Worlds of Capitalism

Institutions, governance and economic change in the era of globalization

Edited by
Max Miller

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Worlds of Capitalism

The past fifty years have been described as a 'golden age' for capitalism but at the beginning of the twenty-first century an increasing number of capitalist and democratically constituted societies are experiencing fundamental problems. The challenge faced by these countries is how to effectively combine economic growth with adequate social welfare.

Worlds of Capitalism analyses competing models of capitalism and examines the correlation between political, social and economic institutions and economic performance. The book focuses on the major forces behind different institutional patterns of capitalism, assessing the extent to which they converge and diverge and the prospect for these different forms of capitalism to balance economic dynamics and democratic processes in an era of accelerated globalization.

This timely book will advance understanding of the origins and evolution of differing models of capitalism as well as suggesting new theoretical approaches for analysing the relations between institutions, governance and economic performance.

The book draws together an international team of contributors, including Douglass North, Harold Demsetz and Michael Piore.

Max Miller is Professor of Sociology at the School of Business, Economics and Social Sciences at the University of Hamburg. His current research interests refer to institutional and societal learning, socio-cultural evolution, new modes of governance, and the foundation of a 'critical systems theory'.

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Preface

The decades following the Second World War have been called a 'golden age' of capitalism. In Western societies unprecedented economic growth and a balancing of the competing claims of capital and labour had, apparently, been brought under the control of political and democratic institutions. However, at the beginning of the twenty-first century, efforts to combine outstanding economic performance with social welfare appear to be irrevocably endangered. Fundamental problems of capitalist *and* democratically constituted liberal societies have become virulent again, and even more so since socialist societies imploded and have entered the period of transition to a capitalist economy. As there is no one single kind of capitalism that can serve as a model, every country has to find its own answer to the problem of how to combine the allocative efficiency and the productivity growth of self-regulating markets with social solidarity and a meaningful life for the individual. Obviously the different responses to this basic challenge entail different emerging institutional patterns of political and economic governance in different regions and countries, thus leading to competing *worlds of capitalism*. What are the major forces behind these different institutional patterns of capitalism, to what extent is there convergence and divergence, and what are the prospects for these different worlds of capitalism to balance economic dynamics and democratic processes in an era of accelerated globalization?

International experts in the field of research on capitalism coming from economics, political science and sociology were invited to present their current thinking and research on these basic issues at a conference which took place in May 2003 in the Hamburg Stock Exchange (Hamburg, Germany) where one could hear the heart of capitalism beating in the immediate vicinity. The organizers of the conference—Michael Gaitanides and Günther Ortmann (both Helmut Schmidt University, Hamburg) and myself (Hamburg University)—had suggested that the basic issues of the conference should be broken down into four problem areas.

The first area addressed was the question as to what extent capitalism exhibits *continuity and change* in the formation of an all-powerful and truly

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global expansion of capitalist economies. What is the precise nature of newly emerging forms of capitalism? To what extent do distinctive institutional arrangements and governance structures in different worlds of capitalism suggest different economic responses to shared disruptive pressures arising from new technologies, growing global interdependencies and domestic socio-economic changes?

A second problem area focused on the *risks and chances of an everincreasing importance of financial markets* and the progressive separation of the monetary and the 'real' sphere of the economy. What are the effects of financial capital and its global circulation on traditional spheres of production? What are the prospects for global financial markets to resolve the dilemma between chaos and external regulation? To what extent do capitalist economies expose themselves to risks arising from increasingly volatile speculative expectations?

A third problem area was the relation between *economics and politics*. The debate in all branches of the social sciences in recent decades has led to growing optimism regarding the efficiency of markets and growing pessimism about the governing capacity of the nation state. In so far as these debates mirror real developments, the division of labour between the private and the public sectors has to be calibrated anew. The question arises as to whether national state welfare policies can still be pursued in the face of an increasing mobility of capital and labour. Given the *growing imbalance between economic power and political control,* what are the consequences of this process for both the future role of governing and individual life chances?

Finally, as social inequalities are increasing on a worldwide scale (albeit with the exception of some regions) the justification of capitalism is again at stake. Hence, a fourth problem area referred to *legitimacy problems of contemporary capitalism*. Obviously, an unrestrained and self-sufficient capitalist economy not only leads to escalating social and economic inequalities worldwide, but may also have severe consequences for the sphere of community. Can market liberalism and social justice be reconciled at all? In what way do institutions in different worlds of capitalism differ with regard to their moral foundations? Moreover, what are the consequences of the increasing economic rationalization of non-economic social fields such as education, public service media, the arts, personal relationships? Will an ever-expanding logic of economic efficiency not systematically undermine the political and cultural values which have been constitutive of modernity?

All these different aspects of contemporary capitalism and the different developmental paths leading to different institutional patterns of dealing with those problem areas within a globalized capitalist economy were indeed debated at the conference and are the focus of the chapters of this book. It seems to be a stroke of good fortune that this collective project of debating contemporary institutional varieties of capitalism could be fully

realized; as the editor I would like to express my respect and gratitude to all the contributors to this volume for their strong commitment and cooperation.

In conclusion, I would like to acknowledge a number of other parties who made a decisive contribution to the successful outcome of this project. First, I am grateful to the publishers of two conference papers which, in the meantime, have already been published elsewhere, for permission to include them here. The chapter by Claus Offe, 'The European model of "social" capitalism: can it survive European integration?', has already appeared in *The Journal of Political Philosophy* 11 (2003), pp. 437–69 (Oxford: Blackwell Publishing); and the chapter by Giovanni Arrighi, 'States, markets, and capitalism, East and West', has probably already appeared in *positions: east asia cultures critique* (Durham NC: Duke University Press) when this book comes out. Moreover, the chapter by Steven Lukes, 'Invasions of the market', is based on a paper which first appeared in Ronald Dworkin (ed.), *From Liberal Values to Democratic Transition: Essays in Honour of Janos Kis* (Budapest: Central University Press, 2003). Permission to include a somewhat expanded and revised version of 'Invasions of the market' in this volume is also gratefully acknowledged.

Second, I would like to thank the following institutions for their financial support for the conference and for the later publication of an English version (Routledge) and a German version (Campus) of this book: the Senate of Hamburg (Behörde für Wissenschaft und Forschung), the German Research Council (Bonn), the Hans-Böckler Foundation (Düsseldorf), the Ebelin and Gerd Bucerius Zeit Foundation (Hamburg/New York), the Hamburg Institute of Social Research (Hamburg), the Friedrich-Ebert Foundation (Berlin), the Körber Foundation (Hamburg), the Karl H.Ditze Foundation (Hamburg), Otto Gmbh & Co. KG (Hamburg) and the German Society for Sociology (section Sociological Theories). When, in the final stage of completing the book (and the translations), the financial resources began to dry up it was the Ebelin and Gerd Bucerius Zeit Foundation (Hamburg and New York) again which helped us out. It has been a most pleasant and encouraging experience to cooperate with all the institutions and foundations gratefully listed here.

Last but not least, my special thanks go to all those kind and helpful people around me who unstintingly supported the conference and book project. Jörg Ebrecht, Jens Fischer, Jan-Hendrik Passoth and Andreas Reckwitz, who at least temporarily belonged to my staff, contributed immensely to the organization of the conference and to the successful outcome of a book manuscript. Ada Whitaker (Instructor in English and Lecturer at Hamburg University) greatly and generously helped in editing English translations. Walter Schindler (Department of Science and Health, Hamburg Senate) was always present to help, by word and deed, if necessary. And the intensive and intriguing discussions with my friends Michael Gaitanides and Günther Ortmann (chairs in economics at the

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Helmut Schmidt University Hamburg) have been an unending source of motivation and guidance for me. We hope this volume will not only inspire new thoughts regarding the relation between economy and society in our globalized and differentiated world, but will also encourage further inquiries across the boundaries of economics, political science and sociology.

Max Miller

Hamburg, May 2005

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1
Introduction

Max Miller

It is characteristic of our time that all over the world proponents and opponents of globalization are confronting each other and fighting for the right path of future global development. Whereas one side commends the actual process of globalization and its megatrends of technological development, internationalization and the deterritorialization of competition as the biggest welfare programme of all times (and thus tries to revitalize the perspective of liberal capitalism in a so-called neoliberal way), the other side claims that a different kind of globalization is possible, involving less social inequality and injustice worldwide and more ecological sustainability, more democratic participation, less suppression of cultural diversity and more political and institutional regulation of economics on a worldwide scale. At one extreme, advocates of globalization basically endorse a kind of market fundamentalism and *laissez-faire* economic globalization; at the other extreme critics of globalization call for more than only a restructuring of the political and legal foundation of economic globalization—the big anti-globalization demonstrations in Seattle in 1999 and in Genoa in 2002 were driven by the slogan that 'a different world is possible'. But what is the real global world like right now?

Since the breakdown of communism at the close of the twentieth century, capitalist economy and society consider themselves as unrivalled models of economy and society, models that seem to lack any substantial alternative—a conviction deeply rooted in Western culture. Alternative structures of economy and society are sought no longer outside capitalism but within its own frame of reference. Of course, there has never been only one brand of capitalism, one unified world of capitalism; however, with the ideological antipodes fading away, contemporary capitalism appears to be enforcing a process of generating differences and alternatives within itself—opening up an array of different *worlds of capitalism*. There are not only the differences between the three most advanced capitalist regions: North America, Western Europe and East Asia. There are many more varieties of capitalism that have been observed by a recently developed branch of research called *comparative capitalism,*1 which looks especially at differences in the social organization, the institutional

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embeddedness and the governance of capitalist economies in different societies and analyses the effects of such differences on economic performance in a competitive world market.
Many questions arise at this point. What for example explains national differences in social and economic policy? Is globalization forcing nations to diverge or to converge (e.g. on an Anglo-American model), or to do both at the same time but in different respects? To what extent are differences the outcomes of different historical paths of development leading to empirical varieties of contemporary capitalism? To what extent is the gap between winners and losers of globalization a consequence of worldwide economic competition, and to what extent is that worldwide competition hampered and distorted by unequal distribution of political power?
Or there are questions of a rather different kind. What for example are the consequences of different forms of capitalism on non-economic social fields such as education, the public media, the arts and even personal relationships? Where is the market out of place and why? To what extent are real developments and critical reflections of capitalism interdependent aspects of capitalist evolution? And what future developments on a worldwide scale can be realistically expected?
These are central questions not only for a number of scientific disciplines (especially economics, political science and sociology) and for a comprehensive diagnosis of our time but also for concrete economics and applied politics. The chapters of this book are intended to substantially increase our present knowledge regarding these questions, especially as they extend into the various problem areas that have already been characterized in the preface: continuity and change in the formation of an all-powerful and truly global expansion of capitalist economies, risks and chances of the ever-increasing importance of financial markets, the relation between economics and politics, and legitimacy problems of contemporary capitalism.
However, underlying all these different problem areas and topics there is a fundamental question: *how are economy and society related to each other in capitalism? Or,* to put it differently: to what extent is society determined by economic forces and/or to what extent is an economy determined by society? And how does the meaning of *capitalism* change if the direction of control changes from economy to society (or non-economic social systems) or vice versa? This fundamental question and the different ways in which it can be answered decisively affect the manner in which differences between different worlds of capitalism and in which potentialities for an economic (and eventually also societal) critique and change of contemporary forms of capitalism can be understood. There is already quite a long and rich history of ideas and theoretical reflections regarding the relation between capitalist economy and capitalist society. In the following some milestones of that theoretical discourse will be briefly recapitulated, followed by a brief preview of how this discourse is continued in

the chapters of this book and what answers arise from that discourse in regard to the two central questions of this volume: where do varieties of capitalism come from and how can they change?

Economy and society: a short history of theories of capitalism

Until the latter part of the nineteenth century the term *capitalism* hardly existed. The *Oxford English Dictionary* indicates the first English use of the term as that of William Makepeace Thackeray in his novel *The Newcomes* (1853–1855). Karl Marx wrote about *capital,* but he did not use the term *capitalism* before the late 1870s, when, in his draft letters to Vera Zasulich (cf. Marx 1983), he discussed whether Russia could bypass the capitalist stage of development. It was Werner Sombart who finally coined the term *capitalism* and introduced it into economic and societal discourse in his 1902 classic, *Modern Capitalism*. Since then there has been much debate over how to define *capitalism*. But most definitions have in common that they refer to *economic* practices that became institutionalized in Europe between the sixteenth and nineteenth centuries and which entail that the means of production and distribution are privately or corporately owned (which necessitates individual rights, specifically property rights), that goods and services are traded in markets (including a labour market), and that economic development decisively depends on a continuous transformation of the process of production through technology and on the accumulation and reinvestment of profits gained in a free market. However, not only definitions of capitalism but also theories referring to the economic and societal phenomena later called *capitalism* changed as these phenomena themselves changed, especially from the second half of the eighteenth century until the beginning of the twenty-first century.

The first version of modern capitalism, the emergence especially in Great Britain of an *agricultural* and *commercial* capitalism in the eighteenth century and of an early industrial capitalism in the first half of the nineteenth century, became the subject of two great competing theory projects, the political economy of a market society developed by Adam Smith and subsequently the critique of political economy by Karl Marx and Friedrich Engels, which assumes the form of a historical-materialist analysis of capital and classes.

At the transition from the nineteenth century to the twentieth, and increasingly during the 1920s, structures of capitalist economy changed pervasively. In the wake of the second industrial revolution large bureaucratic corporations emerged, mass consumption was created by mass production, and mechanisms of political control of economies became firmly established—all this is reflected by new theories of capitalism. Max Weber (1922), Josef Schumpeter (1912), Werner Sombart (1902) and later John Maynard Keynes (1936) and Karl Polanyi (1944) present different analyses of those institutional structures of capitalist economy which Rudolf Hilferding (1910) labelled *organized capitalism*. Finally, after the Second World War efforts were made, e.g. by Raymond Aron (1964), to replace the concept 'capitalism' altogether by the concept 'industrial society'.

The ongoing transformation of capitalism, especially since the 1970s, the transition to flexible forms of the organization of labour and production, the microelectronic revolution, the collapse of a state-socialist alternative, the progressing globalization of capitalism, the reduction of state intervention even in Western societies, the further expansion and pluralization of consumption as a basic prerequisite of highly modern mass culture—all these recent developments have been accompanied by new adjustments in theories of capitalism during the last two decades, such as theories of post-Fordism and of post-industrial society, theories of networked and project-team-like structures of labour, theories which emphasize the dependence of late capitalism on the creation of needs and symbols regarding consumption and, last but not least, theories of *cultural* and *institutional* differences between regional variants of global capitalism—theories which are especially important for this book. It may be helpful here to add a few more remarks regarding these three phases of capitalist development.

The view that *modernity* is based not only on a specific political order (as assumed for example in the political philosophies of Hobbes, 1651, and Locke, 1690) and on a specific intellectual and spiritual grounding (as assumed by the philosophy of the Enlightenment) but, above all, on a specific economic structure has since the end of the eighteenth century inspired those perennially influential grand theories of society which are shaped around political economy. Here only the two grand and competing theory projects of Adam Smith and Marx/Engels will be briefly analysed in order to show that there are not just basic differences but also a basic commonality regarding the mode in which the relation between economy and society is conceived.

In *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776) Adam Smith unfolds his concepts of a 'market economy' and 'commercial society'. He describes a model of societal evolution in which modernity appears as based on advanced forms of the division of labour and on a specific economic logic: an exchange-and-market economy. In Adam Smith's model that logic of economic action presupposes actors who are rational and self-interested by nature and whose behaviour is balanced by moral sentiments and a civil morality they are also naturally inclined to develop. In this sense, it is essentially the individual subject that counts. This basic assumption of the liberal political economy of Adam Smith and his equilibrium theory of market formation (which reconstructs the conditions under which the pursuit of individual interests generates collective goods) laid the foundations of neoclassical economics more than a century later.

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The liberal equilibrium theory of market formation is countered by Karl Marx with his *crisis theory* of capitalism. In *Capital* (1867) Marx also clearly goes beyond a purely economic analysis and reveals the basic structure of bourgeois or capitalist society, in which social labour takes the form of a generalized production of commodities. Marx argues that this mode of production has a rationale that goes beyond the interests of individual subjects (no matter whether they belong to the bourgeois or to the proletarian class) and gathers a supra-individual momentum. The permanent transformation of labour, commodity and value appears as a self-reproducing and expanding social system which not only obscures the mechanism by which a surplus product is generated and appropriated (so that exploitation is less apparent in a bourgeois society than in a slave society) but also transcends any institutional rules.

Hence, in spite of their vast differences, liberal political economy and Marx's critique of political economy share the basic view that capitalism at the core appears as a *non-institutionalized* and *non-regulated* form of economy. Whereas, for the one, individual interests competing in the market are conceived as being prior to any social or institutional norms and rules, for the other it is the unintended dynamics of capital that either breaks existing rules or shapes appropriate political and other social institutions and the cultural sphere. In both great theory traditions of liberalism and Marxism, economy determines society and not the other way round.

In this respect a pervasive paradigm change regarding theories of capitalism occurred at the transition from the nineteenth century to the twentieth and continued until the second half of the twentieth century—a change that parallels the real transformations of Western capitalism: the emergence of large corporations, accompanied by an increase in state intervention and a progressive strengthening of the welfare state at least in certain regions of the Western world. Against the background of these experiences the defining features of capitalism have been increasingly related to its *institutionalization* and *regulation,* implying some leeway for planning and control that ranges from single corporations to whole societies. In many interpretations, from Max Weber until the present, this character of an *organized capitalism* appears to imply both an increase of social or collective rationality and a loss of individual autonomy, and in this sense conveys a fundamental ambivalence of modernity.

Max Weber's theory of the specific and peculiar rationalism of Western civilization provides the initial ignition for an *institutionalist* perspective on economy. In *Economy and Society* (1922) Weber presents economic action in a capitalist society as a distinctive example for the 'rationality' of modern organizations (e.g. rational specialization and combination of labour, bureaucratic administration and a pervasive calculating attitude); and in *General Economic History* (1923) he shows that the social preconditions for the development of *rational capitalism* include the creation of institutional systems for property, law and finance. Moreover, in *Die Wirtschaftsethik der Weltreligionen* (1920) Weber reconstructs the highly specific cultural foundation of Western capitalism and concludes that rational capitalism presupposes specific structures of personality such as selfcontrol and asceticism. It is the *spirit of capitalism* drawing heavily on cultural and psychological factors and on a rationalization of social institutions which, in Weber's highly influential account, explains capitalist economy.

From Max Weber's account until the 1960s the theoretical discourse on capitalism, as already indicated, follows a strong tendency to reverse the direction of control that characterizes classical liberal and Marxist views on the relation between economy and society. Now the view dominates that capitalist economy is made up of a range of *institutions* (including markets as institutions of exchange and firms as institutions of production) and that capitalist economy is not autonomous but socially embedded and subordinated to politics and state regulation. In *The Great Transformation* (1944) Karl Polanyi provides a compelling critique of the belief that national societies and the global economy could be organized through self-regulating markets; in Polanyi's analyses even the selfregulating market of the nineteenth century is shown to be conditioned by state regulations which appear to be constitutive of the rise and reproduction of a market economy. It is, however, not only the role of institutions and regulations, but also the role of the *entrepreneur* as the principal agent of capitalist development, that is discussed in that period of theorizing capitalism; as in Schumpeter's *Theory of Economic Development* (1912), in which he describes the entrepreneur as a 'captain of industry' or 'business leader' on whose deliberate actions economic innovation depends. In his later work *Capitalism, Socialism, and Democracy* (1942), however, Schumpeter diagnoses that the functions of entrepreneurship and innovation are being increasingly taken over by a *bureaucratic* form of management, and—in contrast to Weber—he envisages such a 'bureaucratization of economic life' not as an obstacle but as an inevitable complement to democracy. This is in accord with the recommendations made by John Maynard Keynes in *The General Theory of Employment, Interest and Money* (1936) where planning and control on behalf of the state are suggested (in a manner that became most influential in post-war politics) in order to protect capitalist dynamics and to compensate for social deficiencies created by the economic system. In this era of *managed capitalism* and *mixed economy,* reaching its peak around the middle of the twentieth century, even the opposition between capitalism and socialism, between free-market economy and planned economy, seemed to decrease or even to dissolve—a development clearly foreseen by Schumpeter (1942) and sharply criticized by liberals like F.A.Hayek (1960). Later on, in *Law, Legislation and Liberty* (1973) Hayek would refer back to Adam Smith and propagate capitalism as a 'self-generating or spontaneous order' in contrast with a state-controlled and regulated capitalism which at least in many respects seemed to be indistinguishable from a totalitarian socialist planned economy. Similarly, though from a different perspective, representatives of the *critical theory* of the Frankfurt school also presented a basic critique of the organized and managed form of late capitalism. Theodor W. Adorno and Max Horkheimer, in *Dialectic of Enlightenment* (1947), and Herbert Marcuse, in *One-dimensional Man* (1964), interpret the bureaucratization of late capitalism as the cause of a total commodification and over-determination of social relations and as the basis of far-reaching control even of highly private individual needs and desires.

To the extent that the discourse on *organized modernity* (cf. Wagner 1994) has focused on the organized and managed forms of capitalist economy, it clearly exhibits the direction of control as going from society to economy: it is the non-economic systems of society, above all the political system, that strongly control the economy. Roughly since the 1970s, however, capitalism again has appeared to transform itself, and accordingly theories of capitalism have been transformed as well. In *The End of Organized Capitalism* (1987) Scott Lash and John Urry describe this transformation as a shift from organized to disorganized capitalism. Globalization of the economy, decentralization of managerial decision-making processes and the disintegration of the large or even giant corporation are discerned as major forces in that transition from the logic of modern economy (underlying an organized and managed capitalism) into what has also been called by some scholars *postmodern capitalism*.

The view that 'modernism' has become an outdated narrative was already strongly expressed in Daniel Bell's works. In *The Coming of Postindustrial Society* (1973) Bell envisaged an economic transformation during the last quarter of the twentieth century that comprised a shift from manufacturing to services, concentration on new science-based industries, and new forms of stratification (including the rise of new technical elites). *PostFordism* became a key word in a discussion which, prominently articulated by Michael Piore and Charles Sabel in *The Second Industrial Divide* (1984), is related to the structural reorganization of big industries (disintegrating into a plethora of smaller firms), the shift from mass production to flexible specialization and the revitalization of the market.2 Similarly, other analyses of contemporary capitalism also emphasize that the visible hand of managerial capitalism has been replaced again to a far-reaching extent by the invisible hand of the market, and that this is accompanied by a *neoliberal* retreat of the interventionist state. Moreover, the flexible network ('network capitalism') is presented as a third and distinct form besides market and hierarchy. In *The Information Age: Economy, Society and Culture* (1996, 1997, 1998) Manuel Castells formulates the thesis that through *networking,* supported by the new electronic media, capitalism has reached the summit of its possibilities, even to the point where it starts unasked to rule over the capitalists (which, however, according to Marx is just the very nature of capitalism). In *Le Nouvel Esprit du capitalisme* (1999) Luc Boltanski and Eve Chiapello diagnose a 'new spirit' which underlies network capitalism and which makes this new and virulent form of capitalist economy work. The leanness of companies, the externalization of costs to subcontractors, teamwork, coordinators instead of managers, operatives instead of workers, and customer satisfaction are here described as main features of a capitalist system in which control has become internalized in employees (as far as they share the vision of the enterprise) and externalized in the pressures of market competition and in the demands of consumers. Especially theories which explicitly refer to a 'postmodern capitalism' shift the focus from production to consumption. Authors such as Mike Featherstone in *Consumer Culture and Postmodernism* (1990) and Fredric Jameson in *Postmodernism, or, The Cultural Logic of Late Capitalism* (1991) show that contemporary capitalism presupposes structures of personality which are clearly distinct from Max Weber's model of the disciplined ascetic and include a strong orientation towards hedonism. Featherstone even argues that we are becoming progressively more dominated by a 'consumer culture'.

Undoubtedly, there is still some vagueness in discerning an overall theoretical trend (including, of course, alternatives and controversies) in analysing contemporary forms of capitalism since the 1970s. However, there are at least two basic points of view that characterize recent theoretical developments. First, capitalism is still conceived as a complex of *institutional* arrangements, yet the direction of control between different domains or systems of society has changed from unilinear to non-linear and multidimensional causality. Moreover, the notion of *control* itself has become problematic and is now one of the crucial matters to reflect on not only on the level of single corporations but also on the level of whole societies. Planning euphoria has been followed by planning pessimism, and new concepts regarding social or societal control, such as *governance,* have been suggested in order to account for highly complex and variable forms of exerting influence in contemporary societies, even beyond the borders of nation states.

Second, structures of capitalism are increasingly perceived to be culturally as well as economically grounded. Cultural and institutional differences seem to form the basis for varieties or different worlds of capitalism—a plurality which breaks the unified model of *organized modernity*.

Social institutions, governance and economic performance

Recent sociological *systems theory* explains the specific problems of complexity, coordination and control in advanced contemporary societies as an effect of modern society's primary mode of structural organization, that is, functional differentiation. In Niklas Luhmann's comprehensive social theory (Luhmann 1984, 1997), modern society is described as a 'polycentric society' comprising a variety of functionally specialized social

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systems such as the economy, politics, law, science, religion, education, etc., which cannot substitute for, replace or even simply relieve or directly determine one another. There is no meta-position available in modern society from which one can observe the whole of society, let alone determine or decide the course of any societal processes. Of course, social systems can dissolve, as when a political party succeeds in determining not only the politics of a society but also decisions in the economy, law, science and so on in a far-reaching way. However, as long as social systems persist (in Luhmann's terms, preserve their 'autopoiesis') they will react to causal irritations in their environment (which may include other systems) simply by transforming such an environmental impact into a 'structural self-determination'—if they react at all. Neither the hierarchically organized state, nor the economy, nor any other social system can thus be expected to achieve an overriding control of affairs—at least none that goes beyond a functional system's borders, whether on the level of a nation state or on the level of world society. Hence, from the perspective of highly advanced, functionally differentiated modern societies, it becomes even more doubtful than in the past debate on 'industrial versus capitalist society' whether it still makes sense to say that we live in a *capitalist society* even when the economy is structured according to the basic features that have defined capitalist economies from the very beginning.

Since functional differentiation means the rejection of redundancy, in that each system specializes in fulfilling only a specific function, functional differentiation not only involves a potential increase of societal problem-solving capacities but also a corresponding intensification of the interdependences of the functionally specialized systems and subsystems and consequently a potential proliferation of problems of planning and coordination. If things go well, the economy, for example, may profit from scientific discoveries and technological innovations; and the same holds true for the relation between politics and the law, the economy and politics, science and medicine and numerous other cases. On the other hand, if for example the political system tries to respond to ecological problems by transferring funds from other systems it may burden the economy with additional costs, causing a loss of jobs, which again may surge back into the political system as a political problem (cf. Luhmann 1986). As Luhmann repeats over and over again, modern society's principle of differentiation makes the question of rationality more urgent and at the same time less solvable.

At this crucial point of understanding the (of course) continuing if limited ability of modern society to plan and control, Niklas Luhmann developed in his late writings the interesting notion of a 'structural coupling' between systems and their environment—a notion that relies heavily on the concept of *social institutions*.3 Even if structurally coupled to one another, systems still cannot causally determine one another's operations. Structural coupling entails, however, a concentration and intensification of causalities that irritate and stimulate the structural self-determination of a coupled system (cf. Luhmann 1997:103 ff.). Structural couplings between different social systems presuppose as a medium social institutions such as property, contracts and constitutions (cf. Luhmann 1997: ch. 4). For example, taxes and fees connect (as a medium for structural coupling) politics and the economy, constitutions connect the law and politics, property and contracts connect the economy and the law, universities connect science and education, certificates connect education and the economy, and so on. Thus, social institutions are a medium of coordination between different social systems; they establish certain selectivities regarding a system's processing of information about that system's environment, without, however, exerting any definite and unequivocal control over what is in particular happening beyond a system's borders.

It appears that, on the basis of its developed concept of *functional differentiation,* recent sociological systems theory opens interesting theoretical perspectives for studying the relation between economic and other specialized domains of contemporary societies, above all politics. However, *social institutions* do not only explain structural couplings between function systems, they are an ubiquitous social phenomenon which in social theory since the classics—take for instance Émile Durkheim's notion of a *social fact*4—have traditionally been used to explain the possibility of social order, of coordination and control, at all levels of society. Moreover, as recent developments in a burgeoning literature on *neo-institutionalism* suggest, social institutions cannot only be found in a perplexing multiplicity of forms, and they do not only play a role in the production of the social outcomes of individual and collective actions within any social domain or at any level of society, they can have very *different* outcomes—and this different potential of different social institutions has made them such an important object of inquiry in neoinstitutionalist approaches especially in economics, political science and sociology. It is the impact of different (configurations of) social institutions on the economy that leads to different worlds of capitalism and thus, ultimately, also to differences in economic performance. Of course, the question remains to what extent and in what precise mode institutions can have an impact not only on actions or communications within certain societal domains or social systems such as the economy or politics but also beyond a system's borders and even on a general level encompassing the whole of a functionally differentiated society or even world society.5 For example, to what extent can political institutions and corresponding policy making influence and promote economic performance on a national or even on a global level? Perhaps an approach that could creatively combine the insights of recent systems theory and institutionalism could pave the way for novel insights—but this is not the place to continue that theoretical debate.

Neo-institutionalism can broadly be divided into a rationalist and a culturalist school of thought, frequently also labelled *rational-choice institutionalism* and *sociological institutionalism* (or *organizational institutionalism*) or, as Hall and Taylor (1996:939) express it, as a 'calculus approach' and a 'cultural approach'. Both schools of thought raise the same basic questions namely, what are institutions, what can institutions do, and how can they eventually change?—but they give somewhat different answers. Let us briefly turn to those basic questions and the answers given by the two neoinstitutionalist approaches. To begin with: what are institutions?

The rationalist approach takes its lead from *new institutional economics,* which calls attention to the importance of property rights (Alchian and Demsetz 1973), rent seeking (Krueger 1974) and transaction costs (Williamson 1975, 1985) in the operation and development of institutions; this approach defines institutions as external constraints and incentive systems (cf. North 1990)—or, as Douglass C.North writes in this volume (cf. p. 95): institutions are made up of formal rules (laws, constitutions, regulations), informal constraints (conventions, codes of conduct, norms of behaviour) and enforcement characteristics.

The culturalist approach takes its lead from a constructivist sociology of knowledge (cf. Berger and Luckmann 1966) and from a more sociologically oriented sub-field of organization theory (Meyer and Rowan 1977; March and Olsen 1989, 1995; DiMaggio and Powell 1991; Zucker 1991; Brunsson and Olsen 1993). This approach defines institutions much more broadly than rational-choice institutionalism so as to include not only rules, procedures and norms but also cognitive scripts, unquestioned routines and even culturally taken-for-granted world views and moral templates or shared normative notions that provide frames of meaning for guiding action. As Hall and Taylor (1996) rightly point out, such a definition breaks down the conceptual distinction between 'institutions' and 'culture'.6

What can institutions do? How are they related to the behaviour or actions of individual and corporate actors? According to the rationalist approach, institutions induce actors to accomplish certain action outcomes; they structure the choices of self-interested rational (corporate) actors by controlling their information; and thus different institutions will produce different strategies of the actors and different outcomes of their interactions. According to the culturalist approach, institutions affect not only the strategic calculations of (corporate) actors but also their most basic preferences and thus even their very *identity,* or, to use the words of Fritz W. Scharpf (2000:770): in the view of sociological institutionalism 'institutions will define not only what actors can do, but also their perceptions and preferences—and thus what they will want to do'.

However, in the same article Scharpf also rightly argues that both neoinstitutionalist approaches appear much too deterministic. Hence in the framework of an 'actor-centered institutionalism' (Mayntz and Scharpf 1995; Scharpf 1997) actor orientations (preferences and perceptions) are treated as a theoretically distinct category, and it is presumed that actor orientations are influenced, but not determined, by the institutional framework within which interactions occur.

This points at a crucial aspect of the question as to what institutions can do: what is the precise nature of the relation between institutions and the behaviour or actions of individual and corporate actors 'affected' by those institutions? Recent theoretical debates (Mayntz and Scharpf 1995; Kohler-Koch 1999; Mayntz 2004) suggest that a refined notion of *institutional control* is conceivable which is increasingly referred to by the expression *governance*. Certainly, the term *governance* has, first of all, come to be widely used in the social sciences in order to refer generally to mechanisms and processes underlying the management of issues which may cross organizational and national borders and which involve not only governments but also (international) organizations, civil society, often the private sector, and formal or informal networks (cf. e.g. Rosenau and Czempiel 1992; von Kersbergen and von Waarden 2004). Most important, however, as especially Renate Mayntz (2004) has cogently argued, the meaning of governance can be clearly distinguished from the meaning of steering and control in the sense of strict causal determination—and precisely at this point the notions of *institution* and *governance* correspond to each other. Institutions govern the actions of actors just as rules govern behaviour. In fact some scholars, such as Steinmo (2001), believe that, in the broadest sense, institutions are just simply *rules;* and even if other scholars may find this definition too broad, there is no doubt that the vast majority of attempts to define institutions (cf. also the preceding paragraphs) entail the notion of their rule-based nature as a central meaning component. Hence, just as grammatical rules define the wellformedness of linguistic expressions but cannot determine what the next sentence of this text will be, institutions govern behaviour in the sense that they enable and constrain behaviour without causally determining what precisely will be done at a particular time and place by a particular actor. Institutions have a regulating and orienting function:7 they do not causally (and sufficiently) determine actions but open and delimit ranges of action; and this is not only the case for simple institutions such as salutations but also for institutional governance structures such as markets or complex governance regimes, e.g. some combination of market and hierarchy.

