

# **Democracy and Prosperity**

## **Reinventing Capitalism through a Turbulent Century**

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**PRINCETON UNIVERSITY PRESS**

PRINCETON AND OXFORD

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Published by Princeton University Press  
41 William Street, Princeton, New Jersey 08540  
6 Oxford Street, Woodstock, Oxfordshire OX20 1TR

press.princeton.edu

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Library of Congress Control Number: 2018949305  
ISBN 978-0-691-18273-55

British Library Cataloging-in-Publication Data is available

Editorial: Eric Crahan and Pamela Weidman

Production Editorial: Leslie Grundfest

Jacket/Cover Design: Carmina Alvarez

Production: Erin Suydam

Publicity: Tayler Lord

Copyeditor: Emily Shelton

Publication of this book has been aided by{~?~PE: complete or delete as appropriate}

This book has been composed in Arno

Printed on acid-free paper. ∞

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

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## Introduction

Much of the academic and nonacademic literature on advanced capitalist democracies over the past two decades has painted a critical and pessimistic picture of advanced capitalism, and—closely linked—of the future of democracy in advanced societies. In this view, the advanced capitalist democratic state has weakened over time because of globalization and the diffusion of neoliberal ideas. With advanced business seen as major driver and exponent, this has led to liberalization, privatization, deregulation, and intensified global competition. In Esping-Andersen’s (1985) striking metaphor, it is “markets against politics” with markets winning out. This explains, *inter alia*, why there has been a rise in inequality (labor is weakened) and why this rise has not been countered by increased redistribution. If governments attempted such redistribution, the argument goes, it would cause footloose capital to flee. In Piketty’s (2014) hugely influential account, the power of capital to accumulate wealth is governed by fundamental economic laws which democratically elected governments can no longer effectively counter. If they try, capital just moves somewhere else. Democratic politics is then reduced to symbolic politics; the real driver of economic outcomes is capitalism (Streeck 2011a, 2016).

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

Drawing on a wide literature in economic geography, in innovation studies, and in management, we explain how knowledge-based advanced companies, often multinational enterprises (MNEs) or subsidiaries of MNEs, are increasingly *immobile* because they are tied to skill clusters in successful cities, with their value-added embedded in largely immobile, highly educated workforces. A central aspect of our book is the extent to which advanced capitalist companies are tied geographically into national systems. In our perspective, which reflects a large research program of recent decades, knowledge is geographically embedded—in advanced nations, in regions, cities, and towns—typically in clusters of skilled workers, engineers, professionals, and researchers. Also geographically embedded are institutions, public and private. One way of reading our book is therefore to see it as tying together economic geography, national and regional systems of innovation, and political economy.

As is increasingly understood in contemporary economic geography, the topographical distribution of knowledge competences is of hills and peaks rather than of a flat earth. This reflects the combination of the importance of tacit knowledge (even if partly codifiable), and of the need for colocation in the generation of tacit knowledge. Educated workers colocate in skill-clustered networks (which for them is valuable social capital) and therefore cannot be transported abroad, and companies cannot typically find alternative specialized knowledge competences elsewhere; thus, in business school jargon, “Capital chases skills.” In the modern literature on

knowledge-based MNEs, MNEs are seen as networks of increasingly autonomous companies, which get their value from the collocation with geographically differentiated skill clusters; and the payoff to the MNE derives from the complementarities which may be generated across the network from access to these differentiated knowledge competences.

In turn, skilled employees benefit both from this increased demand from foreign direct investment (FDI) from abroad and also as a result of the knowledge complementarities from the FDI abroad of domestic knowledge-based MNEs. An even more profound benefit from globalization comes from specialization in advanced goods and services in the knowledge economy: the ICT revolution both decentralizes the level and multiplies up the number of groups capable of autonomous projects. This is the basis of specialization manifested in the great expansion of varieties traded across the advanced world. Rising inequality and increased poverty is a consequence of the government-sponsored shift toward the new economy and it is not effectively countered, because the new middle classes are relatively secure and because the old middle classes are opposed to redistribution to the poor. The Meltzer-Richard model fails to predict such opposition since median/decisive voters see themselves as contributors, not recipients. We have put some of the key references and researchers into a long footnote to avoid cluttering the text.<sup>1</sup>

The book can at least partially be read as an attempt to integrate economic geography with political economy. As noted, the national embeddedness of advanced capitalism is not new. We will argue that it goes back a long way and is fundamentally rooted in skilled workforces and a broad range of public and private institutions that promote investment in human capital and in new technology, together resulting in economic growth and prosperity. Central to the creation and continuation of this beneficial interaction between policies, institutions, and investment is democracy itself. When the middle classes are educated and tied into the advanced economy, or have strong expectations that their children will be, they start to favor policies that promote growth, and vote for parties and

political leaders with a reputation for doing so. Those with low or obsolete skills may not go along if they cannot see themselves or their children benefiting from advanced capitalism, and here we find a large audience for populist appeals—in the twentieth as well as the twenty-first century. Our goal in this book is to present a new picture of the relationship between advanced capitalism and the democratic nation-state that runs counter to the standard markets-against-politics perspective and explains the remarkable resilience of advanced capitalist democracies, from their beginnings in the early twentieth century and through the arguably most turbulent century of human history.

## 1.2. The Argument Summarized

This book starts from what appears to us a major puzzle in political economy, though paradoxically one that the literature pays little attention to. This is the exceptional resilience of advanced capitalist democracies (in comparison to any other type of nation state in the last century or so). All the economies which industrialized in the nineteenth and early twentieth centuries were democracies shortly after the end of the First World War; and apart from temporary German and Italian lapses they have remained advanced capitalist democracies ever since.<sup>2</sup> (Czechoslovakia, tenth most industrialized democracy in the early 1920s, is the exception—as a result of external forces.) This resilience is also true of the small number of newly advanced capitalist economies since the end of the Second World War (Japan, Israel, Hong Kong, Singapore, Taiwan, South Korea, Ireland): once they became advanced capitalist democracies they have remained so (with the arguable exception of Hong Kong, again the result of external forces).<sup>3</sup> While the correlation between per-capita income and democracy is well-known (Lipset 1959), and while the near-zero probability of rich democracies reverting to authoritarianism is well documented (Przeworski and Limongi 1997; Svoblik 2008), why this is so remains a black box.

What is particularly puzzling about this resilience is that it took place over arguably the most perturbed century in European

recorded history (apart perhaps from the fifth century). In any case, a dominant theme in the book is how advanced capitalist democracies have responded to and shaped interactively two great technological regimes. The second industrial revolution (or the scientific regime) started in the last third of the nineteenth century and morphed into an organizational revolution of giant Chandlerian conglomerates, often described as the Fordist regime. And then the Information and Communication Technology (ICT) revolution that followed ushered in so-called “knowledge economies.” A fine analysis of changing technological regimes is by Freeman and Louca (2001). In addition to encompassing technological change, the advanced world has seen major wars, the end of empires, the rise and fall of communism, the rise of Asian manufacturing, and exceptional social, occupational, and locational change, including a massive entry of women into the labor market. Most dramatically, two deep financial crises led to prolonged depression and deep recession and slow growth.

The reader will be likely to read this book in the light of the financial crisis. That is partially intentional. But from our perspective it is written in the light of the performance of the advanced capitalist democratic nation-states, both as resilient and as responsible for the huge rise in living standards, decline in poverty, and, relative to other countries, fall in inequality over more than a century, as will be seen in the next section.

Our initial motivation is to understand this striking resilience of advanced capitalist democracies. So one concern of this project has been to develop a broad model of advanced capitalist democracies to explain the resilience. We sketch key elements of this model here. We also see how this may help to solve several other puzzles about advanced capitalist democracies, such as the continued differences in institutions and public policies despite the globalization of production.

In contrast to almost all other approaches, apart partially from Lindblom (1977), we argue that there are powerful *symbiotic* forces explaining why democracy, the advanced nation-state, and advanced capitalism are generally mutually supportive and have been so over this perturbed last century.<sup>4</sup> In common with Hayek (1944, 1966),

Lindblom (1977), Schumpeter (1942), and Poulantzas (1973), we see a strong state as necessary to promote successful innovation-oriented advanced capitalism, notably by enforcing competition on advanced capitalist companies (who would prefer protection and stable profits) and labor market rules to ensure workplace cooperation (against predatory unions). For both Hayek and Schumpeter, and also Poulantzas, capitalism and social democracy are both enemies of such enforcement—capitalism because it eliminates monopoly profits and social democracy because it undermines monopoly wages. But in our model a central component is that the large skilled workforces of the advanced sectors of the economy, and the aspirational voters who seek to join these workforces, have interests aligned with the promotion and success of advanced capitalist sectors, and are generally decisive voters. This contrasts with the general assumption in almost all this literature that democratic capitalism is a clash of interests between labor and capital.<sup>5</sup>

Our approach, building on the alignment of decisive voters with the success of advanced capitalism, assigns a very different role to democratically elected governments, in which they play a central and activist role in an uncertain technological environment promoting change in their advanced capitalist sectors. Democratic governments construct and reconstruct their economies, conditioned by past choices, in response to voter demands for effective economic management and internationally competitive economies and a better life for themselves and their children. This draws heavily on our academic background in the rich comparative political economy of advanced capitalism.<sup>6</sup> A dominating concern in this literature is how democratic governments guarantee the effective organization and reorganization of their advanced capitalist sectors. This literature has also been concerned with understanding heterogeneous socio-economic institutions across different advanced economies which underpin specialization of economic activities: a specialization we also seek to understand in this book. Given the scope for variety, advanced capitalist democracies evolve over time in response to technology and other shocks, but in turn also reshape them; and

they are themselves embedded in different electoral and legislative rules. Common for all are the incentives for governments to promote the advanced sectors of the economy and construct and reconstruct institutions in order to further this goal. We see new technologies as political opportunities, and their adoption is politically determined.

The most distinctive element of advanced capitalism in our approach has already been mentioned—the large skilled and educated workforces of the advanced capitalist sectors. Some of our understanding about skills has developed from comparative political economy, and much has developed from the literature on innovation (Dosi (2000), Malerba (2004), Lundvall (1992, 2016), Freeman (2008), Nelson (1993), Casper (2007), Whitley (1999, 2007)). The skills of these workforces are tacit and cospecific both with each other and with company technologies; technologies are themselves partially codifiable and perhaps patented, but, as Teece (1986) underlined, protected by the cospecific skills of the workforce even in the absence of patents. Moreover, their tacit skills are generally learned from each other, in an overlapping generation (OLG) logic. This implies colocation in work environments and/or skill clusters over time. This is widely recognized in the economics of agglomeration (Glaeser 2010), despite the role of the internet and global trade and finance; it is also true of the different environment of giant Chandlerian corporations, in an earlier technological regime with Fordist and earlier technologies (Chandler 1967, 1977). Quite generally it has pinned down advanced companies or their subsidiaries to the national environment where education and training takes place; the high value-added activities of an advanced company are thus generally embedded in the national or regional or local environment—advanced capitalism is geographically specific and not footloose (irrespective of where the shares or patents are held). Knowledge-based multinationals (typically but not necessarily with core technologies in a particular national environment) may have many geographically embedded skill-intensive subsidiaries (Cantwell 1989). It is only across the low-skill subsidiaries that multinational companies (MNCs) can easily move between locations at low cost, leaving little rent to the countries they are in.

