

Comparative Institutions and Globalization.

In a memo of this length there is insufficient space to fully develop the relatively complex arguments contained in Hall and Soskice's "Varieties of Capitalism" approach. In what follows I provide a very brief summary of the components of the argument which are most relevant for our purposes. For anyone who is not familiar with this literature an excellent summary of the argument is contained in the introduction to the Hall and Soskice volume (2001).

The "Varieties of Capitalism" Approach (Hall and Soskice, 2001): Implications for political and economic responses to globalization.

The varieties of capitalism literature is positioned to address two of the "big questions" with respect to globalization. They are:

- (1) Do we expect to see institutional/policy/economic convergence cross-nationally in response to globalization or not ?
- (2) Under what circumstances would we expect to see a political backlash against globalization ?

A core hypothesis of the literature is that we should *not* expect to see a convergence in socio-economic institutions and policies as a result of the globalization process. The general logic of the argument can be summarized as follows.

We can distinguish two types of market economies – "coordinated" and "liberal" – whose institutional configurations may be characterized in the following way. Institutions in "liberal" market economies (LMEs) are designed to allow economic agents to coordinate their activities most efficiently through competitive market arrangements. Relationships between economic agents are characterized by arms length market exchanges and formal contracting. By contrast, the institutional configurations of "coordinated" market economies (CMEs) are more effective at facilitating non-market modes of coordination such as "relational or incomplete contracting, network monitoring based on the exchange of private information inside networks, and more reliance on collaborative, as opposed to competitive, relationships" (Hall and Soskice p.8).

While the institutional configurations of CMEs tend to facilitate long term relationships between economic actors, those found in LMEs are designed to support fluidity in market relationships. As a result of these distinctions the two institutional configurations are associated with:

- (a) comparative advantages in different types of production (in goods requiring radical innovation in the case of LMEs (e.g. biotechnology, pharmaceuticals, information technology); in goods characterized by incremental innovation in the case of CMEs (e.g engines, high quality consumer goods) and
- (b) different patterns of asset investment by economic actors (in specific or co-specific assets which require the cooperation of other economic actors for their full realization in the case of CMEs; in switchable assets (assets whose value can be more easily diverted to another purpose) in the case of LMEs.)

Based on these arguments, we can make the following *broad* predictions related to the “big questions” listed above:

- 1) Institutional convergence will not take place as a result of globalization because:
 - a) Each “variety of capitalism” is potentially equally effective at competing in a globalized economic environment, based on their individual comparative advantages and,
 - b) Economic actors tend to be tied to existing systems based on their patterns of asset investment.
- 2) A political backlash against globalization is more likely when it is accompanied by attempts to move away from a country’s existing institutional equilibrium.

More specifically, we can derive from the arguments of the varieties of capitalism literature a set of hypotheses about (i) how openness might influence actors’ preferences with respect to the structure of domestic institutions (ii) how the structure of domestic institutions might influence actors’ preferences with respect to economic openness. A core hypothesis of the literature, and of this project, of course, is that these issues are strongly related, so that we need to investigate preferences over “bundles” of policies in both areas.

What specific hypotheses can we derive from the “varieties of capitalism” approach regarding the preferences and actions of different sets of actors related to globalization ?

Testing specific hypotheses.

Firms

As stated above, the contention of the varieties of capitalism approach is that the institutional configurations of CMEs and LMEs create comparative advantages in different areas of production. Core institutions here include the systems of finance, corporate governance, industrial relations, education and training, and social welfare.