Let us finally turn to the last basic question: how do institutions change? The rationalist approach is, as Hall and Taylor (1996) aptly summarize, functionalist, intentionalist and voluntarist in explaining how institutions originate and change. That is to say, it is assumed that institutions are intentionally and deliberately created or changed in order to increase efficiency, for instance with the 'purpose and effect of economizing on transaction costs' (Williamson 1985:1); and the creation of institutions is understood as a quasi-contractual process marked by voluntary agreement among actors. According to the culturalist approach the persistence or change of institutions is, however, not just a functional response to the demand for economic or technological efficiency (as already noted by Selznick 1949). For example, organizations tend to adopt whatever practices are considered by their institutional environment as appropriate or *legitimate* even if these practices do not increase organizational efficiency (Meyer and Rowan 1977; Scott and Meyer 1994).8 Moreover, to the extent that institutions comprise not only formal rules (laws, constitutions, regulations) but also informal constraints in the sense of Durkheimian non-contractual elements of the contract or even culturally taken-for-granted world views, it becomes rather implausible that they could be changed intentionally and voluntarily. What, at least in these fundamentally important cases, is suggested instead by sociological institutionalists and historical institutionalists9 is that institutional change occurs in *path-dependent* evolutionary ways (cf. e.g. Powell 1991). Institutions reflect historical experience (March and Olsen 1989); 'once institutions have been established through complex struggles and bargaining among organized groups, they have a continuing effect on subsequent decision-making and institution-building episodes' (Campbell 2004:25). Yet this continuing effect—an effect that constitutes path-dependence—eventually in combination with power relations instantiated in existing institutions could obviously explain the persistence of institutions and policies over time as well as or even better than institutional change. Hence the question still remains open as to how the creative dimension of interactive social processes can be understood, whereby old institutions change and new institutions emerge.10

What are the major forces or mechanisms underlying institutional change and what differences do different institutional governance structures and regimes make for economic performance and economic change? These are, indeed, vital questions in a world where more than a billion people live on less than a dollar a day, where income differences across countries have increased since the beginning of the global spread of capitalist economy, and where income inequalities between the richest and the poorest fifth of the global population have more than doubled during the last fifty years (cf. UNDP 1998; Enquete-Kommission 'Globalisierung der Weltwirtschaft' 2002).

The contributions to Part I are all concerned with the basic relations between institutions, governance and economic performance; and they all more or less cut across the two neo-institutionalist approaches outlined above. Moreover, they all draw attention to the pervasive problems of institutional and economic change.

In his contribution Johannes Berger looks into the enormous differences of income *per capita* in all countries past and present, and concludes that growth rates everywhere correlate with the development of capitalist organization of the economy. Moreover, the richest countries have democratic constitutions. Immense inequalities of income have emerged since the industrial revolution while growth rates have been positive in almost all periods of time and in all regions of the world. World economic development cannot, therefore, be described as a history of increasing impoverishment. Institutions matter. They are at the root of large income differences across countries.

Turning to the question of what the ultimate causes of economic growth are, Berger finally argues that technological progress is the engine of economic progress, and that institutions (understood in the narrow sense of rational-choice institutionalism) and ideas, knowledge and ideologies (world views) are an important determinant of technological progress, which explains why technological creativity occurs in some societies and not in others.

If the view is widely accepted today that social institutions matter regarding economic performance, Harold Demsetz is one of the economists who already, decades ago, prepared the theoretical ground for such a view. He is—along with Ronald Coase, Armen Alchian, Oliver Williamson, Douglass North and others—one of the founders of that very influential branch of economics which has become labelled as *New Institutional Economics*.

In his contribution to this volume Demsetz is mainly concerned with governance problems regarding one of modern capitalism's great inventions: the corporation and the organized capital market that serves it. According to Demsetz the present discussion of *corporate governance* (as it relates to legislative regulation and control of corporate management) underestimates capitalism's ability to deal with business governance problems caused by management misbehaviour as, for example, in the case of Enron. It is, above all, the following three institutions of capitalism that, in general, restrict or even impede mismanagement: stock price adjustments, the emergence of a market for information about the quality of corporate management, and a capital market that provides a variety of investment opportunities to investors. Thus shareholders themselves can influence ownership structures and the severity of the governance problems they face. Moreover, Demsetz develops a most interesting account of how capitalist institutions originate and change—an account that seems to be deeply rooted in the great tradition of classical liberal thought on political economy. At least with regard to the institutions analysed in this chapter it is, according to Demsetz, not political responses to governance problems but rather basically a reflection of capitalism itself, a self-referential response of capitalist economy, which leads to the rise of these institutions.

In the following chapter Colin Crouch, first of all draws our attention to some crucial methodological problems of the institutional analysis of varieties of capitalism, before he also goes into the question of institu-

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tional and economic change. Crouch argues that there is much more institutional heterogeneity and incoherence in empirically occurring capitalist economies than the research on *comparative capitalism* has so far accounted for (cf. also the next section of this introduction). Moreover, he argues that the institutional heterogeneity of a governance regime triggers and facilitates innovation and that a corresponding theory of institutional change could thus avoid existing shortcomings of the path-dependence theory in accounting for or predicting change. The model of 'institutional entrepreneurialism' subsequently outlined tries to explain how social actors, in a kind of institutional *bricolage,* innovate and change the economic institutions around them by recombining the seemingly irreconcilable functions of old institutional elements in such a way that new institutional forms of governance result.

In concluding the first section of this volume with a dazzling appeal for an increase in our understanding of institutional and economic change, Douglass C.North, winner of the 1993 Nobel prize in economics, begins his chapter by pointing out that economics and economic theory have so far only constructed models of economic change that seem to be deficient in very basic respects. The *rationality assumption,* for instance, works in many cases but does not take us far in understanding economic change which obviously also incorporates non-rational beliefs (e.g. culturally specific patterns of value orientation) that influence and shape our everyday lives. In his model of understanding economic change, North establishes a chain of argumentation leading from reality to beliefs to institutions to organizations to policies to outcomes and finally to an alternative reality. The transition from reality to beliefs seems to be especially significant. This is where *intentionality* comes in;11 and North assumes that intentionality is a key to understanding economic/ social evolution. On the other hand, North argues that we live in a *non-ergodic* world in which intentionality and planning are severely limited—even in the design of institutions. Still, what we can do and what provides the best future perspective in a world of uncertainty is 'to see that we have many choices', and North concludes that the reason for the failure of the former non-capitalist states of Eastern Europe and the Soviet Union is that 'they did not maximize their choice sets' (p. 105).

Thoughtful and inspiring as the chapters of Part I are—and they are followed by equally interesting pieces of work which also, at many points, raise the question of institutional and economic change—by providing such different answers they raise even more questions. For example, what are the entities or even the rules that govern the choice of institutions in the transition from reality to beliefs to institutions? Is it individual human beings, their intentionality and their interests, social classes or some other kind of collectives and their preferences and power, social conflict and social discourse in the sense of arguing and bargaining, or some supraindividual entity such as social systems or (past and present) institutions or even *capital* itself which propel institutional and economic change? What role do endogenous factors such as the properties of some kind of social construction processes play, and what role is played by exogenous factors such as natural catastrophes or shocks coming from the outside such as an externally (globally) caused economic crisis? And if there is change, to what extent are different worlds of capitalism confined to certain paths of development and to what extent can path dependences dissolve? This last question refers to a central topic of the so-called *varieties of capitalism* approach.

Varieties of contemporary capitalism

There is a steadily growing literature on *comparative capitalism* that focuses on institutional varieties of contemporary capitalism (cf. e.g. Crouch and Streeck 1997; Hollingsworth and Boyer 1997; Kitschelt *et al.* 1999; Ebbinghaus and Manow 2001; Hall and Soskice 2001; Streeck and Yamamura 2001; Yamamura and Streeck 2003; Lütz 2003). The literature just cited does not only present cutting-edge research but also provides overviews and summaries so that a very few short introductory remarks will be sufficient here.

The *varieties of capitalism* approach provides a framework for analysing and understanding the institutional similarities and differences among developed economies. Especially in Soskice (1999) and in Hall and Soskice (2001) it is claimed that national economic development and economic policies in advanced economies follow path-dependent trajectories of two kinds that differ with regard to the types and configurations of economic institutions implied: *liberal market economies* (LME) and *coordinated market economies* (CME). LMEs are exemplified by the United States, Great Britain, Canada, Australia and New Zealand, CMEs by Germany, Sweden, Switzerland, the Netherlands, Norway, Austria, Denmark and Japan. The two types are said to differ according to how the crucial actors in a capitalist economy, i.e. firms, resolve the coordination problems they face in relation to other strategic actors (firms) in five spheres: industrial relations, vocational training and education, finance and investment, inter-firm relations and relations with employees (cf. Hall and Soskice 2001:6–8).

Market relations and hierarchies are important in all capitalist economies. However, in LMEs transactions are primarily organized through competitive market arrangements, and usually transactions are of a short-term nature; in CMEs a longer-term orientation prevails, and coordination is primarily achieved by non-market relationships such as networks and centralized associations *(Spitzenverbände)*. Both types (also sometimes called 'Anglo-Saxon capitalism' and 'Rhenish capitalism') are assumed to represent coherent configurations of institutional elements and thus they are presumed to be stable and self-reinforcing systems that will react in more or less predictable ways: an economic crisis will give rise to market-oriented policy responses, or coordinated policy responses, respectively. Moreover, it seems to be very difficult for these varieties to transform themselves into one another. If such a transformation occurs, it seems to be somewhat easier for European-style capitalism to become a liberal market economy of the Anglo-Saxon type. Offe (this volume, p. 154) suggests a reasonable explanation for that: the much stronger social embeddedness and institutional constraints in CMEs are a condition 'that is more easily lost than gained, owing to its dependence upon supportive dispositions of a cognitive as well as moral kind'. Yet although it is much more unlikely, a transformation in the other direction has also been observed, e.g. by Värheim (2003), who describes a change in the Irish political economy from LME towards CME after 1987.

Undoubtedly, the *varieties of capitalism* literature has contributed a great deal to our understanding of how a diversity of capitalisms can exist, reproduce itself and avoid convergence. Nevertheless, this approach has been described as too deterministic regarding the developmental paths national economies will take, and recently a new wave of *varieties of capitalism* literature has begun to generate a more dynamic theory of institutional change (cf. Blyth 2003; Thelen 2003; Crouch and Farrell 2004; Crouch in this volume).

Crouch (this volume) challenges the trend of seeing nation states as exemplifying ideal types of capitalism. By seeking the so-called dominant characteristics of national systems, these studies turn our attention away from internal diversity and even incoherence. More complex and hybrid forms of institutional governance structures require, argues Crouch, new tools and methods of analysis which allow us to specify how different modes of institutional governance (market, hierarchy, association, community, network and state) are differently combined and which potential capacities are associated with the resulting *governance regimes*. His studies show that virtually all empirical cases of capitalism are hybrids. All advanced examples of capitalism comprise a certain distinctive compound of at least the following elementary modes of governance: market, hierarchy and procedural state (dominant mode); the other elemental modes (association, community, network) intervene between firms and the dominant mode (cf. Crouch, this volume, p. 82). This methodologically improved typology does not only allow a much more fine-grained analysis of varieties of capitalism and an appropriate analysis of mixed market economies (e.g. Portugal, Spain, Italy); even more important, precisely those features of empirical cases which previously had not matched preconceived types and had often been disregarded can now be more properly taken into account and evaluated as potential resources for change. It is internal diversity, heterogeneity, incoherence that trigger change and potentially break previous path dependences.12

In Part II three major varieties of contemporary capitalism are highlighted: East Asian (especially Chinese) capitalism, continental European

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(especially German) capitalism and US capitalism. In each case the studies presented entail a wealth of observations and concomitant theoretical considerations and explanations and they all draw developmental lines to the present. They make it plain, however, that we are still far from a comprehensive, analytically and empirically adequate framework for explaining institutional and economic change—at least on a level that is compatible with the complexity and observational richness of the following studies.

In the first study, Giovanni Arrighi presents a detailed comparative discussion of the historical and developmental trajectories of East Asian and Western capitalism with a focus on the following questions: Why did industrial capitalism develop in Western Europe rather than in East Asia? Why was the British-led globalization of industrial capitalism associated with a sharp economic decline of the East Asian region, especially China, for more than a century until the end of the Second World War? And why was this long decline followed by an even sharper economic renaissance in the second half of the twentieth century, leading to the resurgence and rise of China (since the 1990s the world's most dynamic arena of capital accumulation) as the prospective centre of the global economy, at least if the declining phase of US hegemony continues (cf. also Arrighi 2005)? Arrighi discusses a great number of different explanatory approaches of scholars in East and West. What he basically singles out is that there are a number of key ingredients in the formation of the two different worldregional developmental paths which, moreover, interact with one another in specific ways. East Asia and Europe developed different institutional and technological paths very early: a labour-absorbing resource-saving framework (industrious revolution) in East Asia and a class-based, largescale-production framework (industrial revolution) becoming dominant, first of all, in Britain. This 'great divergence' had deep roots in an earlier divergence of the geopolitical environments in which Western European and East Asian states operated—geopolitical differences which in the Chinese/East Asian model privileged state making and national economy making over war making and overseas empire building whereas the British/Western European model did just the opposite. In all the following stages of development these two basic ingredients, *institutions* and *geopolitics,* continued to influence each other in the formation of the different evolutionary trajectories which also interacted with and responded to one another. Processes of hybridization have contributed decisively to the exceptional competitiveness of East Asian capital and labour in the declining phase of US hegemony.

In his chapter Claus Offe inquires to what extent there are institutional and structural features that apply only to European political economies, how these distinctive features can be explained historically and justified in normative or functional terms, and what we can expect and predict regarding the impact economic globalization and European integration will have upon European *social capitalism.* The European model of capitalism basically involves some kind of state-sponsored status order that protects economic agents from the anarchy of the market while (ideally) at the same time improving market outcomes. Will it be possible to translate this (or at least parts of that) institutional framework for cooperation and regulation from the national level to the level of a supranationally embedded European political economy that preserves the 'social quality' and 'embeddedness'13 of the previous European model? Or will European integration in the context of *globalization* (which increases the international exchange of investment, goods, information, people, and simultaneously diminishes the nation states' sovereign capacities) pave the way for, as Offe formulates it, 'the ultimate triumph of market liberalism on the European continent by enforcing upon member states the adoption of regimes of privatization, deregulation and fiscal austerity' (p. 155)? Offe presents a comprehensive and profound discussion of the political and economic conditions under which different outcomes appear to be probable.

In his chapter Michael Piore turns our attention to the very archetype of a liberal market economic model, US capitalism, and his first crucial point is that there is a gap between actual developments in the United States and those which the neoliberal debate would lead one to expect. The market is not the unrestrained arbitrator of social and economic life that is often pictured in accounts of actual developments in the United States. This should not distract us from the fact that, as Piore asserts, inequality (in terms of the distribution of money among individuals) has increased over the last three decades; there has, however, also been 'enormous social progress' in equal employment opportunities due to a movement towards a regime of employment rights driven by political mobilization around social identity. This pattern of institutional development gives both race and ethnicity a salience in the United States that they do not necessarily have in other societies. Moreover, the American model of ethnic diversity seems to be advantageous to the US economy. The institutionalized diversity of labour forces may be efficient; it may create the very competitive pressures which have been thought so far to favour the neoliberal model of open, unregulated markets.

In the last chapter of Part II Robert Brenner begins his contribution with a description of yet another face of US capitalism: the stock market bubble of the late 1990s which was completely unjustified by any real increase in corporate profitability. Thereafter he presents an updated outline of his analysis of the economic crisis of the late twentieth century (Brenner 1998, 2002) focusing on the US economy and its interaction with other leading industrial producers. Proceeding from a vast collection of data, Brenner argues that since the 1970s there has been a decline in the rate of profit within manufacturing industries (where essentially the resources for investment, technical change and economic growth are

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expected to come from), and that the economic slowdown has been caused by two key factors: the emergence of strong industrial rivals (especially Germany and Japan) and the generation of excessive production capacities. Will there be a revival of profitability? There is much in Brenner's cogent argumentation that is reminiscent of the classical Marxist argument regarding the tendency for the rate of profit to fall.14 On the other hand, contrary to Marx's 'law' regarding the fall of the rate of profit, capitalism has over and over again exhibited a basic resilience and a capacity to recover from any crisis encountered so far.

Capitalism and social critique in the era of globalization

'Criticism of capitalism is as old as capitalism itself,' write Luc Boltanski and Eve Chiapello in their contribution to this volume (p. 241). Criticism of capitalism has been especially a domain of the Marxist tradition of critical thought.15 Libraries could be filled with all that has been written from this perspective; and the amount multiplies if all that kind of socialist and communist literature is added which at least to some extent, as Adorno once wrote (cf. 1970, vol. 20:391), turned many sentences of Karl Marx into their opposite the more rigidly they were parroted. However, at least one very deep Marxist and communist conviction, namely that there is a basic alternative to capitalism and that this alternative will inevitably come about, has turned out to be a great illusion. Francois Furet writes in the introduction to the *The passing of an illusion: The idea of communism in the twentieth century:*

One of the distinctive traits of Communism was its inseparability from a basic illusion, which for many years appeared to be validated by Communism's own history, until it was dispelled by that history. By 'illusion'... I mean...that Communism sought to conform to the necessary development of historical Reason, and that the 'dictatorship of the proletariat' thus appeared to have a scientific function... Unlike an error of judgement, which, with the aid of experience, can be discovered, appraised, and corrected, the Communist illusion involved a psychological investment, somewhat like a religious faith even though its object was historical. (Furet 1999:9)

There is, however, an important point about any critique of capitalism that is forcefully brought forward by Luc Boltanski and Eve Chiapello in their contribution to this volume. It not only matters whether a critique is warranted but also whether and why it can play a role in and for future social and economic development. In their chapter they analyse the role played by criticism in the dynamics of capitalism (cf. also Boltanski and Chiapello 1999). Although their analyses are mostly confined to the development of French capitalism from 1930 to the present, they contain elemerits of a general and most interesting model of change of capitalism that creatively adds to all the thoughtful insights presented in previous chapters of this book regarding institutional and economic change. This model of change is organized around the three key concepts: capitalism, spirit of capitalism and criticism of capitalism. To simplify somewhat, the model states that capitalism presupposes a *spirit,* and criticism is a catalyst of changes in the spirit of capitalism. The spirit of capitalism is 'the ideology that justifies people's commitment to capitalism, and which renders this commitment attractive' (p. 241).16 Regarding criticism, the authors distinguish between a 'social critique' as it is traditionally expressed by the labour movement, that is directed to inequalities, deprivation, exploitation and egoism, and an 'artistic critique', that is directed to oppression and pervasive commodification (presuming ideals of liberation, autonomy and authenticity) and which found its classic expression in the Bohemian milieu of the late nineteenth century. Both forms of critique have accompanied the history of capitalism from the beginning, and—as Boltanski and Chiapello show—they play a crucial role at different points in the transitional phases between three stages of French capitalism since the 1930s. Moreover, they also show that capitalism has had an amazing ability to survive by endogenizing some of those criticisms it faced—by changing in such a way that ultimately critiques backed by sufficient social power to make them socially compelling no longer apply.

As Boltanski and Chiapello state at the beginning of their chapter, they have followed the move in 1980s French sociology from a *critical sociology* (in the Marxist theory tradition) to a *sociology of criticism*. But, of course, even then it nevertheless still makes sense to distinguish the validity of a critical argument from its capacity to be integrated or immunized by ongoing processes of capitalist development. Moreover, critiques of capitalism can be articulated with different intentions regarding the scope and depth of argumentation and regarding the critical distance that is created between the way things are and the way they promise to be.17 Critiques can, as Boltanski and Chiapello also write, either have a corrective or a more radical purpose. Both, more corrective and more radical critiques, may be valid and feasible; this book closes with one of each kind.

The first of these critiques, the chapter by Gunnar Geyer and Thomas Straubhaar, comes from economists and turns our minds towards problems of globalization. It can be understood as a powerful address to antiglobalists to be aware of both the risks *and* the potentials of globalization. Gunnar Geyer and Thomas Straubhaar emphasize the significance of *social capital* for the (economic) well-being of societies. Social capital facilitates cooperation within or among social groups. However, it presupposes locationally fixed networks that rely on shared norms, values and understandings, and therefore processes of globalization involve the high risk that social capital will decline with increasing mobility. At least there is a trade-off between growth resulting from mobility and growth due to the cultivation of social capital; so the key question is how to make mobile (highly qualified) people willing to invest in (location-specific) socialcapital activities. Geyer and Straubhaar show that an understanding of *loyalty,* how it can arise and how it may stimulate institutional change and support reforms, is a necessary prerequisite for understanding the conditions under which globalization will improve the productivity of economic and political systems.

The second critique comes from a sociologist who for many years has been working and publishing within the great traditions of critical sociology and social philosophy. In his chapter Steven Lukes does not deny the well known and widely accepted benefits of a market economy, but he raises the question whether the spreading marketization of the world associated with neoliberalism's global ascendancy is on a par with an 'invasion of the market' which means that the economic calculus also penetrates into previously relatively socialized spheres. In *The Theory of Communicative Action* (1981) Jürgen Habermas calls this a *colonization* of the life world through social systems (in this case the economic system) and exposes this highly modern form of 'alienation' as a pathology of modern society. Precisely at this point Lukes raises the question as to what harm market exchanges can really do, why people think they do and when and why they are justified in so thinking; and he suggests three broad distinct answers to these questions by debating three central dimensions within which a 'tyranny of "market imperialism"' (Walzer 1983) can be observed: commodification, inequality and citizenship. Lukes presents a wealth of compelling theoretical and empirical observations that makes it plainly evident that if the economy also excessively controls societal domains that basically do not follow a logic of economic change (e.g. because there are goods that people value because they are just not up for sale) then markets will be clearly harmful.

Yet there is at least one basic and, in principle, encouraging lesson to be learned from all the chapters of this book. There is not only diversity and incoherence within but, above all, also between different worlds of capitalism. As Johannes Berger (this volume, p. 35) states, 'if there are different worlds of capitalism, one can perhaps choose the type of capitalism one wants to live in'. This suggests another question: is there a best of all possible capitalist worlds? This really crucial question may, however, be too big to find a definite answer. Perhaps it is even the wrong question—in the sense that it leads us astray from what essentially needs to be known or could be known; and even if the answer to that question could be known, humans are —as the seventeenth-century philosopher Gottfried Wilhelm von Leibniz maintained—too ignorant to recognize the best of all possible worlds which, in his view, was actually coextensive with the one already existing. Yet another prominent message comes from Isaiah Berlin's *Four Essays on Liberty* (1969), where it is convincingly argued that there is an incommensurability of or trade-off between values, a diversity of goods—freedom and security, efficiency and solidarity, and so on—and a difficulty in realizing all of them simultaneously.18 The radical pursuit of one value runs the risk of hindering the pursuit of other values, whereby utopia becomes impossible. 'There is no social world without loss', writes John Rawls in *Political Liberalism* (1996:197). If that is true, then there is no best of all possible capitalist worlds. But obviously there do exist very imperfect and unsatisfactory capitalist societies; and there certainly can be societal learning processes that change the institutional structures of a capitalist economy and society in such a way that at least basic achievements of modernity (besides a market economy also a law-making and a law-enforcing democratic state and a civil society) can be made real worldwide.

Notes

1 Cf. Part II of this volume ('Varieties of contemporary capitalism') and the corresponding introductory comments on the following pages.

2 Cf. also Piore's chapter in this volume where a short outline of the pre-industrial, the industrial and the post-industrial organization of work is given and where new technologies of production and management (e.g. the 'project team form of work') are briefly described.

3 This is not to deny the fact that within the context of recent sociological systems theory the concept of 'social institutions', especially as it is used by 'neo-instinationalists', has been severely criticized. Willke (1987) states that the concept 'institution' has a great past but a questionable future; and Luhmann (2000) ascertains that a theoretical explication of the concept of 'institution' with regard to its fundamental significance for a theory of society has so far never succeeded and that all further explanations only seem to make the situation worse. However, this critique seems to be rather weird given the development of neo-institutionalist theorizing during recent decades. On the other hand (and this shows how far worlds of scientific discourse can drift apart), Luhmann's *oeuvre* isn't even mentioned in some of the most influential work on 'neo-institutionalism', e.g. in DiMaggio and Powell (1991) and Scott (2001), as correctly observed by Krücken (2002), who tries to compare US 'neo-institutionalism' and European social theories with one another.

4 In his *Rules of the Sociological Method* (1895) Durkheim wrote: 'A social fact is every way of acting, fixed or not, capable of exercising on the individual an influence, or an external constraint; or again, every way of acting which is general throughout a given society, while at the same time existing in its own right independent of its individual manifestations.'

5 The construction of worldwide institutions on the basis of worldwide cultural and associational processes has been studied by John W.Meyer and his colleagues (cf. e.g. Meyer *et al.* 1997).

6 Cf. also the critique of Johannes Berger (this volume, p. 41) on this blurring of the conceptual distinction between 'institution' and 'culture'.

7 This, by the way, has already been a familiar insight to classical institutionalism, e.g. Arnold Gehlen (1956). Cf. also Göhler (1994).

8 Offe (this volume, p. 154) also distinguishes basically two modes of institutional change (cf. also Offe 2001): according to the 'natural selection model' institutions change if they fail to produce expected or promised outcomes; according to the model of 'institutional decay' they change if they lose their

intrinsic support. As Offe points out, both explanatory models can but need not coincide in accounting for empirically observable processes of change.

9 In the literature (cf. e.g. Hall and Taylor 1996; Campbell 2004) 'historical institutionalism' (cf. e.g. Steinmo, Thelen *et al.* 1992) is distinguished as a third neo-institutionalist approach and is located somewhere between rational-choice institutionalism and sociological or organizational institutionalism.

10 This is a central topic in Miller (2006).

11 Viewed from a more sociologically oriented theoretical background one could also say that this is where social discourse (which not only presupposes but may also change intentions) comes in.

12 However, heterogeneity and incoherence need not, in any case, have an innovative effect that will create new institutions and transform economic systems it can also paralyse and block any productive change. This is a well known phenomenon in the sociology of conflict. Hence corresponding theories of change and learning face the task of explicating the precise conditions under which incoherence and differences release processes of change and learning and under which they do not release, or may even block, those processes (cf. also Miller 2002).

13 Offe (this volume, p. 151) defines 'embeddedness' as 'the degree to which contractual relations are premised upon a non-negotiable status order governing economic activity'.

14 In *Grundrisse* (1857–61/1973:748) Marx evaluated his discovery of the tendency for the rate of profit to fall with the following words: 'This is in every respect the most important law of modern political economy, and the most essential for understanding the most difficult relations. It is the most important law from the historical standpoint. It is a law which, despite its simplicity, has never before been grasped and, even less, consciously articulated.'

15 Cf. e.g. the following critical appraisals of the critical potential of Marx's work and the Marxist theory tradition from the very different theoretical viewpoints of Bottomore (1985) and Elster (1986).

16 Although Boltanski and Chiapello do not refer to neo-institutionalist approaches, it seems as if the meaning of their notion of 'spirit' comes very close to the meaning of 'institutions' as understood by the schools of sociological and historical neo-institutionalism.

17 At this point the methodological credo of the young Marx, as he formulates it in the introduction to his *Critique of Hegel's Philosophy of Right* (1843–1844), is still compelling: 'these petrified relations must be forced to dance by singing their own tune to them'.

18 Cf. also Berlin (1956, 2002), Lukes (1994, 1995) and Walzer (1983).

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2

Social institutions, technological progress and economic performance

Johannes Berger

I

Every student of income distribution on a worldwide scale will very soon come across a disturbing fact: *per capita* incomes vary enormously across nations. At present about 190 nation states are members of the United Nations. The fundamental economic fact characterizing this collectivity is the huge variation in national living standards. Rich nations exist beside poor ones, very often in their immediate neighbourhood: take only Mexico and the United States as an example. As Lucas (1988:3) has put it: the diversity across countries in measured *per capita* income levels is 'literally too great to be believed'. As a rule, it even exceeds the inequality within nations that many observers find to be so appalling. In 2001 the reported *per capita* income of the United States amounted to PPP $34,142, whereas the reported *per capita* income of Sierra Leone did not surpass the deplorable level of PPP $490.1 That is, living standards in the United States and Sierra Leone, which according to the Human Development Report of the United Nations is the poorest country of the world, differ by a factor of almost seventy.2

As striking as these differences across countries are differences over time. Small differentials in growth rates, when compounded over extended periods of time, amount to large differences in living standards. A country that grows on average by 2 per cent needs only one generation (roughly thirty-five years) to double its income.3 Schumpeter believed that this growth rate would suffice to eliminate poverty within one generation. Seen historically, a growth rate of 2 per cent is already an unprecedented achievement. It never happened before the epoch of modern economic growth. Between 1870 and 2000 the US economy grew at an average rate of 1.8 per cent per year (Barro and Sala-I-Martin 2003:1). This performance is only a little weaker than Schumpeter thought sufficient to remove poverty within one generation. Though such hopes did not come true, such a performance was sufficient to render the United States the second richest economy of the world in 2000.4 As a brief look at the history of growth will reveal, this achievement was surpassed by far during the post-war era of economic growth. Between 1950 and 1973 the growth rate of the German economy for instance amounted to an astonishing 5.6 per cent; the growth rate of the Japanese economy even to 9.2 per cent on average (Maddison 2001:262). A country with a growth rate of 5 per cent doubles its income every fourteen years. That means that the second generation lives in a country that is about five times as rich as it was a generation before. The economic success of the so-called golden age of growth has no predecessor. However, it was not sustained and ended in the economic downturn of the mid-1970s. The question then is: why did this period of high growth rates come to an end? Behind this question lie more fundamental ones. What are the sources of growth? Why do growth rates differ across countries and over time? Accounting for growth-rate differences may provide a clue as to why there are such large differences in *per capita* income. 'If we want to understand why countries differ dramatically in standards of living,' write Barro and Sala-I-Martin (2004:6) accordingly, 'then we have to understand why countries experience such sharp divergences in long term growth rates.'

The vast differences in economic performance just outlined cry out for an explanation. It is hard to think of a more fundamental question for social scientists in general and economists in particular to answer than why some countries have grown rich while others remain poor (Temple 1999:112).5 Variations of income across nations imply that the life chances of a newborn child crucially depend on the country of birth. It seems that up to now no other factor has had a greater influence on life chances than location of birth. According to calculations made by Fire-baugh (2003:11), about 70 per cent of the variance in individuals' incomes worldwide can be explained by where (in what country) a person lives. This underlines again the centrality of the problem of why growth rates differ.

Searching for the reasons why some nations are so rich and others are so poor, a natural conjecture after the collapse of socialism is to explain the wealth of the rich nations by the capitalist organization of their economies. In particular, the earlier present-day societies managed the transition to capitalist organization the richer they are. Capitalism seems to be an engine of economic progress (indeed, the only reliable one), business cycles notwithstanding. The economically successful nations have been organized in a club, the OECD (Organization for Economic Cooperation and Development) for the last fifty years or so. Members of this club share basic features of economic and political organization. A summarizing label for them is 'liberal democracy', that is, a combination of a liberal economy and political democracy. These liberal democracies outperform the rest of the world in terms of living standards. What is more, all other nations strive to become as developed as the OECD world already is. Some developing nations have already been very successful in reaching this goal. Take only South Korea as an example. Its economic success easily exceeds even the post-war reconstruction of West Germany, which has been described as an 'economic miracle'. The success of South Korea is based on capitalist organization of the economy similarly. Merely to connect growth and capitalism is of course too rough a guide to an institutional analysis of the causes of economic success, but it nevertheless elucidates the central role institutions play in explaining economic performance. Seemingly there is no alternative to a capitalist mode of production if the aim is not individual happiness or emancipation but the simple down-toearth improvement of the living conditions of the masses. This conclusion became inevitable at the latest with the demise of the socialist world. Even the economic upswing of China is not a counter-example. Adam Smith has now arrived even in Beijing (cf. Arrighi's chapter in this volume)—and Karl Marx has gone. It is true that the transition to capitalism is accompanied by increasing inequality, but, as Barro and Sala-I-Martin (2003:8) emphasize, the increase in inequality especially in transition economies has not been pronounced enough to offset the poverty reducing effect of aggregate *per capita* growth on a worldwide scale.

There is not only no economic alternative to capitalism but this mode of producing, exchanging and distributing goods and services has now for the first time in history come to dominate the whole world. Apart from a very few exceptions there seems to be no escape from this mode of production and, accordingly, no escape from a world determined by a capitalist economy. The worldwide spread of a specific form economic organization is a fundamental though often neglected aspect of globalization. In a narrow sense the meaning of the latter concept is confined to the steadily increasing economic integration of countries (the share of trade in GDP being a measure of integration) whatever their type of organization is. In a more comprehensive sense it may also involve the convergence of central institutional features of the economy. Then the question arises: are economic organizations around the world converging to become one unique form? The vanishing of any alternative to a capitalist mode of production is a strong argument for giving an answer in the affirmative. However, after the breakdown of socialism, varieties of capitalism are gaining in importance, so the question of the convergence of market economies not only in terms of performance but in terms of organization is once again at stake. It is a question of its own whether there are worlds of capitalism, how many types of capitalism should be distinguished and whether the differences among them are more than superficial. If there are different worlds of capitalism, one can perhaps choose the type of capitalism one wants to live in, but there is only a slight chance of escaping this mode of economic organization entirely.

Taking a closer look at the advanced capitalist world (the OECD club) the striking fact is that income differences remain rather than vanishing. They are smaller than income differences between the developing world and the developed world, but they still continue to exist. To live in a capitalist country does not guarantee the same living standard for the average member of society. For instance, in 2001 the German GDP *per capita* amounted to 72 per cent of the US value, the GDP of Portugal only to roughly half the GDP of the United States (Institut der deutschen Wirtschaft 2001: table 12.2). Apart from pointing to different growth rates, a preliminary reason for these differences in living standards between advanced countries is that the earlier a capitalist country entered the epoch of modern economic growth (Kuznets 1973), i.e. transformed itself into a capitalist country, the richer it will be. This time, it seems, it is not place of birth but the time of transition to capitalism that is the relevant variable determining the living conditions of the average individual. If one takes income *per capita* as the measuring rod, capitalism is, in a long-term perspective, an economic success story. The longer it has existed the higher will be the living standard attained, economic downturns and depressions notwithstanding. This is especially true of the twentieth century. From an economic point of view, this was the century of the worldwide breakthrough of capitalism. In this respect the medieval age was not overcome on a worldwide scale until the 1950.6 To illustrate the pattern of economic progress a little more I refer to a table compiled by Maddison (2001).

The time span and the geographical area covered by the data in this table are really striking. Its aim is to cover the economic history of all major civilizations since the year 1000. For a number of reasons the quality of the data displayed in this table is certainly far from perfect. Of course one can raise doubts as to the reliability of the statistics it contains. They presumably become the less reliable the more remote the region from the West or the period from the present. However, if nothing more is intended than to get an idea of the general development, the numbers the table exhibits for early periods and remote countries can be taken at face value. Accepting them, as I do, the following conclusions seem inescapable.

First, around the year 1000 all major civilizations were equally rich, displaying the same level of wealth. Prior to 1800, living standards differed little across countries and across time (Parente and Prescott 2002:23). There is not the slightest sign of European economic superiority. What is more (though it is not reflected in this table) in all probability there are good reasons to assume that before the European take-off Asian civilizations were culturally more advanced than medieval Europe.