A second implication of the colocation and cospecificity of skills and capital is geographical specialization. Specialization is deeply embedded in innovation-oriented activities. Again, this follows both from the literatures on comparative and international political economy, and also from the innovation literature including that on national systems of innovation (Lundvall 1992, 2016; Nelson 1993; Cooke 2001). Geographically embedded skills and specialization in turn lead to another symbiosis, namely that each advanced nation in general derives complementarities from trading and capital mobility with other advanced economies. Thus advanced nations gain from globalization with other advanced nations, at least in the advanced sectors. This then is a game of strategic complementarities. In our broad model the greater the specialization, the greater the value the community of advanced governments gain from each individual advanced economy: hence the symbiosis between the advanced nation-state and the extent of advanced globalization. A hegemon may be important in protecting an advanced economy from military threats by nonadvanced economies; but it is not relevant within the community of advanced economies.

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

Spelled out in greater detail below, we thus see our broad approach going some way in explaining the resilience puzzle. It also explains, we believe, five related puzzles which we elaborate below: first, the middle-income trap, and why so few countries have developed into advanced capitalist democracies after the Second World

War. Second, it shows why a thoroughly integrated world economy has not undermined the existence of different forms of advanced capitalist democracies, since their institutional differences cause and are caused by distinct patterns of specialization. Third, it illuminates how democracy reinforces advanced capitalism when it is widely thought to cause “decommodification” by majoritarian demands for policies that undermine markets in the name of equality. Fourth, and related, it goes a long way in understanding the distinct paths to democracy of the different advanced economies, and the limitations of generic arguments such as that of Acemoglu and Robinson (2005). Finally, it helps us understand why advanced democracies, despite generating prosperity and greater income equality than most non-advanced countries, have not responded to rising inequality since the late 1970s. Closely related is the question why advanced capitalist democracies have given rise to populist political movements that oppose the very elites that grow out of the knowledge economy as well as open borders and the prosperous cities and the live-and-let-live values that they give rise to. But first we highlight some key conceptual distinctions, causal claims, and empirical hypotheses that make up our basic argument.

### **1.3. Our ACD Framework Approach**

Our broad thesis is that a relatively simple framework model of advanced capitalist democracies (ACD) evolved over a long period of time, at least over the last century—from roughly the end of the First World War, by which point all the early industrialisers had become democracies. In summarizing this framework more closely than above, we attach central importance to the *sympiotic* relationship between five core elements:<sup>7</sup>

#### **1.3.1. THE ROLE OF THE STRONG NATION STATE**

We follow many analysts before us (for example, Poulantzas (1973), Hayek (1944, 1966), and Schumpeter (1942), among the major theorists of advanced capitalism from quite different political

perspectives) in paying close attention to the central role of the state in putting and maintaining in place key necessary conditions for the operation of advanced innovation-oriented capitalism. The state, to be successful, can be thought of having four sets of tasks:

- (i) Imposing on business the requirement that product markets are competitive; this is a key requirement, for there is considerable evidence that competition (so long as not too intense) is a precondition for innovation. It requires a strong state to impose competition because businesses prefer protected markets with low-risk and high-profits which they can share with politicians. The first country to emerge as a modern capitalist economy, Britain, did not take off until the rampant rent-seeking and corruption that characterized the political system up until the end of the eighteenth century was eliminated (Popa 2015).
- (ii) Imposing on labor the requirement that businesses are allowed the right to manage and to cooperate with management. If labor is too powerful, it may prefer to control production and to limit innovation and skill replacement, or with cospecific skills in a technology to “hold up” management once the technology is installed. Thus a strong enough state is needed to organize labor market rules to prevent this.
- (iii) In addition to these rules of the game, the third role of the state is to invest in a range of public goods, especially in the areas of education, training, and research. Here the problem for the nation-state is that if advanced capitalist companies are mobile, they will take the benefits of these investments and locate elsewhere. Thus the benefits of knowledge generated in the nation-state need very broadly to remain there.
- (iv) Finally the state needs to negotiate out through the political system and interest groups how advanced capitalism and the state can reset rules and reinvest in response to shocks. Fioretos 2011 shows this with insight

over the whole postwar period in relation to France, Germany, and the UK). More generally, in periods of deep uncertainty—as in the early 1980s—it needs to debate the direction to be taken to promote advanced capitalism. In an important recent book, *Marketcraft: How Governments Make Markets Work*, Vogel discusses this process at length, in particular in relation to the United States and Japan since the 1980s.

### 1.3.2. ALIGNED INTERESTS OF DECISIVE VOTERS WITH ADVANCED CAPITALISM

Why should a strong enough state behave in these market-enhancing ways? If capitalism is politically strong it will be tempted to demand protection from the state, and politicians will be tempted to make bargains with it. Advanced capitalists will exchange profits with the state for protection and the quiet life. Poulantzas (1973) saw this as a fundamental problem facing capitalism. Arguably one of the most brilliant Marxist theorists from the 1960s to the 1980s, his “regional” theory simply posited that the state had the “function” of maintaining a competitive environment; this both geared business to innovation and prevented businesses from collective action such as investment strikes because of the collective action problem they faced when competing against each other. This approach may appear slightly mystical, but it showed how Poulantzas was aware of the problem.<sup>8</sup> Hayek (1944, 1966) was equally aware of the need to impose competition requirements on businesses if they were to innovate. His concern was with democracy: he believed that voters as workers would vote for protection to guarantee their jobs. And Schumpeter (1942) was equally aware of the problem and thought that advanced capitalism would lead to corporatism and an end to a competitive environment, or that voters would choose socialism.

We take a quite different position. Along with Lindblom (1977), but without his emphasis on the structural power of capital, we argue that governments pursue policies supporting advanced capitalism in the nation-state because the electorate, or at least decisive voters,

punish governments which don't.<sup>9</sup> We argue that they do so because a large number of voters see themselves as benefiting from advanced capitalism, whether directly as employees or as aspirational voters: thus we take the opposite position to the standard view of political economy, that the interests of workers are opposed to those of capitalists.

Within advanced capitalist democracies, political parties and their leaders need to build up reputations among decisive voters as effective economic managers to be electable: that is to say, they need to build up a reputation for maintaining and, where necessary, changing the product and labor market rules (mainly, product market competition and labor market cooperation) and the public infrastructural investments (education, skills, research, universities) necessary for innovation-oriented capitalism. We can think of these as electable parties. An important question is what ensures a majority, or decisive vote, for these policies and parties. Who are these voters?

First, there is a large vote from employees in advanced capitalist companies. Advanced capitalism has required since the second (or scientific) industrial revolution from the last third of the nineteenth century, a large skilled and educated labor force, cospecific and collocated with the technology of the company in question (Thelen 2004; Goldin and Katz 1998). It is often wrongly thought that the knowledge of the company is a technology which can be codified and patented; but technology is almost always cospecific with the tacit skills of the workforce (Teece, 1986). The level of skills and education is relative to the prevailing technology, but management in the advanced sectors has always had to secure the cooperation or motivation of the labor force, because of the significant costs of hiring and firing. This is as true of semiskilled workers under Fordism as of contemporary software engineers: they could easily stop the line, and replacing them involved both strikes and significant retraining costs, especially if training new workers required the tacit cooperation of existing semiskilled workers. Thus we can think of this skilled workforce as gaining rent from advanced capitalism above the competitive market value of their skills. In one form or another this aligns

the interests of the skilled worker with advanced capitalism. Because advanced capitalism is skill-intensive, this electorate is very large.

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

By this token, when some families are blocked from experiencing upward mobility they tend to react politically against the system, which we see as the root cause of populism. For reasons we will spell out below (and in detail in chapters 3–5), the transition to the knowledge economy has produced blockages, and this raises the question of whether populism is a threat to advanced democracy.<sup>10</sup> We think not. The reasons are discussed in detail in chapter 5, but the most fundamental in our view is that those benefiting from the knowledge economy have an obvious incentive to make sure that a solid majority will continue to feel included in, and benefit from, the knowledge economy in the future. That said, we do not want to minimize the challenges of potentially creating a large left-behind minority who feel alienated from society and democratic institutions. Even if populist parties will never attain majority status, populist appeals could prove a destabilizing force in democracy (as they arguably have in the United States and in Britain), and we do not want to underestimate the social costs of large minorities losing hope in the future and turning to drugs or crime as a consequence. This is a serious problem *for* democracy, even if it is not a serious threat *to* democracy (or advanced capitalism, or the nation-state). As we spell in out in chapters 3 and 5, this problem has been addressed much

more effectively in some democracies than in others (in particular through the training and educational system).

### 1.3.3. SPECIALIZATION AND LOCATION COSPECIFICITY

This is perhaps the most novel element of the argument, and it underpins the symbiosis discussed above, between decisive voters and governments promoting the framework rules and infrastructural investments needed for advanced innovation-oriented to function effectively.

A critical and major empirical assumption we make about advanced capitalism is that (at least since the scientific revolution) it has been skill-intensive. That is an empirical assumption, and Braverman (1998) argued to the contrary that the microprocessor would result in a fall in skill-intensity. That has not happened so far in the advanced sectors; it has, arguably, as in Asian manufacturing, turned what had been advanced sectors in the Fordist era into less skilled sectors today. We will discuss in the conclusion different future scenarios depending on the nature and trajectory of technological developments. In the contemporary world, however, advanced capitalism is built on a large skilled labor force. More than forty-two percent of twenty-five-to-thirty-five-year-olds today have tertiary degree in the OECD (compared to twenty-six percent among fifty-five-to-sixty-four-year-olds), and more than half of the current university-age cohort will acquire a tertiary education, with the great majority of those who do not acquiring a higher secondary degree. Many of the latter will expect their own children to go to university. Almost eighty percent of the working-age population in contemporary OECD countries have at least a higher secondary degree (OECD 2016, 41). In a middle-income country like Turkey, the number is thirty-seven percent.