For example, in coordinated market economies, the dense network of long-term institutionalized relationships across firms, business and trades associations, and investors, allows for effective monitoring of firm performance and the provision of reliable “private” information about the operation of companies, which reduces the need for investors to rely on current balance sheet data in making their decisions. This, in turn, allows firms to embark on more incremental development strategies, aimed at long term, rather than short term financial goals, and to retain skilled workers during economic downturns. Also important here are the strong and interrelated systems of vocational and firm-specific training, and high levels of employment and/or unemployment protection which (as discussed in the following section on workers), facilitate the development of a workforce with the high-levels of firm and industry specific skills necessary for the pursuit of diversified mass and quality production strategies. The long-term relationships and high levels of investment in firm and industry specific skills promoted by the institutional structure of coordinated market economies, it is argued, facilitate

incremental innovations and confer a comparative advantage in more established lines of production (such as, for example, engines, high quality consumer goods) (p.37).

In contrast, the institutions of finance and corporate governance in liberal market economies encourage firms and managers to be especially attentive to their performance in terms of publicly available indicators such as current earnings and share prices, in order to attract investment. This focus on short term economic goals encourages an emphasis on radical development strategies aimed at maximizing short term profits, and on reliance on high levels of flexibility in hiring and firing to protect profit margins in times of economic downturn. Accompanied by low levels of employment protection and educational systems designed to encourage workers to acquire high levels of general skills (of which more below), this institutional configuration gives LMEs a comparative advantage in the production of goods requiring high levels of general skills and radical innovation (for example, biotechnology, pharmaceuticals, information technology)

Hypotheses

There are some simple hypotheses which we could test here to great effect regarding the preferences and strategies (economic and political) of firms. For example:

(1) We should expect the preferences and strategies of firms to vary according to *both* (a) their sectoral location and (b) their institutional environment.

- Broadly speaking, where a firm's production profile "matches" the institutional configuration of the country in which it is located (i.e. the country's institutional configuration affords it a comparative advantage in the production of the type of good in which the firm specializes), we would expect the firm's preferred policy bundle to combine economic openness with the maintenance of existing socio-economic institutions. Thus, for example, German engine manufacturers are likely to support economic openness as long as it is *not* accompanied by a dismantling of the institutional structure which supports their comparative advantage in this area.
- Where the firm's production profile does not "match" the institutional configuration of the country in which it is located (e.g. US auto manufacturers, German software firms) we would expect a firm to engage in a range of political and economic strategies including:
 - (a) lobbying for domestic protection
 - (b) outsourcing to more institutionally favorable environments and
 - (c) lobbying for domestic institutional change.

(2) An additional observable implication of the Varieties of Capitalism argument is that patterns of international FDI should be influenced by the match between product line and the socio-economic institutional configuration of the destination country. A negative finding here would considerably weaken the comparative institutional advantage argument (and hence a significant part of the argument for continued institutional divergence in the face of globalization would fall apart), yet the hypothesis has not been subjected to rigorous empirical testing.

It would be of considerable interest to include questions in the survey designed to assess the relative importance of regulatory structures in determining these decisions re FDI. For example, Ireland has attracted 25% of US “greenfield” investment in the EU over the past 10 years, with 1% of its population. How much of this pattern can be accounted for by the Irish government’s provision of generous incentives in terms of tax concessions and subsidies ? and how much by the country’s regulatory environment ? Certainly the pattern of investment fits with the predictions of the varieties of capitalism argument. Ireland is one of only two LMEs in the EU (the other being the UK) and the bulk of inward FDI from the US has been concentrated in precisely the high tech areas argued to be favored by the institutional environments of LMEs - e.g. chemicals; bio-pharmaceuticals and healthcare; computer hardware and software; electronics, and financial services. Moreover the domestic regulatory environment and the skill composition of the population are often cited as important factors influencing the investment decisions of US firms who opt to operate advanced research facilities as well as manufacturing in their Irish locations.