Second, Europe took the lead in the course of the industrial revolution. As a consequence of this revolution, as the West grew rich, differences in living standards between nations increased dramatically between 1800 and 1950 (Parente and Prescott 2002:23). Note that the growing divergence observed for about 200 years can easily be traced back to the process of economic modernization. Without it no substantial income differential would exist between nations or world regions. It is the breakthrough achieved in Great Britain around 1800 that makes the difference. Since

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Table 2.1 Levels of *per capita* GDP and interregional spread, 1000–1998 (1990 international dollars)

Region	*1000*	*1500*	*1820*	*1870*	*1913*	*1950*	*1973*	*1998*
Western Europe	400	774	1,232	1,974	3,473	4,594	11,534	17,921
Western offshoots	400	400	1,201	2,431	5,257	9,288	16,172	26,146
Japan	425	500	669	737	1,387	1,926	11,439	20,413
Asia (excluding Japan)	450	572	575	543	640	635	1,231	2,936
Latin America	400	416	665	698	1,511	2,554	4,531	5,795
Eastern Europe and former USSR	400	483	667	917	1,501	2,601	5,729	4,354
Africa	416	400	418	444	585	852	1,365	1,368
World	435	565	667	867	1,510	2,114	4,104	5,709
Interregional spread	1.1:1	2:1	3:1	5:1	9:1	15:1	13:1	19:1

Source: Maddison (2001:126).

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then economic inequality has characterized the relationship between world civilizations. And only since then has the split between developed and developing countries existed. Before the breakthrough achieved in England during the eighteenth century this distinction would have been entirely meaningless. Of course this breakthrough had its predecessors. Economic historians point to the fact that the economic and social revolution did not originate in the late eighteenth century but rather with the age of European discoveries and the scientific revolution of the sixteenth century. 'With the spreading of the industrial revolution to Western Europe and to European populated countries in the Americas and the Pacific,' Bourguignon and Morrison comment (2002:728), 'world inequality soared.' Whereas the European populations were enriched by economic modernization, the Asian region is characterized by stagnation or slow growth. Over the nineteenth century and the first half of the twentieth century the world became divided into three income camps.

In the richest camp—the Western industrial nations—average income from 1820 to 1950 shot up by a factor of six. In the poorest camp—Asia and Africa—average income grew only by about 70 percent. In Latin America and Eastern Europe, incomes roughly tripled. So the material consequences of the Industrial Revolution are easily summarized: Higher incomes more unequally distributed.
(Firebaugh 2002:1)

After the 1950s economic modernization started to spread to the whole world. Now countries outside Europe entered the epoch of modern economic growth, though at different points of time. As a consequence, between-nation income inequality has declined in recent decades, though the decline has been modest. Nevertheless it can be expected that, as China and India modernize, global income inequality will continue to decline.

Third, 'world income growth, though strongly inegalitarian, contributed to a steady decline in the head count measure of poverty throughout the period under analysis' (Bourguignon and Morrison 2002:733). As the table shows, growth rates are positive in almost all periods of time and in all regions of the world. Following Barro and Sala-I-Martin (2003:6) aggregate growth is probably the single most important factor affecting individual levels of income. It led to a 'substantial reduction in world's poverty rates and head counts over the last thirty years' (*ibid.:* 10). There are only a few exceptions to this regularity. Sub-Saharan Africa in particular failed to participate in economic progress. But it would be misleading to describe world economic development as a history of increasing impoverishment, a view still very popular in the media, and in left-wing intellectual circles.

Fourth, and finally, as the table shows, the interregional spread increases continuously. 'Divergence in relative productivity levels and living standards,' writes Lant Pritchett (1997:3) in a widely cited paper that has helped to establish the divergence view of economic development, 'is the dominant feature of modern economic history.' In a similar vein, Boltho and Toniolo (1999:8) observe that 'despite much greater overall prosperity...inter-country gaps today are greater than 100 years ago'. They regard the absence of living standards convergence in the world as the 'biggest failure of the last century'. However, before rushing to conclusions on the basis of the empirical evidence displayed in Maddison's table, some caveats are appropriate. First of all, increasing inequality does not imply increasing poverty. Though the rich are getting richer a lot faster than the poor, the poor are not getting poorer (Easterly and Levine 2001:19). Then the spread is a very crude measure of inequality. In addition, whether growing divergence is typical of world income distribution or not depends on the measure of inequality, on the unit of comparison (individuals or nations) and on the data set forming the basis of the analysis. For instance, if the Human Development Index (HDI)7 is taken as the relevant measure, then international comparisons exhibit convergence rather than divergence (Crafts 2000:11). In particular, the regional or national mean income values have to be weighted by their share of the world population. Otherwise, without using population-weighted GDP *per capita,* countries like China and Luxembourg would count as one data point in a calculation of income inequality, ignoring the fact that there are more than 2,000 Chinese for each inhabitant of Luxembourg. Using country weightings to evaluate the development of income inequality, the latter is reduced by a substantial degree. But even then the differences in living standards between countries remain substantial. They are by most measures much larger than within-country income differences (Parente and Prescott 2002:11). Thus the question remains: what forces can explain income differences across countries, both between developing and developed countries and across the advanced countries themselves? It is this question to which I now turn.

II

In the last two decades a number of publications have addressed this question directly. Why isn't the whole world developed, asks, for instance, Easterlin (1981)? Why are some nations so rich and some so poor? This question is the subtitle of a magisterial study by Landes (1998). Why do some nations forge ahead and why do some fall behind while others are able to catch up? These are the questions Abramovitz (1986) tries to answer in his well known paper.

There is an obvious answer to all these questions that is perfectly attuned to the sociological way of thinking. Differences in living standards are due to the impact of social institutions on the economy. I am not going to jeopardize the idea that social institutions matter. To the extent that economics has escaped the predominance of neoclassical thinking that has again and again been blamed for undervaluing the effect of institutions, economists nowadays can agree with sociologists in emphasizing the decisive role institutions play in explaining economic performance. However welcome this convergence of economic and sociological thinking may be, it does not suffice simply to point to the role of institutions. In fact, referring to institutions and their effect upon the economy does not solve the problem of explaining income differences but is at best a guiding principle in the search for an explanation. Mere reference to institutions leaves too many questions open. First, where do institutions come from? Economists tend to answer this question by starting from a world where institutions either do not exist (the Hobbesian state of nature) or do not matter (the Walrasian ideal world of frictionless exchange). Sociologists tend to refer to prior, less differentiated institutions from which more differentiated institutions emanate. Second, which institutions count? That is, which are conducive and which are detrimental to growth? Following North (1990), the enforcement of property rights, the government's share of GDP and the extent of economic regulation can be seen as the most important determinants of economic performance. Hall and Jones (1999) point to the role of corruption and bribery. In a popular book, *The Mystery of Capital,* de Soto (2000) argues that it is not riches, that is, the possession of goods, that distinguishes the West from the rest of the world, but the legal representations of those riches. The reason why capitalism triumphs in the West and fails everywhere else, as the subtitle of the book claims, is that only in the West was a parallel system of representation and title created, aiming at securing property rights and thus enabling owners to appropriate the fruits of their possession. The West created what might be called a mirror of the real world of possessions in the cultural world of legal entitlement. Though I am in sympathy with the general argument that only the cultural reflection of factual distribution turns possession into legal ownership, thus providing an elementary precondition of growth, it does not deliver the final answer to the question why some countries are richer than others. Property rights can be distributed differently. The point is to find out which distributional patterns foster growth and which hamper it

A third reason why mere reference to institutions is at best a starting point but by no means the end point of an exploration aiming at understanding the immediate and ultimate factors responsible for growth and growth differences is that it leaves open the question of where institutional variation comes from. It is necessary to know why in some countries institutions exist that are conducive to growth and in other countries institutions that are inimical to it. What rules govern the choice of institutions? Even the question may be wrongly formulated, since possibly institutions are more imposed than chosen. Not even countries are entirely free in their choice of institutions. Their choices are limited by their past. Nevertheless the difficulty of explaining institutional variation remains. In particular, as Acemoglu *et al.* have made clear (2002:1370), to estimate the impact of institutions on economic performance, a source of exogenous variation in institutions is needed. Otherwise it cannot be ruled out that the causal chain runs from economic performance to institutions. Good institutions thus may be a kind of luxury goods. Rich economies can simply afford better institutions.

A fourth problem concerns the general pattern of institutional change. Are inferior institutions replaced by superior ones in the course of history, so that efficiency is achieved? If I understand it rightly, North's early work exemplifies this position. In his later work, however, he dismisses it: 'Throughout most of history, the experience of the agents and the ideologies of the actors do not combine to lead to efficient outcomes' (1990:96, cf. also 16, 137).

Up to now I have tacitly presupposed that only institutions matter as an explanatory variable in attempts to account for different levels of economic performance. But ideologies, as already touched upon in the quotation from North, may be just as important as institutions. A more generic term than ideology that includes normative and evaluative aspects as well as cognitive aspects is *culture*. From a genuinely sociological point of view the notions of culture and of institutions have to be strictly separated. Culture is not a social fact. It belongs to the realm of meaning. Even if evaluative, normative and cognitive ideas penetrate the social sphere they have to be distinguished from it conceptually. Culture, as Margret Archer put it, is the content of a library. Whatever can be written down in a book or paper belongs to the sphere of culture. Of course ideologies may seize the hearts and minds of people and are therefore powerful forces that no analysis of the course of development can neglect. None the less it makes sense to draw a clear distinction between institutions, on the one hand, and ideologies as a major component of culture on the other. 'Culture as a whole,' Archer writes (1988:xvi), 'is taken to refer to all intellegibilia, that is to any item which has the dispositional capacity of being understood by someone.' Drawing a distinction between culture and institutions is a precondition of assessing the extent to which ideologies or belief systems, on the one hand, and norms that are the substance of institutions, governing actions, on the other hand, can account for economic outcomes.

To reiterate: institutions matter. As Acemoglu *et al.* (2002:1395) emphasize, they are at the root of large differences in *per capita* income across countries. However, the question is: do they matter more than other factors that may affect the conversion of inputs into outputs? I have already discussed the role of ideologies or culture in general, of which ideologies form a sub-set. Another relevant factor is policy, especially the policy of trade openness. The overwhelming importance of institutions compared with policies has been confirmed by Rodrik *et al.* (2002). Based

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on a sample of eighty countries, they tested the role of institutions compared with the influence of world market integration and geography. They find that the quality of institutions trumps everything else. This result is questioned by approaches the authors call the geography view and the integration view. According to the first view what matters is the geographical location on earth, which determines central living conditions like the climate, the endowment of natural resources and the spread of tropical diseases. According to the second view it is integration into the world market that plays a vital role. In view of the extensive debate on the pros and cons of globalization and the widespread fears associated with the process, a few words concerning this issue may be appropriate.

On the basis of the central theorems of international trade, both national and international policymakers repeatedly argue that integration into the world economy through international trade is a safe way to increase prosperity substantially. In sharp contrast to these claims Rodrik (2003:8) holds that 'the traditional theory of trade does not support such extravagant claims, as trade yields relatively small income gains that do not translate into persistently higher growth'. Despite what the decade-long debate on globalization and its potential dangers and opportunities presupposes, trade openness plays no significant role in explaining economic success or failure, at least not compared with the role of institutions. In accordance with this insight Paul Krugman repeatedly warned against exaggerating the impact of world market integration on economic performance. Nations simply do not compete like firms do (Krugman 1996). In the larger developed countries about 90 per cent of production is still for the domestic market and 90 per cent of consumption is produced at home (Trigilia 2002:251). The other side of the coin is that if economic success has mainly internal causes, optimistic expectations related to the positive effect of world market integration are misleading, too. 'Free trade,' writes, for instance, Irwin:

is not a magic bullet that can solve all economic problems. The real and substantial gains from free trade should not be exaggerated when other fundamental economic problems are pressing. The rule of law and the protection of property rights that enable the market mechanism to provide the right incentives for investment and commerce, in addition to stable macroeconomic policies, are preconditions for reaping the full benefits of international trade.

(Irwin 2002:68)

The author quotes Macaulay (1845!):

It is not one single cause that makes nations either prosperous or miserable. No friend of free trade is such an idiot as to say that free trade is the only valuable thing in the world; that religion, government, police, education, the administration of justice, public expenditure, foreign relations, have nothing whatever to do with the well-being of nations.

From the very beginning discussion of the consequences of free trade was not limited to its economic consequences. There is a venerable tradition of pointing out the negative effects of free trade on the moral tissue of modern society, a line of thought that is now prominent again in populist literature and that motivates a worldwide social movement like ATTAC. Even such a reputable witness as Theodore Roosevelt exclaimed: 'Thank God I am not a free-trader. In this country pernicious indulgence in the doctrine of free trade seems inevitably to produce fatty degeneration of the moral fibre' (see Irwin 2002:226). Concerns of this kind are met with a lively response in sociology. Free-traders have a difficult standing in this camp. Downplaying the role of free trade and emphasizing the role of institutions fits well with the main thrust of sociological thinking. However, the general idea that institutions matter neither explains where institutions come from, or what the source of institutional variation is, nor is it sufficient to develop a reliable estimate of the effect of institutions on economic performance.

I don't want to be misunderstood. I am not going to belittle the rediscovery made by the economic profession in recent years of the central role institutions play in accounting for differences in economic performance across nations. Quite the contrary is true. The turn to institutional economics is certainly one of the most intriguing theoretical developments in economics of the last three decades. Nevertheless up to now relatively limited progress has been made in analysing where institutions come from, to pick up only one point (cf. Engerman and Sokoloff 2002). From a sociological point of view, institutions are either the result of an evolutionary process or they originate in a contract, concluded by actors that expect gains from contracting. In general, institutions, conceived as a set of norms governing the way a society solves central problems that are relevant to its continuation, are not a matter of expedient choice. Nor is there a guarantee that social evolution will lead to efficient institutions. The insight that institutions, no matter whether they result from deliberate choice or from evolution, cannot be fully explained by efficiency consideration, could serve as an adequate basis for a dialogue between economics and sociology, even if both disciplines assess the explanatory power of efficiency considerations differently. In this dialogue, sociology, or, to be more precise, that part of the discipline that does not belong to the rational choice camp, will presumably insist that the transition from a natural state where no norms at all exist to a state characterized by the authority of norms backed by a coercive state is a myth. This Hobbesian narrative does not capture the coming into being of institutions. In sharp contrast, sociology emphasizes that the binding power of contracts relies on the noncontractual elements of contracts. In particular it rejects the idea of the exclusively contractual origin of norms or institutions conceived as a set of norms. Norms stem from other norms which precede them. And the direction that the development of norms takes is influenced not only by power and interests but, equally important, by cognitive achievements, too.

III

Up to now I have confined myself to explicating the general role of institutions in explaining economic performance. There is no doubt that institutions matter. But the central question as to what precisely accounts for the large differences in living standards across nations and across time still remains to be answered. Though emphasizing the role of institutions accords perfectly well with the main thrust of sociological thinking, this emphasis is only a starting point and not the end of the story. It remains to be settled (1) what factors in general may influence economic growth, (2) what are the causal links that channel the impact of institutions on economic outcomes and (3) which institutions are conducive to growth (and which are possibly detrimental)?

For any attempt to answer questions like these it is essential to refer to a model or, to be more modest, an explanatory framework that not only distinguishes between different types of causal forces but between levels of explanatory variables, too. It becomes more complicated if one allows in addition for reverse causality. In what follows I refer to a model or analytical framework that draws on the prior work of Maddison (1991:12), Hall and Jones (1999) and Rodrik *et al.* (2002) but modifies it in some way.

This framework allows for distinguishing between the proximate causes of economic success—capital accumulation and total factor productivity (technology)—and the more fundamental determinants, institutions and ideologies (cf. Hall and Jones 1999:86). The problem in commenting on this figure is that those of my potential readers who are trained in economics may feel that I may dwell too long on it whereas those trained in sociology may want me to expand on it more. Hoping that there is a intersection of both expectations, I shall try to be as brief as possible and as thoroughgoing as necessary. I will restrict myself to highlighting six points.

First, it is now standard practice to distinguish between proximate and ultimate causes in attempts to account for different national income levels. Proximate causes are the factors of production, capital and labour, on the one hand, and the efficiency of their use on the other. This efficiency depends on the technology employed. The distinction between

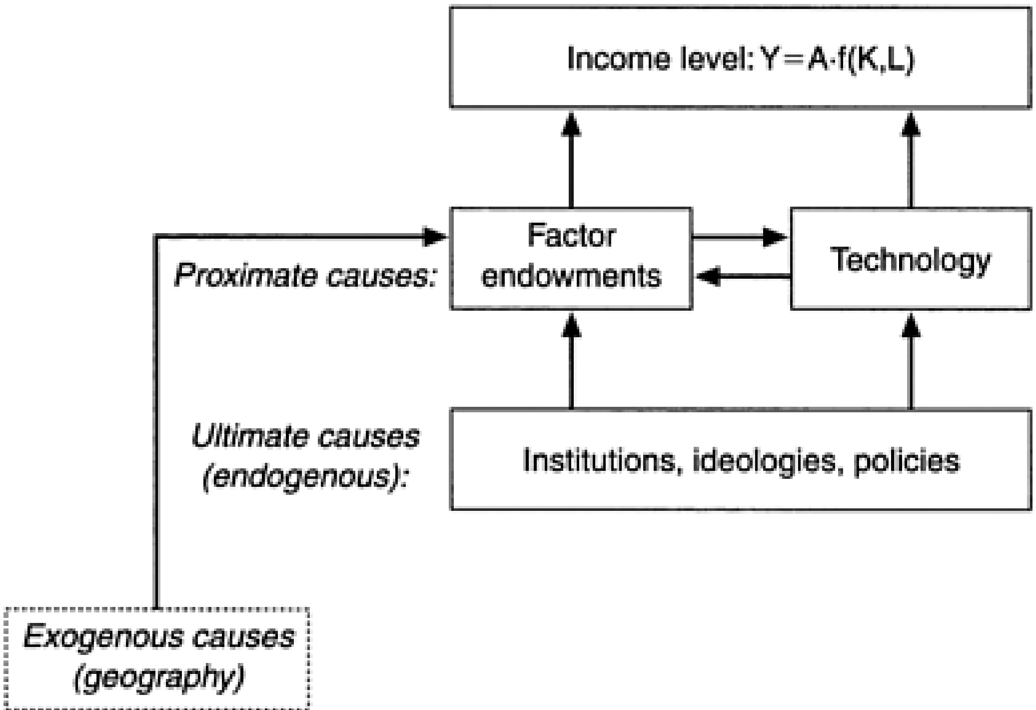

Figure 2.1 A framework for the analysis of income differences across nations.

inputs and their productivity or efficiency is best made clear by referring to a macroeconomic production function:

$$Y=Af(K, L) \qquad (1)$$

where Y is output (GDP), A, the technology parameter, is an index of the state of technology, *K* means capital and *L* labour as inputs. *A* is not an input but has the effect of augmenting the output produced, given the inputs. Other terms for *A* are the residual (of a growth-accounting procedure) or total factor productivity. The latter has to be distinguished from labour productivity, since it refers output not to labour but to a composite index of inputs. A specific, widely used version of this aggregate production function in attempts to distinguish the sources of growth is the so called Cobb-Douglas production function:

$$Y=AK^{\alpha}L^{1-\alpha} \qquad (2)$$

where a is the profit share in total output and $1-\alpha$ is the wage share.

Rewriting equation (2) in growth rates one gets:

$$\frac{\Delta Y}{Y}=\frac{\Delta A}{A}+\alpha\frac{\Delta K}{K}+(1-\alpha)\frac{\Delta L}{L} \qquad (3)$$

Subtracting on both sides of this equation the growth rate of the

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population, *n,* one gets an equation that determines the *per capita* growth rate of output, $y=Y/N$ (provided that $\Delta N/N=\Delta L/N$ or or that L/N, the participation rate, is constant):

$$\frac{\Delta y}{y}=\frac{\Delta A}{A}+\alpha\left(\frac{\Delta K}{K}-\frac{\Delta L}{L}\right) \qquad (4)$$

One of the main deficiencies of equation (2) is that it does not take into account the contribution of human capital *(H)* to the level and growth of output. Assuming that skills multiply the effect of unskilled labour equation (2) changes to:

$$Y=AK^{\alpha}(HL)^{1-\alpha} \qquad (5)$$

Dividing both sides of (5) by L and substituting *Y/L, K/L* and *H* by their respective growth rates yields:

$$\frac{\Delta Y}{Y}-\frac{\Delta L}{L}=\frac{\Delta A}{A}+\alpha\left(\frac{\Delta K}{K}-\frac{\Delta L}{L}\right)+(1-\alpha)\frac{\Delta H}{H} \qquad (6)$$

Equations (4) and (6) serve as a basis for the so-called growth-accounting approach that tries to determine the contribution to economic performance of the inputs capital and labour on the one hand, and the technology (A) on the other.8 The growth rates of the GDP, the capital formation and the labour force can be taken or calculated from the national accounts of economic indicators. The same is true of the profit share and the wage share. Mankiw and Romer Weil (1992) use as a proxy for the stock of human capital the share of the working-age population in secondary education.9 Subtracting from the GDP *per capita* growth rate the growth rate of physical capital *per capita* (and human capital *per capita*) weighted with their income shares yields a measure of technological progress.10

The central result of the bulk of growth-accounting literature now is that technological progress rather than factor accumulation accounts for most of the income and growth differences across nations (Easterly and Levine 2001). Recall Marx's proclamation: 'Accumulate, accumulate, this is Moses and the prophets!' However, according to the growth-accounting literature it is not factor accumulation but 'something else' that is most important for explaining economic success. This 'something else' has been labelled variously as the technology parameter, technological advance, total factor productivity (TFP), the Solow residual or, most tellingly, a measure of our ignorance (Abramovitz 1993). Abramovitz, whose study in 1956 triggered empirical research on the sources of growth, calculated that amazingly 90 per cent of the growth of the US economy between 1870 and 1950 was due to the residual, not to

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factor accumulation. Since then an extensive literature has been devoted to the question whether input factors or 'something else' are responsible for the level and growth of national income. Though Abramovitz certainly overestimated the contribution of technological progress to growth, mainly because of measurement errors and omitted variables, to my mind a fair summary of the growth-accounting literature is that TFP growth accounts for the bulk of output per worker growth11 (Easterly and Levine 2001:9).

I now turn to the problem of how technological progress is to be modelled. This is my second point. The debate on the role of technological improvements is shaped by the dispute of two opposing camps. At one extreme are scholars who regard technology as a public good. According to Solow's famous formulation, technological advance falls like manna from heaven. It is accordingly both exogenous and a public good. All countries have equal access to it. Consequently differences in income can originate only in differences in levels of physical and human capital (Temple 1999:134). This position has come under attack since the upswing of so-called endogenous theories of growth. These theories stress that technological progress is both endogenous and at least to some extent proprietary. As a result technological progress is not only firm-specific but country-specific, too. Approaches located at the other extreme regard the differential distribution of knowledge as central to the problem of explaining variations in economic development. I follow the latter approach. In order to capture the effect of technological progress on economic performance one has to deviate from the neoclassical standard model of economic growth and to allow for country-specific variations in total factor productivity.

There are two possible deviations from the standard model the crucial assumption of which is that total factor productivity is common across countries. First, technological progress is not a common pool but at least to some extent private property. Second, even if it is to some extent a common pool, it may be differentially used by the nations of the world, depending on domestic barriers to the use of the common pool. 'Differences in international incomes,' Parente and Prescott conclude (p. 1), 'are the consequences of differences in the knowledge individual societies apply to the production of goods and services.'

Even if this problem can be settled, the growth-accounting procedure would suffer from another serious shortcoming: its additive structure. As Abramovitz (1993:236 f.) has stressed, 'we cannot gain a truly meaningful idea of the effects of technological progress by first estimating the contributions of tangible and intangible capital accumulation...and then seeing what is left over.' The reason why this is misleading is that both proximate sources of growth interact like the ingredients of a cake. Growth accounting fails to account adequately for the role of technological progress as long as it regards it as a separate contribution to

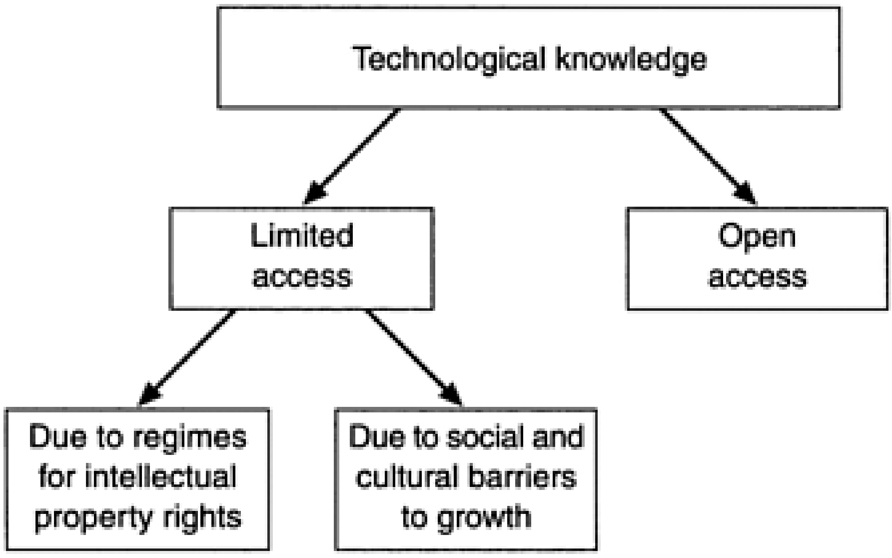

Figure 2.2 Technological knowledge.

growth, not embodied in capital (Maddison 1982:24). Technological progress fosters capital accumulation and vice versa. 'The interdependence of the proximate sources,' Abramovitz (1993: *ibid.*) states, 'runs both ways.... Although technological progress supports capital accumulation, both tangible and intangible capital accumulation also influence technological progress... It is these lines of influence...from capital accumulation to technological progress that are at the heart of the new growth theories.' It is often assumed that the latter shift the emphasis from technological progress to capital accumulation gain. In fact they regard the acceleration of technological progress as the main engine of growth. The new growth theories hold that capital formation is the precondition to develop and exploit the output increasing qualities of technological progress.

My third point is to clarify the meaning of ultimate causes of growth as a necessary precondition of evaluating their impact on economic performance. The relevant literature identifies the ultimate causes of the level and the growth of income more or less with the institutional setting of the economy. Hall and Jones (1999) use the term *social infrastructure* as the generic term. I would like to follow this proposal, but I think it is more appropriate to speak of a social and cultural infrastructure instead of a social infrastructure alone. To this infrastructural level belong, apart from institutions in the narrower meaning of the term (the rules of the game), both government policies and, most important from the point of view of sociology, ideologies. The social and cultural infrastructure in general and social institutions in particular have an impact both on physical and human capital formation and on technology. The first step in accounting for differences in economic performance is to determine the extent to which factor accumulation and technological progress are responsible for these differences.

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The second step is to explain why both the level of technology and the investment rate (i.e. factor accumulation) vary across countries. The importance of institutions does not rely only on the fact that they encourage savings and investment. Good institutions are equally important for technological progress, fuelled by the innovative behaviour of entrepreneurs. This innovative behaviour in turn is dependent on ideas concerning new products and new ways of producing. In so far not only factor endowments but their productivity as well is related to differences in social infrastructure across countries. As Hall and Jones (1999:95) hold, this infrastructure is 'the primary, fundamental determinant of a country's long-run economic performance'.

Fourth, as mentioned, Hall and Jones mean by social infrastructure institutions and government policies that provide incentives for individuals and firms in an economy. From a sociological point of view ideologies are at least as important as institutions and policies. By ideologies I do not mean false consciousness, as in Marx, but world views or fundamental attitudes of mind towards reality that are typical of a culture or a civilization. I hold that no culture is more conducive to the spirit of technological (and social!) improvement than Western culture. This chapter is not the place for outlining its main features, so I have to confine myself to pointing to the central role inventions play in this cultural context. Getting rid of the past and turning to the future is typical of Western culture. To modernize implies to liberate from all forms of tradition. In Europe, writes Landes in his magisterial study of the wealth and poverty of nations (1998:57), 'a new sense of progress replaced an older, effete reverence for authority'. This new sense of progress was rendered possible by the strict separation of faith and knowledge that is constitutive of the Western attitude to reality. Separating the spheres of religious faith and scientific knowledge is a cultural precondition for the coming into being of a spirit of invention. Why, asks Landes (1998:98), 'this peculiar European *joie de trouver?* This pleasure in new and better? This cultivation of invention, or what some have called the invention of inventions?' Again, I lack the space to answer these questions thoroughly. However, any attempt to answer them will soon be involved in debates on the history of ideas and the peculiarities of European intellectual history. Without an intellectual movement stretching from the Reformation to the Enlightenment this culture of invention would not have been possible. 'Economists,' Mokyr (1990:171) criticizes, 'have traditionally been leery of *mentalités* as a factor in long-term economic development. In the budding literature on the economic rise of the West such factors have been ignored or curtly dismissed.' Sociology, as long as it was interested in the issue of economic development, certainly emphasized the role of ideas and mentalities. Max Weber's study of the religious roots of the spirit of capitalism is still a shining example for a study that places ideas centre stage. Yet if sociology cannot be blamed for being leery of mentalities it can be blamed for having dismissed the whole issue of long-term economic development.

Following Mokyr, the question why some nations are so rich and others are so poor boils down to the question why technological creativity occurs in some societies and not in others (1990:11, 151). Of course there is no single reason for this creativity. No doubt property rights play a key role in the process. They ensure that innovators can cash in on technological progress. Without guarantees that innovators can reap the fruits of their endeavours the necessary incentives to technological progress are wanting. But at least equally important are intellectual or mental developments. If one looks for an event that distinguishes the West from other major civilizations, a first candidate is the scientific revolution of the sixteenth century, centuries before the industrial revolution set in. Mental changes, observes Mokyr, are 'a natural candidate for the explanation of the technological take-off that took place in Western Europe (1990:171). Emphasizing the role of ideas and culture leads to a new view of total factor productivity. Whereas in previous research it was taken as a measurement residual to be minimized by further research, it has since been reinterpreted and has emerged as the key driver of economic growth. 'Ideas—scientific and engineering knowledge, R&D, expertise' Quah (2001:4097) notes, 'constitute the prime candidates for explaining TFP.'

So far I have stressed first that ultimately technological progress is the engine of economic growth and second that not only institutions (the rules of the game) but ideas, knowledge and ideologies (world views) are an important determinant of both factor accumulation and technological progress. Growth is mainly knowledge-driven. This implies that growth rates differ across countries because of the proprietary quality of knowledge. Now, the development of new ideas depends not only on the amount of time and money spent but on the institutional setting as well. So far I have left open what types of institutions are conducive to economic growth. Expanding a little on this question brings me to my fifth point. As far as institutions are concerned, the literature concentrates on the vital role of enforcing property rights. 'Social institutions to protect the output of individual productive units from diversion,' Hall and Jones (1999:84) maintain, 'are an essential component of a social infrastructure favourable to high levels of output per worker.' Suppressing diversion by private agents is a central task of the government, but, as Hall and Jones emphasize, the government must itself refrain from diverting. Examples of public diversion are expropriation, confiscatory taxation and corruption. The main form of diversion in the advanced countries is probably rent seeking (Hall and Jones 1999:84,96).

Be that as it may, property rights are not the whole story. The institutions of capitalism encompass more. Capitalism is an economic system in

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which private firms supply the majority of goods and services on markets. This approach, focusing on the firm as a social system striving to secure its survival by covering its expenses incurred in factor markets, out of its revenues yielded by product markets, can be traced back to Max Weber. It places the firm at the centre of the institutional structure that is constitutive of capitalism. A frequent mistake made in almost all the relevant literature is to identify capitalism with the securing of property rights. Certainly there is no capitalism without a system established to enforce property rights but the reverse of this contention is not true. Capitalism implies property rights but property rights do not imply capitalism. The latter is defined by a specific distribution of property rights, i.e. the monopoly of the means of production. Of course, one can describe a firm by referring to private property rights, but it is essential to see that those property rights are concentrated in the hands of proprietors and the managers they hire to act in their interests. It is not simply property rights but the monopoly of property rights in physical assets that is typical of a capitalist firm. A second typical feature is incomplete contracting. Contractual incompleteness, along with control over non-human assets, makes the substance of a capitalist firm. Control over human assets is based on control over non-human assets (cf. Hart 1995). An approach that places the firm at the centre of capitalist structure accords well with the idea that the pace of innovation depends substantially on the research and development decisions of the firm. Anyway, emphasizing the role of knowledge in economic progress implies emphasizing the role of firms in the process of innovation.

In an ideal-typical view of the market economy the proprietors or their agents are free to contract with the suppliers of factors. They contract if and only if they believe that contracting is favourable to the firm. To run a firm in a purely capitalist environment implies the absence of a lender of last resort that is willing to bail the firm out if it threatens to go bankrupt. A social structure characterized by the strict separation of ownership from non-ownership at the level of the firm (entailing two different forms of income, contract income and residual income), free contracting and selfreliance can be blamed for being authoritarian, if not exploitative. However, it is precisely suited to solve a central problem which socialism was unable to solve and therefore failed: the principal/agent problem of delegation and commitment typical not only of the relation between workers and the management but between management and the planning board as well.

Given that my description of the capitalist institutional structure encompasses the main institutional features of capitalism, it can be used to identify three main sources of variation of that structure: weakening the distinction between labour and capital, softening the budget constraint and limiting the freedom to contract. It then becomes possible to classify types or worlds of capitalism along these dimensions and to study their impact on economic performance. It has not yet been settled which type of capitalism is economically superior. Whether, for example, an economy performs better the more the freedom of contracting is guaranteed is an empirical question. For instance, Hall and Soskice (2001:21) distinguish between liberal market economies and coordinated market economies but avoid arguing that one type is superior to the other. They restrict themselves to stating that 'both liberal and coordinated market economies seem capable of providing satisfactory levels of long-run economic performance'. Though I sympathize with the idea that coordinated market economies perform in principle no worse than liberal ones, the investigation into the causes of income differences cannot end with it. No serious student of the impact of institutions on economic performance will be satisfied with answers of that kind. The challenge is to determine as precisely as possible which institutional features have what impact on growth.