Not only is labor skill-intensive in the advanced sectors, those skills are tacit (i.e., difficult to codify) and cospecific with other skilled workers, and they are also cospecific with the relevant technology, even in cases where the technology is itself is codifiable and thus (generally) patentable. This in turn implies that the skilled

workforces of advanced companies are colocated and have to work physically together. The great Chandlerian companies of the Fordist era typically had huge plants or connected sets of plants—the advanced sector of their era—which housed the skilled workforce, often from sophisticated manufacturing through to research and development. Many find it surprising that colocation has increased in the knowledge economy, despite the internet. This is often today in the form of skill clusters, so that knowledge is geographically confined, and both workers with the relevant skills and knowledge-based companies wanting to tap into the relevant knowledge cluster have strong incentives to locate there.

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

This is consequential for how we understand modern capitalism. First, the common view of footloose capitalism makes little sense in relation to advanced companies, or at least their knowledge-based part. This is different from the behavior of MNEs in nonadvanced countries. It is different to financial assets, including the ownership of companies. And it is different to the ownership of patents. But even if the technology or discovery is codifiable, it is typically cospecific with skilled workforces. (Not always, as in the case of patents for therapeutic drugs.) In the substantive sense of the value-added of their knowledge, advanced companies are relatively immobile. Equity capital is liquid and can be owned in many different national markets, but its value is still tied to firms that are nationally embedded, hence also to the skilled workforces on which they depend. Short-term financial assets, such as foreign currency holdings or short-term bonds, impose constraints on macro-economic policies—notably, the capacity of governments to build up large debts or to use currency devaluations—but these are self-imposed constraints, as we will see in chapter 4. Besides, they have no effects on the capacity of governments to use balanced budgets to

redistribute, or to use countercyclical fiscal or monetary policies in times of high unemployment.

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

Our argument about the immobility of capital in ACDs runs counter to common claims to the contrary. Among the more prominent examples in the academic literature are Streeck (2010), Piketty (2014), and Rodrik (1997, 2017), who all argue that capital mobility undermines the capacity of governments to tax and finance the welfare state. For Piketty this is the basis for his prediction that  $r > g$ , which will produce ever-greater concentration of wealth. Yet Piketty's own data show that after taking account of destruction of capital and capital taxation, in fact  $r < g$  for the entire period from 1913 to 2012—that is, basically during the period of democracy (see figures 10.10 and 10.11). The dire prediction for the future relies on the key assumption “that fiscal competition will gradually lead to total disappearance of taxes on capital in the twenty-first century” (2014, 355), coupled with a sharp drop in growth rates.<sup>11</sup>

A look at actual capital taxation rates instead reveals remarkable stability. While top statutory capital tax rates have come down in most countries since the 1980s, Swank and Steinmo (2002) show that such cuts were accompanied by a broadening of the tax base that left effective tax rates virtually unchanged from 1981 to 1995. The most ambitious attempt to estimate capital tax revenues as a share of the capital base (called the implicit tax rate) by Eurostat shows no tendency for decline in European ACDs between 1995 and 2015 (see table 1.1). If anything, the opposite is true. The United States is an exception because corporate tax rates were cut in the Republic tax

TABLE 1.1. The implicit tax rates on capital, Western European countries, 1995–2015

	1995	2000	2005	2010	2015	Diff 2015–1995
Belgium	24.7	28.8	31.1	27.4	38	13.3
Denmark	27.9	31.6	45.3	38.7	34.4	6.5
Germany	20.8	26.4	20.4	19.2	24.2	3.4
Ireland	.	17.2	22.3	16	14.5	-2.4
Spain	.	27.9	35.9	26.2	30.3	2.2
France	36	42.3	44.1	43.5	52.7	16.2
Italy	24	24	24.7	28.6	34.3	10
Netherlands	19.6	18.6	13.5	10.9	12.1	-7.5
Austria	25.9	26.8	24.3	23.4	29.9	4
Portugal	19	28.4	24.4	25.4	26.5	7.4
Finland	31.5	40.6	28.6	29.2	31.4	-0.1
Sweden	18.8	39.2	31.5	27.5	32.7	14
UK	24.4	34	33.4	32.6	31.6	7.2
Norway	38.7	42.5	41	42.7	30.3	-8.5

Source: Eurostat–European Commission, 2017. *Taxation trends in the European Union. Data for the EU member states, Iceland and Norway*. Luxembourg: Publications Office of the European Union.

reform, but only to about the average rate of other OECD countries, which is twenty-one percent (the United States had exceptionally high rates before the reform). Of course, there is no reason that governments should rely on capital taxation to fund the welfare state, and such taxation rarely exceeds twenty-five percent of revenues (with income and consumption taxes making up the bulk of the rest).<sup>12</sup> The composition of taxation is a political choice, not a matter of the structural power of capital to exit.

#### 1.3.4. STRATEGIC COMPLEMENTARITIES AND INSTITUTIONAL HETEROGENEITY

Because of nationally-rooted specialization in an integrated world economy, the advanced capitalist democracies are engaged in a game of strategic complementarities. Globalization between them increases the payoffs from the game, as opposed to constraining domestic political choice or suborning democracy of the advanced economies.

In Chandlerian companies in a Fordist regime, free trade and freedom of foreign direct investment movement are both important,

as they are in knowledge economies. In knowledge economies, as knowledge competences become more decentralized, so knowledge-based MNEs become more like networks of autonomous subsidiaries with complementary knowledge competences. In both cases there is a political incentive to promote globalization across the advanced economies; but it is arguably more important in the contemporary world. There are several implications of this insight:

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

Equally, as we have seen, since companies are relatively immobile geographically, it limits both actual exit and the credibility of exit threats. The critics of capitalism are right that footloose capital constrains what states can do; it is just that advanced capitalism is not footloose.<sup>13</sup> Thus we find the idea thoroughly unpersuasive that advanced capitalism has suborned the autonomy of democracy through globalization, and is responsible for austerity, poverty, and cutbacks in redistribution and the welfare state. One can of course find examples of governments giving tax concessions to companies that promise to retain jobs instead of moving them to low-wage countries. Such pressures and temptations arise naturally as part of Vernon's (1966) product life-cycle as production becomes more routinized and can be performed by robots or low-skilled workers abroad. But we think it is far more remarkable that governments in ACDs routinely shun such temptations. At the height of deindustrialization in the 1980s governments across ACDs engaged in policies that accelerated the decline of sunset industries by cutting back subsidies, privatizing unproductive public enterprises, and removing barriers to competition from low-wage countries while betting on

new high value-added industries moving in to take advantage of an abundance of high-skilled labor (and the associated institutional supports). Nor are such “tough” industrial policies catering to the collective interests of “capital”—even in the broadest Poulantzas(1973) or Lindblom (1977) interpretation. The Rehn-Meidner model informing the economic strategy of the Swedish LO, the major union confederation, and of the Social Democratic Party was deliberately designed to force low-productivity firms to die or to innovate. A right-wing version of this modernization strategy was pursued in the UK and it was vehemently opposed by business. Sometimes the siren song of jobs from declining companies are too hard to resist, but more often than not these companies are shown the door.

B. *Redistribution and the welfare state is democratically decided, for better and (often) for worse.* In understanding inequality before and after redistribution and the policies toward the welfare state in advanced societies, there is consequently little mileage to be gained from focusing on the political power of advanced capitalism; in ACDs (though not elsewhere) capital is politically weak. Instead, for understanding “bad” outcomes, the focus should be on three aspects of advanced democratic systems: first, that the winners from advanced economies are typically the decisive voters—they choose policies to re- and in some measure also predistribute; they may or may not make those choices to compensate the losers; and in particular they may choose not to compensate the poor. (Moreover, if we think of populists as losers of advanced capitalism, they are if anything more hostile to compensating the poor.) Second, that “rules of the democratic game” differ as one moves from consensus PR-based systems to majoritarian “winner-takes-all” Westminster systems (Iversen and Soskice 2006); and further still to the porous American system in which primary elections and semidisciplined parties enable money to influence outcomes (Hacker and Pierson 2010). Third, the level of political information among the electorate exacerbates bad outcomes (Iversen and Soskice 2015). In understanding the problematic of inequality and poverty in the advanced world, it is at these aspects of democracy that we will look, and it is on these aspects that critics of contemporary politics in advanced democracies should focus. We

are, needless to say, strong proponents of democracy, but the failure of adequate redistribution in advanced economies lies in the workings of democratic systems rather than in the political power of capital.

*C. A key underlying condition for a democratic system to support heavy investments in education and research infrastructure is their geographical immobility.* Geographic immobility relates to the rents of skilled workers and the alignment of their interests with advanced capitalism. Critically it also explains the logic behind the heavy infrastructural investments needed to support advanced capitalism in the first place. For if it could be taken abroad (as companies could do in the absence of the tacit skills of the domestic workforce and their cospecificity with company technology), then incentives for governments and voters to invest would collapse.

### 1.3.5. THE FUNDAMENTAL EQUALITY OF DEMOCRACY

We have established above that advanced capital in ACDs is immobile and that the state for that reason is powerful. We have also argued that democracy and capitalism are in a symbiotic relationship in the sense that decisive voters—skilled or aspirational or both—vote for parties and policies that promote the advanced sectors, which raise the demand for skills, and so on. In this section we suggest that the essence of democracy is not redistribution or equality, as so commonly assumed, but the advancement of middle class interests, and we capture this idea as the “fundamental equality of democracy” (to distinguish it clearly from Piketty’s (2014) “fundamental inequality of capitalism”).

The interests of the middle classes are aligned with advanced capitalism via two key mechanisms. The first is direct inclusion into the wealth stream created by the continuous progression of the advanced sectors. By far the most important path to such inclusion is education, since the advanced sectors are skill intensive. Even when the skills of middle-aged workers fall behind the needs of the advanced sectors, these workers can benefit indirectly if their

children acquire the skills needed to move up in the economy. Such intergenerational mobility creates aspirational voters who will also support policies that push forward the advanced sectors—notably through investment in education and research and development (R&D), coupled with strong competition rules.

The second mechanism is the welfare state, broadly construed to include cash transfers, social insurance, and public services. Accounting for more than one-third of GDP on average, wide-ranging tax-financed middle-class programs ensure that those with high and rising incomes share some of their wealth with the rest of society. This is especially important in the transition to the knowledge economy because gains of new technology have been concentrated at the upper tail of the income distribution. The tax-and-transfer system ensures that these gains are shared with the middle classes.