Implications for Survey Design

- We need to make sure that we have sufficient variation in both *institutional configurations* (i.e. sufficient numbers of LMEs and CMEs); and in the *sectoral locations* of the firms which we survey (i.e. we need to make sure that we survey firms in each country whose production profiles match and do not match the country’s institutional configuration, according to Hall and Soskice’s definitions).
- Useful questions to ask in the light of the specific hypotheses discussed above would include:
 - Their raw *policy preferences* over (a) different types of economic openness (trade versus protectionism; capital controls etc.); (b) the structure of domestic socio-economic institutions (education and training systems; social welfare (including employment and unemployment protection; healthcare provision; childcare provision etc.); industrial relations systems; financial systems.)
 - Questions about their preferences over *policy bundles* (i.e. to get at how proposed reforms in domestic socio-economic institutional structures influence their attitudes to openness and vice-versa).
 - The extent and nature of their *political* activity related to these preferences. Are they actively involved in lobbying or negotiation on these issues (for protection, for institutional change, for a strengthening of existing institutional profiles) ? If so, who with – with different types of employers within employers organizations ? with trades unions ? or directly with politicians ?
 - Their *economic* strategies, in particular with respect to outsourcing and FDI. Is outsourcing to more favorable institutional environments an important alternative to lobbying for firms who find themselves in an unfavorable domestic institutional environment ? With respect to FDI how important are regulatory frameworks in influencing firms location decisions - do CME “type” firms invest primarily in CMEs etc. ?

Workers

A core issue which we want to address in the project is the relationship between economic openness and the demand for welfare state protection.

Estevez-Abe, Iversen, and Soskice (2001) outline a clear and useful set of hypotheses here. They are developed as follows:

- (1) Workers need to be provided with high levels of employment protection in order to rationally invest in *firm specific* skills. Firms whose product market strategies require these skills (for example, those employing diversified mass production strategies where firm specific knowledge and the capacity for flexibility in the types of tasks pursued within the firm are at a premium (e.g. Japanese auto makers)) will thus be supportive of high levels of employment protection.
- (2) To reduce the risks associated with investment in *industry-specific* skills, on the other hand, high levels of employment protection are less important (workers are free to move between companies within a sector). However, high levels of unemployment protection are critical (to reduce the risks to the worker of investing in a particular economic sector). Again, therefore, firms whose product market strategies require these skills (for example, high-quality niche market producers) will support high levels of welfare state protection in this area.

The institutional configuration of coordinated market economies tends to support one or both of these patterns of educational investment. For example, in Japan, high levels of employment protection are combined with large investments in firm specific training; while in Germany high levels of employment and unemployment protection, combined with an effective vocational training system, result in high levels of investment in specific skills at both the firm and industry level (facilitating a strategy of diversified quality production (Streeck 1992)).

Hypothesis 1: Because the availability of workers with specific skills is critical to firms in maintaining their comparative advantage in production in an open economic environment, and because most workers have heavily invested in these specific assets, therefore, we should expect a strong cross-class alliance (incorporating employers and low and high skilled workers with specific skills) to develop in CMEs, favoring the continued support of existing systems of employment and unemployment protection.

There is also the possibility a cleavage developing along gender lines here. As argued by Estevez-Abe (1999), in order to protect the value of her investment in specific skills, a woman requires extra protections to her employment security and income in times of career interruption which, due to their relative costliness, firms may be unwilling to support, at least where a sufficient supply of male workers is available. As a result, women tend to be more willing to invest in general skills and thus have less of a stake in the continuation of the existing institutional configuration.

Hypothesis 1(a): In CMEs, support for existing systems of employment and unemployment protection is likely to be weaker among women than among men.

In contrast, in liberal market economies, low levels of employment and unemployment protection encourage workers to invest in general skills which are easily transferable across firms and sectors, rather than investing in risky specific assets. This institutional configuration brings comparative advantages in production strategies requiring radical innovation – at least where substantial numbers of high general skilled university graduates are produced. As a result, employers in these systems have little incentive to support high levels of social protection.