In search of a solution to this problem it may be promising to change the formulation of the question. Instead of searching for the sources of growth it may be more fruitful to concentrate on barriers to it. This is the last point I want to make. Concentrating on the barriers to growth is a cogent research strategy if one assumes—as Parente and Prescott (2002) do—that the stock of usable knowledge is the same for all societies and that the latter differ only to the extent that domestic barriers prevent firms from making use of this knowledge. Concerning these barriers to growth, the 'usual suspects' mentioned in the literature are: first, a predatory state that entails a substantial risk of expropriation either by taxation or by disregarding property rights; second, rent-seeking behaviour encouraged by a political environment that privileges the securing of income opportunities via influencing legislation instead of engaging in productive activities; third, monopoly rights of employees who fear to lose in the process of technological innovation and, fourth, a culture that is inimical to innovation. The more the stock of usable knowledge is common to all countries the more cultural barriers to riches are relevant in explaining income differences. However, if there is no such common pool and countries differ in the extent to which they have access to knowledge that can be commercially exploited, then the question becomes, in the words of a leading theorist of endogenous growth, Paul Romer, 'In a developing country like the Philippines, what are the best institutional arrangements for gaining access to the knowledge that already exists in the rest of the world? In a country like the United States, what are the best institutional arrangements for encouraging the production and use of knowledge?' (1994:21).

In a country like the Federal Republic of Germany, I am inclined to add, the question is: how to mobilize sufficient support for a culture of technological innovation? The shrinking support for technological progress was already Parsons' (1972) concern in the late 1960s. He was

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afraid that especially the younger cohorts would refuse consent to an ongoing process of rationalization. It depends not least on consent to technological progress whether Germany can retain its living standards and standing among the economically leading countries of the world or whether it will fall back and degenerate to become an industrial museum. No matter whether the different use of a common pool of knowledge or different production rates of technological progress is the relevant variable, in order to explain differences in national income among countries a theory of total factor productivity is needed (cf. Prescott 1998) identifying the forces that either foster or hinder the creation of new knowledge. To develop such a theory is a task in which the endeavours of economists and sociologists can combine.

Notes

1 PPP stands for purchasing power parity. In international income comparisons it is now customary to convert the domestic currency into PPP dollars. The basis for this conversion is to calculate the number of domestic currency units to buy a set of products equivalent to what can be bought with one dollar in the United States.

2 For similar figures cf. Rodrik (2003), Barro and Sala-I-Martin (2003), Lucas (1988), etc. The reported values differ with the data base used (World Bank, *Human Development Report,* Maddison (2001) or Heston *et al.* (2002)) and the chosen year of observation.

3 A continuously growing capital with an initial value of $y(0)$ will after t years increase to $y(0)\exp(rt)$ according to the formula: $y(t)=y(0)\exp(rt)$. From this it follows that it doubles every log2/ryears. To check this, replace $y(t)$ through $2y(0)$, take logs of both sides and solve for t. Log2 is approximately 0.7. If $r=0.02$, t, the time it takes $y(0)$ to double, is about thirty-five years. If $r=0.07$, $t\approx 10$, etc.

4 Only Luxembourg outperformed the United States, but Luxembourg cannot be compared with the United States because of its tiny population. Wealth is measured by income *per capita*.

5 Whereas this question was still central to the sociology of modernization some decades ago (cf. Berger 2000), the discipline has in the meantime—owing to its 'cultural turn'—more or less completely abandoned it.

6 Economically the medieval age can be characterized by the predominance of agricultural production over the industrial and the service sectors. In the advanced countries the share of the agricultural sector in domestic product has fallen from about 50 per cent to below 5 per cent within one century.

7 The HDI includes three key components: longevity (measured by life expectancy at birth), knowledge (measured by literacy and years of schooling) and income (measured by PPP dollars *per capita*) which are combined to build an average deprivation index. Cf. United Nations Development Programme: *Human Development Report,* various editions.

8 Note that $\Delta y/y=\Delta Y/Y-\Delta L/L$. Equation (4) is chosen if no distinction is made between differently skilled workers. Of course calculations based on equation (6) explain much better the level and the growth rate of *per capita* income. In that case A, the measure of our ignorance, shrinks.

9 Another frequently used measure of investment in education in cross-country growth studies is mean years of education in the working population.

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10 For the purposes of this chapter I may ignore the distinction made in the literature between growth accounting and level accounting. In addition I leave out of account both the difference between income levels *per se* and *per capita* as well as the difference between growth accounting and growth regressions (cf. Temple 1999:120 ff.). Ignoring these differences does not bias the main results.

11 In this I follow Easterly and Levine (2001:9). However, the issue of whether factor accumulation or technology is the main proximate cause of national income differences has not been settled at all. Mankiw *et al.* (1992) maintain that about 80 per cent of cross-country income variation can be explained by investment, population growth and human capital.

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3

Business governance and the institutions of capitalism

Harold Demsetz

I

Governance problems have been much ignored by economists if judged by the history of economics after becoming a unified discipline. Partly this is because the corporation is central to the business governance problem, but the corporation did not become an important form of business until late in this history. More important than this, the task that was central to economics during its first 200 years suppressed the problem of business governance. This task was to understand the operations of an economic system in which the price system, not governance, guides resource allocation decisions. Indeed, it is the possibility of achieving a sensible allocation of resources without conscious planning of resource allocation that constituted the mystery of the market-based economy. As a tool for penetrating this mystery, neoclassical economics formulated a model of the firm that, for all practical purposes, concedes no real control to management. Prices, not managements, 'call the tune'. Management in this model consists solely of reacting to prices in ways that maximize the profit of the firm.

The institutional emptiness in neoclassical theory's formalization of the firm attracted attention here and there, but it took Berle and Means, in their book *The Modern Corporation and Private Property* (1932) to bring this forcibly to the attention of economists. They emphasized the considerable differences between the modern corporation and the firm of economic theory, whose closest empirical counterpart is the small, family-owned and managed firm. The corporation's diffuse ownership structure and its reliance on professional managers led Berle and Means to question whether maximization of firm profit can be the effective criterion of management that it is assumed to be in the firm of neoclassical theory. Issues of governance and malfeasance loom potentially large in the corporation, whose resources might be diverted from uses that serve shareholders to those that serve management. Berle and Means do not treat this as mere possibility but as fact, and this leads them to claim invalid neoclassical theory's conclusions about resource allocation.

II

The Berle and Means discussion of the separation between ownership and control in the modern corporation suffers from a nirvana fallacy. A real institution, here the modern corporation, is implicitly contrasted to the idealized firm of neoclassical competitive theory. The modern corporation is then judged to undermine efficient resource allocation because it compares poorly to the idealization. On this faulty reasoning, one could believe that capitalism has made a mistake in being so accepting of the modern corporation. However, the idealized firm of neoclassical theory faces no risk or expertise problems, whereas the modern corporation exists because it helps to mitigate these problems. The importance of risk to investors makes the abstract firm of neoclassical economics irrelevant as a standard by which to judge the impact of the corporation on the efficiency with which resources are allocated.

The corporation's advantages are no secret. It allows the individual investor to share in the equity of a firm without requiring the investor to commit a large sum or to become involved in the firm's operations, and it enables the investor to protect uncommitted capital from liabilities that the firm may acquire. None of these advantages accrues to investors in the equity of proprietorships and partnerships. Additionally, shares in corporate equity trade easily, and trade more easily the larger is the number of investors who own stock in the company. These properties of corporate shares make maintenance of a diversified portfolio easier for the investor, allow the investor to specialize in matters other than the managing of the corporation and in which the investor is more expert, free capital not committed to the corporation from liability incurred by the corporation, and more easily alter the equity holdings of the investor through the operation of markets that, generally, are very active. Very many investors and potential investors would be made worse off and would choose not to hold an equity stake at all if the corporation, or something like the corporation, did not exist.

Not only management entrenchment problems but also solutions to risk and expertise problems flow from diffuse ownership of the modern corporation. This ownership structure necessitates the delegation of authority, and not only because, as a practical matter, this facilitates business decision making as compared to involving thousands of uninformed shareholders in the day-to-day operations of the firm. Delegation also arises as a means for limiting the liabilities that might otherwise occur from the corporation's business dealings. It is unlikely that investors could be relieved so easily of these liabilities if they were directly and actively involved in the business decisions that resulted in the creation of them. Limited liability requires operational distance between shareholders and the day-to-day business dealings of the corporations in which they own stock. No doubt, this is one reason for boards of directors, one function of

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which is to insulate shareholders from the charge of being responsible for a corporation's debt. Management entrenchment problems result, but the degree to which they are present generally imposes costs on shareholders that are smaller than those that would arise from a greater liability burden.

Far from being failed experiments of capitalism, the corporation and the organized capital markets that serve it rank high among capitalism's great innovations. And capitalism itself, in at least three ways, reduces the cost of the governance problems that come with the corporation: (1) stock prices adjust to account for known or suspected governance problems, (2) market institutions arise to help investors become informed about the severity of governance problems, and (3) capital markets provide investors with a wide variety of ownership structures from which they may choose investments that correspond to their preferences in regard to trade-offs between control, on one hand, and risk, liability, and liquidity, on the other hand.

Stock price adjustments. Price adjustments that reflect abnormal governance situations make it profitable for investors to uncover these abnormalities and to seek to remedy them, sometimes by way of hostile take-overs. These price adjustments have been quite dramatic in recent years, reducing stock prices by 90 per cent for corporations involved in contemporary severe misdoings. And, during the decades of the 1980s and 1990s, hostile take-overs have had a profound effect on business organization. The 1980s marked the beginnings of a strong response to management entrenchment problems that had emerged after the Korean War. Over half of all major US corporations became targets of hostile take-over bids early in the 1980s, and many other corporations restructured just to keep from becoming a target.1 The take-over movement was so successful that managements of the largest US corporations began to petition state governments for protection from corporate 'raiders'. The battle between the transforming force of markets and the conserving force of politics is evident here.

Information providing institutions. Market institutions that provide information about the quality of management are an aid to the process of price adjustment but are distinct from it. Such information has always been part of the product of investment analysts, but other sources of information are possible and these will receive greater emphasis now that conflicts of interest within the community of investment analysts have surfaced. At the time of writing, for example, a new effort is being made by Institutional Shareholder Services, a proxy advisory group to institutional investors. ISS now ranks corporations on governance quality, for example, by noting the existence of 'poison pill' amendments to the corporation's governance structure or by ascertaining the 'appropriateness' of the level of CEO compensation. A poor ranking can be transformed into a good ranking if a corporation alters its governance arrangements to accord with the standards used by the ISS.

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Variety of investment opportunities. The third way in which capitalism reduces governance cost, variety of investment opportunities, is not so widely understood. Variety of investments properly includes the different categories of investment instruments, such as bonds, mutual funds, savings accounts, and real estate, but in this chapter, so as to retain a focus on the corporation, a narrower construction of variety is used; this includes only investment offerings within that single category of investment we call common stock. Different corporations present investors with different mixtures of governance quality and liquidity of investment. People can choose to purchase shares in corporations that have highly concentrated ownership structures; these corporations, because ownership is concentrated, generally control management effectively but provide less liquidity of investment. Or, people can purchase shares in corporations with very diffuse ownership structures, which tend to offer less control of management but high liquidity of investment. Investors can reduce the real burden posed by the corporation's governance problem by purchasing corporate stocks that, in combination, best fit the personal weights they give to the comparative importance of governance quality and investment liquidity. A well working economic system offers a set of investment opportunities that is rich in the variety of trade-offs between these characteristics of stocks. This provides a significant means by which the real cost of misgovernance is reduced. Investors who, because of wealth, personality, and obligations, find misgovernance very costly can reduce the probability of bearing this cost; investors who do not find misgovernance so costly can increase the probability of enjoying liquid markets for their investments.
The degree of diffuseness in ownership structures can be measured by the percentage of shares owned by a corporation's five largest shareholding interests. A 1975 sample of 411 *Fortune* 500-type US corporations, examined by Demsetz and Lehn (1985), shows great variation in the structure of corporate ownership structures available to investors. The percentage of shares owned by the five largest shareholders varies from a low of 1.27 per cent to a high of 87.14 per cent (with a mean value of 24.81 per cent). Investors have a rich set of different combinations of investment liquidity and governance quality from which to choose, and this set is larger if capital markets are defined on a worldwide basis. The diffusely owned corporation has competed successfully for investor funds in the presence of competition from corporations having more highly concentrated ownership structures, indicating that many investors value investment liquidity highly when making their portfolio choices.2
Capitalism's investors also wield vote-casting power for the corporations whose shares they own. This can be used to affect the severity of some of the governance problems they face. Among other things, the vote franchise affects the degree of diffuseness in a corporation's ownership structure. A majority of votes cast by shareholders, for example, is needed

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before management can increase the number of authorized shares. Majority approval also is needed if a corporation is to repurchase 20 per cent or more of outstanding stock. Since number of shares outstanding generally correlates with number of shareholders, these requirements give shareholders, or at least a majority of shareholders, a way of influencing ownership structure. Majority approval is also required before a friendly merger is consummated. Even a hostile take-over, if it is to succeed, needs the tender of shares by a substantial number of target company shareholders, often the holders of 50 per cent of outstanding shares. Mergers and hostile acquisitions, should they succeed, are likely to alter ownership structures in predictable ways. Target company shareholders also can affect the outcome of an attempted take-over in other ways, by acquiescing to or rejecting super-majority amendments, poison pills, and other devices that alter the costs and benefits of a take-over.

For virtually every firm there comes a time in its history when its shareholders must decide on the future shape of the firm's ownership structure. No firm begins life with a diffuse ownership structure. Instead, a few large shareholding interests dominate ownership of a young firm. These interests will have been involved in the firm's beginning and early development. Representing a majority of votes, they have the legal power to determine the degree to which the firm will raise additional equity capital in the public market. That some firms become diffusely owned as they develop, and others do not, means that controlling shareholders in these firms have judged their opportunities differently, but it also means that they have been able to affect ownership structures.

Of course, different countries offer different variants and mixtures of responses to governance problems. These compete with each other in worldwide markets for capital and goods, and this competition is bound to weed out some of these responses to governance problems. Until just recently, for example, German policy had been to constrain the arrangements that would have been formed through market processes by giving legal standing in corporate decisions to constituencies such as employees and communities. Politics surely played a role in this, but so, also, I suppose, did a belief by some that corporate decisions fail to take account of all persons affected by these decisions. I do not engage in debate about this here except to note that every action fails to take account of all persons, even this policy. The inflexibility the policy imposed on corporate decision making and the concern it gave to how a 'pie' is to be shared instead of to how large the 'pie' is to be weakened the competitive ability of the German economy on worldwide capital and goods markets. Lack of competitiveness has led to abandonment of some provisions in this policy. Of course, an alternative desired by some would be to erect barriers to exchange across worldwide markets for capital and goods, but such isolation, while helping some, would impose much greater harm on the German population as a whole.

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The non-political responses to governance problems described above have been identified by me as a reflection of capitalism, and surely they are. In terms of taxes paid and benefits received, and as a matter of principle if not practice, citizens in a socialist economy are joint owners of state firms, but they have no quality rating agencies that market information about governance, they cannot pick and choose which state firms will, and which will not, be in their personal investment portfolios, and they cannot benefit from price information or from a wide variety of ownership structures. Citizens of socialism are necessarily invested in the entire spectrum of state firms, not some sub-set that better matches their preferences. They cannot divest themselves of ownership, and, so, they are unable to choose that combination of risk, liquidity, and governance quality that best fits their preferences. The burden of misgovernance in state firms is therefore greater than if investor choice could exist. It should be noted that state firms are not without misgovernance.

III

Business news stories in several parts of the world indicate that governance problems persist despite the protections provided by capitalism's institutions, but, of course, these institutions even if working smoothly cannot do away with risk and uncertainty. Investors who seek equity investments of a highly liquid sort will invest in firms with diffuse ownership structures and, as a result, will face a (chosen) higher probability of misgovernance. Some of today's management behaviour fits the Berle and Means concept of misgovernance. Extremely high compensation and consumption of corporate 'perks' have occurred in a few instances, and these do conform with Berle and Means's expectations. These instances, however, represent a minority of the business problems being discussed. Most of the practices alleged to have taken place since 2000 do not fit the Berle and Means concept of misgovernance very well. Their concept is of a management that abuses shareholders in the way it uses corporate assets. Most contemporary misbehaviour by management does not suggest attempts to abuse shareholders. The misinformation that has been involved in contemporary problems targets the financial analyst, the business press, creditor institutions, and the general investment public. The purpose was to maintain share price and keep lines of credit open. In some cases, management itself owned many shares, but the main beneficiaries of these misrepresentations, to the extent that they succeeded, would have been the corporation's shareholders, or, at least, most of them. It is true that the creditworthiness of the firm would be undermined if the larger investment community became aware of the deception, and that this would have harmed the firm's shareholders. It is also true that some shareholders of the involved company might have based decisions about buying more stock on the basis of misinformation. Still, it was not management's intent either to be caught or to feather its own nest by fleecing shareholders. Indeed, I wonder just how many shareholders might have objected to these misrepresentations if they had believed they would remain undiscovered.3

The alleged misconduct that comes closest to fitting the Berle and Means concept of misgovernance is the high level of compensation received by several top management people. Part of this compensation, in some cases, came in the form of high explicit salaries, but another part, and that which has been objected to most, came as returns received by management from the ownership and sale of stock options. The take-over movement of the 1980s and 1990s sparked the adoption of compensation plans that tied management compensation to share value, the object being to give management a strong incentive to work for shareholders. No doubt there was and is room to improve such plans, perhaps by requiring that management hold the options they receive for a suitably long time. However, the principle of using options does not itself stand as an example of corporate misgovernance. Quite to the contrary, it is an example of how misgovernance might be overcome by providing incentives for management to serve shareholders. Had stock options and other methods of tying compensation to stock prices yielded normal returns, the practice would not now be discussed as misgovernance. The basis of the charge of misgovernance, then, is the excessiveness of the compensation so received. In this respect, option compensation is not different from excessive salary compensation.

Two views of these excess returns yield different judgements about stock options. One view is that management sought and acquired stock options because it knew with a fair degree of certainty that future business conditions would, in the short run, raise the value of these options to levels that would yield extremely high returns. On this view, the use of stock options involves the bilking of shareholders by management and fits the Berle and Means notion well. The second view is that, looking forward, option-based compensation was not thought likely to yield excessive returns, and that it certainly would not have done so if the stock market had behaved normally. But the stock market behaved abnormally, rising unexpectedly rapidly and carrying the value of options with it. On this view, the bubble in stock prices, and not corporate misgovernance, accounts for the high return on stock options. After all, simultaneously, shareholders also were enjoying unexpectedly high returns on their shares.

The stock market bubble of the late 1990s is implicated in much of the misbehaviour of which management is being accused. An abnormally large part of personal wealth stood on these high stock prices. Stability of these prices became atypically important to a wide variety and large number of people, including management, shareholders, and the general public. The reward to be expected from successful promulgation of rosy images of corporate conditions, putting debt in off-balance sheet subsidiaries, and dumping of options in anticipation of worsening conditions became quite large. This does not excuse such behaviour, but it explains it without recourse to a decline in moral standards. Just as a steadfast moral standard leads to an increase in bank robberies if bankers keep more cash in their vaults, so a constant standard of morality among business managers leads to an increase in corporate misdoings if stock prices underpin a larger fraction of personal wealth. Of course, it might also be that more people did reduce their standards of moral behaviour. Perhaps boom times have this effect. Similar behaviour occurred during the stock market bubble of 1928–1929.

The institutions of capitalism, as discussed in preceding sections, reduce the costs associated with the Berle and Means type of governance problem. Do they also reduce the severity of contemporary-type governance problems? Reputational capital is at risk in these governance problems. Furthermore, there is a positive pay-off to uncovering these misdeeds, especially to members of the 'supply side' of capital markets. Private parties, in fact, have been much involved in the initial discovery and revelation of contemporary management misbehaviour. It is none the less true that the scoundrels will always be with us, not only in business, but also in government and family. But there is an important difference between the institutions of capitalism and those of government. It is probabilistically possible in both to grow wealthy in deceitful ways. Honest, competent behaviour, whether in government or business, yields promotion, higher salary, and respect; in this, there is no discernible difference in the encouragement given to honest behaviour. But capitalism, unlike socialism, allows and encourages private retention of profit honestly won. This permits people to become wealthy without recourse to deceit or illegal dealings. This honest pathway to great wealth has no counterpart in the institutions of socialism, since profit or economic rent cannot be retained legally by the individuals who are responsible for having created it. To become very wealthy within the institutions of socialism virtually requires illicit dealings. This suggests that capitalism is less prone to misrepresentation and deceit than is socialism.

IV

The response in the United States to contemporary business leadership problems has been varied. Where fraudulent dealings and representations are involved, indictments have been brought. Charges of insider trading and demands for restitution of funds have been made. In these instances, we are dealing with alleged violations of existing law. Other managerial practices violated no law and did not lead to indictments. Instead, changes have been made in law and in listing standards. Most prominent among these in the United States have been the major provisions of the

Sarbanes-Oxley Act and the new standards for listing that have been set in place by the NYSE and NASDAQ. Sarbanes-Oxley imposes new requirements that directly affect top management and that impose new organizational requirements on corporations. Top management is subject to a pay-back requirement for personal compensation received from bonuses and stock sales if received during a twelve-month period that follows a revision of a financial report if the revision has been made necessary because of misconduct in the gathering and presenting of the data contained in the report. The pay-back provision triggered by misconduct in the reporting of financial statements can have a perverse effect on management behaviour by discouraging revision of financial reports for fear of triggering the pay-back provision. Fraudulent reporting, it should be noted, had already been punishable at law. Additionally, insider trading is made more difficult by a requirement that management report sales and purchases of own-company stock within a shorter period following the transaction.

The Sarbanes-Oxley Act also demands that auditor and compensation committees be composed of directors with no other connection to the corporation. The hope here is to reduce the likelihood that these committees will conduct themselves on behalf of management instead of serving shareholders. Whether, in the long run, this will make these committees responsive to shareholder interests remains to be seen. There is a risk in this provision of Sarbanes-Oxley that management will be deprived of the advice and services of board members who, because of affiliation with the corporation in other capacities, are knowledgeable about the firm's problems and operations.

Taken in its entirety, the Act is likely to reduce needed revisions of financial reports even while it reduces misconduct in their preparation. It remains to be seen whether the reconstituted compensation committees will much alter levels of management compensation. The larger degree of independence of auditor committees is likely to bring higher standards to bear on financial reports in the short run, but one may doubt that this independence can be maintained in the long run, and, if it can be, how it will be used. After all, committee members with no other affiliation in the corporation they serve might still be close friends of top management personnel or might receive a wide variety of benefits outside the corporation for serving the interests of top management.

The New York Stock Exchange and NASDAQ have changed their standards for listing, requiring firms that seek listing to have a majority of independent directors on their boards and to have independent directors play a more important role in the compensation and nominating committees. In addition, shareholders are required to approve most equity compensation plans. It does not seem to me that this adds much to Sarbanes-Oxley. More potent would be an institutionalized threat to delist firms found guilty in court proceedings or in SEC decisions of violating reporting requirements or of abusing accepted rules of governance behaviour.

It is worth noting that neither these changes in listing standards nor the provisions of the Sarbanes-Oxley Act affect the ownership structure of corporations. Perhaps this is to be expected, since the misdoings they address are not, in the main, a result of diffuse ownership. Management behaviour is the target, not management entrenchment. Measures that could affect management entrenchment would be of an entirely different sort. A leading example would be the rejection by corporate charting states in the United States of legislation whose objective is to create impediments to hostile take-overs. Another example would be legislation that reduces the legal barriers that now make it difficult for mutual funds and insurance companies to take a large position in the equity of a specific corporation. The Sarbanes-Oxley Act could have reduced the extent to which ownership and control are separated if it had endorsed such measures, but then it would stand accused of not dealing with the problems that appear at the centre of the current uproar about management behaviour.

A more thorough consideration of the management entrenchment problem would bring to light some considerations that at present seem unrelated to entrenchment, but which, in the long run, offer more enduring remedies. A discussion of three such considerations concludes this chapter. They involve business tax policy, insider trading, and wealth distribution.

Business tax policy. A doubling in 'degree of diffuseness' of a firm's ownership structure, other things remaining the same, will reduce the typical shareholder's share of the profit/loss residual by 50 per cent. As a result of this reduction, the typical shareholder will make only one-half the effort he or she would otherwise have given to improving the quality of management. The same result follows if a 50 per cent tax is levied on corporate profit. Measured in terms of shareholder effort to improve management, the 50 per cent tax is equivalent to a doubling of the diffuseness of a corporation's ownership structure.4 Unincorporated and incorporated business firms experience the same incentive effect if subjected to the same tax.

In the United States, corporations are double taxed, in that the corporation itself and dividend receivers both pay taxes on, respectively, corporate profit and corporate dividends. A reduction or elimination of the tax paid by dividend receivers, but not of that paid on profit by the corporation itself, has a special effect on corporate governance. It creates pressure on corporate management to retain less of what is earned and to pay more to shareholders. This removes resources from management's control and puts them in shareholder control.

Corporate governance is improved in two ways by a reduction in the tax on dividends. First, there is greater incentive for shareholders to monitor and police management, because each dollar wasted by management that could have been paid out as dividends is worth more to shareholders. Shareholders, therefore, will monitor management more carefully. Second, there is greater incentive for management to pay out a larger fraction of earnings as dividends, thus reducing the resources that remain in management's control. The tax bill offered by President George W. Bush contains a provision that there be no double taxation. If passed, this would eliminate the tax on dividends. Though not much discussed, the effect of this would be to improve corporate governance.

Insider trading policy. Shareholders who have large stock holdings in a single corporation are strongly motivated and better able to monitor and control management than are minority shareholders. The presence of such shareholders, called blockholders, reduces the degree to which management is entrenched. However, blockholders are burdened with greater firm-specific risk than are minority shareholders and also with more involvement in the corporation's policies and business practices. If all shareholders receive the same return for the investments they make there is no reward for bearing the special costs that come with a blockholder stake. Hence, if a supply of blockholder investors is to be attracted, there must be some means of differentiating between them and minority shareholders in terms of return received on investments made. A special compensation to blockholders seems to be absent; large and small share holdings receive the same dividend per share and, for shares bought or sold at the same time, receive or pay the same price. However, the needed differential return comes to blockholders in the form of access to inside information, for, by virtue of their voting strength and large financial stake, they have access to valuable information not also available to minority shareholders. The degree of access, moreover, will correlate with the size of the ownership stake taken by an investor. This information enables blockholders to better time trading in their company's stock and in the stocks of firms that supply to and purchase from their company. In this way, they receive compensation for bearing firm-specific risk.

The fact that insiders do better than outsiders when trading stock is well documented. Not generally recognized, however, is that this access to insider information, by making corporate ownership structure less diffuse, makes corporate management more responsive to the interests of shareholders. Insider trading profit can be viewed as the compensation offered by minority shareholders to majority shareholder for bearing firm-specific risk and costs of monitoring and disciplining management. To the extent that responsiveness to private owners is viewed as the pathway to socially desirable allocations of resources, as it is by Berle and Means, insider trading, in this respect at least, serves society. Of course, insider trading has other effects, some of which may not be socially beneficial, but empirical work (Demsetz 1986) shows that corporate ownership structure is more concentrated in those firms that by the nature of their business environment are more in need of careful monitoring and disciplining of management. Effective policies against insider trading make the corporate governance problem more, not less, severe.

Policies towards wealth and its distribution. The degree to which an investor sacrifices diversification by holding a non-trivial fraction of a corporation's shares is dependent on the size of the companies in which the investment is made and also on the private wealth of the investor. The larger is an investor's wealth, the smaller is the degree to which this wealth must be concentrated in order to take a controlling position in the ownership structures of a few corporations. Holding other relevant conditions constant, and abstracting from wealth transfers between nations, it follows from this that high *per capita* wealth countries are those in which corporate governance problems can be ameliorated at less risk to those who take controlling positions in the ownership structures of firms.

The severity of the corporate governance problem, then, is a function of wealth, and, as we shall see, of the distribution of wealth also. Public policies that affect a nation's wealth, and its distribution, also affect the severity of the corporate governance problem. In the United States, as mentioned above, the five largest shareholders, irrespective of shareholder type, own about 25 per cent of the equity for *Fortune* 500 size firms. Institutional investors, such as mutual funds, account for a portion of this, but institutional owners may have governance problems embedded in their own organizations. Setting institutional investors aside, the five largest individual and family shareholders own about 10 per cent of outstanding shares for *Fortune* 500 size firms.5 A calculable fact is that the aggregate net wealth of five families in the United States would be woefully inadequate to the task of owning 10 per cent of the shares *of Fortune* 500 firms if wealth were distributed equally in the United States. An egalitarian distribution of wealth, even in wealthy countries, simply is incapable of sustaining effective control of professional management by shareholders for corporations that must be large to be competitively viable. Some non-trivial degree of inequality in the distribution of wealth is required.

Extreme inequality of wealth also compromises a country's ability to resolve business governance problems. Persons possessing an extremely large fraction of a country's wealth, such as large landowners once enjoyed in some South and Central American countries, simply cannot manage this wealth effectively because they lack both time to manage so much wealth and knowledge of the many different investment opportunities that would need to be tapped if risk is to be reduced. Employing others to help manage this wealth, perhaps by lending it to others, introduces its own governance problems.

Somewhere between an egalitarian and an extremely unequal distribution of wealth is a distribution that is best suited to the task of resolving the control problems of large firms. The larger is *per capita* wealth the less unequal is this 'best at control' wealth distribution. A poor nation that insists on an egalitarian distribution of wealth burdens itself with insurmountable business governance problems if it insists on having firms whose worldwide industries require large size to be competitive. The best opportunities for such a country lie in small-scale manufacturing, farming, and retailing, or in allowing wealth from citizens of other countries to flow into corporations. Free-flowing capital markets offer significant and quick relief from problems of controlling large enterprises in countries suffering from great poverty, but their use requires overcoming biases against ownership by foreigners.

Wealth considerations also help explain ownership structures that we observe in cross-country comparison. High *per capita* wealth in the United States, in combination with a legal system that gives good protection to minority shareholders, has two effects. First, wealthy persons more easily can take blockholder positions in very large firms. Second, other persons, not normally thought of as wealthy but who, none the less, are not poor, are willing in larger numbers to take minority positions in corporations. The increase in numbers of such persons has the effect of making share ownership more diffuse. Thus, large block holdings whose owners can exercise influence on management and who can compete with management for the support of minority shareholders are combined with a large number of small shareholding positions. This combination is reflected in the skewed distribution of share holdings in the United States. In contrast, in South and Central America, lower levels of wealth and less effective protection of minority shareholders keep the not so wealthy from participating heavily in the ownership of corporations. The result is ownership based on block holdings by members of families who founded the business firms. *Per capita* wealth in Italy during the post-World War II period, for example, has been smaller than in other major Western European countries; wealth distribution has also been more egalitarian than in many Western European countries. It is no surprise to find that Italy's economy has smaller firms than other Western European economies.

Notes

1 See Jensen (1993). Debt was used on a large scale to finance these acquisitions. This became a debt of the acquired firm if the take-over was successful, the effect of which was to compel it to pay interest to holders of this debt, usually to those who had launched the take-over. This deprived management of retained earnings that might have been squandered.

2 See Barca and Becht (2001) for a collection of studies of corporate ownership structure in Europe.

3 I say 'most' shareholders because there must have been some who contemplated the purchase of more shares or the sale of shares already owned, or who simply rejected overly rosy or overly pessimistic assessments. These could have been harmed.

4 This does not carry over to a weakening of voting power, as would come from doubling the number of shares.

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5 Percentages are larger in advanced European and Japanese corporations, but I have no good explanation for this.

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4

The role of governance in diversity and change within contemporary capitalism

Colin Crouch

Neo-institutionalist analysis of forms of capitalism has contributed much to our understanding of different forms of economy. In establishing itself it has had to acquire two characteristics, which it must now start to transcend. These are: a tendency to dualistic analysis, and an insistence that empirical cases of national systems constitute coherent wholes. Moving beyond these positions will enable neo-institutionalism better to model the extent of diversity among capitalist economies, and to account for major change within them. Below I suggest that this can be achieved through an approach to compound forms of economic governance.

The former characteristic—the tendency to dualism—was probably needed if the idea that all capitalist economies would tend towards a neoclassical form—the hegemonic contention of neoliberal political economy that the institutionalists found in their path—was to be contested. If the neoliberal model was conceded to be one form of actually existing capitalism, then it was enough to identify one other viable form in order to make the case for diversity. Moving beyond this position involves not only entertaining a broader range of forms of capitalist economy, but also relativizing the place of the neoclassical model within it.

Insistence on coherence is more complex. It considerably helps macrosocial analysis of an economy if it can be shown that certain kinds of similarity can be found among institutions within it. These emerge from the way in which 'a given set of national, regional or sectoral institutions tends to create equilibrium forms of firm behaviour, combined with a broader set of factors that include the presence of specific public policies, social coalitions and socio-economic conditions' (Hall 1999). For example, Streeck (2001) proposes that German and Japanese capitalism are distinguished from the Anglo-American variety by their distinctive *and linked* financial systems, corporate governance, worker citizenship, approaches to employment, welfare states, industrial relations, training and wage distribution. There is, however, also evidence of *contrast* among institutions; of forms of complementarity whereby characteristics of one institution 'balance', by contrasting with, or remedying the onesidedness, of another. It should be noted that I here use 'complementarity' in the way that it is used in ordinary speech and in the natural sciences; in much recent neoinstitutionalist literature there has been a disconcerting tendency to use the term to refer to both contrast and similarity.1

Both logics—of similarity and of complementarity—clearly exist, and particular empirical *ensembles* combine elements of both. The logic of complementarity is that certain efficiencies are achieved when balancing or contrasting characteristics are found alongside each other: the advantages of the mongrel over the pedigree animal. The latter has heavily reinforced characteristics, which means that vulnerabilities are exaggerated, while the mongrel avoids such reinforcement and may therefore appear more 'balanced'. At the same time, of course, the pedigree animal, precisely because it has exaggerated characteristics, does some things particularly well. Animals used for specialized performance tasks, like racing, are always pedigree. Both types of animals offer advantages, but they are different types of advantage. The same may be true of ensembles of institutions. Those based on balanced complementarities may be adept at certain activities; those based on similarities at others. And societies (unlike animals) not being tightly coordinated organisms, can have both characteristics simultaneously.

There is a danger that theory builders will use whichever of the two logics makes the most convincing story. Since the two forms are (in the strictest sense!) complementary, one or the other can always be employed, giving an impression of an explanatory achievement when all that has been done is a labelling exercise. This usually happens because they construct their models by working from a small number of empirical cases which they regard as paradigmatic, and embed its characteristics—which contain a complex mass of similarities, complementarities and mere accidents—into the theoretical type. They then present an overall account which looks plausible but which is not vulnerable to counterfactual test.