Exactly who benefits and how much from the knowledge economy is a matter of democratic politics, which varies with the institutional framework of each country. In this book we pay particular attention to electoral and party systems, but for now we can capture the role of electoral politics with the simplified notion of a “decisive voter.” Given that democratic governments ordinarily depend on support from a majority and given that politics is broadly organized around class and economic interests, this decisive voter will be someone from the middle of the income distribution (although not necessarily the median). With a right-skewed distribution of income, a majority has income below the mean and the decisive voter will therefore also typically be someone with income below the mean.

Contrary to standard notions, the overriding concern of the decisive voter is neither equality nor redistribution, but rather his or her own income and welfare, with due attention to efficiency costs of taxation. Although the literature tends to equate political equality with economic equality, there is no reason that the decisive voter should care about those at the bottom of the distribution, except insofar as he or she fears falling into the ranks of the poor (or fears that his or her offspring will)—an insurance motive we discuss in subsequent chapters. Nor is there any reason for decisive voters to oppose

rising incomes for those above them, as long as such windfalls are shared. There are clearly efficiency limits to taxing the rich but whatever the optimal level of taxation from the perspective of the decisive voter, we should expect democracy to ensure that the net income of the decisive voter keeps up with the capacity of the economy to generate income. This capacity is reflected in per-capita income, or average income, and we can therefore represent the political logic of ACDs as a simple identity:  $Y_D/\bar{Y} = k$ , where  $Y_D$  is the disposable income of the decisive voter,  $\bar{Y}$  is average disposable income, and  $k$  is a nationally-specific constant (defined over some suitable length of time to smooth out short-term fluctuations).<sup>14</sup> Needless to say, this assumes that the decisive voter does not change over time because of, say, declining voter turnout or reforms in the electoral system.

Much of the contemporary literature on advanced capitalism implies, however, that any such equality of democracy has ended—if it ever existed. Globalization critics like Rodrik imply that footloose capital has undermined the capacity of labor—which presumably includes our decisive voter—to maintain its share of national income. In Piketty, what he calls the “fundamental inequality of capitalism” ( $r > g$ ) guarantees that national wealth and income will increasingly accrue to those at the top of the distribution. In the more political interpretations of Streeck (2016), Bartels (2008), Gilens (2012), and Hacker and Pierson (2011), the will of the majority is subverted by the outsized political resources of business and the rich, again causing a concentration of income at the top while the middle and lower classes lose out.

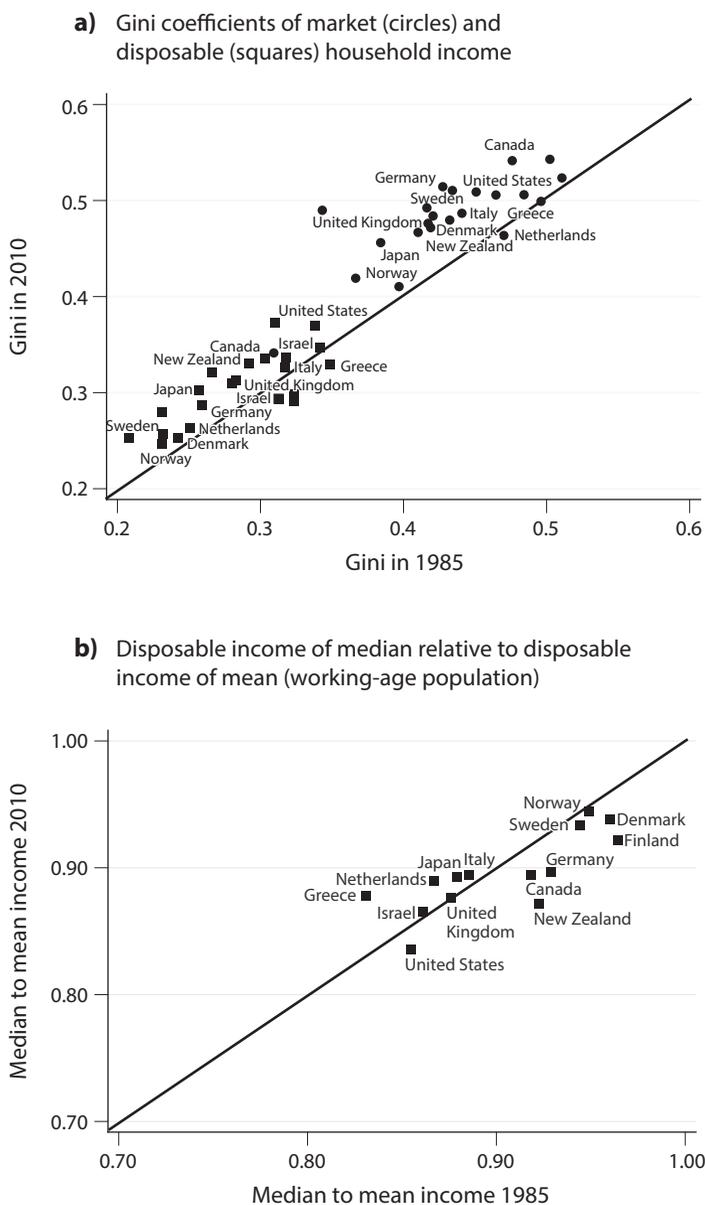
At first blush these pessimistic conjectures seem to be borne out by the data. No matter what measure is used, inequality has risen significantly since the 1980s across all ACDs. For example, Piketty shows that the top decile share of US national income rose from about thirty-five percent in 1980 to about forty-seven percent in 2010 (Piketty 2014, 24). Goldin and Katz (2007) show a similar rise in US wage inequality. Across twenty-two ACDs the Gini coefficient of market household income has risen an average of eleven percent from 1985 to 2014, according to data from Solt (2016), and the disposable income Gini (after taxes and transfers) increased a

more modest seven percent. (The pattern is illustrated in figure 1.1, panel a.)

Yet there has been no corresponding decline in the  $Y_D/\bar{Y}$  ratio if we proxy  $Y_D$  by median disposable income and  $\bar{Y}$  by mean disposable income. This is shown in figure 1.1 (panel b) for a sample of ACDs for which we have comparable data starting in 1985 and ending in 2010. The  $Y_D/\bar{Y}$  ratio in 2010 is more or less the same as it was in 1985 for most countries (the observations lie close to the 45-degree line), and the average difference in the ratio between the two years,  $\Delta r$ , is indistinguishable from zero:  $\Delta r = [-0.043; 0,047]$ . So it appears that the median income group has been exceptionally successful in keeping up with the overall growth of income. We think this is also bound to be true for more accurate measures of decisive voter income since decisive voters tend to be closer to the means as voter nonturnout is concentrated among the poor.

New Zealand is something of an outlier with a drop in the  $Y_D/\bar{Y}$  ratio from .92 to .87 between 1985 and 2010, or about six percent. Even in this case, however, it is notable that average real incomes rose by thirty-five percent in the same period, so the middle class was much better off in 2010 than in 1985. The Gini of disposable household income in this period rose by twenty percent, according to data from Solt (2016). This highlights the general fact that while income inequality has been rising fast, the relative position of the median has been fairly stable, even in an “outlier” like New Zealand. This is also true in the case of the other negative “outlier”: Germany. Here the relative income of the median declined from .93 to .90, or about four percent from 1985 to 2010 (undoubtedly in large part because of unification); yet the mean income rose by more than fifty percent. Even in cases where relative income of the median has slightly slipped, the middle group of income earners is thus clearly enjoying rising incomes despite increasing inequality.

The stability of  $Y_D/\bar{Y}$  is particularly remarkable considering that the data cover a period with the most dramatic increase in inequality since the emergence of democracy. The middle class is a critical constituency for democratic governments, yet it has no interest



**FIGURE 1.1.** Measures of distribution of income, 2010 vs. 1985. (a) Gini coefficients of market (circles) and disposable (squares) household income; (b) Disposable income of median relative to disposable income of mean (working-age population). Labeled observations are the countries for which data are available in panel (a). The first observation for the United States refers to 1995, not 1985. Sources: (a) OECD Income Distribution Database (IDD): Gini, poverty, income. Data extracted on December 31, 2017, 13:11 UTC (GMT) from OECD.Stat. (b) Solt, Frederick. 2016. “The Standardized World Income Inequality Database.” *Social Science Quarterly* 97. SWIID Version 6.2, March 2018.

in inequality per se; only in seeing its own fortunes rise with the economy as a whole. Even when the gains are concentrated at the top, the middle benefits. As we discuss below, in the United States about seventy percent of federal tax revenues comes from the top ten percent of earners, and about forty percent from the top one percent. Indeed, we argue in this book that the reforms that enabled the knowledge economy to take off created huge inequalities, yet were supported by a majority of voters. Those left out of the new economy are generally also weak in the political system. Indeed, a recurrent theme of this book is that democracy, not capitalism, is to blame for the rise of low-end inequality. Phrased positively, greater equality is a democratic choice, which is little constrained by capital.

Our argument may seem to run counter to the evidence in Gilens (2005, 2012), Bartels (2008), Peters and Ensink (2015), and others that the rich are much more politically influential than the middle class. But as we will discuss in detail in chapter 4, this evidence does not in fact say much about whether the economic interests of the middle class are attended to in government policies. The reason is that these analyses compares preferences for policy change with actual policy change, and many policy changes are at the margin and do not much affect how well the broader interests of different classes are represented. If it was truly the case that the rich almost monopolized political power, it would be very hard to understand the emergence and persistence of large-scale middle-class programs such as Medicare and Social Security, let alone why the top one percent of earners pay almost half of the bill for these programs. Moving outside the United States, the notion that middle-class interests are ignored in public policies is even less plausible. Those with high education and income may simply understand the constraints on government policies better than others—the obvious example here is the need for countercyclical fiscal policies—and this will show up as congruence between preferences for change and actual change (see Elkjær and Iversen 2018 for evidence). But this is not synonymous with deciding whose class interests are favored by government policies; the fundamental equality of democracy is an expression of middle-class power.

In the following we develop our argument further by applying it to the five puzzles we identified above in addition to the resilience

of ACDs: the middle-income trap; the strengthening of advanced capitalism by democracy; the rise of democracy; persistent varieties of capitalism in an age of globalization; and the lack of response to rising inequality.

#### **1.4. The Middle-Income Trap Puzzle**

A remarkable fact is that the group of advanced democracies has only been slightly expanded since their rise in the nineteenth and early twentieth centuries. The distribution of world income has become marginally more equal since the 1980s, but this is virtually all due to the rise of a few populous poor countries to the ranks of middle-income economies, notably China and India, and not the rise of middle-income countries into the high-income group. For more than a century, entry into the advanced group has only occurred in the instances of Singapore, South Korea, Taiwan, Israel, Ireland, and Hong Kong.