Amongst workers, we can expect the development of cleavages along skill lines here. High skilled workers - potential “winners” from a successful globalization strategy based on radical innovation in product lines - will tend to be unwilling to pay for social protection policies on which they do not expect to have to rely and which are perceived as damaging to economic competitiveness. By contrast, low-skilled workers - potential “losers” from globalization - are more likely to demand either protection, or an increase in welfare state protection to compensate for the increased risks associated with economic openness.

Hypothesis 2: In LMEs we are likely to see a low-skill/high-skill cleavage developing amongst workers. High-skilled workers will tend to favor economic openness combined with low levels of social welfare protection. Low-skilled workers, by contrast, will favor either (a) protection or (b) an increase in welfare state protection to compensate for the increased risks associated with economic openness.

Hypothesis 2a: We may also expect to see a public/private sector worker cleavage developing here, with public sector workers less concerned about the effect of welfare state protection on economic competitiveness.

Implications for Survey Design.

- Again, we need to make sure that we have sufficient variation in both *institutional configurations* (i.e. sufficient numbers of LMEs and CMEs); and in the *sectoral locations* (sector of production as well public/private) of the workers which we survey (to allow us to test hypotheses regarding the impact of sectoral location on workers’ preferences).
- It will be extremely important to gather detailed information on the nature (on-the-job, vocational, general education system) and extent of workers’ training. This is what will allow us to test the key hypotheses about the importance of asset specificity in determining preferences and, as pointed out in the project description, is very poorly covered in existing surveys.
- Clearly, gender will also be an important demographic here.
- With respect to *policy preferences* we will want to ask similar questions to those asked in the firm surveys i.e.

- Their raw *policy preferences* over (a) different types of economic openness (trade versus protectionism; capital controls etc.); (b) the structure of domestic socio-economic institutions and policy (with a particular emphasis here on social welfare (including employment and unemployment protection; healthcare provision; childcare provision etc.), and other forms of domestic compensation policy, but also probably regarding the education and training systems, industrial relations systems; financial systems).
- Questions about their preferences over *policy bundles* (i.e. to get at how proposed reforms in domestic socio-economic institutional structures influence their attitudes to openness and vice-versa).
- With respect to *political action* we want to survey workers about the extent and nature of their political activity related to these preferences.
 - In terms of voting behavior (a) which, if any, of these issues do they regard as electorally salient (b) who do they intend/have they previously voted for (supported).
 - Would they/ have they engaged in lobbying or negotiation related to these preferences ? If so, who with, their unions ? employers organizations ? politicians ?
 - Would they/have they engaged in public protest related to these preferences ? Strikes, mass protests etc.
- (One interesting possible question to ask with respect to workers' *economic* strategies might be whether they would migrate to improve their economic prospects (perhaps to an environment in which their skills would attract better rewards, or where their levels of social protection are higher). This is, after all, the employee equivalent of capital relocation and is an increasingly relevant issue – especially in an EU context.)

Politicians

The role of politicians is significantly under-theorized within the varieties of capitalism approach.

In its simplest form, the hypothesis of continued institutional divergence in the face of globalization rests on several assumptions. They are:

(1) The institutional configurations of CMEs and LMEs result in patterns of comparative advantages which allow each to compete equally effectively in a globalized economic environment.

(2) The majority of firms/workers in each country respond rationally to the incentives created by this institutional configuration so as to invest (in terms of their skills and production profiles) in the “appropriate” areas and hence will be in a position to “win” from globalization as long as this institutional configuration remains consistent (given (1)).

(3) Governments base decision-making on the preferences of this majority and hence we expect continued institutional divergence.

Significant institutional change is only predicted in the model when a nation's institutions are out of equilibrium (i.e do not match). In this situation poor economic performance will result and institutional/policy change is predicted, although the direction of change is unclear.

The role of politicians in this process is a curiously passive one. Yet understanding it in more detail seems to be critical if we are to move effectively from explaining the preferences of workers and citizens over policy (as discussed above) to explaining actual policy outcomes. Politicians play an important mediating role in the translation of societal preferences into policy outcomes. Even in highly corporatist systems, they are at the very least an important player in the bargaining game over institutional reform. Without understanding politicians preferences and strategies with respect to globalization therefore, we are left with an incomplete picture.