This risk is avoided if one always follows Weber, who argued that an ideal type should be developed as a 'one-sided accentuation' of logically implied characteristics, representing the imposition of a single rationale, *from which of course it is fully expected that empirical cases will diverge*. This does not permit mixing the logics of similarity and complementarity. It also requires a separation between the logic of structures, such as is involved in the construction of an ideal type, and the logic of actors' interests, which may be far less 'pure'. Complementarities then need to be analysed separately and added to the account.

What we therefore now need in neo-institutionalism is a framework of ideal types that we can apply to empirical cases, not aiming to reduce these to dualism if we have good reason to believe that a larger number of types is involved. We should also not decide *a priori* that an individual case must be characterized by institutional isomorphism, as space must be left for the principle of complementarity. Further, we should escape the polemical need for ever to engage in a polemic with neoliberalism, which

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is not a scientifically driven need. We should be driven by the logic of theory construction and its encounter with data, not political debate.

A new approach to institutional analysis

Institutions can be seen as endowing actors within them with certain capacities. The number of capacities relevant to a particular activity is an empirical question, but whether a particular capacity is present is a simple binomial matter: it is present or absent, 1 or 0. These capacities exist across various different fields. Where there is similarity, the pattern of capacities is the same across different fields. Where there is perfect complementarity, the pattern in the complementary set of fields is exactly the reverse of that in the initial set. Where there is partial complementarity, the pattern in the complementary set merely varies in some manner from the initial set, but it has to be a manner that actors find useful, otherwise the linked demand for the two sets of institutions necessary to the economist's concept would not be found. For example, as in the accompanying tabulation.

Context I′

Field	*Capacity*									
	1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*
F1	1	1	0	0	1	1	0	0	1	1
F2	1	1	0	0	1	1	0	0	1	1
F3	1	1	0	0	1	1	0	0	1	1
F4	1	1	0	0	1	1	0	0	1	1
...										
Fj	0	0	1	1	0	0	1	1	0	0
...										
Fk	1	1	0	1	0	1	0	0	1	0

Here, field *Fj* provides perfect complementarity in the sense of compensation for fields *F*1–4. Field *Fk* provides partial complementarity if actors find it useful to combine it with fields *F*1–4. If they do not find it useful, it may nevertheless be a redundant resource that becomes part of a future complementarity.

Links and barriers

In the interest of parsimony we start a modelling process by hypothesizing a strain towards isomorphism across fields and sub-fields within an identifiable context. Such a hypothesis is plausible if we can demonstrate the existence of unifying factors working to achieve institutional homogeneity within a bordered framework. In the case of presumed 'national systems', the main examples of bordered frameworks used in the literature, state policy and national legal institutions provide such plausibility. These unifying factors produce strong links between institutional forms: for example, ensuring that a neoliberal corporate governance system is paralleled by a neoliberal labour market regime. It follows from this hypothesis that complementary institutions, those following a different structural logic and providing different patterns of competences, can exist only when there are identifiable barriers which protect them from the dominant linking, homogenizing forces. It is therefore an important research task to identify any such barriers. We should expect to find institutional entrepreneurs at work trying to forge and break both links and boundaries in order to insert elements of complementarity that will improve the range of capacities available to their institutions.

We cannot predict *a priori* where links will be at their weakest, or where barriers will exist; they may be quite arbitrary, historical accretions. But we can specify some likely sources, and identify both diffusion mechanisms and barriers. First, to the extent that we can order fields of institutions as being at some kind of 'distance' from each other, we can hypothesize that diffusion is more likely between proximate complexes than remote ones. (For example, we should expect to find more strains towards similarity between the structure of the financial system and that of the labour market than between the former and the structure of religious life.) Second, if it can be established that the patterns found in some fields (or even subfields) are more 'powerful' than those in others, we should expect pressures for diffusion from the powerful to the powerless. 'Power' might here refer to the resources that can be wielded by the interests dominant in certain (sub-) fields, or it might refer to majority against minority situations. For example, behaviour favoured by the authorities within stock markets is likely to be more influential than that favoured by sport authorities.

To model this more formally, let us assume that, in a particular case, all fields share some patterns of capacities, but they vary across others. To express this more formally in the following diagram: all fields *F*1–7 share pattern *P′* (1 1 0 1 1 1 0 0 0 1) across capacities *C*1–5, but while fields *F*1–5 continue with this pattern for capacities *C*6–10, fields *F*6–7 here follow pattern *P″* (1 1 0 1 1 0 1 1 1 0).

Context I′

Field	*Capacity*										
	1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*	
F1	1	1	0	1	1	1	0	0	0	1	*(Linked by diffusion mechanism 1*
F2	1	1	0	1	1	1	0	0	0	1	
F3	1	1	0	1	1	1	0	0	0	1	
F4	1	1	0	1	1	1	0	0	0	1	
F5	1	1	0	1	1	1	0	0	0	1	
F6	1	1	0	1	1	0	1	1	1	0	Institutional barrier *Linked by diffusion mechanism 2*
F7	1	1	0	1	1	0	1	1	1	0	

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The role of governance

The mechanisms by which the predictability and regularity fundamental to institutions are ensured are those of their governance (see also Lütz 2003). It is therefore the literature that provides us with typologies of governance that provides us with the elements of a differentiated account of institutions. I shall here use the typology that originated in the study of the US economy by Campbell *et al.* (1991). This was further formalized by Hollingsworth and Boyer (1997) and by Hollingsworth (2002). It concentrates on the following modes of governance: market, hierarchy, association, community, network and state. Following Van Waarden (2002), I want to distinguish further between two different state governance modes: the substantive state (which develops its own policies for intervening directly in economic processes) and the procedural state (which maintains and enforces a system of private law whereby social actors can enforce contract procedures on each other).

We can hypothesize that different modes are associated with specific sets of capacities. If, as above, $C1-j$ is a series of combinations of positive and negative positions *(P′)* on a number of potential capacities within a given field *F*1, we may treat form of governance *G′* in the same way that we did institutional context *I′* at the outset: as a coherent and enduring guarantor of a certain structure of capacities. Looked at another way, it is the fact that *I′* is dominated by *G′* that it possesses *P′;* and the fact that *I″* is dominated by *G″* that it possesses *P″,* as in the accompanying tabulation.

Context I′

Field	*Capacity*									
	1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*
		Governance mode G′								
F1	1	1	0	1	1	1	0	0	0	1

Context I″

Field	*Capacity*									
	1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*
		Governance mode G″								
F1	0	1	0	1	0	1	0	1	1	0

We need next to analyse each governance mode itself. We can do this: (1) by defining these in terms of certain abstract characteristics, which they either possess or not (i.e. a binomial approach to definition); and (2) by hypothesizing that, where a specific form of governance exists, it operates over all fields. Therefore the set of capacities becomes a set of

Context I′ Characteristics of governance mode

	Capacity									
	1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*
All fields	1,0	1,0	1,0	1,0	1,0	1,0	1,0	1,0	1,0	1,0

binomial possibilities, and if a pattern is valid for one field, it is valid for all, leading to the following arrangement. In a separate exercise, these characteristics need to be linked theoretically to hypothesized capacities, which can then be subjected to empirical test.

The principal forms of governance

The characteristics which will be considered here are those which would affect the behaviour of a firm existing within the domain of the governance mode. The activities of a firm in relation to its external environment can be modelled simply in terms of its acquisition of resources, its utilization of them while it is engaged in this task of adding value, and its subsequent disposal/distribution of them. Before they are shaped by any institutional processes and governance regimes, resources exist potentially in a public realm, or do not exist at all. The capitalist firm needs to make these resources private, so that it can use them for profit-making activities. The standard way in which this happens in pure models of capitalism is for the resources to be commodified, that is, turned into a form that renders them purchasable, and, in a separate move, turned into private property. This property is then fashioned by the firm in various ways and resold, again as private property. However, this does not exhaust the ways in which firms can access resources, which is where modes of governance other than the market come into play. Ways of executing these processes can be reduced to the following binomial possibilities:

1 *Sources: exogenous versus endogenous.* Are the resources which the firm uses external to it, in the public realm and therefore needing to be acquired, or already internal to the firm?

2 *Acquisition: allocation versus purchase.* Does the firm internalize resources from the public realm by having them allocated to it (e.g. as club goods) or by purchasing them?

3 *Mobility: high versus low.* Does the firm engage in frequent, rapid transactions of resources, or does it exchange them rarely?

4 *Communication: dialogue versus signalling.* Are the processes of acquisition, utilization and disposal communicated through substantive and complex exchanges of speech acts or through signalling?

5 *Formality versus informality.* Are these processes conducted through clearly established, written procedures, or casually and implicitly?

Table 4.1 A firm's relationship to resources under ideal-typical governance modes

Relationship to resources	*Modes of governance*						
	State (substantive) (S)	*Association (A)*	*Community (C)*	*Network (N)*	*Market (M)*	*State (procedural) (P)*	*Hierarchy (H)*
1 Sources							
Exogenous	✗	✗	✗	✗	✗	✗	
Endogenous							✗
2 Acquisition							
Allocation	✗	✗	✗	✗		(✗)	✗
Purchase					✗	(✗)	
3 Mobility							
Low	✗	✗	✗			(✗)	
High				✗	✗	(✗)	✗
4 Communication							
Signalling	✗				✗	✗	
Dialogue		✗	✗	✗			✗
5 Degree of formality							
High	✗	✗		(✗)	✗	✗	✗
Low			✗	(✗)			
6 Structure of relations							
Vertical	✗	✗		(✗)			✗
Horizontal			✗	(✗)	✗	✗	✗
7 Enforcement capacity							
High	✗	✗	✗			✗	
Low				✗	✗		✗
8 Reach of enforcement							
Extensive	✗		✗		✗	✗	
Limited		✗		✗			✗

6 *Structure of relations: vertical versus horizontal.* Are relations among those involved in these processes hierarchical, with some actors clearly superordinate to others, or on a basis of equality?

7 *Enforcement capacity: high versus low.* Are the rules that in principle govern these processes within the external, public environment typically capable of enforcement with high or low efficacy?

8 *Reach of enforcement: extensive versus limited.* Do the enforcement mechanisms in question extend generally across the society, or are they limited to those directly connected to the firm?

Combining governance modes and these standard alternative characteristics, we can develop the scheme shown in Table 4.1. These eight binomial choices appear across the range of different resources, which (following Hall and Soskice 2001 and Hollingsworth 2002) will be taken to comprise, principally but not exhaustively:

1 Finance and corporate governance.
2 Employee relations.
3 Skill acquisition of personnel.
4 Knowledge.
5 Relations with competitor firms, customers and suppliers.

It will be a core (but testable) hypothesis of governance system theory that modes of governance apply consistently across their jurisdiction, producing similarity and not complementarity. In the pure case, institutional barriers of the kind we have already discussed, which limit the jurisdiction of particular governance modes, have to be identified if we find a second or third governance mode at work within the same institutional arena. Therefore, if finance and corporate governance are regulated by the market, so will be employee relations. At the level of ideal-typical theory building, therefore, we do not need to complicate the model in Table 4.1 by adding the third dimension of field or type of resource; but to study complementary institutions we need precisely that kind of complexity.

The allocation of different binomial choices to different governance modes has been carried out in a strictly ideal typical way. The implications of the central defining concept at the heart of each mode have been derived purely deductively and theoretically on the assumption that the particular mode in question is the sole form of governance in operation within any one case. This differs from the more common practice of most institutionalists, which is to take an empirical example of what they consider to be a key exemplar of a type, and read its characteristics into the type. Table 4.1 sets out the types in a particular order. It starts with the substantive state, as the purest form of governance as government. Association has been placed next to the state because it differs from it in the smallest number of characteristics. Community is placed next, because it differs from association in the fewest characteristics, and so on.

The substantive state. The ideal, in the sense of pure or extreme, concept of the substantive state is one in which its central, coercive power shapes the entire environment of the firm. From the firm's perspective all resources are exogenous, because provided by the state. The state allocates them through its administrative structure. Resources have low mobility, because to secure change the firm has to apply to the state administration. Communication is through the signalling of requests and commands; the state is not here defined as a democratic one, but simply as a state, working through a centralized and potentially coercive structure. These processes are formal; relations are vertical; and the state has in principle a high capacity for enforcement. The state is characterized by the extensiveness of its general reach. When and if they were operating according to their basic principles, the state socialist economies of the former Soviet bloc operated something like this.

The association. In the pure concept of an associational economy, firms are members of formal organizations, which are responsible for all the firms' relations with the external environment. From the firm's perspective all resources are exogenous, because provided by the association, which allocates them through its administrative structure. Resources have low mobility, because to secure change the firm has to apply to the association. Communication is through dialogue, because associations are defined as membership organizations. These processes are formal; relations are vertical; and the association has in principle a high capacity for enforcement among its members, but its reach is not general. The guild economies of medieval Europe functioned partly, but only partly, according to this model. The association differs from the state in that it has an internal dialogue structure and limited reach.

The community. In the pure concept of a community economy, firms are strongly embedded in informal and usually local and enduring webs of relationships, which constitute all their relations with the external environment. From the firm's perspective all resources are exogenous, because provided by the community, which allocates these resources through its customs. Resources have low mobility, because they are embedded in the community. Communication is through dialogue, because communities are defined as membership structures. These processes are informal; relations are horizontal; and the community has a high capacity for enforcement among its members, and beyond to an extensive reach. Many subsistence peasant economies function partly according to this model. The community differs from the association in the informality of its procedures, the horizontal character of its relations and the extent of its reach beyond a defined membership.

The network. In the pure concept of a network economy, firms are linked loosely with other firms and with non-firm organizations in limited understandings concerning reciprocity. From the firm's perspective all resources are exogenous, because provided by the network, which allocates these resources through its structures. Resources have high mobility, because the binding undertakings of the network are weak. Communication is through dialogue, because networks are defined as membership structures. These processes can be either formal or informal, giving us two subtypes. In the former case, there is an explicit agreement among the firms concerning the inception, conduct and conclusion of the network; in the latter, understandings develop in a similar way as in community, but always in a more limited and less embedded way. In both forms, relations are horizontal; and the network has a low capacity for enforcement among its members, because their relations are weak. It also has no reach beyond the members. Arrangements among small numbers of multinational firms to develop new products together, as described by Ohmae (1985), would be examples of networks, particularly the formal kind. The network differs from the community in the partial and superficial character of the bonds that link firms. This emerges in its different position on the mobility, enforcement and reach variables. It is doubtful whether the network could ever constitute a sole system of governance, because of its partial character.

The market. In the pure concept of a neoclassical market economy, firms are linked to each other and to resources and factors of production solely by relations of supply and demand as signalled by price under conditions of perfect competition. All resources are exogenous, because acquired in the market, through purchase. Resources have high mobility, because they respond solely to price signals. Communication is solely through these signals; participants in the market are anonymous and therefore cannot participate in dialogue. Processes are formal, because calculations have to be precise for the market to work efficiently. Relations are horizontal; and the market has a low capacity for autonomous enforcement because of the criterion of anonymity. However, if its functioning can be guaranteed, its reach is extensive, all transactions being in principle commensurable. The market differs from the network in its dependence on price rather than allocation as its mode of acquisition of resources, its similar dependence on price signals rather than dialogue, and its extensive reach. Like the network, it is doubtful whether the market could ever constitute a sole system of governance, because of its weak capacity for enforcement.

The procedural state. In the pure concept of a procedural state, firms make contracts with resource sources, these contracts taking a form prescribed (or permitted) by either statute or case law. All resources are exogenous, because acquired by means of the contract, through either allocation or purchase. (It is not possible to derive anything determinative here from the concept of the contract.) Resources may have high or low mobility, depending on the legal processes involved. Communication is solely through contract signals and judicial decision. Contract processes are formal; but relations are horizontal. There is in principle a high capacity for enforcement through legal process, and this capacity has extensive reach throughout the society. The contract differs from the market in its capacity for enforcement and the indeterminacy of some variables.

The hierarchy. In the pure concept of a corporate hierarchy, all resource questions are handled through the managerial structure of firms themselves, including hierarchical relations between firms at different stages of the production process. All resources are endogenous to this hierarchy, and are allocated within it by administrative decision. Resources have high mobility, because they are at the disposal of the central management. Communication is through signals from this management, these signals also being formal. Relations are by definition vertical. There is a low capacity for external enforcement, because management lacks legitimacy outside the bounds of the hierarchy itself. This also implies limited reach. The hierarchy stands alone among the forms of governance in many respects, because it is the only one that has no reference to institutions outside the firm or hierarchical network of firms. Possibly some large Japanese and Korean enterprises resemble it in empirical form.

From ideal types to existing compound forms of governance

The most striking conclusion to be drawn from an inspection of these ideal types of governance is that hardly any of them is likely to be fully autonomous, certainly not in dealing with economic relations of any complexity. They are all therefore unlikely to be found alone, but will exist in combinations that offer some degree of complementarity to 'compensate' for their exaggerated pedigree characteristics. Some display a rigidity of resource allocation across all aspects that makes it difficult for them to respond to changing demand among consumers (the substantive state, association, community). In practice these forms are likely to exist alongside elements of the market. This happens either openly and willingly or in the form of black markets. If we are considering capitalist economies, then the market is by definition always present to some degree, even when associations, communities and other governance modes are also active. Other forms lack autonomous enforcement capacity (networks, markets), and are almost certain to coopt external agencies, in particular the procedural state. In fact, in anything beyond a very primitive system, what is called the free-market economy is always really a hybrid between the pure market and the procedural state. Further, unless an economy consists solely of autonomous small firms, what passes in common discussion for the 'market economy' is really a compound of market, procedural state and hierarchy. Virtually all large firms constitute hierarchies, and hierarchy differs considerably from market as a form of governance.

In practice, all advanced examples of capitalism comprise a compound of at least these three elemental modes (*MHP.* market, hierarchy, procedural state). This provides considerable complementarity and ranges of options to firms, which will rarely find that such a governance regime absolutely prevents them from doing something that they want, though

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they may experience transient rigidities when the transaction costs of changing paths appear high while the need for change does not seem overwhelming.

Within this main compound type, the other elemental modes operate by interposing themselves between firms and the dominant mode. For example, a firm embedded in community within a market economy is not engaged in the subsistence economy, but reaches out through its community to a market. A substantive state within a capitalist economy changes the way in which firms subject to its interventions encounter the market, but it does not suppress markets, and has to be careful of the impact of its actions on market forces.

It is possible to formulate other compound types, which would comprise those combinations of ideal types also likely to be encountered in empirical research. *MHP* will always predominate, but minority or even trace components can still be important, even decisive, in making niche characteristics available to certain kinds of producer in specific national or regional economies. (Similarly, while H_2O will always be by far the dominant constituent of any bottled water, it is different combinations of sodium, potassium and other elements that impart distinctive flavour and other properties which determine the market niches of particular brands.) For example, one possible form is *MHPA*—economies in which associations *(A)* play a particularly important role—often seen as the *modèle rhénan* (Albert 1991), or a coordinated market economy (Hall and Soskice 2001a). Another form, *MHPS,* with a strong substantive state (S), would express the model of the post-war French economy (Schmidt 2002).

A further source of variation is in the strength of the component elements within a compound. For example, while the US and Japanese economies are both cases of *MHP,* the relative importance of *H* is considerably higher in the latter. (To continue the chemical analogy, if the US economy might be stereotyped as M_2P_2H, the Japanese could be MPH_2.)

These empirically observable compounds must never be confused with ideal types, as they embody more than one logic of governance, and the exact form of the compromise, or structure of the complementarities, among them may vary considerably. If we were to develop a full research programme, we should after a time be able to estimate the relative importance of all the different modes within an individual economy (temporarily accepting that national economies constitute whole economies). Therefore, in the US case, we would take account of the role of hi-tech military expenditure as an important example of *S,* rather small roles for *A* and *C* (community), but a larger one for *N* (network), giving something like the following as a final account of governance in the US economy:

Sx, Az, C*z, Ny, Mw, P*w, *Hw*

where *w>x>y>z.*

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However, to give a more accurate account still, this would need to be nuanced according to sector and locality. For example, in sectors and areas dominated by small firms *H* plays a smaller role relative to *M* and possibly *N* or *C;* in sectors dominated by government contracts (aerospace, some aspects of computers and information technology) *S* is more important. In several hi-tech sectors *N* plays a stronger role than elsewhere.

A major conclusion from this account is that virtually all empirical cases are hybrids. The brings us to the hypothesis: that institutional heterogeneity will facilitate innovation, both by presenting actors with alternative strategies when existing paths seem blocked and by making it possible for them to form new combinations among elements of various paths.

This hypothesis can be set against those that point to the advantages of institutional similarity, but it cannot dispose of the logic of the rival argument. There will be examples of both confusing and creative incoherence, only the latter constituting complementarity in either of the senses used here. Can we say anything about the kinds of conditions likely to be associated with each? We can possibly make some progress if we can predict ways in which a particular governance mode might make it difficult for a firm within it to tackle certain kinds of task, any potentiality for functional equivalents being inadequate for solving the problem within the terms of the mode. Adoption of elements of a different mode more adept at performing the task in question would then enable the firm to solve this problem. If the second mode is simply different from the first, but not necessarily in ways likely to assist the firm solve its problem, it might be more likely to create confusion and therefore inefficiency.

Functional equivalence

But how good is our knowledge of the capacity of different governance forms? Some authors make strong claims. For example, several assert that the pure market is superior to most other forms of governance in stimulating radical innovation. Our analytical, not to mention prescriptive, capacity would increase considerably if we could confidently make statements of this kind. Unfortunately, as Regini (1996) has demonstrated well, the existence of functional equivalents raises considerable difficulties for such simple means-ends associations: actors are able to bend governance mechanisms to carry out surprising tasks. In Regini's own main example, Italian machine-tool firms have demonstrated a capacity to provide training for a skilled work force, even though the existing literature had argued that the provision of such skills required forms of associational governance which Italy lacked.

Functional equivalence, if it is strategically achieved by institutional entrepreneurs, can be described as a situation where actors within I'' refashion G'' so that, while retaining its own characteristics, it gives the same substantive outcome as G' in the accompanying figure. This does not mean that anything is possible, and that we should therefore abandon all attempts at institutional analysis. Different forms of governance are associated with different capacities, but knowledge of this cannot be derived in a mechanistic, *a priori* way. We are dealing with creative human actors who, faced with an institution that does not 'work' in a certain way, will sometimes fashion it until it does.

Context I′

Capacities	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*
	Governance mode G′									
Field *F1*	1	1	0	1	1	1	0	0	0	1
	Governance mode G″									
Capacities	1	2	3	4	5	6	7	8	9	10

Context I″

Functional equivalence and the process of recombining elements of governance forms together help us model the behaviour of institutional entrepreneurs. Entrepreneurial actors will not be content with the overall structure of governance institutions they find around them, but will try to borrow and adapt components from a variety of them, including elements lying around as redundant capacities, in a kind of institutional *bricolage* to produce new combinations that bring together the apparently incompatible functions of those which went before. Combining the apparently irreconcilable is a major form of innovation. We can take the analogy of experimental fruit growers. If there seems to be a clear biological choice between a tomato that is sweet to taste and one that has a robust skin for transport, it can be guaranteed that in some tomato growers' laboratory there is a project for producing a sweet but robust tomato.2 Of course, the search is not guaranteed success. And if the sweet robust tomato finally appears, its invention does not suddenly render *retrospectively* false the knowledge that had previously shown these two characteristics to have been incompatible in the past. That knowledge had indeed served as a spur to the research that found a way, creating new knowledge. Research on governance and institutions should operate in the same way. The capacity of humans to learn means that, where there is knowledge of the past (even inaccurate knowledge), there is no pure repetition of an action. As is well known, the repeatability of an experiment, said to be fundamental to the scientific character of knowledge, is not possible when creative human actors are involved.

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Governance and power

We may very well suspect that, when actors seem incapable of changing certain institutional practices where change would seem to be in their interests, there are in fact political considerations, in the sense of power issues, which trump other apparent interests. Power is fundamental to governance, because if governance mechanisms sustain regularities of behaviour, they must have the capacity to lead actors to behave in ways other than maximizing their own conception of their interests.

Only a naive approach to governance assumes that there is necessarily a higher good in responding to the pressures of the governance mode; the regularities sustained do not necessarily impose a public good over private goals; nor does it relate in any way to a dichotomy between market (selfinterest) and state (public interest). It is common in many accounts of governance to see this coercive element as typical only of formal government (Greenwood *et al.* 2002; Leach and Percy-Smith 2001; Rhodes 1997). However, formal associations, community groups and other forms of governance all have their ways of exercising constraint. A governance mechanism may constitute a pressure to force actors to act in the interests of a group which has achieved a power position rather than in their own chosen way. For example, a king may force subjects to fight in his dynastic wars; a colonial power may require people living in the colony to serve the interests of the ruling class of the empire rather than those of their local community. In the conflict between governance and inclination, the analyst should not necessarily assume a conflict between public interest and self interest.

It must similarly be remembered that the market is a device not only for ensuring that individuals achieve their choices, but for ensuring that their choices take a certain form. The market is a highly complex site of mechanisms designed to ensure that actors achieve their aims through a process of competitive exchange in which all goods and transactions are assigned a price within a common system of prices. Actors may themselves prefer the greater security and ease of fixed, shared arrangements rather than a competitive process. Or they may prefer some other form of distribution than exchange. This may be the case with the poor, who have little to offer within exchanges; or with those possessing superior strength or power of some kind, who might achieve superior returns without making exchanges. It is for this reason that Hollingsworth and Boyer's (1997) dichotomy between 'self-interest and obligation', with the market being located within the zone of self-interest rather than obligation, is unsatisfactory; it ignores the problematic concept of the self embedded in the market's highly structured actors.

Social situations, least of all those which are involved in governance, are rarely 'innocent' spaces where all we need to understand are actors acquiring and using knowledge to achieve goals. Differential power among actors, which they deploy in zero-sum ways, is an ever-present possibility. It is possible to model power relations as one of the means by which the increasing returns, that are fundamental to path-dependent situations, become established. Even where actors start with initially equal endowments, randomly chosen actions can favour the interests of some rather than others, conforming to the further path-dependence criterion of initial, random, small events. Assume a situation in which a collective group of actors initially selects randomly from a variety of equally available possible institutional means to solve a problem; and that more than one, but not all, of the available possibilities could in principle solve the problem. Each member of the group has one vote in the selection of the possible solution. At the point of initial choice, none of the actors knows which solutions will succeed, so the choice is truly random. Also unknown to the actors is that every available choice differentially provides a reward for one or other of the members of the group, and in addition gives that actor an additional vote in all future rounds. After a first round the process is repeated, the actors having learned from their experience in the first round. After a number of rounds, one or more members of the group will emerge with a dominant voice. Increasing returns will have been produced, and a path dependence established which favours some members of the group over the others. They are in a position of power. In situations where members of the group *start* with differential power, the true path-dependence context of small initial events is missing, but the increasing returns component of path dependence will be present. In situations of this kind, which are found very frequently in real life, the path dependence differentially benefits the power-holding or insider interests, but all members of the group also benefit from the fact that a solution has been found to the collective problem.

Learning curve considerations and power imbalance work together to produce over-determined path dependence: all actors become more expert at pursuing the courses of action which favour powerful interests; this process in itself further advances the position of those interests *and* gives subordinate groups reasons for supporting a *status quo* that leaves them subordinate. And it must be assumed that, *per definitionem,* dominant interests play a particularly strong role in the management of governance mechanisms. Potential rivals to a dominant group not only lack the power to mount a challenge, but lack expertise and the possibility of convincing others that alternative actions, and therefore alternative modes of governance, are practical and viable. This is a theoretical account of the strength of conservatism. Interests and experiences alike develop around existing governance regimes and seek to maintain and strengthen them and block possible changes. 'Workers of the world unite: you have nothing to lose but your painfully acquired knowledge of how to survive' is not a rousing slogan, as Przeworski (1985) has demonstrated at length.

Modelling governance for complementarity
The governance regime and its associated pattern of insider and outsider interests may persist even if the existing regime begins to fail to deliver results. A path and its associated mode of governance may therefore continue to be followed by rational actors even if it no longer produces general positive returns, because it does produce insider rewards for powerful interests. If a governance regime depends solely on power balances of this kind, then its eventual failure to produce these insider returns would enable the powerful actors to change a path—provided they also had adequate knowledge of how to follow an alternative.
Alternatively, innovation may be triggered by a change in the identity of the most powerful interests. Such a change is exogenous to the particular set of practices around the established path dependence and governance mode, but it may be endogenous to the wider collectivity. Again, however, to the extent that issues of learning are involved, even such actors may be unable to force a change. As in the 'innocent' case, the chances of achieving a change in a failed path will depend on actors' access to alternatives, through other practices or a capacity to borrow from neighbours. In the case of a change in the identity of the powerful group, the newcomers may bring with them access to approaches perfected within other, 'their' institutional arenas, which are then transferred to the one in question.
These considerations are more important than any formal properties that render a particular type of governance mode more or less likely to encourage innovation. To illustrate, in principle the market form of governance encourages innovation—because, to resist competitive challenge, a firm must keep introducing new products. On the other hand, the market also encourages short-term perspectives, because profits have to be realized. This may inhibit radical innovation that needs long lead times for research and considerable uncertainty as to outcome. In contrast, governance by formal business associations may be considered likely to inhibit radical innovation, because associations are defined by the sector in which they find themselves and therefore have little interest in encouraging activities which might challenge those boundaries. But they are capable of restraining short-term incentives which might inhibit long-term decisions. The overall outcome whether the market or an associational regime is more likely to favour radical innovation is undetermined. In such a situation much will depend on the identity of the particular interests associated with the dominant governance form, *and* on how they, as Bayesian actors (Breen 2000; Western 2000), perceive those interests.
Assume that the delivery of health service resources in a particular society is governed by markets. Health providers, insurers and clients all realize their health needs through this mechanism, and therefore feel threatened by any attempt to shift to a different system of delivery. Meanwhile, those too poor to achieve much health care at all have hardly any voice within the market and will be ignored, even by highly innovative action

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within it. In this context, an attempt by interest associations in an exogenous area, but which can develop ways of influencing debate and conflict about health—for example, a set of trade unions—could press for innovation in a way not likely to emerge from the market itself. On the other hand, in a health insurance system governed solely by associations, innovation in the interests of excluded actors might come through the market.

To illustrate the point further, we can use the example of the university as a form of governance of scientific communities. When the University of Oxford and its colleges were secure in their store of endowed resources and government grants, they took little interest in what relationship they might have with science-related business in the region around them (Proudfoot forthcoming). In fact the predominant view in the university had been that engagement with anything local to the relatively low-population region around Oxford could diminish the international status that the university claimed. It was far from being a regionally embedded institution. This view changed rapidly during the 1990s as existing sources of resources seemed far less secure, and as university scientists and authorities perceived the advantages that its rival Cambridge was drawing from its associated high-technology local production system. The University of Oxford began to act less like a secure insider, and sought out means of innovation, including those which connected with its surrounding local economy and society. As a consequence university authorities and leading scientists took a number of measures which have brought the university to the centre of a flourishing biopharmaceuticals sector (Jong Kon Chin forthcoming; Proudfoot forthcoming; Segal *et al.* 2000).

We can therefore attribute safely to governance mechanisms only formal qualities; substantive ways in which they are used will depend heavily on power and varied patterns of insider and outside relations.

We can express the main points from the above as follows. When a number of governance patterns are available to them, and assuming that the power relations within which they are embedded do not inhibit them, actors seek out those elements of one governance mode that seem to be associated with certain desired outcomes, and elements of others that give different ones, in order to maximize their performance. Let us assume

Field	*Capacity*									
	1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*
	Governance mode G′									
F1	1	1	1	0	0	0	0	0	0	0
	Governance mode G″									
F1	0	0	0	1	1	1	0	0	0	0
	Governance mode G″′									
F1	0	0	0	0	0	0	1	1	1	1

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that there are three governance modes, which seem to be associated perfectly complementarity with capacities as in the accompanying tabulation.
Context I′

	Capacity									
	1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*
Governance mode	*G′*			*G‴′*			*G‴′*			
Field F1	1	1	1	1	1	1	1	1	1	1

Actors in context I′ therefore try ideally to achieve the following pattern (see figure).
Several devices might be available to recombine governance modes in this way. First, they might make searches back into their own past experience, trying to use hidden or dormant alternatives within their own repertoires (Crouch and Farrell 2004). Here we can envisage dormant alternatives as a kind of palimpsest; in terms considered immediately above, modes *G″* and *G‴′* had been present in *I′* before, but had become obscured by *G′,* perhaps by the latter's more frequent use or by its role in a dominant power coalition.
Second, agents might operate simultaneously in different arenas, enabling them to transfer experience from different action spaces, or secure access to the arenas of others, to enable them to transfer experience from other agents through networks of structured relationships *(ibid.)*. This has been already anticipated in the idea of segregated zones within an institutional context, within which other patterns of capacities, and hence other forms of governance, are found. An important aspect of the costs of transferring experience here comprises the barriers that exist to 'protect' the various governance modes and the ease of negotiating them.
A further possibility is that, of several viable alternatives, only one is discovered, leading to possibly false 'one best way' solutions. This can be easily accommodated to the concept of the search for recombinant elements of governance, but it also directs our attention to an issue that until now we have neglected: exogeneity and the strength of the boundary around an 'institutional context'. Just as, between fields within an institutional context, we have to account for both boundaries and their absence, we need to do the same to boundaries that define those contexts themselves. The contexts with which we usually work may well be set within wider ones: national systems may be set within world-regional or global ones. This is then a matter of a wider system within which *I′, I″,* etc., are located (e.g. an international regime within which national systems are located). It is possible that within such a wider system *(W)* particular governance modes are dominant which clash with those within *I′* or *I″*. As these are drawn within W (i.e. their external barriers melt), their locally

dominant patterns might weaken; though they may remain concealed as redundant capacities, available for future use. This may well be happening, for example, as the German and Japanese corporate governance systems are forced to change in line with the requirements of the AngloAmerican form which is globally dominant (Dore 2000).

In the simplest case we have an impermeable context: no knowledge, learning, action or power relations enter it from outside or (for simplicity) leave it to move outside. At the other extreme would be a case so thoroughly open to external influence that it has no barriers at all. But this is a limiting case, as by definition this cannot constitute a discrete context or system able to be studied at all; it has become part of whatever context(s) permeated it. In between come contexts with various patterns of openness and boundaries. These boundaries can be permeated in a number of different ways: for example, by knowledge diffusion and/or by power relations (Crouch and Keune 2004); and these can flow through actual movement of personnel or the transfer of ideas and/or control mechanisms by themselves. In relation to each identified potential influence source, we need to identify its potential forms of transmission and the boundaries it will encounter.