We can illustrate this using patent data because the number of patents per capita is a measure of the size of the advanced sector (as opposed to GDP per capita, which is affected by oil and other natural wealth). If we focus on OECD and major middle-income countries with at least five million citizens, figure 2.1 shows the number of patents per one million working-age adults in 1976 compared to 2015. The data are from the US Patent and Trademark Office, where nearly every major patent is taken out by individuals, labs, and firms from around the globe.<sup>15</sup>

It is apparent that the ACDs are clustered in the top right corner and that only South Korea, Taiwan, and Singapore have made the transition into this group from 1976 to 2015. This ties into our argument, since in each of these cases powerful governments were deeply committed to becoming advanced capitalist countries. Taiwan, South Korea, and Singapore were semi-authoritarian and in each case, governments were powerful enough to impose competition (in different ways, but always involving trade) and shift massive resources into the educational system. Taiwan and South Korea have since become democracies with powerful electoral

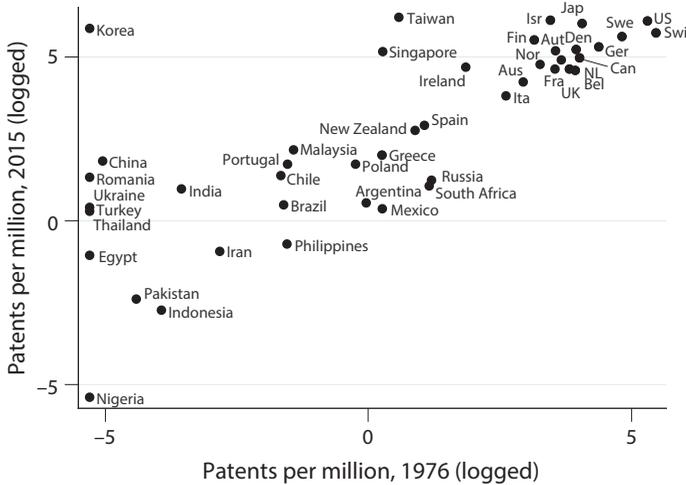


FIGURE 1.2. Number of patents per one million people (logged) in the working-age population, 2015 vs. 1976. The data are from the US Patent and Trademark Office and show the total number of patents granted as a share of working-age population in millions, by the country of residence of the inventor. Countries all the way to the left received zero patents in 1976 and have been assigned an arbitrarily low value (since numbers are logged). *Source:* OECD.Stat. Data extracted on March 3, 2018, 02:19 GMT.

lobbies for advanced capitalism. Singapore has only slowly moved in a fully democratic direction, but its commitment to education and open trade has been unwavering; it is in fact the only advanced country that is (still) not fully democratic.

The difficulty of breaking into the rich ACD club is known in the economic literature as the “middle-income trap” (e.g., Kharas and Kohli 2011). Eichengreen et al. (2012) have persuasively argued that the key barrier is the creation of large knowledge-intensive sectors sustained by internally driven innovation. It is precisely the existence of such dynamic, skill-intensive sectors that define advanced capitalism as we use it in this book. This is as true today as it was at the turn of the previous century.

In fact, if one considers the distribution of the *world population*, the share who lives in rich democratic countries has *declined* since the Second World War, and the total number of people living in these countries has barely risen. Paradoxically, in the face of this evidence most of the recent work on globalization has focused on the concern

that rich countries might fail in global competition with “low-wage” countries and decline into the middle income group. But no country has suffered this fate, and the gap to middle-income countries is stable. Simply put, there is no convergence, whether viewed from above or from below.

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

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

of advanced capitalism. But it is only the rare cases where governments had the relevant incentives, connections, and capacities (Breznitz 2007).

3. The democratic institutions necessary to support advanced capitalism are mostly absent. First, there has to be government support for broad-based public investment in education (and a range of supporting institutions that we discuss later), and this in turn requires disciplined political parties that are preeminently concerned about their reputation in a political system where governments must continually appeal to electoral majorities. Reputation-based political parties are also necessary for the government to be sufficiently independent of local strongmen and business interests to ensure that they will not allocate resources or restrict competition for short-term political support. Such reputation-based democratic institutions failed to emerge in most countries. Instead, the middle-income countries tend to be characterized by an economic system where firms seek rents from the political system by offering bribes in exchange for protection against market competition, while politicians accept bribes for personal gain and in order to wage personalized electoral campaigns or party-internal contests. Consistent with this logic, Svoboda (2013) shows that voters in in such a setting will rationally conclude that all politicians are bad, giving even honest politicians reasons to act like them. While Latin America has many candidates for moving out of the middle-income trap, this logic captures the Latin American dynamic of weak product market competition legislation ensuring the market dominance of large, typically family-owned conglomerates, *Grupos*, with close links to the political systems (Schneider 2009).

From this we can begin to understand why it is so difficult for middle-income countries to join the rich camp. Unlike the neo-classical notion that technology is available to every country, it is in fact embedded in immovable national workforces. Advanced technologies therefore have to be built from within, and for middle

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

### **1.5. The Puzzle of Democratic Politics Strengthening Capitalism**

It is natural to think that democracy and capitalism are on a collision course. One is based on a principle of equality (“one person one vote”) while the other is based on a principle of market power (“one dollar one vote”). Esping-Andersen captured this tension succinctly in the title of his 1985 book *Politics Against Markets*, and it underpins the entire power resources approach to capitalist democracies.<sup>16</sup> Streeck (2013) interprets every major institutional change, economic crisis, and distributive outcome in the post-WWII period in terms of the struggle between (egalitarian) democracy and (inegalitarian) capital, with capital gradually winning out as its mobility rises.<sup>17</sup> Piketty (2014) concurs but does not even perceive a need to analyze democratic politics because mobile capital inevitably undermines the capacity of democratic governments to either arrest the growth of capital or accelerate the growth of the economy. So how can we claim that democracy prevents markets being undermined, leading to divestment and capital flight?

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

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

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

Politically, what sustains the equilibrium is a large electoral constituency of educated workers attaching importance to the competence of government parties in managing the institutions promoting successful advanced capitalism. This constituency is supplemented in multiple ways by those who are not direct beneficiaries of advanced capitalism: there is a wide aspirational community of families concerned that their children can access these advanced sectors. And there is a wider set of “sheltered” service sectors whose

prosperity depends on the success of the advanced capitalist system; these include both high-skilled sectors such as culture, the media, entertainment, much of the health and fitness system, the education system at all levels, and large parts of retail, law and finance, but also some lower paid workers employed in successful cities in transport care and so on. Specifically:

The electability of parties requires that they are credibly seen by this broad electorate as having the competence to manage and promote advanced capitalism. As voters choose politicians for their reputation for good performance, bad types are crowded out (Svolik 2013). In our perspective, the possession of this reputational competence is a valence issue across parties, although the particular form that advanced capitalism is promoted – the “growth model” -- involves distributive conflict. Thus we will argue that there is a symbiosis between democracy and advanced capitalism in advanced societies. So long as the constituency of actual or aspirational direct or indirect beneficiaries of advanced capitalism is large enough that it includes enough decisive voters, then there will be pressure on governments to promote the conditions for the success of advanced capitalism.

Our key assumption is that that constituency is big enough in the advanced economies. And that if governments are seen as successfully promoting these conditions, then that constituency is reinforced. Under these conditions there is a symbiotic relation between democracy and advanced capitalism.<sup>18</sup>

One element of institutional frameworks that needs highlighting is the one governing industrial relations and the power of unions. This gets to the core of the relationship between capitalism and politics. First, as with all other aspects of the institutional framework, governments (and the political system more generally) can only impose legislatively feasible frameworks; in the UK neither the early-twentieth-century Liberal government nor the 1950s Conservative government could have legislated against unions had they wished to, because decisive voters were, respectively, craft workers and then, in the 1950s, semiskilled workers, who would have suffered from “right to manage” legislation. Crafts (forthcoming) argues the failure of UK

governments to introduce serious competition legislation through this long period explains its weak economic performance; and it is plausible to argue that serious competition would have required the “right to manage.” But Thatcher did introduce effective competition requirements in the 1980s and Blair accepted her legislation because they did not face this electoral constraint, and because they saw this as benefiting the innovative capacity of advanced capitalist sectors. Second, disciplined industry unions and employee representation within the company have been integral to competitiveness in skill-intensive export-oriented manufacturing industries in coordinated capitalism and hence part of the relevant institutional frameworks. This was not always the case, and it only holds when companies see cooperative unionization as a better alternative in managing highly skilled employees with autonomous responsibility than individual wage/career structures and/or company-based social protection. This highlights another point:

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

In exchange, the economic success of advanced capitalist sectors cashes out in many ways for governments, from electoral success to military resources; governments of all political colors are therefore concerned to build appropriate institutional frameworks, sometimes conflictually—so long as they remain electorally and politically

successful. To a far greater extent than is recognized in the literature, governments and mainstream political parties are concerned with their medium and long-term viability, and voters reward parties for sustained good economic performance. Political parties represent distinct interests, especially in multiparty PR systems, but they also serve as bridges between the present and the future which enable voters and companies to thrive over long periods of time.<sup>19</sup> This does not mean that parties have no incentives to pursue short-sighted policies, but rather that such policies come at a cost in terms of lost reputation. When the economic gains from far-sighted policies are sufficiently large—in the context of an advanced economy—the costs of reputation from short-sighted policies are correspondingly large.