For example, we have no clear sense from the varieties of capitalism literature of whether institutional divergence emerges primarily as a result of the lobbying efforts of invested firms and trade associations, or because, as we might infer from (2) and (3) above, the median voter is assumed to have a stake in the existing system (at least as long as that system continues to sector good economic performance). Both arguments are made in the (2001) volume and both could be effectively tested by means of our survey.

In addition, in order to understand how societal preferences are aggregated in the political process, it is essential to consider in more detail politicians electoral concerns. How salient are these issues in electoral terms ? Are some (for example welfare state cutbacks, or high profile announcements about the capture of new foreign investments and associated job creation), more salient than others (for example, indicators of a decline in economic competitiveness) ? Are politicians more concerned with the preferences of the median voter, or with those of certain core constituencies, especially where these constituencies are closely tied with organized movements (such as unions or employers organizations) ? Do representatives of political parties have their own ideological concerns which may limit the range of responses to globalization which they are willing to consider ? Under what conditions are the preferences of "losers" from the globalization process given political weight ?

Also of importance here is the issue of the effect of politicians on electorates. We know that politicians can be important opinion leaders. Moreover in the case of the relatively complex economic trade-offs which we are considering here it seems reasonable to assume that their role in communicating the nature of the trade-offs involved, and the range of potential policy "packages" which are available, will be particularly important. This gives politicians scope to pursue their own ideological concerns, or the concerns of their core constituencies, with respect to globalization and domestic socio-economic change, by influencing the policy preferences of the median voter.

We can start to get at a lot of these questions, and hence start to understand the role of politicians in this process, simply by gathering some basic information which we currently lack.

What types of information would be useful here ?

- Who do politicians meet to discuss the issues which we are interested in – firms, employers associations, unions ? and from which sectors ? groups from civil society ?
- How often do they meet these groups ?
- What is their assessment of the electoral salience of the issues which we are considering ? – different forms of economic openness; different forms of welfare state protection (employment and unemployment protection, healthcare, childcare etc.); industrial relations; education and training; the financial system etc.
- What is the salience of issues of policy compared with issues of economic performance - success at attracting high profile FDI; economic competitiveness; unemployment; growth; inflation etc.
- What do *they* see as the important policy trade-offs which exist with respect to globalization (if any) ?
- *What are their preferences over the policies, and policy bundles which we included in the surveys of firms and workers ?*
 - Again, their raw *policy preferences* over (a) different types of economic openness (trade versus protectionism; capital controls etc.); (b) the structure of domestic socio-economic institutions (education and training systems; social welfare (including employment and unemployment protection; healthcare provision; childcare provision etc.); industrial relations systems; financial systems.
 - And questions about their preferences over *policy bundles* (i.e. to get at how proposed reforms in domestic socio-economic institutional structures influence their attitudes to openness and vice-versa).

Clearly we would need to include representatives of all of the major political parties in each country surveyed.

The impact which we could make by gathering even this basic information in these areas would be huge, because we currently have *no* decent surveys of politicians (and partisan) preferences over different types of globalization and the configurations of domestic socio-economic institutions. Existing surveys tend to contain very limited questions (with questions about socio-economic policy often very simplistic and based on traditional uni-dimensional conceptions of “left” and “right” cleavages over economic issues). These questions are totally inadequate to testing any hypotheses about the preferences of parties over complex economic trade-offs in today’s globalized economic environment. Moreover, since they do not provide an accurate assessment of the structure and range of variation in partisan preferences on these issues, they severely restrict our ability to assess the significance of partisanship in influencing socio-economic outcomes.

Combining this survey with those conducted at the firm, worker, and associational levels should provide us with an invaluable resource for understanding how the political negotiation process over these issues works.