An attempt must then be made to rank the modes found in terms of their relative dominance. Relationships between mechanisms also need to be specified. In particular, when we encounter mechanisms which may conflict with each other, can we anticipate: (1) a clash between them, likely to end in confusion or the destruction of one by another; (2) an unimportant relationship, for example in the case of a division of labour between the mechanisms, such that a potential clash never arises; or (3) potential creative joint operation of the mechanisms, perhaps in changing relationships to each other?

Proceeding in this way, we can give an account of diversity in the structure of capitalism—within and between national economies—that certainly gets beyond dualism, and escapes a form of analysis that is tied to a debate with neoliberalism. At the same time, we remain theoretically grounded, and can accommodate and even anticipate change. Governance theory, combined with a move towards a more formal kind of analysis, therefore points the way forward for neo-institutionalism.

Notes

1 For a discussion of this see Crouch (2004).

2 Höpner's (2001) account of how, contrary to initial expectations, the German co-determination system (associational governance) seems to have become compatible with a shareholder corporate governance (market) would be an institutional example.

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5

Understanding the process of economic change1

Douglass C.North

The subject of my paper, which is actually that of a book I am just finishing, is understanding the process of economic change. We do not understand the process of economic change. We do know a lot of things that are important for the background of this paper. We have evidence about the characteristics of economic performance around the world in the past. We know that over the last 200 years we have experienced in part of the world enormous, unprecedented growth, whether measured in *per capita* income terms or other indicators of material well-being. We also know that growth has been very uneven. Some countries have been very successful in terms of material well-being and some have been left behind so that more than a billion people live on less than a dollar a day. Additionally, human well-being in terms of health has improved and has improved even among poor countries. Life expectancy in the last century has doubled in parts of the world and has increased almost as much even in some poor countries. So on both of these conditions, material well-being and the welfare of human beings, we have had enormous successes. We also have had spectacular lapses. Some societies have not enjoyed these attributes. We also know that in the twentieth century we killed more people in warfare than in probably all of previous history—a sobering notion.

We know a lot about what makes economies work. We can put it very simply: if an economy is rich it is because it is productive. If it is poor it is because it is not productive. Broadly speaking, productivity increase is a function of the amount of physical and human capital that has been put into the production process. Now, if that is so—and we do have a generally good knowledge that people prefer more goods to less, that they would rather be rich than poor—the question is: why isn't all of the world rich? And the answer is that while we know a lot about what makes economies work, we do not understand the process of economic change. And until we do we are not going to be able to solve the kind of problems that were laid out for you last night2 when you heard one conference speaker talking about the problems of the environment—and there are real problems—and another about problems of violence in the world—and there are real problems. Both speakers gave very interesting discussions; what was disappointing was that when asked what could be done about it, they did not have good answers. But you cannot have good answers unless you understand what is happening to you. So what we are going to go through today is an attempt to improve that understanding.

Now, if we are going to understand the process of economic growth and change, we have to theorize. Facts do not speak to anything. We have to develop a theory. And it is there that our problems begin, because the theories that we have are completely inadequate to deal with the problems we are interested in. Economic theory does a magnificent job of telling us how markets work when we have well developed markets. It does not tell us how we achieved such markets. Economic theory is, in essence, frictionless, static, and ergodic.

If you say it is static and therefore it does not deal with change, you may turn to evolutionary theory, which has become very popular among economists and other social scientists. But evolutionary theory suffers from two serious, maybe fatal, defects in terms of helping us out. One is that the way we get change in evolutionary theory is by sexual combination and mutation. This is not the way we get change in the economic, social, and political world. Two, in evolutionary theory the outcome is blind. That is, the outcome of the mutations that occur is not a result of deliberate action on the part of individuals attempting to change the way the world works. And obviously the key to understanding the process of human economic change is the intentionality of the players. In order to overcome these defects we must ask ourselves how to deal with the world in which we introduce frictions, a world that incorporates time and therefore is not static, and one that incorporates human intentionality as a basic part of the argument.

So let us start with frictions. The frictionless world of economic theory assumes perfect knowledge of alternatives. In fact we exist in a world of uncertainty with very imperfect knowledge. Institutions are ways to structure human interaction to reduce the ubiquitous uncertainties that humans face in all kinds of dimensions in the world. It is true that the structure may be intended to reduce the uncertainties of only the people who make the rules. But whatever it is, the objective of institutions is to structure human interaction in such a way as to accomplish the intentions of the individuals making the rules.

If you are going to structure human interaction to produce the result you want, then you have to ask what was missing in the new growth economics. Growth economics told us a lot about productivity growth and the things that make economies productive, about human capital and technological change and science and so on. It did not talk about incentives; and that is what institutions are: they are incentive systems. They are, what's more, very imperfect incentive systems. And so if we want to ask how institutions work, we ask whether in fact they accomplish the objective of inducing the players to accomplish certain outcomes.

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Now, what do institutions comprise? They are made up of formal rules, informal constraints, and enforcement characteristics. I take each in turn. Formal rules are laws, constitutions, regulations. Informal constraints are conventions, codes of conduct, norms of behaviour; and, as I hope to demonstrate as we go along, the informal constraints are in many respects more important than the formal rules. And then there is enforcement of both the formal rules and informal constraints. The three together define the way the game is played, and indeed you cannot understand the way the game is played without understanding how these combine to produce the outcomes. Let me give you an illustration from history and then let me give you an illustration from modern football.
When Latin American countries became independent in the early nineteenth century most of them adopted the US constitution as the model to determine the way in which their society should work but with radically different results from the United States. The reason was not that formal rules were different—they were not; but the informal constraints—the norms of behaviour and conventions—and the enforcement characteristics were radically different in Latin America than in North America. The result was radically different performance characteristics in the society. So you must have the three together.
In football, whether in the European style or in American football, there are formal rules that define the way the game is supposed to be played, informal constraints such as you are not to injure the player on the other team deliberately, and enforcement characteristics—referees and umpires—to see that the game is played that way. You may be more gentlemanly and ladylike here in Europe than we are in America, but in America professional football is frequently won by playing dirty. You try to break the quarterback's leg on the other team and if the quarterback is crucial you are going to win the game.
Enforcement is always imperfect and to the degree that enforcement is imperfect the game is different from what the rules and norms specify. So the combination of formal rules, the informal norms of behaviour, and enforcement characteristics define the way the game is played whether it is football or whether it is a society —Germany, the United States, or any other. And therefore we have to pay a lot of attention to each of them; and, indeed, one reason why I separate out the three parts—unlike some game theorists do who model institutions and put them all together—is that I want to look at each and what part each plays when I come to analyse the performance characteristics in the society over time. The changes in enforcement can radically alter the way in which the game is played, as can changes in norms of behaviour or changes in the formal rules.
Let me now talk about the static character of economic theory. What is missing in economics and economic theory is the incorporation of time into the models we have. Time is continually involved in what we are

talking about: the existing institutions—formal rules, norms, and enforcement—have evolved and are cumulative over time. Indeed, what you have today, at a moment of time, are rules of the game that have evolved over long periods of time, frequently with very different sources. Therefore, you are always a prisoner of time. You are a prisoner of the past, a prisoner of the present. I know this very well because in the activity I am sometimes engaged in—which is running around the world advising countries on economic development—I learn very quickly (and it is sobering!) how little difference you make. It is a world in which you are already stuck. Culture is the accumulation of beliefs, norms, rules, and so on that together define where we are today in terms of the way the game is played. It is the result of a cumulative process of the past of incorporating beliefs and norms and so on—historically to today. It is the source of what has frequently been talked about at this conference: path dependence. Path dependence means nothing more than that the heritage of past rules and norms and beliefs plays a big part in constraining the choice set in the present. In the present we are bound in terms of our choices by what has happened and by the rules and norms from the past.

But there is one other aspect about time that is not understood and, indeed, gets us into a basic conflict with a lot of what I have heard around this room. That is, it is a non-ergodic world. When Paul Samuelson wrote the *Foundations of Economic Analysis* (1947), which is after all the bible of neoclassical economic theory, he was careful to argue that it was an ergodic world; and by an ergodic world—I am going to have a loose definition rather than the kind you find in the dictionary—Samuelson meant that the fundamental underlying structure to an economy is such that if you understand that structure then you know how to structure the game or modify the game over time. The notion of ergodic is derived from the physical sciences. The physical sciences are built on the notion that there is a fundamental underlying structure which can be defined, and that this structure, if we understand it, allows us to continue to be able to modify the way the game is played and to be able to make predictive statements about the future. If we want to develop a new theory regarding some aspect of the world we do so by reductionism, that is, we go back to the fundamental entity that composes it, whether it is elements in chemistry, genes in genetic change, or protons, or neurons, or whatever, in physics. We build our theory from there to understand more about the world around us. This use of the physical sciences, however, misled economics and the social sciences in a big way because there is nothing ergodic about our world. Paul Samuelson's colleague Bob Solow said that the trouble with economists is that they tend to believe that there is such a fundamental underlying structure and if you understand it you can solve the world's problems. There is nothing about the evolving world that makes it ergodic.

This does not mean that theories we have developed in economics like price theory (which is a very valuable set of tools) do not have predictive value with respect to the present. It does mean that we are evolving in a world that has no parallel with what has happened in the past—we have created a world that is unique, is different, and is continually evolving in new and novel ways. That has all kinds of radical implications for understanding this world. It means that to the degree that the world we have created is new and novel we may not understand it correctly, and indeed it would be surprising if we do.

To understand the process of change we must first deal with institutions. Second, we want to correct 'time', and we get at that by looking at a world that is non-ergodic and also by incorporating institutions and time from the past. Three, we are concerned with where we get our ideas from. This too is something that makes social sciences radically different from the physical sciences. As noted earlier, in the physical sciences, if you want to find out what is going on, by reductionism you can go back to the fundamental unit and then build your theory on the basis of that unit and arrive at a new and better theory to deal with new problems. But we do not have a fundamental unit in the social sciences. The world we have constructed is a construction in the human mind. It does not exist outside the human mind.

Let me say that again: the constructions that we have are strictly what we have devised. Every economic, social, and political theory is a theory that we have built and constructed. We have produced a very elaborate structure, which has lots of implications for where we are going. But that structure does not exist independent of the human mind and therefore the degree to which that structure mirrors what I have called 'reality' will determine how well the theory 'works'. So what we have is an attempt by human beings to understand the world. Economic theory builds its understanding by using what is called the rationality assumption. The rationality assumption works for a limited variety of human choices, and indeed in price theory and in microeconomic theory it has given us models that have been very effective. But as soon as we get beyond a very simple set of relationships, understanding the world requires that we understand how the mind and the brain interpret it. This is where human intentionality comes in. Human intentionality means that we deliberately try to understand, try to build theories about the world around us; and to the degree that we are successful we have a better understanding of the world and what makes it go.

Now at this point we run into a fundamental dilemma. Economists assume that people are rational, and by 'rational' they mean they are logical, consistent, and usually with minds that work rather like the software in a computer, taking in information and spitting out outcomes. But we have got to find out how the mind really works. Well, happily, we are beginning to have some understanding. Work in experimental economics and in brain imaging is giving us an idea about how the mind works in particular settings. Experimental economics—the kind that got Vernon

Smith the Nobel Prize in 2002—attempts to ask how people behave in particular settings. Experimental economists do this using the kind of incentive structure which we use in economics, which is money. They formulate a particular structure with particular incentives for the players with respect to pay-offs and then see how they behave. They are interested in what has always been a standard behavioural assumption of economists, which is a maximizing behavioural assumption, which means that you prefer more money to less and act accordingly. Indeed, the easiest way to tell this story is by what is called the ultimatum game.

The ultimatum game says that if I offer you $100, to divide with another person, you get the $100 provided that she agrees to the amount that you offer her. But if she rejects it, neither of you will get anything. Now, a good economist would say: Well, what you would do is you would keep $99.99 and give her one penny; and because you are both better off you both would accept these terms. Well, only economics graduate students make that assumption, and that is because we brainwashed them a long time ago. When the experiment is tried out among other students, even in a very capitalistic and materialistic world like the United States, we get very different results. Recently this game has been tried out around the world in different cultural settings. Not just this game, I might add—this is a very simple game, the ultimatum game—but dictator games and all kinds of games designed to see that we understand how humans behave in particular settings. Only in the Amazon jungle was a tribe found that behaved as American economists behave. Everywhere else the results were different.

They were different, but at this point it was a puzzle as to what their difference was. Would you give another person 35 per cent or 40 per cent, because you are being generous, have a generous spirit; or was it because you are afraid of rejection? There are varied results, and none of them looks like the economist's result. Even when the game is tested in such a way that we can discriminate between a fear of rejection and people's generosity and people acting on different impulses, we still get a very different game than the economist's results. The reason why this is important is that when we begin to use all these results we can start to make a lot more sense about a lot of institutions and a lot of structures we see around the world than we could before.

We can go beyond this, to the areas of the cognitive sciences. One of the things we are very interested in is where do the predispositions of humans with respect to behaviour come from? Experimental and environmental ecologists have come up with a view, which is not new to them—it actually goes back to a lot of the work in sociobiology—which is that the 3 million years of hunters and gatherers produced genetic predispositions on the part of human beings that condition the way in which they think about the world in some fundamental respects. The experimental and environmental ecologists go further than I would, making this an overwhelmingly critical factor in shaping performance. That cannot be

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correct, for reasons I will come to—but it does give us a handle on innate predispositions that we can test. And here we come to brain imaging. Kevin McCabe (cf. e.g. 2003) has been asking under what conditions people cooperate and where are the limits of cooperation. We talked a lot here about trust and cooperation, so you will be very interested in this issue, which has a lot to do with the degree to which we have low costs of transacting in different kinds of markets. When we do brain imaging we get a very different result when an exchange is between people who know each other or are closely related to each other than when it is between people who do not know each other. All of these are parts of the pieces I want to put together.

Now, what is missing so far? What is missing—listen carefully—is 9/11. To what degree can human behaviour be explained on the basis of rational calculating deliberate decision making? One of the universals that we find all through history, and there is no exception to it, is that people have explanations for things that are above and beyond what they can explain in terms of experimental or what we would call semi-scientific analysis. Religions are universal, superstitions are universal. And if we do not deal with them, if we confine ourselves to a rational kind of calculus that so far I have been talking about and that is the bread and butter of economists, we are not going to be able to make sense out of the world. We are beginning to recognize that we must model not only the kind of world that is a rational calculating world that we can figure out in terms of the kind of game-theoretic models that I have described, but also the world in which religion, belief systems are derived from, and have their force in things like the 9/11 phenomenon. In a world in which there are weapons of mass destruction that can blow us off the face of the earth, we had better understand the sources of fanaticism and belief systems that run counter to our rational calculus.

And so a lot of what we want to do in building up a model of understanding the process of economic change has to do with understanding the implications of non-rational behaviour. Not anti-rational, not even irrational, but non-rational in the sense that it goes beyond the world we can explain in terms of experimental scientific method as it exists today. Now, obviously that world has changed radically. From the Middle Ages we have gradually been able to make sense, in terms of scientific analysis, of an enormous range of things that were once attributed to superstitions and beliefs and so on. But you will note, very interestingly, that religions have become more forceful, more influential in much of the world. Superstitions still persist and dominate a great deal of what we do. So we are concerned with a general understanding of the process of change that can incorporate not only the things that we can explain on the basis of rational analysis but also the degree to which non-rational beliefs influence and shape our everyday life.

So let us begin to rebuild our explanation taking these things into account; and let us start with cognitive science. If we are going to make sense out of the way people make choices—and that is what economics has always been, and correctly is, about—we had better understand where the choices come from. And we are never going to understand where the choices come from if we simply adopt the rationality assumption. It is not that the rationality assumption is wrong, it just does not tell us what we need to know. And until we understand how the mind and brain work, how learning takes place, how we interpret the world and how that interpretation changes, we are not going to be able to make any sense out of the various kinds of ways by which we make choices in a world that is complex. We are going to have to learn a lot more not just about the mind, but also about the brain. Let me make for a minute a distinction between them.

The senses—eyes, ears, nose, feel—provide signals to the brain and the brain attempts to make sense out of them by neural networks that make up the brain. When we do brain imaging we can actually see how neural networks work. Neurons are connected by electrical impulse, and we observe that when something tends to happen over and over again the impulses get stronger; and so we build up from an initial blank slate. We build up connections, which are our explanations of the world around us. And so we try to make sense out of the world around us. The brain is where all this takes place. The brain weighs only $3\frac{1}{2}$ lb, but it is the most amazing $3\frac{1}{2}$ lb of complexity that exist anywhere. It would take a room full of computers to do what the brain does. But if the brain 'translates' the evidence of the senses, it is the mind that constructs the elaborate structure by which we 'understand' the world around us and via the intentionality of the players attempts to control our environment. The explanations we build up do not really start from scratch, because we have initial genetic predispositions that tend already to have wired the neurons in certain ways. But we add to those all the time by experience. So we have initial predispositions that are being modified by experience, and by experience of two kinds. One is cultural, and this is why culture is important and why, even though it is a slippery word, it is crucial, because the heritage we have from the past as embodied in schooling, education provided by our family, and so forth, has already incorporated a great deal into the way in which we think. And, two, by actual experiences. When we put the two together—the cultural heritage we have and the experiences we have—then we begin to see the way in which we understand the world around us.

A number of competing frameworks exist. The one which I subscribe to at this time, although tentatively, is called the connectionist model. A connectionist model is essentially a particular view about how the mind and brain and neural nets not only work in a moment of time but how they learn. By learning I mean how they interpret new evidence, how they accept or reject information that is or is not consistent with our predispositions and, therefore, how we gradually evolve new explanations and new

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theories. The heart of that explanation is what is called by cognitive scientists 'representational redescription'. What representational redescription means is that we take evidence which we have developed to have a particular explanation in a particular realm and we generalize it to apply to other realms. That is how learning takes place and it enables the human mind to deal with new and novel problems. I gave you a simple illustration when I said that economics borrowed from the physical sciences, and that borrowing has played a very valuable role in the development of, for example, price theory. We borrow in all kinds of realms. What we have, therefore, is a restructuring which attempts to make sense out of the world around us.

Such restructuring has implications for incentives. We say that institutions are incentive systems, and that they are very imperfect—not only because sometimes it pays to evade them but also because what we consider incentives varies with different cultural heritages. Incentives in one culture may be disincentives in another culture. So the incentive structure is not a fixed phenomenon. It is not something which by benefit-costs calculus can be applied across all societies; quite the contrary. Different societies and different belief systems, different cultures, have different structures of the way they see the world, and therefore different incentive systems. So when we try to devise institutional frameworks that will do what we want in terms of structuring the game, we must be very careful to recognize that the incentive system is at least partially, not completely, a dependent variable of the cultural heritage of that particular society. And this is one reason why economists have so frequently fallen flat on their faces when they have gone to advise foreign countries. They assume a basic kind of economic model is applicable everywhere. But the cultural heritage which accounts for the degree to which we make sense out of it is not universal. So it is not that the incentive system is not the right issue; the incentive system is always the right clue to asking all the right questions. It is just that we want to be sure that we have the incentives correctly defined in terms of the way they work.

Now we turn to institutions. Here again we produce some very complex problems that we still do not have complete answers to. A structured society begins with an institutional framework that defines who gets to make decisions. The institutions must specify how decisions are made. We aggregate choices, political decisions in the society, both in a democracy—whether a direct democracy such as Switzerland or an indirect one such as France, the United States, and Germany—and in an authoritarian regime. We begin by having a structure that defines who gets to make decisions. But beyond that we have a set of political rules that defines the way the political game is played. This is crucial: it is polities that counts, not economics. It is the way in which you define the political game that in turn is going to determine outcomes, because it is the politicians who define the economic rules of the game—the property right structure and its enforcement mechanisms. The problems of a transition economy ultimately come

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back to the polity. So we are interested in the institutional structure of polities and how they work, and then in the economic rules of the game. We do not know how to create polities that will do what we want; we are better at defining the economic rules of the game. That set of political beliefs, given to the people who are making the decisions, determines the institutions they will create which are the incentive structure in the system. The institutions in turn spawn or create organizations. Firms, trade unions, political bodies—congresses or whatever—social groups, universities: all of those are organizations.

Why do we separate organizations from institutions? Entrepreneurs in organizations are the players in the game; institutions are the rules of the game. The players are going to be changing the way the game is played, given their access to decision making and rule making. And therefore we are very interested in who the entrepreneurs of organizations are and how, indeed, they can affect organizations—via the political process or through changes in informal norms of behaviour which gradually evolve over time. Whatever it is, we are very interested in the entrepreneurs of organizations because, as I said, they are the actors. And if we want to understand how the game is being played or being changed, we must ask ourselves who are the actors who can change it, and how, indeed, they can effect that change. Competition in the world is ubiquitous, and it is ubiquitous because scarcity is ubiquitous. If we have scarcity then what we have is competition, because we do not have enough of anything to go around. Entrepreneurs in organizations compete with each other, whether they are firms competing in a particular market, politicians competing for access to political power, or professors in universities competing with respect to prestige. Competition is the driving force of change, since it forces entrepreneurs in competition to attempt to improve their competitive position.

If the world were an ergodic world, then when as entrepreneurs we undertook to implement a policy we would see whether the outcome was consistent with intentions, and if the outcome was not consistent with intentions we would modify the policy over time until we would get it right. And therefore the heart of what all this is about is the feedback on the policies that are enacted and the degree to which the policies produce the outcomes that we intended by enacting them. Most of the time the outcome surprises. The outcome surprises because the incentive structure embodied in institutions is always imperfect. Our ability to modify the game is imperfect. Outcomes diverge from intentions. The rise and decline of the Soviet Union is a wonderful story because it is a story about beliefs. But the crucial part is not the rise of the Soviet Union but its demise. One of the fascinating things about the Soviet Union's demise was the degree to which outcomes diverged from intentions more and more widely so that gradually there was stagnation in the Soviet economy and inability to do anything about it. That is crucial, but presumably in an ergodic world we would always get it right eventually. But in a non-ergodic world there is no guarantee that we will get it right eventually. That is a crucial dilemma.

Let me just give you a sobering lesson from someone who has been an economic historian for most of fifty years of being an academic. And that is, throughout history—and I have written about everything, from the Neolithic revolution to the present time—all societies have collapsed and disappeared eventually over enough time. They did so because they did not adjust, they did not continually understand the world they created. And societies keep continually creating a world, and when they do not understand it eventually it collapses. The decline of the Soviet Union is the most extraordinary collapse of any society in all of history, since it was done without deliberate outside intention on the part of anybody, and it was a society which evolved from nothing to being a superpower and then declined to almost nothing in a space of seventy some years. That is an extraordinary phenomenon. But that collapse is a testimonial to the degree to which our understanding of the world evolves with the way we change that world.

Now the foregoing constitutes a research agenda, and if I have correctly understood the overall nature of the process of economic change there is a lot we do not understand. We have created in the modern world an institutional structure which is enormously complex. Economics has not paid attention to institutions and has not looked at the complexities of the world that we have created, and here the sociologists are way ahead of us. If you take a look at the network analysis sociologists have done, you will see that the interrelationships that are a part of the structure are very complex. This leads to three basic problems about the modern economy that we are dealing with that pose some very serious dilemmas.

The first is the movement from personal to impersonal exchange. Of all the factors that have shaped and continue to shape the inability of Third World countries to become rich, that is the most fundamental. A world of personal exchange is a world in which it pays the players who engage in exchange to live up to the agreements. It pays them because they have repeat dealings with each other, they know each other and therefore they have to rely on that kind of exchange. But a world of impersonal exchange is just the reverse. It is a world in which we do not know the other players, we are never going to see them again, there are no repeat dealings, and therefore *ceteris paribus* we should take it and run. So, to use a game theory analogy, a world of personal exchange is a world in which it pays to cooperate; a world of impersonal exchange is a world in which it pays to defect. Economic historians have explained how, in the Middle Ages, institutions very gradually evolved in a way that altered the pay-off to cooperation, to make impersonal exchange possible. The movement from personal to impersonal exchange is a fundamental dilemma in our world. In Third World countries third-party enforcement via polities is obviously a basic stumbling block, since we do not know how to create polities to effectuate third-party enforcement.

The second fundamental problem concerns specialization and division of labour, which Adam Smith said was the source of the wealth of nations. He had it partly wrong. What makes for the welfare of the nations is not specialization and division of labour in general but specialization in knowledge. Modern economic growth stems from a world in which we become highly specialized in knowledge. Now that has the result that we know an enormous amount more and therefore potentially can be vastly more productive. But it requires that knowledge be connected with other knowledge, and that is not automatic at all. In fact the integration of knowledge across disciplines and different parts of the economy and society is a crucial dilemma and one that is an ongoing problem with respect to our ability to be able to effectively develop and to get Third World countries to be developed. In terms of good economic theory you would expect that someone who takes a Ph.D. in chemistry from Germany and goes back to Bangladesh would command a salary vastly higher than anywhere else because there is a scarce number of Ph.Ds. in chemistry in Bangladesh. Not so. She will get a lot higher salary in Germany or in the United States. She is not worth a lot by herself. She is worth a lot when her knowledge is integrated with other kinds of complex knowledge. We are beginning to understand that. For example, the synergy between universities in the United States and the development of new knowledge and its application has become a major factor in economic development in the United States, and it is one where we lead the world and for good reason.

The third problem is that we do not automatically get efficient markets just by *laissez-faire*. There is no such thing as *laissez-faire*. Milton Freedman is brilliant, but he led us astray. All markets that work well are structured. We want the players to compete via price and quality rather than compete via—well, I have one brief story. When I was in Russia, after the demise of the Soviet Union, I was talking to a banker and I said, 'How do you compete?' 'Oh,' he said, 'that's easy. We kill each other.' That is a form of competition but it is not what we have in mind. We want to have competition that competes via price and quality rather than other margins. Such competition is not automatic anywhere and indeed it is very uncommon in lots of the world. Adam Smith said it was not the deliberate intent of the butcher and the baker and the candlestick maker to improve human welfare. It is the fact that the butcher, the baker, and the candlestick maker in effective competitive markets produce that outcome whether they intend it or not. Now the key part of that statement is the structure of that market and the effectiveness of competition.

Let me end with three generalizations. One, if we ever are going to improve the world, if we are going to survive in a world where we have made ourselves vulnerable to mass destruction, we are going to do so only if we understand and have a much better understanding than we presently

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do about this process that we are talking about. Two, somebody who has not been quoted very much during this conference but was the greatest economist of the twentieth century in my view, had it right and had it wrong in one respect, and that is Hayek. Hayek had it wrong because he thought that social engineering was always bad. He had to be wrong about that because we do not have a choice. If human intentionality is the way the game is played we do not have a choice but try to structure the game. He was right, however, that in a world of uncertainty, in a world in which we do not know what is going to happen, in a world in which we are continually developing new and novel ways, what gives us the best chance of survival is to maximize the choice set. So we allow for lots of different ways to try things in the hope that we will get one that will be right. In a world of uncertainty no one knows the right choice, and therefore we have to simply see that we have many choices. The reason for the failure of the Soviet Union is that they did not maximize their choice sets. The reason why Western Europe and the United States have been relatively successful is that their adaptive efficiency (by that I refer to the existence of flexible institution sets) has allowed for lots of experimentation and change. Finally, three, and something that I have only talked around about—it is a dynamic world, it is a world of continual change; and if we are not self-conscious and aware about the dynamic change, do not try to incorporate that in the way in which we think about the process, we are going to continually face new problems and we will not succeed in solving them.

Notes

1 Editor's Note: This is an authorized transcription of the talk that Douglass C. North gave at the conference *Worlds of Captialism* on 31 May 2003 (cf. also this volume, p. xi).

2 Editor's Note: North refers to an evening event (a Soirée of the conference *Worlds of Capitalism* on 30 May 2003) on which Gerd Leipold (Greenpeace International, Amsterdam) and Jan Ph. Reemtsma (Hamburg, Institute for Social Research) presented notes on 'Globalization and the Environment' and on 'Globalization and Violence' respectively.

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6

States, markets and capitalism, East and West

Giovanni Arrighi

Writing in the mid-1960s, Geoffrey Barraclough contended that when the history of the first half of the twentieth century—which for most historians was still dominated by European wars and problems—came to be written in a longer perspective, no single theme would prove of greater importance than 'the revolt against the West' (1967:153–4). In a similar vein, we may today contend that when the history of the second half of the twentieth century will be written in such a longer perspective, the chances are that no single theme will prove of greater importance than the economic renaissance of East Asia. The purpose of this chapter is to investigate some of the implications of this potentially epoch-making phenomenon for our understanding of the past, present, and future of historical capitalism.

Towards an Asian future?

The East Asian renaissance has unfolded through a 'snowballing' process of connected economic 'miracles' in a succession of East Asian states, starting in Japan in the 1950s and 1960s, rolling on in South Korea, Taiwan, Hong Kong, Singapore and some ASEAN countries in the 1970s and 1980s, and culminating in the 1990s and early 2000s in the emergence of China as the world's most dynamic arena of capital accumulation. According to Terutomo Ozawa—who first introduced the 'snowballing' metaphor to describe the process (1993:30–1)—'the Chinese miracle, though still in its inchoate phase, will be no doubt the *most* spectacular of [all preceding miracles] in terms of speed...of growth and structural upgrading and the *most* dramatic in terms of its impact on the rest of the world...especially on neighbouring countries' (Ozawa 2003:700; emphasis in the original). Owing to China's demographic size, its continuing economic expansion is indeed far more subversive of the existing global hierarchy of wealth than all the previous East Asian economic miracles put together. For all these miracles (the Japanese included) were instances of upward mobility within a fundamentally stable hierarchy. The hierarchy could and did accommodate the upward mobility of a handful of East Asian states (two of them city states) accounting for about one-twentieth of world population. But accommodating the upward mobility of a state that by itself accounts for about one-fifth of world population is an altogether different matter. It implies a fundamental subversion of the very pyramidal structure of the hierarchy. According to recent studies of world income inequality, this subversion has apparently already begun. To the extent that these studies identify a statistical trend towards declining inter-country income inequality in the 1990s, the trend is due *entirely* to the rapid economic growth of China (Arrighi *et al.* 2003).

Equally important are the political-economic implications of the extraordinary Chinese expansion not just at the regional but at the global level as well. 'Asia's rise is the economic event of our age,' proclaims Martin Wolf in the first of a series of articles in the *Financial Times:*

Should it proceed as it has over the last few decades, it will bring the two centuries of global domination by Europe and, subsequently, its giant North American offshoot to an end. Japan was but the harbinger of an Asian future. The country has proved too small and inward-looking to transform the world. What follows it—China, above all—will prove neither.... Europe was the past, the US is the present and a China-dominated Asia the future of the global economy. That future seems bound to come. The big questions are how soon and how smoothly it does so.

(Wolf 2003)

As we shall see, the Asian future envisaged by Wolf may not be as inevitable as he seems to imply. There are none the less signs that, at least regionally, that future may come sooner rather than later. Thus, in December 2003, the president of the Asian Development Bank, Tadao Chino, cited the rapidly increasing importance of the People's Republic of China as the key reason for the bank's upbeat expectations for the economies of South and East Asia. Tyler Marshall of the *Los Angeles Times* takes this assessment as 'one more piece of evidence pointing to the shift of geopolitical power underway in Asia'.

In the space of a few years, China has become an economic power and increasingly potent political force in a region where the United States once stood unchallenged—from New Delhi in the west, to South East Asia, to Tokyo and Seoul in the east.... Much of China's new status stems from its emergence as one of the world's major trading nations and, in the process, an important market for export-oriented neighbors. But there is a strong political dimension to this power as Beijing's new leaders show themselves prepared to set aside old disputes and engage, rather than bully, other nations.

(Marshall 2003)

While rapidly catching up with the United States as the biggest trading partner and importer of last resort of the East Asian region, China's importance relative to the United States is growing rapidly even outside the East Asian region. The European Union, for example, forecasts that by 2010 China will probably overtake the United States as its biggest trade partner. A former Merrill Lynch chief economist sees China already playing the role of 'global locomotive' along with the United States. Similarly, Nicholas Lardy sees no one else coming close to the Chinese as 'global customers'. 'They've been a big driver of global trade expansion and a significant force in promoting the recovery' (Pine 2003).

Equally important, China has begun to overshadow the United States in the promotion of multilateral trade liberalization. Regionally, it has sought integration with ASEAN by agreeing to a Treaty of Amity and Cooperation while simultaneously seeking economic ties with Japan, South Korea, and India. Globally, it joined Brazil and India in leading the global South's offensive at the 2003 WTO meeting in Cancun against the Northern practice of imposing market opening on the South while remaining fiercely protectionist in lines of production where the South has the greatest comparative advantage, first and foremost agriculture. China's stance contrasts sharply with the US abandonment of multilateral trade negotiations in favour of bilateral free-trade agreements aimed at breaking up the Southern alliance that emerged at Cancun, or at gaining support for the Bush administration's War on Terrorism (Smith and Cooper 2003; Vatikiotis and Murphy 2003; Kwa 2003). 'Ironically,' comment Michael Vatikiotis and Murray Hiebert, 'China was once suspicious of multilateralism when the US championed multi-pronged anticommunist alliances during the Cold War. Today it's the other way around with Washington favouring bilateral trade and security agreements with those it considers "friends and allies"' (Vatikiotis and Hiebert 2003).

Whatever their eventual outcome—an issue to which we shall return in the concluding section—these tendencies raise problems of interpretation that challenge predominant understandings of processes of capitalist development and their relationship to the formation of states and markets. In this chapter, I will focus on what in my view is the most puzzling, and difficult to solve, among these problems: the demise *and* seeming resurgence of East Asia, and within East Asia of China, as the centre of the global economy. As Gilbert Rozman has observed, 'East Asia is a great region of the past, having been in the forefront of world development for at least two thousand years, until the sixteenth, seventeenth, or even the eighteenth century, after which it suffered a relatively brief but deeply felt eclipse' (1991:6). How does this eclipse relate to the nineteenth-century globalization of Western capitalism? And above all, what is the relationship, if any, between the present economic renaissance of East Asia and its earlier position in the forefront of world development?

These questions invite us to re-examine the relationship between processes of market formation and capitalist development. The predominant view among historians and social scientists is that the relationship is one of mutual reinforcement. Indeed, discursively and analytically the two processes are often treated as if they were the same thing. The ongoing economic renaissance of East Asia has none the less been accompanied by a growing awareness of a fundamental world-historical discrepancy between the two processes. For it now appears that through the eighteenth century trade and markets were more developed in East Asia in general, and in China in particular, than in Europe. And yet, in the nineteenth and early twentieth centuries East Asian primacy in market formation was eclipsed by the spectacular achievements of European and then North American industrial capitalism.