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

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

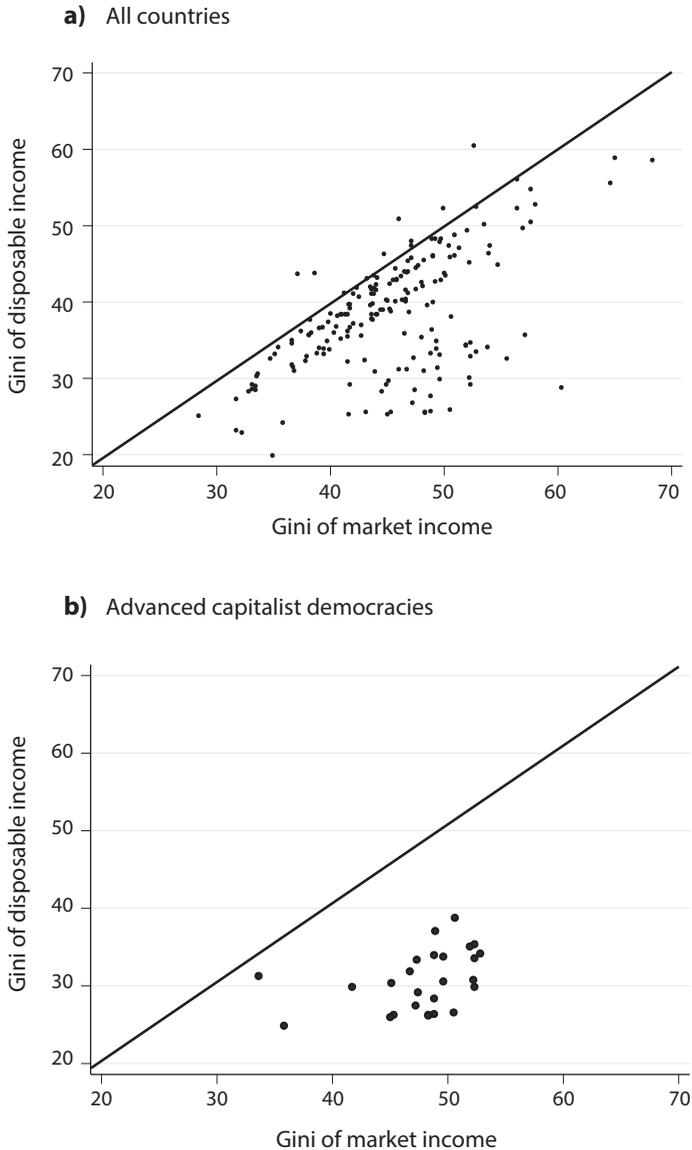
By contrast to Marxist arguments, as well as Lindblom's (1977), we do not see political systems setting the frameworks which capitalists would have chosen. On the contrary, the institutional frameworks of the advanced countries forced capitalists to compete and take risks rather than guaranteeing them safe and high returns on their capital. These national frameworks (in different forms) both

supplied the public goods necessary for innovation, and imposed the competitive incentives to generate innovation. The political basis for these policies were educated workers and aspirational constituencies.

But within these broad efficiency mandates, governments have considerable discretion to tax and redistribute as they see fit since they are not constrained by capital mobility. Indeed, advanced democracies tend to be more redistributive compared to both non-democracies (where governments have little incentive to redistribute) and to nonadvanced democracies (where governments have little discretion to redistribute). This is very clearly illustrated in figure 1.3. Lower inequality is especially evident for net income, after taxes and transfers, reflecting higher levels of redistribution in advanced countries compared to other countries. Greater redistribution is partly a reflection of the role of middle classes in demanding a share of income through the democratic system, partly a result of democratic coalitions that include representatives of lower classes, and partly a reflection of the role of social insurance as a complement to skill-intensive production, as we discuss in greater detail in subsequent chapters. But it also reflects the strength of the state to redistribute, which is largely missing in low- and middle-income countries (democratic or not). These differences are very stable over time.

## **1.6. The Puzzle of the Rise of Democracy and Advanced Capitalism**

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



**FIGURE 1.3.** The distribution of income in advanced democracies compared to nonadvanced countries. *Notes:* (a) displays the pre- and post-fisc Ginis for 192 countries. The years are the latest available, where 85% are from 2008 or later and only 5 observations are from before 2002. (b) includes Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, the UK, and the United States. *Source:* Solt, Frederick. 2016. "The Standardized World Income Inequality Database." *Social Science Quarterly* 97. SWIID Version 6.2, March 2018.

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

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

Once the transition to democracy has occurred, the sustainability of the system depends on these skilled workforces because a) they want the system of advanced capitalism to continue, since their market income depends on its market success, and b) they have the organizational capacity to block or render a return to authoritarianism very costly. By contrast to Boix's (2003) condition that capital be mobile to prevent expropriation, the "functionally equivalent" condition is that these skilled workforces support the system of advanced capitalism. By contrast to Acemoglu and Robinson (2005), the nonreversibility of democracy does not lie in the institutions themselves ("credible commitment to redistribution") but in the organizational capacity and economic importance of skilled workers.

This then explains the conditions for democratization in advanced capitalist systems: the skilled workforces with their cospecific skills will eventually be well-entrenched enough to have the bargaining

power to impose democracy on governments. And nondemocratic governments—promoting advanced capitalism—will eventually accept democracy, since these skilled workforces also wish to promote it. As advanced capitalism promotes the number and bargaining strength of skilled workers, democracy becomes highly stable.

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

### **1.7. The Puzzle of Varieties of Advanced Capitalism in an Age of Globalization**

A large literature, mainly in economics, has been devoted to the idea that there is a single optimal way—a best practice—of organizing economies to pursue growth or maximize GDP. At various stages, especially in the 1980s and 1990s, the OECD, the World Bank, and the IMF propagated these beliefs, sometimes referred to as the Washington Consensus.<sup>20</sup> It might have been expected that advanced capitalist democracies would have seen convergence, especially in corporate governance, labor market rules, as well as institutions playing roles in training and in technology transfer. Moreover, advanced companies face broadly similar conditions in international product and financial markets, and with respect to overseas direct investment.

But that has not generally been the case, despite major relaxation of government rules in the last quarter-century and despite the fact that companies are free to move (Hall and Soskice 2001). In fact, although corporations are now organized with greater flexibility and are more decentralized, each advanced capitalist democracy has remained different from each other: some advanced capitalist democracies are closer to each in broad variety of advanced capitalism terms, but there are many institutional differences between even Denmark and Sweden (Ibsen and Thelen 2017). As already noted, redistribution and welfare states, while they have changed over time, remain different across advanced capitalist democracies. These institutional differences are for the most part at the national level. In particular, there are great differences in knowledge competences and patterns of specialization across, but also within, countries.

Our approach is quite consistent with these differentiated patterns, even in a global world in which financial markets are competitive and capital movements are unconstrained. These results are of course widely known (Garrett 1998; Swank 2002), but our approach provides a clear analytic framework for understanding them as “equilibrium” phenomena.

1. The first key point is again the limited mobility of skilled knowledge-based workforces in the advanced economies. Nor can companies usually replicate the skills of the workforce elsewhere because training in tacit skills depends largely on new employees working with existing ones who can impart the tacit knowledge. Nearly always companies or skilled educated employees depend on other companies or other facilities (including research) in the area. This is strongly reinforced by and reinforces geographical specialization.
2. Not only can the advanced company not move, but it cannot seldom threaten credibly to do so. Capital does not have structural power in this sense. Moreover, advanced companies generally lack collective action capacity since the state imposes competitive product market rules. As Poulantzas (1973) puts it only slightly differently, the

nature of capitalism is competition, especially if legally reinforced, so we should not expect advanced capitalism to act collectively as a class for itself. Hence advanced capitalist companies (even if they should want to do so) cannot force the state to lower corporation taxes or limit redistribution or cut back welfare states. Nor by the same token can they force states to change rules governing varieties of capitalism.<sup>21</sup>

3. A key implication is that advanced capitalist democracies will have an incentive to support globalization, at least relative to the sectors in which the economies specialize. Each advanced country benefits more from globalization the more specialized advanced countries are drawn to the table. In this sense, it is a classical strategic complementarities (or network externalities) game.
4. Finally, note that this is reinforced in a world of knowledge-based MNEs. Together with the geographical immobility of these sophisticated innovation-oriented research, development and production clusters, the impetus for nation-states to encourage the globalization of FDI by knowledge-based MNEs is clear. Pushed by the immobility of knowledge and the benefits of accessing via FDI complementary knowledge based in other advanced countries, the autonomy of the advanced state is enhanced (Cantwell and Mudambi 2005).

All this enhances the power of the individual advanced capitalist democracy, for the specialization of each advanced state is desired by the others. This permits institutional, political, and policy differentiation.

### **1.8. The Puzzle of Rising Inequality without Redistribution**

Unlike those who see the rise of inequality as the result of a subordination of democracy to capital, we see rising income and wealth inequality instead as a function mainly of technological change and choices made by politicians trying to satisfy the demands

from middle- and upper-middle-class constituencies.<sup>22</sup> Skill-biased technological change (SBTC) is a well-established driver of income inequality, with a clearly articulated economic logic. Because ICT technology substitutes for semiskilled, routine tasks while it complements high-skilled, nonroutine tasks, demand drives up relative wages of the high-skilled (Autor, Levy, and Murnane 2003; Autor, Katz, and Kearney 2008). Yet, even here politics is essential because the SBTC thesis only speaks to the demand side, and the supply of skilled labor is heavily influenced by government policies, in particular spending on higher education (Goldin and Katz 2007).

Democratic politics is even more important in explaining wealth accumulation. If we assume—very loosely—that the middle and upper middle classes are key constituencies for governments, following the logic above, then we must ask what these groups want from the government. Clearly, they want to become wealthier, and a large portion of the wealth that Piketty (2014) assigns to capital is in fact in the form of housing and pension funds, which are also owned in large numbers by middle and upper middle classes. It is hardly a surprise that they see an interest in policies that help increase the value of these assets, and politicians of all stripes obliged from the 1990s onwards by making it easier to own real estate and to build up pension funds (Popa 2016). Indeed, as we show in detail in this book (especially in chapter 4), the entire reconfiguration of financial, educational, and regulatory institutions in the 1990s and 2000s was induced by politicians eager to satisfy the demands from those who stood the best chance to benefit from the emerging knowledge economy. Especially those in the rising cities were richly rewarded by higher housing prices, better education, and ballooning private pension funds (associated with rising bond and equity markets). In fact, as is now well-known, most of the great increase in wealth in the advanced economies which Piketty associated with business capital stemmed from the increase in house prices in urban agglomerations resulting from the rise of knowledge economies in the past three decades (Bonnet, Bono, Chapelle, Wasmer 2014).

But if the democratic state is powerful and advanced capital weak, why was rising inequality from the 1980s not accompanied

by increased redistribution? As we suggested above, this puzzle is rooted in what we see as a misunderstanding of the politics of ACDs. There are two parts to this puzzle; one is about the top half and the other is about the bottom half. At the top end there is no doubt that financialization of the economy, coupled with the extraordinary fortunes made by top professionals and entrepreneurs in the new high-tech sectors, has stretched the income and wealth distribution, as documented by Piketty (2014) and others. But it is a mistake to think about this as a zero-sum game. In the most extreme case of rising top-end inequality, data in the United States from the Internal Revenue Service show that the share of federal income tax revenues paid by the top one percent has risen from about twenty percent in the early 1980s to nearly forty percent in the 2000s. The latest figures released by the IRS are for the year 2014 and show that 39.5 percent of federal income tax revenues were paid by the top one percent of earners, while 19.9 percent came from the top .1 percent.<sup>23</sup> The bulk of total federal income tax revenues, seventy-one percent, were accounted for by the top ten percent of earners. The average tax rate paid by the top one or ten percent has not changed much from the 1980s to 2014—there was a slight drop in the 2000s that was reversed under Obama—so this dramatic increase in top-end shares is driven by rises in top incomes.<sup>24</sup> Still, high incomes are the main funders of the major middle-class programs such Medicare, Social Security, and public higher education. If rising inequality is driven by the transition to the knowledge economy, the middle and upper middle classes have benefited, either directly through the market or indirectly through the tax-financed welfare state. Across ACDs, while marginal tax rates have fallen, after accounting for deductions, the overall burden of financing the welfare state has not shifted from the top to the middle.

