficients calculated by the Luxembourg Income Study (LIS) for the most recent available survey (usually around 2000-4). See http://www.lisproject.org/ for methodological details.
Government Spending
Total government expenditure in 2006, from OECD in Figures 2007 (http://fiordiliji.sourceoecd.org/vl=3566561/cl=17/nw=1/rpsv/cgi-bin/jsearch_oecd_stats)
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