In light of this discrepancy, the questions raised above concerning the demise and seeming resurgence of East Asia can be reformulated as follows. First, why did industrial capitalism develop in Western Europe rather than in East Asia, where processes of market formation were more advanced? Second, why was the British-led globalization of industrial capitalism associated with a sharp economic decline of the East Asian region, and especially of its Chinese centre for at least a century (let us say from the First Opium War to the end of the Second World War)? And why was this long decline followed by an even sharper economic renaissance of that same region in the second half of the twentieth century? Finally, what can the comparative East-West experience tell us about the prospective consequences of the ongoing East Asian renaissance?

The Smithian dynamic: Eastern entrapment and Western escape

In seeking answers to these questions, I shall begin by briefly reviewing the emerging literature on the reasons why comparable processes of market formation gave rise to industrial capitalism in Western Europe but not in East Asia. This literature revolves around two main themes: the theme of 'Smithian dynamic' and the related notion of 'high-level equilibrium trap', used by Mark Elvin (1973) to characterize late imperial China; and the theme of 'industrious revolution', used by Jan de Vries (1993, 1994) to characterize economic expansion in seventeenth and eighteenth-century Western Europe. In R.Bin Wong's conceptualization, the Smithian dynamic is a process of economic improvement driven by productivity gains attending a widening and deepening division of labour limited only by the extent of the market (Wong 1997:16). As economic improvement raises incomes and effective demand, the extent of the market increases, thereby creating the conditions for new rounds of division of labour and economic improvement. Over time, however, this virtuous circle comes up against the limits imposed on the extent of the market by the spatial scale and institutional setting of the process. When these limits are reached, the process enters a high-level equilibrium trap.

This conceptualization explicitly challenges the argument that, prior to the industrial revolution, Europe and China were moving along radically different trajectories of economic development. In Philip Huang's (1990) version of the argument, while Europe was growing along an evolutionary trajectory headed towards the industrial revolution and unlimited economic improvement, China was growing along an 'involutionary' trajectory characterized by decreasing returns to the increasing number of days worked annually. Against this view, Wong points out that what de Vries calls early modern Europe's industrious revolution and what Huang calls China's 'growth without development' share important features that 'were part of the Smithian dynamics of market-based growth supported by labour intensification in the advanced regions of China and Europe in the centuries preceding the industrial revolution'. And if Europe and China were experiencing the same Smithian dynamics, then the real puzzle is not why China was caught in a high-level equilibrium trap, but why Europe escaped such a trap through the industrial revolution (Wong 1997:30–1; see also Sugihara 2003).

Andre Gunder Frank and Kenneth Pomeranz have made the same point even more forcefully. Frank has underscored how Adam Smith himself saw China as being ahead of Europe along the same developmental trajectory, and how he did not foresee the emerging bifurcation of that trajectory.

Smith...was the last major [Western] social theorist to appreciate that Europe was a Johnny-come-lately in the development of the wealth of nations: 'China is a much richer country than any part of Europe,' Smith remarked in 1776. Smith did not anticipate any change in this comparison and showed no awareness that he was writing at the beginning of what has come to be called the 'industrial revolution'.

(Frank 1998:13)

Pomeranz, for his part, has challenged on empirical grounds the argument that Western Europe grew faster because it had the more efficient markets for goods and for factors of production. Even as late as 1789, he argues:

western European land, labor, and product markets...were on the whole probably *further* from perfect competition—that is, less likely to be composed of multiple buyers and sellers with opportunities to choose freely among many trading partners—than those in most of China and thus less suited to the growth process envisioned by Adam Smith.

(2000:17; emphasis in the original)

Taken jointly, the works of these authors challenge the still dominant view that the rise of the West to global supremacy in the nineteenth century was somehow due to a prior Western superiority in the creation of a market economy. They remind us of what Adam Smith already knew but Western social thought subsequently forgot—namely, that throughout the eighteenth century the Chinese national market far surpassed in size and density any Western national market. This greater size and density of the Chinese national market was due not just to China's much greater population. It was due also to levels of commercialization, transport infrastructure, agricultural productivity, sophistication of manufactures, and *per capita* incomes as high as, or higher than, those of Europe's wealthiest countries. It follows from this forgotten fact that primacy in the formation of a national market cannot be taken as a reason, let alone 'the' reason, why in the nineteenth century Europe/England displaced East Asia/China as the centre of the global economy. Indeed, China was caught in a Smithian high-level equilibrium trap precisely because of its very success in the development of a national market. Rapid growth of production and population had rendered all resources *except labour scarce,* and this, in turn, made profitable innovations increasingly problematic. In Elvin's words:

With falling surplus in agriculture, and so falling *per capita* income and *per capita* demand, with cheapening labor but increasingly expensive resources and capital, with farming and transport technologies so good that no simple improvements could be made, rational strategy for peasant and merchant alike tended in the direction not so much of labor saving machinery as of economizing on resources and fixed capital.... When temporary shortages arose, mercantile versatility, based on cheap transport, was a faster and surer remedy than the contrivance of machines. This situation may be described as a 'high-level equilibrium trap'.
(Elvin 1973:314)

The question then arises of how and why England/Europe managed to escape this high-level equilibrium trap through the industrial revolution that took off at the end of the eighteenth century and became the prime mover of the rise of the West to global supremacy in the nineteenth century. If the common Smithian dynamic of the European and Chinese economies cannot account for the profound rupture of possibilities initiated by the development and massive deployment of mineral sources of energy in the manufacture and transport of commodities, what can? Following E.A.Wrigley (1988, 1989), Wong conceives of this development as an historical contingency largely unrelated to previous developments. Its main features were productivity gains, based on coal as a new source of heat, and steam as a new source of mechanical energy, that far surpassed

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what could be achieved under the Smithian dynamic. 'Once this fundamental break took place, Europe headed off along a new economic trajectory.' But the break itself remains unexplained: 'technologies of production,' we are told, 'do not change according to any simple and direct economic logic'. Like 'forces of production' in Marxist accounts, they are 'the exogenous variable that drives other economic changes' (Wong 1997:48–52).

In contrast to Wong, Frank traces the occurrence in England/Europe and the non-occurrence in China/Asia of the industrial revolution to opposite outcomes of the common Smithian dynamic. In Asia in general, and in China in particular, economic expansion created the labour surplus and capital shortage that underlie Smithian high-level equilibrium traps. In Europe, in contrast, economic expansion created a labour shortage and a capital surplus. It was this opposite outcome that, according to Frank, after 1750 led to the industrial revolution (Frank 1998:304). The intensive burst of technological innovations that remains exogenous (that is, unexplained) in Wong's reconstruction of the European and Chinese dynamics thus becomes endogenous in Frank's reconstruction. As we shall see, however, this endogenous explanation of the industrial revolution has no satisfactory explanation of why a common dynamic had opposite effects in the West and in the East.

Pomeranz (2000) does provide an explanation by tracing what he calls the Great Divergence to differences in resource endowments and in core-periphery relations—that is, to the fact that the Americas provided core regions of north-west Europe with a far more abundant supply of primary products and demand for manufactures than East Asian core regions could obtain from their own peripheries. Like Wong, he relies on Wrigley's earlier contention that a rich domestic endowment of cheap fossil fuel was essential to the take-off of the industrial revolution in Britain. But in his view, in the absence of American supplies of primary products it would have been impossible for European technology and investment to develop in labour-saving, land-and-energy-gobbling directions, at the very moment when the intensification of resource pressures previously shared by all core regions were forcing East Asian development along ever more resource-saving, labour-absorbing paths.

All these explanations of the nineteenth-century divergence of the European and East Asian developmental paths contain important elements of truth. They none the less either miss relevant historical aspects of the divergence or beg a number of questions that they themselves raise. First, while Britain's endowment of cheap fossil fuels may have some validity in explaining why Britain escaped from the Smithian trap through the industrial revolution earlier than the rest of Europe, it cannot explain why China—which also had known and very considerable deposits of coal—did not make a similar escape. More important, feedbacks and spin-offs from the mining, transportation, and utilization of coal, as well as American supplies

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of primary products, became crucial to the British/European breakthrough later rather than earlier in the nineteenth century (O'Brien 2001:360, 364). Agreed, sums up Patrick O'Brien:

the Great Divergence and the Industrial Revolution form part of an interconnected narrative; and the degree of divergence in labor productivities and real incomes between Europe and China, that had so clearly appeared by 1914, is inconceivable without the massive supplies of basic foodstuffs and raw materials imported from the Americas and other primary producers. But since those supplies came on stream over the second half of the nineteenth century, questions of what started and what sustained the Industrial Revolution should not be conflated.

(O'Brien 2001:367)

Second, as Frank maintains, according to all available evidence (including Adam Smith's own assessment), prior to the Great Divergence wages and demand were higher and capital more abundant in Europe than in Asia, and this difference in all likelihood contributed to making labour-saving, energy-consuming technology economic in the West but not in the East. Nevertheless, Frank provides no explanation of why processes of market formation that were more advanced in the East than in the West were associated with higher wages and demand, and more abundant capital, in the West than in the East. By his own account, before the industrial revolution the only competitive advantage the Europeans had *vis-à-vis* the East was based on the mining and transportation of American silver, as well as its investment in various trading ventures, including intra-Asian trade. In his view, however, this one competitive advantage enabled the Europeans to hold out in Asia for three centuries but not to gain a commanding position in a global economy that remained centred on Asia, because the flow of American silver benefited Asian economies more than the European. Throughout the eighteenth century European manufactures in Asia remained uncompetitive and China remained the 'ultimate sink' of the world's money (Frank 1998:283, 356–7). But if this was the case, as it indeed was, why was China affected by a shortage and Europe by a surplus of capital? And why was Europe experiencing greater demand for labour and higher wages than China? Frank does not even ask these questions. But as we shall see, they are crucial to an understanding of the East-West dynamic, both past and present.

Third, as argued in the first section, the puzzle of the European escape from a Smithian high-level-equilibrium trap through the industrial revolution must be dealt with in conjunction with the puzzle of why the globalization of that revolution was associated for about a century with the economic decline, and then with a rapid economic renaissance, of the East Asian region. In concluding his critical assessment of Pomeranz's thesis, O'Brien asks:

if the English economy might well (but for coal and its close involvement with the Americas) have gone the way of the Yangzi Delta, then why has even that commercialized and advanced region of the Manchu Empire taken such a long time to regain the economic rank and status it held in the world economy in the mid-eighteenth century?

(2001:367; emphasis in the original)

As we shall see, the really interesting and difficult question is not why it has taken so long for the Yangzi delta, China, and East Asia to regain the economic ground they had lost *vis-à-vis* the West since the mid-eighteenth century. Rather, it is how and why China has managed to regain so much ground, so quickly, *after* more than a century of political-economic eclipse. Either way, a model of the Great Divergence must tell us something, not just about its origins, but also about its development over time, its limits, and its prospective consequences.

Towards a fusion of the industrious and industrial revolution paths?

Starting from premises very similar to Wong's and Pomeranz's, Kaoru Sugihara has attempted to construct such a comprehensive model. Sugihara substantially agrees with Pomeranz's and Wong's accounts of the origins of the Great Divergence. He none the less departs from them in emphasizing the importance of major differences in the man-land ratio between the core regions of East Asia and those of Western Europe before 1800, as both cause and effect of an unprecedented and unparalleled East Asian industrious revolution. From the sixteenth century through the eighteenth, he claims, the development of labour-absorbing institutions and labour-intensive technologies in response to natural resource constraints (especially scarcity of land) enabled East Asian states to experience a major increase in population accompanied, not by a deterioration, but by a modest improvement, in the standard of living (Sugihara 2003:82, 94, 117 n. 2).

This escape from Malthusian checks was especially remarkable in China, whose population had previously risen several times to a ceiling of 100 million to 150 million, only to fall, whereas by 1800 it rose to nearly 400 million. This was clearly a world demographic landmark,' notes Sugihara, 'and its impact on world GDP far outweighed that of post-industrial revolution Britain, whose share of world GDP in 1820 was less than 6 per cent.' The 'Chinese miracle', as Sugihara calls this massive escape from Malthusian checks, was replicated on a smaller territorial scale in Japan, where population growth was less explosive than in China but the improvement in standard of living more significant (Sugihara 2003:79, 89–90).

Whatever the actual world-historical significance of this East Asian industrious revolution, Sugihara's central claim is that its instrumentalities and outcomes established a distinct East Asian technological and institutional path that has played a crucial role in shaping East Asian responses to the challenges and opportunities created by the Western industrial revolution. Particularly significant in this respect was the development of a labour-absorbing institutional framework centred on the household (often, though not always, the family) and, to a lesser extent, the village community. Against the traditional view that small-scale production lacks internal forces for economic improvement, Sugihara underscores important advantages of this institutional framework in comparison with the class-based, large-scale production that was becoming dominant in England. While in England workers were deprived of the opportunity to share in managerial concerns and to develop interpersonal skills needed for flexible specialization, in East Asia:

an ability to perform multiple tasks well, rather than specialization in a particular task, was preferred, and a will to cooperate with other members of the family rather than the furthering of individual talent was encouraged. Above all, it was important for every member of the family to try to fit into the work pattern of the farm, respond flexibly to extra or emergency needs, sympathize with the problems relating to the management of production, and anticipate and prevent potential problems. Managerial skill, with a general background of technical skill, was an ability which was actively sought after at the family level.

(Sugihara 2003:87)

Moreover, as long as East Asian peasants observed social codes, the transaction costs of trade were small, and the risk involved in technical innovations was relatively low. Although the East Asian institutional framework left little room for big innovations, or for investment in fixed capital or long-distance trade, it provided excellent opportunities for the development of labour-intensive technologies that made an unmistakable contribution to the increase in *per capita annual* income, even if they did not increase output per day or per hour. The difference between this kind of development and development along the Western path 'was that it mobilized human rather than non-human resources' (Sugihara 2003:88, 90).

This disposition to mobilize human rather than non-human resources in the pursuit of economic improvement continued to characterize the East Asian developmental path, even when East Asian states sought to incorporate within their economies Western technologies. Thus, by the 1880s, the Japanese government adopted an industrialization strategy based on the recognition that in Japan both land and capital were scarce, while labour was abundant and of relatively good quality. The new strategy

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accordingly encouraged 'active use of the tradition of labour-intensive technology, modernization of traditional industry, and conscious adaptation of Western technology to different conditions of factor endowment'. Sugihara calls this hybrid developmental path 'labor-intensive industrialization', because 'it absorbed and utilized labor more fully and depended less on the replacement of labor by machinery and capital than the Western path' (2003:94).

In the first half of the twentieth century, labour-intensive industrialization increased the competitiveness of Japanese products *vis-à-vis* other Asian countries, such as India, which had a long tradition of labour-intensive technology but were prevented by colonial rule to develop in the same direction as Japan (Sugihara 2003:95–6). Nevertheless, the fusion of the East Asian and Western developmental paths remained limited through the Second World War. As a result, despite an increase in land productivity, and the growth of labour-intensive industries, East Asia's labour productivity continued to lag behind that of the West, and the region's share of world GDP continued to decrease. It is not altogether clear from Sugihara's account what exactly prevented the fusion of the two paths from materializing more fully than it did in the first half of the twentieth century. From his scanty remarks on this issue, it would seem that the main reason was scarcity of natural resources within Japan, and above all, the constraints that Western control over global natural resources imposed on Japanese industrialization (Sugihara 2003:101–2, 155). Be that as it may, Sugihara is quite explicit on the circumstances that *did* enable the fusion to materialize fully (and bear extraordinary fruit) after the Second World War.

First, the establishment of the Cold War regime under US hegemony radically changed the politics of the situation:

In contrast to the pre-war situation, Japan was expected to use her economic strength to counter communist penetration in Asia, and was now able to import all necessary raw materials and resources, including oil, from the rest of the world (by contrast, the US ban on oil exports to Japan in 1941 was an immediate cause of the [Pearl Harbor] attack). In the post-war period Japan also enjoyed favorable opportunities to increase exports of manufactured goods to advanced Western countries. This change in international circumstances allowed Japan, and later a number of other Asian countries, to pursue the systematic introduction of capital-intensive and resource-intensive heavy and chemical industries to an economy with relatively cheap and disciplined labor.

(Sugihara 2003:81)

Second, the United States and the Soviet Union, in competition with one another, translated abundant mineral resources into powerful military industrial complexes based on large-scale production in the steel, aircraft, armament, space, and petrochemical industries. As a result, the capital and natural resource intensity of the Western developmental path increased further, creating new opportunities for profitable specialization not only in labour-intensive industries but also in the relatively resource-saving sectors of capital-intensive industries. Japan promptly seized these opportunities by shifting from labour-intensive industrialization—a strategy that aimed at combining directly within particular industries or factories imported technologies and cheap labour trained to replace capital—towards the development of interlinked industries and firms with different degrees of labour and capital intensity, while retaining a strong overall bias towards the East Asian tradition of greater utilization of human than of non-human resources (Sugihara 2003:105–10, 112–14).

Finally, the surge of nationalism under the Cold War regime created conditions for fierce inter-Asian competition between relatively low-wage industrializers and higher-income countries:

As soon as wages in one country rose even fractionally, [that country] had to seek a new industry which would produce a higher quality commodity to survive the competition, creating an effect similar to the 'flying geese pattern of economic development.' At the same time, successive entrance of new low wage countries ensured the lengthening of the chain of 'flying geese.' It is this aspect of industrialization, part of the enlargement of the East Asian path, that has been responsible for the increase in East Asia's share in world GDP.

(Sugihara 2003:110)

The flying geese pattern of economic development to which Sugihara refers is a 'leading sector' model of spatial diffusion of industrial innovations. Originally advanced by Kaname Akamatsu (1961), it was subsequently developed into several new versions (Kojima and Ozawa 1985; Cumings 1987; Ozawa 1993, 2003; Kojima 2000). One of these versions underlies Ozawa's snowballing process of connected East Asian economic miracles mentioned at the beginning of the chapter.

Sugihara's idea of the continuing significance of a distinctive labour-absorbing, resource-saving East Asian path helps in explaining why this snowballing process has occurred in East Asia to a far greater extent than anywhere else. Nevertheless, his re-evaluation of the historical significance of the industrious revolution raises more questions than it answers concerning the origins and limits of the Great Divergence. For one thing, like Frank, Sugihara does not even ask the question of why, prior to the Great Divergence, China was affected by a shortage and Western Europe by a surplus of capital, and why Western Europe was experiencing greater demand for labour and higher wages than China. Moreover, in explaining both the initial failure and the eventual success of the Japanese-led fusion of the industrious and industrial revolution paths, Sugihara resorts to geopolitical considerations that remain exogenous (that is, unexplained) in his model. His contention that in the first half of the twentieth century Western control over global natural resources played a major role in preventing Japan from realizing more fully than it did the fusion in question is hard to dispute. And so is his contention that in the second half of the century the establishment of the Cold War regime, intense competition between the two superpowers in building capital- and mineral-resourceintensive military industrial complexes, and the surge of nationalism in the former colonial world, created a favourable geopolitical environment for the hybridization of the two paths first in Japan and then in the East Asian region at large. But the very importance that he rightly attributes to the geopolitical environment in retarding and then speeding up the hybridization of the two paths in the twentieth century raises two crucial questions.

First, is it not possible that the geopolitical environment was just as important in creating the conditions for the bifurcation of the two paths in the late eighteenth and early nineteenth centuries? Or, to rephrase, is it not possible that much of what remains unexplained about the origins of the Great Divergence in Wong, Frank, Pomeranz, and Sugihara himself can be traced back to differences between the geopolitical environments of the Western European and East Asian world regions? And if so, which differences are most relevant to an understanding of the origins of the Great Divergence? Second, what is the relationship between the geopolitical environment and the formation of distinct national and world-regional developmental paths? Are these paths mere 'products' of the environment, or are they key ingredients of its formation/transformation? And if they are such ingredients, how did the Great Divergence contribute to transform the broader geopolitical environment from being unfavourable to being favourable to the hybridization of the industrious and industrial revolution paths?

As argued elsewhere from a variety of perspectives (Arrighi 1994; Arrighi and Silver 1999; Arrighi, Hui *et al.* 2003), world-regional and global geopolitical environments did indeed contribute decisively to the emergence of interacting but distinct developmental paths in Western Europe and East Asia. And development along these divergent paths did in turn promote major transformations of the geopolitical environment both globally and regionally. The substance of the argument can be summed up in three main propositions.

First, in the course of the three centuries that Fernand Braudel (1984:79) calls the 'extended' sixteenth century with reference to Western European history (1350–1650), and which correspond almost exactly to the Ming period of East Asian history (1368–1643), Western Europe and East Asia came to be organized geopolitically into two mutually interacting but distinct inter-state systems, sufficiently similar to be comparable but

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sufficiently different to give rise to two divergent developmental paths. Second, over the following two centuries development along these divergent paths strengthened Chinese/East Asian primacy in state and national economy making but created the conditions for the British/Western European escape from the high-level equilibrium trap typical of Smithian dynamics through a novel combination of capitalism and imperialism. Third, this novel combination is the truly 'independent' variable that lurks behind all the other determinants of the Great Divergence of the nineteenth and early twentieth centuries. But once that combination attained its economic, political, and social limits, the reconstitution of the global market under US hegemony created a particularly favourable environment for the East Asian-centred fusion of the industrious and industrial revolution paths. Let us look at each of these propositions in turn.

The geopolitics of the Great Divergence before the industrial revolution

The idea of an inter-state system as the geopolitical environment of national developments was originally conceived to describe the European system of rule that emerged in the course of the 'extended' sixteenth century and was eventually institutionalized at Westphalia in 1648 (see, among others, Gross 1968). More recently, Japanese scholars specializing in the reconstruction of the China-centred tribute trade system have shown that this system presented sufficient similarities with the European inter-state system to make their comparison analytically meaningful (see Ikeda 1996 for an overview of the contribution). Both consisted of a multiplicity of political jurisdictions that appealed to a common cultural heritage and traded extensively within their region. Although cross-border trade was more publicly regulated in East Asia than in Europe, since Song times (960–1276) private overseas trade had flourished and transformed the nature of tribute trade, the main purpose of which, in Takeshi Hamashita's words, 'came to be the pursuit of profits through the unofficial trade that was ancillary to the official system' (1993:75–6).

We can even detect analogies in the inter-state competition that characterized the two regional systems. The separate domains that were held together by the tribute trade system centred on China were 'close enough to influence one another, but...too far apart to assimilate and be assimilated'. The tribute trade system provided them with a symbolic framework of mutual political-economic interaction that none the less was loose enough to endow its peripheral components with considerable autonomy *vis-à-vis* the Chinese centre. Thus, Japan and Vietnam were peripheral members of the system but also competitors with China in the exercise of the imperial title-awarding function, Japan establishing a tributary-type relationship with the Ryukyu kingdom, and Vietnam with Laos

(Hamashita 1994:92, 1997:114–24). Sugihara goes even further in maintaining that the diffusion of the best technology and organizational knowhow within East Asia makes it 'possible to think of the presence of an East Asian multi-centered political system…with many features analogous to the interstate system in Europe' (1996:38).

These similarities make a comparison of the two inter-state systems analytically meaningful. But once we compare their structures and modes of operation, we can detect two differences that provide a plausible and parsimonious explanation of the subsequent Great Divergence. One concerns the distribution of power among political jurisdictions, and the other the extroversion/introversion of the two systems.

Even before the 'extended' sixteenth century, political, economic, and cultural power in the East Asian system was far more concentrated in its Chinese centre than in the Western European system, where a centre proper was much harder to identify both politically and economically. In the course of the 'extended' sixteenth century, this difference became sharper with the institutionalization of the Western European balance of power on the one side, and the defeat of Japanese attempts to challenge militarily Chinese centrality on the other. In addition to being characterized by a different distribution of power, the two systems differed also in the way in which they related to the outside world and to one another. Although trade within, between, and across political jurisdictions was essential to the operations of both systems, the economic and political weight of long-distance trade (including trade between the two systems) relative to short-distance trade was far greater in the Western European than in the East Asian system (Arrighi *et al.* 2003:280–1).

Whatever the historical and geographical origins of these two differences, their consolidation in the course of the 'extended' sixteenth century led to a bifurcation of the East Asian and Western European developmental paths. In East Asia, China led the way in a process of selfcentred development, focused more on state making than on war making, and more on domestic than on foreign (especially long-distance) trade. The result was Sugihara's Chinese Miracle. Contrary to some of Sugihara's remarks (2003:86), eighteenth-century European thinkers (including Adam Smith) were quite impressed by this achievement. The remarkable peace, prosperity, and demographic growth that China experienced for much of the eighteenth century was a source of inspiration for leading figures of the European Enlightenment. Leibniz, Voltaire, and Quesnay, among others, 'looked to China for moral instruction, guidance in institutional development, and supporting evidence for their advocacy of causes as varied as benevolent absolutism, meritocracy, and an agriculturally based national economy' (Adas 1989:79; see also Hung 2003). The most striking contrast with European states was the Chinese empire's size and population. In Quesnay's characterization, the Chinese empire was 'what all Europe would be if the latter were united under a single sovereign'—a characterization that was echoed in Adam Smith's remark that China's 'home market' was as big as that of 'all different countries of Europe put together' (Quesnay 1969:115; Fairbank 1983:170).

This positive image of China subsequently faded, not because of European economic achievements as such, but because of European military superiority. European merchants and adventurers had long emphasized the military vulnerability of an empire ruled by a scholar-gentry class, while complaining bitterly about the bureaucratic and cultural handicaps they met in trading with China. These indictments and complaints gradually translated in a fundamentally negative view of China as a bureaucratically oppressive and militarily weak empire. This negative view, in turn, contributed to transforming China in the political imagination of the West, from a model to be imitated into the antithesis of the British model that was becoming hegemonic in Western thought (Adas 1989:89–93, 124–5).

The British model that was becoming hegemonic in Western thought had developed along a path that in key respects was indeed the antithesis of the East Asian path. While the Chinese/East Asian model privileged state making over war making, and national economy making over the formation of overseas commercial and territorial empires, the British/Western European model did just the opposite. From the fourteenth century through the eighteenth, war making and overseas empire building jointly constituted the most prominent form of inter-state competition in the European system. They were integral aspects of the enlarged reproduction of the European balance of power and of the extroversion of the European system—that is, of the dependence of the successful pursuit of power *within* the system on access to resources (human and non-human) *outside* the system. As William McNeill sums up the process with specific reference to the period 1600–1750:

Within the cockpit of western Europe, one improved modern-style army shouldered hard against its rivals. This led to only local and temporary disturbances of the balance of power, which diplomacy proved able to contain. Towards the margins of the European radius of action, however, the result was systematic expansion —whether in India, Siberia or the Americas. Frontier expansion in turn sustained an expanding trade network, enhanced taxable wealth in Europe, and made support of the armed establishment less onerous than would otherwise have been the case. Europe, in short, launched itself on a self-reinforcing cycle in which its military organization sustained, and was sustained by, economic and political expansion at the expense of other peoples and polities of the earth.

(McNeill 1982:143)

No self-reinforcing cycle of this kind could be observed in East Asia. Qing China did expand its frontiers north and west, but the economic benefits of expansion fell far short of what would have been required to sustain the costs of an armament race, European-style. As Wong points out, the logic of political economy emphasizing competition with foreign states had little in common with China's emphasis on the mutual benefits of domestic exchange. Rather than extract resources from peripheries, the Chinese state was more likely to invest in them. Political expansion to incorporate new frontiers committed the government to a shift of resources to the peripheries, not extraction from them (1997:148).

As previously noted, the separate political jurisdictions of the East Asian inter-state system did compete with one another. Sugihara (1996:37–8), for example, detects a competitive relation in two complementary tendencies typical of Tokugawa Japan: its attempt to create a tribute trade system centred on Japan instead of China, and its extensive absorption of technological and organizational knowledge in agriculture, mining, and manufacturing from Korea and China. In other words, as Heita Kawakatsu (1994:6–7) put it, Japan was trying to become a mini-China both ideologically and materially.' In this endeavour Japan was eventually highly successful, matching and eventually overtaking Qing China's industrious revolution. Nevertheless, this kind of competition drove the East Asian developmental path not closer but further apart from the European: towards a deepening of the division of labour within households and micro-regions rather than between metropolitan core regions and overseas peripheral regions; towards short-distance (intra-regional) rather than long-distance (inter-regional) trade; towards state making rather than war making.

The extent of this divergence can be gauged by the opposite trends of foreign trade in the two systems in the eighteenth and early nineteenth centuries. In this period, a growing number and variety of European governmental and business organizations built overseas commercial empires of growing scale, scope, and sophistication. As a result of these activities, European trade not only expanded far more rapidly than in the seventeenth century, but it expanded so as to promote the division of labour with the Americas that enabled European core regions to specialize in labour-saving and land- and energy-intensive directions. East Asian states in contrast showed no tendency whatsoever to build overseas commercial empires. Even trade contacts among Asian countries, as Sugihara acknowledges, 'shrank sharply from the early eighteenth century and did not recover until the West forced China and Japan to open their ports to foreign trade in the middle of the nineteenth century' (1996:38–9). As a result, the very success of the industrious revolution in both China and Japan intensified the shortage of natural resources, forcing development in both countries along ever more resource-saving, labour-intensive paths.

This is the bifurcation that figures prominently in Pomeranz's model of the nineteenth-century Great Divergence. All that is argued here is that the industrious-industrial revolution bifurcation had deep roots in an

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earlier divergence of the geopolitical environments in which Western European and East Asian states operated. In the East Asian inter-state system, a more centralized and introverted power structure provided a more favourable geopolitical environment for development along the industrious revolution path. But the more balanced and extroverted power structure of the Western European system provided a more favourable geopolitical environment for the mobilization through trade and coercion of the extra-systemic resources necessary to escape from the high-level equilibrium trap of even the most successful of industrious revolutions.

Equally important, the operation of McNeill's 'self-reinforcing cycle' of escalating intra-European military competition sustaining and in turn being sustained by expansion at the expense of other peoples and polities of the earth did not just create the kind of core-periphery relations between Europe and the Americas that according to Pomeranz enabled Britain to embark upon the land- and energy-intensive industrial revolution path. It played also a decisive role in creating the conditions for the 'take-off of the revolution in the capital goods industries, which was far more crucial than the earlier revolution in textile production in bringing about the Great Divergence. As McNeill underscores:

both the absolute volume of production and the mix of products that came from British factories and forges, 1793–1815, was profoundly affected by government expenditures for war purposes. In particular, government demand created a precocious iron industry, in excess of peacetime needs, as the postwar depression 1816–20 showed. But it also created the condition for future growth by giving British ironmasters extraordinary incentives for finding new uses for the cheaper products their new, large-scale furnaces were able to turn out. Military demands on the British economy thus went far to shape the subsequent phases of the industrial revolution, allowing the improvement of steam engines and making such critical innovations as the iron railway and iron ships possible at a time and under conditions which simply would not have existed without the wartime impetus to iron production.

(McNeill 1982:211–12)

This interpretation supports Wong's contention that technologies of production are 'the exogenous variable that drives other economic changes' (see p. 115 above). But it also suggests that what appears as exogenous in a strictly economic model becomes endogenous (that is, intelligible) in a political-economic model that incorporates inter-state power struggles among the 'variables'. Sugihara himself introduces such a variable when he attributes the further increase in the capital and natural resource intensity of the Western developmental path in the Cold War era to the

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armament race between the United States and the Soviet Union. But as McNeill (1982) has shown in great detail, the armament race is no novelty of the twentieth century. Rather, it has been integral to the inter-state competition that since the 'extended' sixteenth century drove European states to the four corners of the earth, as well as the single most important source of the organizational and technological transformations that made that expansion possible.

If much of what is unintelligible in Wong's, Frank's, Pomeranz's, and Sugihara's accounts of the Great Divergence becomes intelligible once we bring into the picture long-standing differences between the geopolitics of the Western European and East Asian inter-state systems, not everything does. In particular, geopolitical differences as such cannot explain how and why Britain/Western Europe, in comparison with and in relation to China/East Asia, came to experience the overabundance of capital that made development along the industrial revolution path feasible and economic. For incessant wars, the armament race, and the building of overseas empires involved large investments of capital in personnel and material, the benefits of which materialized (if at all) only after long periods of time. This kind of investment contributes to explaining why Britain/Europe experienced the higher wages and higher demand that in Frank's model made investment in labour-saving technology economic in Britain/Western Europe but not in China/East Asia (see p. 115 above). But they make even more inexplicable the overabundance of capital that according to the same model made such an investment possible. In other words, if through the eighteenth century China was the 'ultimate sink' of the world's money, as Frank correctly maintains, where did Britain/Western Europe get all the capital needed to finance incessant wars, increasingly expensive rounds of the armament race, and the construction of increasingly large overseas empires?

Capitalism East and West, before and after the industrial revolution

In order to answer this question, we must bring into the picture another key ingredient of the Great Divergence: capitalism. There are many conceptions of capitalism, but for our purposes Braudel's is the most useful. In Braudel's conception, capitalism is 'the top layer' of the world of trade. It consists of those individuals, networks, and organizations that systematically appropriate the largest profits, regardless of the particular nature of the activities (financial, commercial, industrial, or agricultural) in which they are involved. Braudel distinguishes this layer from the lower layer of 'market economy', which consists of regular participants in buying and selling activities whose rewards are more or less proportionate to the costs and risks involved in these activities (Braudel 1981:23–5, 1982:21–2, 229–30, see also 1977:39–78).

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This conceptualization enables us to distinguish between a Smithian dynamic of market-based economic expansion and a Braudelian capitalist dynamic. As Braudel underscores, the essential feature of historical capitalism has been 'its unlimited flexibility, its capacity for change and *adaptation*' rather than the concrete forms it assumed at different places and at different times (Braudel 1982:433; emphasis in the original). At a certain stage of its development, capitalism specialized in industrial activities, inducing many to regard industry as its 'true' identity. And yet:

[after] the initial boom of mechanization, the most advanced kind of capitalism reverted to eclecticism, to an indivisibility of interests, so to speak, as if the characteristic advantage of standing at the commanding heights of the economy...consisted precisely of *not* having to confine oneself to a single choice, of being eminently adaptable, hence non-specialized.

(Braudel 1982:381; emphasis in the original; translation amended as indicated in Wallerstein 1991:213)

As these passages show, the distinguishing feature of the Braudelian capitalist dynamic is the continual switching of resources from one kind of activity to another in the endless pursuit of monetary profit. As in Marx's general formula of capital *(M-C-M'),* the investment of money *(M)* in a particular combination of commodities *(C)* is strictly instrumental to an increase in the monetary value of the investor's assets from *M* to *M'* (1959:146–55). Indeed, in a strictly capitalist dynamic the transformation of money into commodities may be skipped altogether (as in Marx's abridged formula of capital, *M-M'*) if and when circumstances create more profitable opportunities in the credit system than in the trade and production of commodities, as has recurrently happened in the leading centres of capitalist accumulation, from early fifteenth-century Genoa, Florence, and Venice to late twentieth-century United States, Western Europe, Japan, and Hong Kong (Arrighi 1994).