Moving to the lower half of the distribution, across most advanced democracies there has been no or little effort to address rising inequality. We argue that the reason for this lack of government responsiveness is declining political support in the middle and upper middle classes for expanding redistributive social programs—and the unwillingness of even the lower middle classes to redistribute

to the poor. This unwillingness is reflected in terms such as the “undeserving poor” in contemporary populist discourse. Underpinning this shift is a breakup in an alliance between skilled and semiskilled workers, which had characterized the postwar industrial economy, and the rise of new middle and upper middle classes of highly educated and relatively secure workers. Only where there are strong political-institutional incentives to include representatives of low income groups in government coalitions have policies been responsive to rising inequality and insecurity at the bottom. Indeed, it is not only the poor being left behind; in some advanced economies it is also the old middle classes who had their heydays under the Fordist economy.

More work is needed in this area to understand the demand of current and former industrial workers. It is clear that they are concerned to maintain access to “their” welfare state but also to close that access to immigrants; also that they want to block redistributive transfers to the “undeserving poor,” especially in the form of “benefits”; thus it may be that in some advanced economies there is a yet wider group of decisive voters against relief of poverty.

As we set out in more detail in chapter 3, a major underlying cause of the challenge to the postwar consensus over the welfare state was the decline of Fordist mass production since the 1970s, and the concomitant shift toward knowledge-intensive production. These changes have severed previously strong complementarities in production between skilled and semiskilled workers. Deindustrialization contributed to this process by gradually segregating many low- and intermediary-skilled workers into insecure, often part-time or temporary, service jobs (Wren 2013). The combined effect of new technology and deindustrialization has been a divergence in employment security and income between core and peripheral workers (Kalleberg 2003), with the college-educated in much more secure positions.

A key question for our entire understanding of the role of democratic politics in redistribution is the extent to which governments have stepped in to compensate and assist workers who have been adversely affected by deindustrialization and technological change.<sup>25</sup>

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

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

In addition to these coalitional dynamics, however, the transition to the knowledge economy has reconfigured political divisions and the party system. Semiskilled workers—and sometimes their children—have largely lost their foothold in the dynamic sectors of the economy and are increasingly segmented into precarious low-end jobs in service sectors, including social care and personal services, delinked from their erstwhile peers in industry. Some continue to be employed in industry, but industrial employment has been declining rapidly in most advanced economies. Instead, a new web of interdependencies has emerged in the urban centers of the new knowledge economy, organized around those with higher education. Workers with high school degrees and lower-level secondary vocational training in the old manufacturing cores are left out of this

new economy, and they increasingly live in small towns and rural areas, which have for the most part lost their importance as suppliers for the urban economy.

Politically, many among these left-behind groups have abandoned traditional center-left parties, which are increasingly chasing the emerging urban, educated voters with liberal, cosmopolitan views. Instead, many have thrown their support behind populist parties, which promise to restore the status of the old industrial (mostly male) skilled workforce while retaining core elements of the old welfare state. Immigrants, who are seen as a threat to the white working class, are deliberately left out of this scheme. This new divide is not synonymous with the “insider-outsider” conflict identified by Rueda and others, because many of the “insiders” in that story are in fact the losers in the new knowledge economy, even as “outsiders” (many of whom are immigrants) fare worse. It is better approximated by the rise of a new “cultural” (or “libertarian-authoritarian”) dimension in politics, which has been convincingly documented by Kitschelt (1995), Häusermann (2010), Oesch (2012), Kriesi and Pappas (2015), Häusermann and Kriesi (2015), and others, but it has deep material roots. Attitudes about this new dimension are closely related to education, occupation, and location. In chapter 5 we interpret the new political divide from the political economy framework developed in this book, with a strong emphasis on the role of education and educational institutions.

What ultimately makes advanced democratic capitalism resilient in the face of technological change and the rise of the populist challenge is the continued expansion of education combined with opportunity in the advanced sectors. Only in an extreme crisis like the Great Depression is there a serious risk that populism may grow so widespread that the foundations of both advanced capitalism and democracy will come under attack. Nonetheless the cleavage in PR systems between traditional mainstream parties and sometimes green parties, especially on the center-left, and rising populist parties is the most salient political division in the knowledge economy, just as in majoritarian systems the most salient political divisions

may be within the mainstream parties themselves. It is also an economic, social, and cultural division, for it undermines the quality of democracy, even if it does not upend it.

### 1.9. Conclusion: Coevolving Systems

In political economy there is a long tradition for analyzing the interplay of markets and politics, but while it offers a nuanced view of politics, it substitutes a detailed understanding of the organization of firms, production, and labor for broad notions of “markets.” The modern literature on voting behavior in the advanced democracies, political parties, electoral systems, or the operation of legislatures, or even economic policy-making and the welfare state, talks little of the world of advanced capitalism or organized business or multinational companies. By contrast, firms and their organization are often at the center of analysis in business schools, industrial economics, and business history, but this literature rarely considers the role of political institutions: governments, political parties, electoral systems, and voters. The Marxist tradition, and some of the work inspired by it, considers structural constraints on democratic politics, and this is what leads it to erroneously conclude that the nation-state is weak and capital strong. Precisely the opposite, we argue, is the case.

We attempt in this book to move beyond the above approaches, and in this concluding section we briefly summarize the main elements of our theory and its implications for the study of politics and capitalism.

1. *The primacy of the democratic state.* The central idea in our basic theory of the relationship between politics and capitalism is that advanced capitalism is driven and maintained by national governments who are concerned about the long-term competitiveness and strength of their national economy. Governments are comprised of leading politicians, typically with careers within a political party, whose concern for economic strength largely derives from the long-term economic concerns of party supporters, determining whether they vote or abstain or even switch party adherence—hence feeding back into their future careers directly and via the support from

lower-level party politicians. Economic strength in turn increases the capacity of government in a wide range of areas, and from this leading politicians also benefit. Thus we see the framework of advanced capitalism being conditionally promoted within the political framework of relatively long-lived parties with overlapping generations of politicians and supporters as well as—critically—potential voters with equally long-term and often loose party identification to whom a well-functioning economy is of great importance. Political promotion of the framework of advanced capitalism is conditional on its being consistent with winning elections.

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

This political weakness of advanced capitalism extends into all areas outside the institutional framework. In particular, advanced capitalism has no impact on decisions over redistribution and poverty, or the protection of the low-skilled, including their unionization and the operation of low-skilled labor markets. These issues are determined by majorities or coalitions in legislatures. Whereas political positions on institutional frameworks are nonpartisan, positions in these other areas are likely to be partisan. It is true, of course, that business opposes redistribution, but it has no credible way to threaten exit or disinvestment because it depends and thrives on the infrastructure of locational cospecific assets that is embedded in

advanced sectors of the economy. Massive redistribution where such threats would become credible are not in the interest of politicians who largely cater to the winners of the transition to the knowledge economy, who have no interest in such redistribution.

2. *Political economies are spatially anchored.* Our argument explains how institutions (especially overlapping generations of knowledge bearing companies and workers) remain within the same *space* over long periods of time; indeed it explains how knowledge—which should in principle be almost costless to move—remains in particular locations. Unlike most work in the comparative political economy literature but in line with that of business history, the knowledge-bearing company of advanced capitalism is seen as the carrier of technical, market and organizational “know-how” across time but within a national or more narrowly defined space. We model such companies as complex webs of locational cospecific assets embedded in overlapping generations of employees.

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

methodologically we see our work—microfounded in complex spatially defined webs of cospecific assets—as tied to the economics of geography and specifically the economics of agglomerations and social networks.

If advanced companies are the spatially-defined “people-carriers” of know-how over time, political parties are the spatially-defined ‘people-carriers’ of their interests. Precisely because interests are locally embedded, political parties representing these interests have to be as well. This is why the communist dream of an international labor movement has largely remained unfulfilled.

3. *The system of representation underwrites the economic system.* The institutional patterns of both advanced capitalism and of (usually) democratic politics have varied across the advanced nations but with stability over time. In particular, coordinated capitalism has been associated with negotiated political systems and liberal capitalism with competitive political systems. There have been relatively stable differences within these broad varieties, as between the centralized British and decentralised American political system, and associated differences in their institutions of capitalism. Other notable relatively stable differences are between Sweden, Germany, and Japan.

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

4. *Wage coordination and welfare states secure cospecific assets.* Union centralization and/or coordinated wage bargaining plays a

major role in determining the equality of the earnings distribution. For us this derives from the different nature of skills in different varieties of capitalism. Groups of workers are strong when they can credibly threaten to hold up employers. This is a consequence not of employment or skills per se—employers can in principle replace workers with general skills at low cost—but of skills that are costly to replace and whose withdrawal is costly to the employer in lost production. Thus *cospecific* skills cause particular problems for employers; and for employers to invest in them, they need the assurance that wages will be set at least partially *outside* the company, whether across the industry or more widely. Otherwise they risk holdup by their skilled workers. Hence, employers support disciplined unions and industry or economy-wide bargaining, just as they also support strong rules governing co-determination within companies.

Workers with cospecific assets also have an insurance need for strong unions and coordinated wage bargaining. The reason is that they face a similar holdup problem by employers since it is difficult for them to employ their skills elsewhere, and they also face the risk that their skills could be made obsolete by technological change. So, just like employers, they need to know that the return on their investment in cospecific assets is safeguarded. Hence we see coordinated wage bargaining and social protection as stemming in part from an insurance need for cospecific asset investment by both employers and workers in coordinated economies. Equally, employees need the guarantee of codetermination within the company to ensure retraining and employment security if they are to be supportive of technological change by the company.

5. *Globalization strengthens the state.* In our analysis globalization is not capitalism unleashed but the choice of advanced national governments in response to the collapse of Fordism as a competitive organizational technology and the onset of the information technology revolution. Eliminating barriers to trade and capital mobility is seen to promote the interests of their advanced sectors—both to enable domestic multinationals to access complementary foreign technologies and markets requiring customization, and to enable foreign multinationals to access their national technologies and markets.

They are not, we argue, threatened by footloose multinationals, still less by political coordination of foreign multinationals. Indeed, protectionism in the 1930s came on the heels of the hitherto most globalized economy, and it happened because of domestic pressure for social protection in the face of mass unemployment, and against the interest of big capital.

The welfare state has since assumed the role that trade protectionism once disastrously filled, what Ruggie calls embedded liberalism, and globalization has come in response to the endless search of advanced country governments for greater prosperity. Trade facilitates specialization in lines of production in which companies have a comparative advantage because of the institutional framework. Trade therefore also entrenches and facilitates cross-national differences in institutions, and this is reinforced by foreign direct investment. We see more tendencies toward convergence in nontraded, low-wage service sectors where flexibilization of labor contracts is a common trend in the past two decades. Still, most evidence confirms that there have not been races to the bottom in redistribution or corporate tax rates. Moreover, in all these cases differential outcomes are determined in our analysis by domestic political coalitions. Thus we conclude that it is to be expected that governments of advanced countries with strong advanced capitalist sectors are the dominant powers in the contemporary world—*not* the EU, nor multinationals, nor transnational standard-setters, public or private.

6. *The transition to the knowledge economy has transformed the party system.* There is a rich literature on the de- and realignment of electoral politics and party systems across advanced democracies, which shows that the traditional left-right dimension has been complemented by an increasingly salient crosscutting “cultural” dimension. Positioning on the two dimensions is closely tied to occupation and location, and we provide a political economy explanation for these linkages. Broadly speaking, the knowledge economy has produced a large number of highly educated people, most of whom reside in the urban centers. As we have argued, these centers are hubs for economic and social networks based on cospecific assets, and they are the engines of economic growth. People who thrive in this

new economy typically support the entire institutional infrastructure that underpins the knowledge economy—most obviously investment in schools and education, but also public goods such as libraries, parks, culture, neighborhood development, and social services that make the urban space an attractive and secure place to live and work. Ethnic, sexual, and cultural diversity is largely seen as complements to a thriving economy, and the extensive opportunities for forming social networks with those from similar educational backgrounds do not require conformity to any particular norm set. To do well in many if not most sectors of the knowledge economy, highly educated individuals have to feel highly comfortable with diversity.

Those with lower education, working in occupations outside the advanced sectors, and typically residing in smaller towns or stagnating suburbs, by contrast, see little advantage to policies that are advantaging the urban centers, and they generally oppose ethnic-cultural diversity, which is seen as a threat to their own conformist lifestyles and a source of competition for scarce jobs and welfare benefits. This does not supplant the distributive cleavage in democratic politics, clearly, but it does add a spatial dimension to that cleavage and it does mean that there is now a large constituency for populist politics concentrated among those whose skills, occupation, and past are closely connected to the old and disappearing industrial economy.

## NOTES

### Chapter 1: Introduction

1. The centrality of clusters for the location decisions of knowledge-based companies was underlined by Porter's seminal *The Economic Advantage of Nations* (1990; also 2000). At a similar time, Cantwell's synoptic *Technological Innovations and Multinational Corporations* (1989) set out the changing geographical and locational roles played by MNEs, on which we draw. Other leading contributors and relevant citations are Acs (2002), Audretsch (1998), Feldmann (2000), Iammarino (Cantwell and Iammarino 2003, Iammarino and McCann 2013), McCann (Iammarino and McCann 2013), and Overman (Overman and Puga, 2010). Two main contributors are Glaeser's *Triumph of the City* (2013) and Storper's *Keys to the City* (2013). An important related literature emphasizing the advanced Triads of the modern "global" economy is developed by Rugman (2000, 2005).

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

3. And even then the primary driver was China, not Hong Kong.

4. In fact, surprisingly, there are rather few "common" models linking up advanced capitalist systems to democratic advanced nation-states. Outside of Marxist works on capitalism and the state (Poulantzas 1973, 1978; Miliband 1969; Jessop 1985; Glyn 2007; Lapavistas 2014; Piketty 2014; Streeck 2014), there are a limited number of well-known approaches, most notably Hayek (1944), Lindblom (1977), and Schumpeter (1942); in public choice theory, a somewhat different approach (Buchanan and Tullock 1962; Brennan and Buchanan 1980; Peltzman 1976; Stigler 1971; Krueger 1974; Olson 1982); and, in a quite different take, Przeworski and Wallerstein (Przeworski and Wallerstein 1982).

5. In the Przeworski and Wallerstein model, capital and labor can reach a compromise where workers restrain wages and capitalists invest the higher profits to raise the welfare of all as long as time horizons are sufficiently long.

6. The list of literature that has heavily influenced our thinking is long: from Shonfield (1968), Johnson (1982), Wade (1990), Berger and Dore (1996) and Zysman (1983), to neo-corporatism and the study of labor market institutions (Schmitter 1974; Streeck 1987; Crouch 1993; Lehmann 1993; Pontusson 2005), varieties of capitalism (Hall and Soskice 2001; Amable 2003; Iversen 1999), skill

cospecificity and electoral systems (Iversen and Soskice (Iversen and Soskice 2001; Iversen and Soskice 2006) and Katzenstein's seminal work on "small states" (Katzenstein 1985), as well as the Regulation School (Boyer 1990), power resources theory and the welfare state (Rueschemeyer, Stephens, and Stephens 1992), the developmental state (Weiss 1998; Block 2010; Mazzucato 2015), to the historical evolution of institutions (Hall 1986; Thelen 2004; Martin and Swank 2008).

7. There is a strong emphasis in our discipline on causal identification, and some readers will find our focus on multidirectional causality challenging. While each causal claim we make can in principle be identified, we do not limit our argument to those claims that can be easily identified, and often we resort to historical interpretation and examples. We thus engage with evidence at multiple levels, from natural experiments to statistical analysis and historical narrative—all tied together by the theoretical framework outlined here. See Hall (2003) for an insightful discussion of these methodological issues.

8. For other work in the structural Marxist tradition see Block (1977), Wright (1979), and Jessop (1982), and in the more instrumentalist version of Miliband (1969), where senior judges, civil servants, and politicians share schools, universities, gender, ethnicity, and therefore interests with capital.

9. Lindblom agrees with the Marxists in their emphasis on the structural power of business, but unlike them he recognized that politicians are ultimately motivated to win democratic elections by building up a reputation for good governance. To do so required public policies to be well-aligned with the interests of capital so as to create conditions that would incentivize business to invest and grow the economy. We take from Lindblom his emphasis on electoral incentives, but we do not agree that these necessarily lead to policies that capital would want.

10. There is, however, a great deal of variance in the extent to which this is true, which is tied to the structure of the training and educational system. This helps explain variance in the strength of populist sentiments across countries.

11. Piketty hedges his bet by saying that "things are more complicated in practice," but he clearly believes that capital mobility will put great fiscal pressure on governments.

12. Indeed, it has long been the position of social democratic parties that it is not the returns of capital that should be taxed, but only the portion of those profits that is consumed rather than reinvested (for illustrations and an analysis of a postwar policies in Europe, see Eichengreen 1997).

13. The rich can in some measure reduce their tax burden by recording some of their profits in offshore tax shelters, as uncovered in the leaked Panama and Paradise Papers. Of course, this has always been true (think Switzerland), and tax authorities are in a never-ending cat-and-mouse game with corporations and wealthy individuals to try to close loopholes and clamp down on outright tax evasion. The OECD estimates that the use of tax havens cost governments worldwide about 240 billion in 2015 ("After a Tax Crackdown, Apple found a New Shelter for Its Profits," *New York Times*, November 6, 2017). That is a considerable number, but it must be kept in perspective: it amounts to less than 0.05 percent of the OECD GDP (and about 0.03 percent of worldwide GDP).

14. The requirement is in fact slightly weaker—namely, that net transfers to the middle class are a constant share of the net incomes of the rich (see Elkjær and Iversen 2018, who show that this condition is easily satisfied for a larger country sample over a longer period of time).

15. The other major international grantor of patents is the European Patent Office, but data are only available from 1980. After adding European patents to USPTO, the numbers make no difference to the overall pattern in comparing 2015 to 1980, and we would not expect that to change for 1976.

16. This approach sees politics in capitalist democracies as a function of relative class power and class alliances and sometimes class compromises, which together determine cross-country variation in distributive politics (see Stephens 1979; Huber and Stephens 2001; Korpi 1983, 1989, 2006; Esping-Andersen 1990).

17. According to Streeck, “More than ever, economic power seems today to have become political power, while citizens appear to be almost entirely stripped of their democratic defenses and their capacity to impress upon the political economy interests and demands that are incommensurable with those of capital owners” (2011, 29).

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

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

20. A confusing factor is that there has been as a great increase in regulatory systems over the same period, covering the growth of complexity, uncertainty, environmental and safety issues. We discuss these developments in chapter 4.

21. It is true that before investing in an economy advanced companies have to have some guarantees that they will not be expropriated or taxed at rates that will make the investment unprofitable. But that guarantee is built into the incentives democratic governments have in promoting the advanced sectors and therefore not taxing them at rate where forward investments do not pay. Because access to knowledge clusters and the associated specialization (see next section) come with attractive pricing power, there is considerable scope for governments to share in the “rents” of the knowledge economy.

22. This includes Piketty and Streeck, discussed above, but also writers from a wider left tradition: Hacker and Pierson (2011) do so in relation to the extraordinary inequalities of the United States and the stagnant incomes of middle-class

America. For Simon Johnson the great investment banks, with close links to successive administrations, caused the financial crash. Glyn's *Capitalism Unleashed* (2007) offers a tour de force of the political economic history of the last four decades, and argues that advanced capitalism—with the continuing support of the state—has had adverse economic consequences on distributional outcomes (the share of profits, income inequality, the welfare state) as well as unemployment and financial stability. Central to all these arguments is the claim that advanced capitalism has neutered, bought out, taken over, or suborned democratic politics to act in the interests of advanced capitalism.

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

24. The consequences of the Republican tax reform of 2017 are not clear at the time of writing, but it is unlikely to change much in the analysis. For individual filers with incomes between 200,000 and 425,000, the tax rate will rise from 33 to 35 percent, while most joint filers with incomes between 400,000 and 480,000 will see little or no change. Filers above this level will see their rates cut from 39.6 to 37 percent. Joint filers below 300,000 (200,000 for single filers) will see rates decline by between 1 and 3 percent. Of course, the net effect is complicated by changes to deductions, but nothing suggests significant burden shifts except among the top one percent (the very rich will pay less; other rich more).

25. The increase in inequality and labor market dualism have been subject of a rich literature in recent years, most notably Rueda (2005; 2008), Thelen (2012), Rehm (2009; 2011), Rehm, Hacker, and Schlesinger (2012); Hacker et al. (2013); Margalit (2013); Emmenegger et al. (2012); and Wren (2013). Our own work builds on and contributes to this literature.

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