If the Braudelian capitalist dynamic is best symbolized by a mixture/alternation of Marx's general and abridged formulas of capital (*M-C-M'* and *M-M',* respectively), the Smithian market dynamic is best symbolized by Marx's formula of commodity exchange, *C-M-C',* in which money *(M)* is mere means in the transformation of a set of commodities *C* into another set *C'* of greater utility. Ideotypically, the main difference between the two dynamics is that, other things being equal, the first tends to generate surpluses of means of payment (the accumulation of such surpluses being pursued as an end in itself), whereas the second does not (money being just a means of transforming one set of commodities into another of greater utility).

This difference enables us to explain why in the seventeenth and eighteenth centuries the leading capitalist states of Europe came to experience a surplus of capital, in comparison with China's shortage, in spite of the latter's persistent balance of payment surplus *vis-à-vis* Europe. For the intense political-military competition that underlay McNeill's self-reinforcing cycle of military empowerment and geographical expansion created also the conditions for an enlarged reproduction of the (Braudelian) capitalist dynamic, and a consequent growth of the surplus of capital accumulating within the European credit system. This enlarged reproduction of the Braudelian capitalist dynamic was not due to European primacy in the formation of capitalist dispositions and organizations. Braudel himself draws a parallel between the merchants and bankers of Shanxi province and the overseas Chinese originating from Fujian and other southern coastal provinces on the one side, and the business networks that constituted the pre-eminent capitalist organizations of sixteenth-century Europe on the other (1982:153). As William Rowe has noted in summing up the evidence, '[w]hatever the reason, the divergences between Chinese and Western social histories since 1500 are not due to the fact that the progressive West discovered capitalism and the modern state and China did not' (1990:262).

The presence of comparable capitalist organizations, however, did not make the capitalist dynamic equally dominant in the two regional systems. For capitalism to become dominant at *the level of the system,* it had to become embedded in increasingly powerful states:

Capitalism only triumphs when it becomes identified with the state, *when it is the state*. In its first great phase, that of the Italian city-states of Venice, Genoa, and Florence, power lay in the hands of the moneyed elite. In seventeenth-century Holland the aristocracy of the Regents governed for the benefit and even according to the directives of the businessmen, merchants, and moneylenders. Likewise, in England the Glorious Revolution of 1688 marked the accession of business similar to that in Holland.

(Braudel 1977:64–5; emphasis added)

In this sequence of states that became identified with capitalism—the Italian city states, the Dutch proto-nation state, and eventually a state, the English, that was in the process of becoming not just a nation state but the centre of a world-encircling maritime and territorial empire—each state is larger and more powerful than its predecessor. It is this *sequence,* more than anything else, that evinces the capitalist transformation of the European regional system. And conversely, the absence of anything comparable to such a sequence can be taken as the clearest sign that the East Asian regional system itself was not in the process of becoming capitalist, in spite of the existence of capitalist organizations analogous to the European ones and in spite of greater advances than in Europe in the formation of market economies. As Wong notes:

Much European commercial wealth was tapped by needy governments anxious to expand their revenue bases to meet ever-escalating expenses of war.... Both European merchants and their governments benefited from their complex relationship, the former gaining fabulous profits, the latter securing much-needed revenues. The late imperial Chinese state did not develop the same kind of mutual dependence on rich merchants. Lacking the scale of financial difficulties encountered in Europe between the sixteenth and eighteenth centuries, Chinese officials had less reasons to imagine new forms of finance, huge merchant loans, and the concept of public as well as private debt.
(Wong 1997:146)

Indeed, under the Ming, and especially the Qing, capitalism in East Asia became even more an interstitial formation than it had been under the Song or the Yuan. It became embodied ever more exclusively in an Overseas Chinese diaspora whose influence on the region's main seats of power remained insignificant, despite its importance in linking the Chinese coast with South East Asia. *At the level of the system* capitalism was thereby 'externalized', in the sense that it developed most fully on the outer rim rather than at the centre of the region's most powerful states.

This situation changed radically when the European system became dominant globally. Contrary to Marx's and Engels's famous claim that cheap commodities were the 'heavy artillery' with which the European bourgeoisie 'batter[ed] down all Chinese Walls' (1967:84), even after British gunboats had battered down the wall of governmental regulations that enclosed the Chinese domestic economy, British capitalism had a hard time in outcompeting Chinese merchants and producers. From the 1830s imports of British cotton textiles did devastate some sectors and regions of the Chinese economy (Johnson 1993:171–4). Yet British cotton cloth was never able to compete in rural markets with stronger Chinese cloth. Moreover, as foreign imports displaced handicraft spinning of cotton yarn, the use of cheaper, machine-produced yarn gave new impetus to the domestic weaving industry, which managed to hold its own and even expand (Feuerwerker 1970:371–5; Hamilton and Chang 2003). Western firms that set up production facilities within China could never penetrate effectively the vast interior of the country and had to rely on the indigenous Chinese traders for the supply of raw materials and the marketing of their products (Kasaba 1993; Chen 1984:58–61; So 1986:103–16). Western products and businesses did triumph in a few industries. But outside of railways and mines, the China market generally spelled frustration for foreign merchants (Nathan 1972:5).

Far from destroying indigenous forms of capitalism, the incorporation of China within the structures of the UK-centred global capitalist system led to a renewed expansion of the Chinese merchant networks and

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communities that over the previous millennium had developed in the coastal regions of China and in the interstices of the China-centred tribute trade system. As the capacity of the Qing government to control channels between the Chinese domestic economy and the outer world declined in the wake of the Opium Wars and intervening domestic rebellions, profitable opportunities for Chinese merchants operating within these networks and communities proliferated. Many of these merchants made their 'first tank of gold' in the opium trade. But the greatest expansion of the Overseas Chinese capitalist stratum was based on the 'coolie trade', the procurement and transshipment of indentured labour for service overseas and bank profits on their remittances home. Besides making the fortunes of individual merchants, the coolie trade also made the fortunes of the port cities of Singapore, Hong Kong, Penang, and Macau, all of which to varying degrees became major seats and 'containers' of the wealth and power of the Chinese business diaspora. Equally important, it increased Chinese settlement throughout South East Asia, thereby strengthening the capacity of the Overseas Chinese to profit from one form or another of commercial and financial intermediation within and across jurisdictions in the East Asian region (Hui 1995: ch. 3; Northup 1995; Headrick 1988:259–303).
The capitalist stratum of the Overseas Chinese benefited from the fiscal and financial pressures faced by the late Qing as a result of wars, rebellions, worsening trade conditions, and natural disasters. These pressures forced the Qing court not only to relax controls on their activities but to turn to the Overseas Chinese for financial assistance. In exchange for assisting the Qing court, the Overseas Chinese obtained offices, titles, protection for their properties and connections in China, and access to the highly profitable arms trade and government loan business (Tsai 1993:63). To be sure, these closer ties were often the cause of tension with the governments of the countries in which the Overseas Chinese resided or did business. But up to the final collapse of the Qing in 1911 the Overseas Chinese capitalist stratum managed to profit handsomely from the intensifying competition among the region's governments, both indigenous and colonial (Hui 1995: ch. 3).
The revitalization of Chinese capitalism in China and overseas was not the only result of the intensification of inter-state competition that ensued from the subordinate incorporation of East Asia within the structures of the UK-centred global system. For at least one century its most important effect was a fundamental transformation of the rivalries between China and Japan. As Kawakatsu (1994:6–7) and Hamashita (1988:20) underscore, Japan's industrialization and the territorial expansion that went with it were a continuation by new means of centuries-long Japanese endeavours to recentre upon itself the East Asian tribute trade system. Nevertheless, the change in systemic context transformed radically the nature of rivalries between China and Japan by inducing both of them to

expand and modernize their capital goods industries, in an attempt to neutralize Western military superiority, the full implications of which had been revealed brutally by the Opium Wars (Tsiang 1967:144).

For about twenty-five years after they were launched, industrialization efforts yielded similar economic results in China and Japan. On the eve of the Sino-Japanese War of 1894, in Albert Feuerwerker's assessment, 'the disparity between the degree of modern economic development in the two countries was not yet flagrant' (1958:53). Nevertheless, Japan's victory in the war was symptomatic of a fundamental difference in the impact of the industrialization drive on the two countries. In China, the main agency of the drive was provincial authorities, whose power *vis-à-vis* the central government had increased considerably in the course of the repression of the rebellions of the 1850s, and who used industrialization to consolidate their autonomy in competition with one another. In Japan, in contrast, the industrialization drive was an integral aspect of the Meiji Restoration, which centralized power in the hands of the national government at the expense of provincial authorities (So and Chiu 1995:53, 68–72).

The outcome of the Sino-Japanese war, in turn, deepened the underlying divergence in the trajectories of Japanese and Chinese industrialization. China's defeat weakened national cohesion, initiating half a century of political chaos marked by further restrictions on sovereignty, crushing war indemnities, the final collapse of the Qing regime, and the growing autonomy of semi-sovereign warlords, followed by Japanese invasion, and recurrent civil wars between the forces of nationalism and communism. This catastrophic state breakdown is probably the single most important reason—to answer O'Brien's question (see p. 117 above)—why it took such a long time for the Yangzi delta and China to regain the economic rank and status they held globally in the mid-eighteenth century.

Victory over China in 1894, followed by victory over Russia in the war of 1904–1905, in contrast, established Japan, to paraphrase Akira Iriye (1970:552), as 'a respectable participant in the game of imperialist polities'. The acquisition of Chinese territory (Taiwan in 1895, followed by the Liaodong peninsula and the securing of all Russian rights and privileges in South Manchuria in 1905, and culminating in China's recognition of Japanese suzerainty over Korea, annexed as a colony in 1910) provided Japan with valuable outposts from which to launch future attacks on China, as well as with secure overseas supplies of cheap food, raw materials, and markets (Peattie 1984:16–18). At the same time, Chinese indemnities amounting to more than one-third of Japan's GNP helped Japan to finance the expansion of heavy industry and to put its currency on the gold standard. This, in turn, improved Japan's credit rating in London and its capacity to tap additional funds for industrial expansion at home and imperialist expansion overseas (Duus 1984:143, 161–2; Feis 1965:422–3).

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This bifurcation of the Japanese and Chinese developmental paths culminated in the 1930s in the eclipsing of Britain by Japan as the dominant power in the region. With the Japanese seizure of Manchuria in 1931, followed by the occupation of North China in 1935, full-scale invasion of China from 1937, and the subsequent conquest of parts of Inner Asia and much of South East Asia, Japan seemed to be finally succeeding in recentring upon itself the East Asian region. The Japanese bid for regional supremacy, however, could not be sustained. As the massive destruction inflicted on Japan by the US strategic bombing campaign in the final months of the war demonstrated even before Hiroshima and Nagasaki, Japanese advances in Western military technology could not keep up with US advances. But the Japanese bid collapsed also because it called forth in China countervailing forces as firmly opposed to Japanese as to Western domination. Once the Japanese had been defeated, the formation of the People's Republic of China would contest Western hegemonic drives in a struggle for centrality in East Asia that has shaped trends and events in the region ever since.

Origins and prospects of the East Asian economic renaissance

The struggle for centrality in East Asia that ensued from the defeat of Japan in 1945 and the establishment of the PRC in 1949 has thoroughly shaped the snowballing process of connected economic miracles that constitutes the East Asian economic renaissance. Both processes—of struggle and of renewal—have gone through three partly overlapping stages. In the first stage, the main agency of expansion was the US government, whose strategies of power propelled the upgrading of the Japanese economy and created the political conditions of the subsequent transborder expansion of the Japanese multi-layered subcontracting system. In the second stage, Japanese business itself became the main agency of expansion. As the catchment area of Japanese investment and subcontracting networks came to encompass the entire East Asian region, Overseas Chinese business networks were revitalized. In the new climate provided after 1970 by the US-China opening, the fortunes of these networks became linked with the double pursuit by the Chinese government of economic advancement and national unification, creating the basis of a grand Chinese economic circle. In the incipient third stage, it is precisely the Chinese government acting at times in concert with the Chinese capitalist diaspora in Taiwan, in Hong Kong, and throughout South East Asia that appears to be emerging as the leading agency of the regional expansion (Arrighi 1996:36–7).

As argued in greater detail elsewhere (Arrighi *et al.* 2003:309–17), these three stages of the East Asian economic renaissance can be interpreted also as stages of a process of revival of key features of the East Asian tribute trade system in a radically transformed global context. In the initial stage, the Cold War split the region into two antagonistic camps and reduced most East Asian states to the status of vassals of one or the other contending imperial centre—the United States and the Soviet Union. As the Korean War demonstrated, however, even at this stage Western supremacy was more precarious than it seemed. It was indeed this precariousness that induced the United States to revive unwittingly a typical feature of the seemingly defunct East Asian tribute trade system—that is, a regime of gifts and trade between the imperial and the vassal states that was very favourable economically to the vassal states. This was the 'magnanimous' early post-war trade and aid regime of Pax Americana to which Ozawa (1993:130) and Sugihara (2003:81) trace the origins of the succession of connected East Asian economic miracles.

In spite of US 'magnanimity', the fault lines between the US and Soviet spheres of influence in the region started breaking down soon after they were established—first by the Chinese rebellion against Soviet domination in the late 1950s, and then by the US failure to split the Vietnamese nation along the Cold War divide. Effective as it was in reproducing a balance of terror with the Soviet Union, the hi-tech and capital-intensive US military apparatus proved ineffectual in enforcing US commands against the determined resistance of the Vietnamese people backed by Chinese and Soviet support. Worse still, massive US spending at home and abroad to sustain the war effort in South East Asia precipitated a major fiscal crisis of the US warfare-welfare state and contributed decisively to the sharp contraction of US global power that reached its nadir at the end of the 1970s with the Iranian revolution, the Soviet invasion of Afghanistan, and a new crisis of confidence in the US dollar (Brodine and Selden 1972; Arrighi 1994:321–3).

In the midst of this crisis, the militaristic US regime in East Asia began to unravel as the Vietnam War destroyed what the Korean War had created. The Korean War had instituted the US-centric East Asian regime by excluding mainland China from normal commercial and diplomatic intercourse with the non-communist part of the region, through blockade and war threats backed by 'an archipelago of American military installations' (Cumings 1997:154–5). Defeat in the Vietnam War, in contrast, forced the United States to readmit China to normal commercial and diplomatic intercourse with the rest of East Asia. The scope of the region's economic integration and expansion was thereby broadened considerably but the capacity of the United States to control its dynamic politically was reduced correspondingly (Arrighi 1996; Selden 1997).

It was in this context that Japanese business gradually replaced the US government as the leading agency of the East Asian economic renaissance. The prodigious upgrading of the Japanese national economy from the 1950s through the 1980s, and the expansion of Japanese business networks in the region and beyond in the 1970s and 1980s, marked the re-emergence of a pattern of inter-state relations that resembled more closely the indigenous (East Asian) pattern—in which centrality was determined primarily by the relative size and sophistication of the system's national economies—than the transplanted (Western) pattern—in which centrality had come to be determined primarily by the relative strength of the system's military industrial complexes. The limits of industrial militarism as a source of power were laid bare by the defeat of the United States in Vietnam. But it was Japan's growing influence in world politics in the 1980s that demonstrated the increasing effectiveness of economic relative to military sources of world power. For Japan's growing influence was based primarily on the role that the Japanese government and Japanese business played in supplying the inexpensive credit and cheap commodities that enabled the United States to reverse the precipitous decline of its power. The previous relationship of Japanese political and economic vassalage *vis-à-vis* the United States was thus transformed into a relationship of mutual dependence. Japan remained in the grip of US military power, but the reproduction of the US protection-producing apparatus came to depend ever more critically on Japanese finance and industry.

Japan's growing economic power in the 1980s was not based on any major technological breakthrough. In part, as Sugihara (2003:105) observes, it was due to the profitable opportunities that the strong growth of capital-intensive and resource-intensive technology in the United States and in the Soviet Union created for Japanese specialization in labour-intensive industries and resource-saving activities. For the most part, however, it was due to a reversal of a secular trend in business organization that Japan was particularly well positioned to turn to its own advantage. For the worldwide proliferation of vertically integrated, multinational corporations intensified competition, forcing them to subcontract to small businesses activities previously carried out within their own organizations. The tendency towards the bureaucratization of business through vertical integration that had made the fortunes of US corporate business since the 1870s thus began to be superseded by a tendency towards informal networking and the subordinate revitalization of small business (Arrighi and Silver 1999: ch. 2; cf. Castells and Portes 1989:27–9; Piore and Sabel 1984:4–5, 15, 19–20; Harrison 1994:244–5).

The strategy of big business, operating transnationally, to turn the advantages of small business into an instrument of the consolidation and expansion of its own power has been in evidence everywhere. But nowhere has it been pursued more consistently and successfully than in East Asia. Without the assistance of multiple layers of formally independent subcontractors—notes JETRO (Japan's External Trade Organization)—'Japanese big business would flounder and sink' (Okimoto and Rohlen 1988:83–8). Starting in the early 1970s, the scale and scope of this multilayered subcontracting system increased rapidly through a spill-over into a growing number and variety of East Asian states (Arrighi *et al.* 1993:

file:///C|/Users/Marco%20Rosa/Desktop/0415349001/files/page_135.html [30-08-2010 19:42:29]

55 ff.). Although Japanese business was its leading agency, the spill-over relied heavily on the business networks of the Overseas Chinese, who were from the start the main intermediaries between Japanese and local business in Singapore, Hong Kong, and Taiwan, and later on in most South East Asian countries, where the ethnic Chinese minority occupied a commanding position in local business networks. The region-wide expansion of the Japanese multi-layered subcontracting system was thus supported, not just by US political patronage 'from above', but also by Chinese commercial and financial patronage 'from below' (cf. Hui 1995; Irwan 1995).

Over time, however, patronage from above and below began to constrain rather than support the capacity of Japanese business to lead the process of regional economic integration and expansion. As a representative of Japanese big business lamented, '[w]e don't have military power. There is no way for Japanese businessmen to influence policy decisions of other countries.... This is a difference with American business and it is something Japanese businessmen have to think about' (Friedland 1994:42). This difference did not just mean that Japanese business could not match the capacity of the US government-business complex to influence the policy decisions of third countries. It meant also that Japan's own policy decisions were far more susceptible to being shaped by US interests than US policies were of being influenced by Japanese interests.

Equally important, US business began restructuring itself to compete more effectively with Japanese business in the exploitation of East Asia's rich endowment of labour and entrepreneurial resources, not just through direct investment, but also and especially through all kinds of subcontracting arrangements in vertically disintegrated or loosely integrated organizational structures. Since arrangements of this kind were a distinctive feature of large-scale business in late imperial China and still are in contemporary Taiwan and Hong Kong (Hamilton and Chang 2003), we may interpret the formation and expansion in East Asia of US subcontracting networks as another instance of Western convergence towards East Asian patterns. The fact that the convergence has been particularly strong in the East Asian context can be traced in part to the legacy of the China-centred industrious revolution. As Sugihara maintains (see p. 118 above), development along the industrious revolution path—unlike development along the industrial revolution path—did not deprive labour of the opportunity to share in managerial concerns and to nurture interpersonal skills needed for flexible specialization. On the contrary, it fostered versatility rather than specialization in a particular task, and flexibility rather than rigidity in responding to emergency needs and in anticipating and preventing potential problems. The presence in the region of an abundant supply of entrepreneurship and high-quality labour probably owes much to this legacy—a legacy which the preservation of a ubiquitous small business sector and of a large peasantry undoubtedly helped to reproduce over the 'long' century that separates the heyday of the East

Asian industrious revolution from the onset of the present East Asian renaissance. Equally important, however, is another legacy of the East Asian developmental path, namely the extensive business networks of the Overseas Chinese capitalist stratum.

As argued in the preceding section, the Overseas Chinese diaspora had for centuries been the primary locus of the seeds of capitalism that sprouted in the interstices of the China-centred tribute trade system. But the greatest opportunities for the growth of this interstitial capitalist formation had come with the subordinate incorporation of East Asia within the structures of the UK-centred global system in the wake of the Opium Wars. In the early twentieth century, significant parts of the capitalist stratum of the diaspora attempted to transform its growing economic power into political influence over mainland China by supporting the 1911 revolution and the Guomindang in the warlord era. But the attempt failed owing to escalating political chaos, the take-over of China's coastal regions by Japan, and the eventual defeat of the Guomindang by the Chinese Communist Party.

The communist victory replenished the entrepreneurial ranks of the diaspora by generating a new spurt of Chinese migration to South East Asia and especially Hong Kong and Taiwan as well as the United States (cf. Wong 1988). Shortly afterwards, the price boom associated with the Korean War revived the flow of interregional trade and created new business opportunities for the Overseas Chinese. And so did the withdrawal of the European and US colonial-era large-scale enterprises and the arrival soon after of new multinational corporations seeking capable joint venture partners (Mackie 1998:142). Nevertheless, under the US unilateral regime that emerged out of the Korean War the Overseas Chinese role as commercial intermediaries between mainland China and the surrounding maritime regions was stifled as much by the US embargo on trade with the PRC as by the PRC's restrictions on domestic and foreign trade (cf. Baker 1981:344–5). Moreover, in the 1950s and 1960s the expansion of Overseas Chinese capitalism was held in check by the spread of nationalism and national development ideologies and practices in South East Asia (Suryadinata 1989:122). In spite of this unfavourable environment, Overseas Chinese business networks managed to develop further and consolidate their hold on the commanding heights of most South East Asian economies (Wu and Wu 1980:30–4; Mackie 1992:165; Hui 1995:184–5).

The Overseas Chinese capitalist stratum was thus eminently well positioned to seize the highly profitable business opportunities that were opened up by the transborder expansion of Japan's multi-layered subcontracting system and by the growing demand of US corporations for business partners in the region. And the more intense competition over the region's low-cost and high-quality human resources became, the more the Overseas Chinese emerged as one of the most powerful capitalist networks in the region, in many ways overshadowing the networks of US and Japanese multinationals (Arrighi *et al.* 2003:316). Indeed, by the early 1990s—as Japan plunged into a long-drawn-out recession—the East Asian economic renaissance entered its third stage, the stage of Chinese-driven integration and expansion. For the reincorporation of mainland China in regional and global markets in the late 1970s and in the 1980s brought back into play a state whose demographic size, abundance of entrepreneurial and labour resources, and growth potential surpassed by a good margin those of all other states operating in the region, the United States included. If the main attraction of the PRC for foreign capital has been its huge and highly competitive reserves of labour from the perspective of cost, quality, and control—along with the actual and potential markets created by the mobilization of these reserves—the 'matchmaker' that has facilitated the encounter of foreign capital and Chinese labour has been the Overseas Chinese capitalist diaspora (Lardy 1992:37–82; Fukasaku and Wall 1994:26–42; Kraar 1993:40).

This role of matchmaker was made possible by the determination with which the PRC under Deng sought the assistance of the Overseas Chinese in upgrading the Chinese economy and in seeking national unification in accordance with the 'One Nation, Two Systems' model, whose twin goals were China's economic expansion and the recovery of Hong Kong, Macau and, eventually, Taiwan. A close political alliance was established between the Chinese Communist Party and Overseas Chinese business, one that would be strengthened following the 1997 reversion of Hong Kong and the further integration of Hong Kong and other overseas Chinese business interests through their role in governing Hong Kong and their participation in China's National People's Congress.

As Chinese entrepreneurs began moving from Hong Kong into Guangdong almost as fast as (and far more massively than) they had moved from Shanghai to Hong Kong forty years earlier, the Chinese government redoubled its efforts to win the confidence and assistance of the Overseas Chinese. By 1990 the combined investments of US$12 billion from Hong Kong and Taiwan accounted for 75 per cent of the total of all foreign investment, almost thirty-five times more than Japan (calculated from So and Chiu 1995 and *Far Eastern Economic Review,* 19 September 1992, p. 12, and 9 June 1994, p. 44). An unknown but by all accounts significant portion of the investment from Hong Kong and to a lesser extent Taiwan was in fact Japanese and other foreign capital invested through the intermediation of Chinese businesses. It is none the less unlikely that any correction of the figures to take this fact into account would change substantially the overall picture of an expansion of foreign investment in China increasingly driven by the activities (including activities of intermediation) of the Overseas Chinese operating in close alliance with the PRC's ruling elites.

In sum, each stage of the ongoing East Asian economic renaissance has been driven by a different agency but all stages have involved one form or another of hybridization of the East Asian and Western developmental paths. Focusing on one important aspect of this process—the hybridization of the industrious and industrial revolution paths—Sugihara suggests that it may result in a reversal of the secular trend towards worsening global income inequality. 'If the "European miracle" was a miracle of production...the "East Asian miracle" has been a miracle of distribution which brought the benefits of global industrialization to the majority of the world population.' Given the environmental destruction brought about by the diffusion of the energy-intensive Western path, he goes on to conclude, for 'the miracle of distribution to continue, the Western path must converge with the East Asian path, not the other way round' (2003:116).

There is indeed some evidence that supports Sugihara's contention. As previously noted (see p. 110 above), to the extent that a trend has emerged in the 1990s towards declining inter-country income inequality, it is entirely due to the rapid economic growth of China. Should China continue to grow at present rates for another twenty to thirty years, and above all, should it draw on to its path of successful development other poor but populous countries, first and foremost India, the global economy would definitely be characterized by greater income equality than at any time since the onset of the Great Divergence. There are none the less several reasons for being cautious in foreseeing a smooth continuation of the ongoing China-led miracle of distribution.

First, China's economic expansion has been accompanied by the rapid growth of income inequality within China—an inequality that is estimated to have become among the largest in the world (Riskin *et al.* 2001). If this is indeed the case—and the evidence is compelling—the upward mobility of the PRC in the global value-added hierarchy would in fact reflect a far greater upward mobility of a limited number of (predominantly coastal) areas and a lesser upward mobility (or even downward mobility) of much of the rest of the country. This tendency constitutes a departure from the pattern of even development typical of the East Asian path and may become a major obstacle to further expansion. Not only does it restrain the growth of the domestic market, thereby reproducing the dependence of the expansion on the willingness and capacity of the United States and other Western countries to absorb ever increasing labour-intensive imports. More important, it is likely to engender social and political tensions that may jeopardize further growth (cf. Perry and Selden 2000). To be sure, the so-called 'fourth generation' of PRC leaders, headed by Hu Jintao and Wen Jiaobao, has shown greater awareness than previous generations of the social costs and problems of uneven development. While retaining ambitious economic growth targets, it has put a new emphasis on balanced development between rural and urban areas, between regions, and between economy and society (Kynge 2003; *Economist* 2004). It none the less remains an open question what this new emphasis will amount to in terms of actual social reforms, and whether it will succeed in making continuing economic growth socially sustainable.

Second, China's rapid economic growth has thus far failed to open up for the world's poor countries an ecologically sustainable developmental path, because convergence has been predominantly from the energysaving East Asian path to the energy-consuming Western path rather than the other way round. Energy consumption *per capita* remains considerably lower in East Asia than in Western Europe, let alone North America. But Chinese consumption of fossil fuels in factories and by a rapidly growing fleet of motor vehicles makes an increasingly significant contribution to global warming and has turned some Chinese cities among the world's most polluted. Also, in this respect, the PRC's new leadership has shown greater awareness than its predecessors of the environmental costs of energy-intensive economic growth. Nevertheless, it remains unclear how an ecological balance can be restored when 300 million to 500 million rural residents are expected to turn into city dwellers by 2020 (Bradsher 2003; Kynge 2003).

Third, and most important, China cannot expect the world's most powerful states, first and foremost the United States, not to attempt to disrupt its continuing economic expansion. This at least is the conclusion—half prognosis and half prescription—of the most ambitious product of recent US international relation theorizing, John Mearsheimer's *The Tragedy of Great Power Politic?.*

China is still far away from the point where it has enough [economic] power to make a run at regional hegemony. So it is not too late for the United States to…do what it can to slow the rise of China. In fact, the structural imperatives of the international system, which are powerful, will probably force the United States to abandon its policy of constructive engagement in the near future. Indeed, there are signs that the new Bush administration has taken the first steps in this direction.
(Mearsheimer 2001:402)

As it turns out, in response to 9/11 the Bush administration has moved in a quite different direction. By getting itself bogged down in the Iraqi quagmire, it was forced to deepen rather than abandon the constructive engagement of China. Better still for China, the self-inflicted troubles of the United States in West Asia have created conditions favourable to the re-emergence of Chinese economic and political centrality in East Asian (Arrighi 2005). It is possible that by the time the United States has disentangled itself from the Iraqi quagmire, Chinese centrality in the East Asian region (as well as US dependence on Chinese cheap credit and commodities) will be so consolidated as to bring to bear on the United States a different kind of 'structural imperatives' than those envisaged by Mearsheimer. But it is also possible that the United States will in any case attempt to preserve its global dominance by disrupting the China-led miracle of redistribution. It is impossible to tell what the outcome of such an attempt would be. But the more unsustainable the Chinese economic expansion will have become, socially and ecologically, the easier it will be for the United States to mobilize locally and globally forces capable of slowing it down or bring it to an end.

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7

The European model of 'social' capitalism

Can it survive European integration?

Claus Offe

The three sets of questions I want to discuss here are as follow. (1) Is there such a thing as 'European capitalism'? Are there institutional and structural features that apply more or less to *all* European political economies and *only* to European political economies? How do European political economies and societies contrast if compared with their liberal counterparts of the English-speaking world? (2) If they exist, how can these distinctive similarities, or family affinities of European capitalisms, be explained in historical terms and justified in normative or functional terms? (3) What can we expect and predict concerning the impact of European integration upon the distinctive features of European 'social capitalism'? Is it likely that European societies will converge in the process of integration on the distinctive European 'social model', as represented by and inherited from European nation states, or is there evidence of trends to the opposite? If so, European integration would undermine the 'Europeanness' of the emerging political economy of the European Union (EU).

'European' capitalism?

As to the first of these sets of questions, much of the historical and social science literature is preoccupied with an approach that has been labelled 'methodological nationalism' (Smith 1979). The national state and society, not 'Europe' as a whole, are the standard unit of analysis, and for good reason. On the one hand, the nation state, at least in modern history, must be conceived of as a self-contained and self-governing entity with distinctive centres of legitimate political rule and the enforcement capacity which has effectively enabled it to shape the institutional structure of its society and economy. Also, until recently, most of the data which are available for social scientific analysis are gathered by national agencies, such as national statistical offices, according to national standards and definitions. Virtually all cross-sectional comparative literature compares countries, and to a much lesser extent sub-national units (such as regions) or supranational units (such as 'families of nations', cf. Castles 1993).

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There are, however, a number of features that European societies are thought to have in common. Some of these features have remained distinctively European, while others have spread from Europe and its pioneering role to other parts of the globe. Instances of such historically rooted and distinctive features of 'Europeanness' are Christianity, the legacies of the absolutist state (Ertman 1997; Anderson 1993), the modes in which this form of political rule has been overcome, a history of vast inter-state warfare, colonialism, doctrines and precepts of revolutionary liberation, the nation state, the sciences, and capitalism itself. This list does, however, invite the objection that there are as many dissimilarities among European states and groups of states: Christianity is divided into Roman Catholicism and Orthodoxy in the fourteenth century and then again into the former and Protestantism in the sixteenth. Revolutionary liberation and nation state building occurred in some countries, but not (or with much delay) in others. Some states acquired vast colonial empires, others not. Some countries in Europe were capitalist pioneers, others latecomers. And so on. Nevertheless, historians and sociologists have elaborated structural similarities which supposedly govern all (or, at any rate, most) European societies (Kaelble 1987; Crouch 1999; Therborn 1995). These similarities are either of a substantive or of a procedural nature, manifesting themselves in distinctive structures or in ways of 'getting things done'. As to the former, religious life, the family, the city, political parties and party cleavages, economic institutions, and artistic forms are cited as instances of shared features of all European societies. As to 'pro-cedural' similarities (and as an offshoot of the Weberian problem of 'occi-dental rationalism', or 'modernization', with its dialectic of liberating gain of control and the concomitant loss of freedom within 'iron cages'), 'Europe' has been associated with the idea and practice of limiting, balancing, and managing diversity and conflict, and buffering the consequences of change, through the use of state power (cf. Crouch 1999: ch. 14).

The social, economic, and political contours of Europe are not easy to determine. Even if it comes to defining a sub-set of its features, such as the welfare state, we are bound to conclude that 'the idea of a European welfare state model does not leap automatically from the data' (Baldwin 1996:35). The rhetoric of the 'European social model', as it was inaugurated by Jacques Delors in the early 1990s, may be criticized for representing more of a normative vision than a consolidated reality. Much of the academic literature points to the wide range of variation that can be observed among European welfare states, economic institutions, and forms of democracy. Perhaps a reasonably clear and meaningful identity of 'the' European model emerges only if Europe is contrasted with nonEuropean global regions, such as East Asia, the underdeveloped South, or North America (Munkler 1995). Moreover, (West) European history of

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the second half of the twentieth century is to a large extent shaped by the United States and its military, political, intellectual, economic, and aesthetic hegemony. What ties social actors together are links (such as mass air travel, global markets, the Internet) of a global, not a European, scope. Arguably, 'Europeanness' is nothing that can be found in the shared histories of European societies but, to the contrary, something that is in the still elusive state of 'becoming', an artefact of European integration and its homogenizing impact. Also, in speaking of 'European' society, authors often have in mind some features that characterize core West European societies and which (partly) serve as a pole of attraction or a model for imitation to societies located on Europe's eastern and southern peripheries.

Yet in spite of these various caveats concerning the risks of reifying 'Europeanness', modern European history is arguably shaped, I submit, by what one might call a 'logic of discontinuity'. This discontinuity applies in time and space. It is a 'logic' in that discontinuity poses challenges and calls for types of responses that exhibit some European elective affinity. Spatial discontinuity results from the contest over land borders and the need of all states to define and defend their contested territorial base against neighbouring states, which historically usually happened in the form of international war, conquest, and separation.1 By discontinuity in time I mean the relative frequency of regime changes in European history. There is hardly any European country that matches the United States in either the stability of its territorial shape or the longevity of its constitution.2 In view of these two distinctive European features of discontinuity, every political elite of every state at virtually every moment of its modern history has to fear three kinds of enemies: 'reactionary' classes and elites representing the past who challenge the current regime; 'progressive', or 'rising', social classes threatening the current regime from, as it were, the opposite direction and in the name of some splendid future; and foreign rival states. A third kind of discontinuity within European societies has to do with an overlap of religious divisions and those of social class, with both of them being well crystallized in terms of both formal representative organizations (such as political parties, Churches, associations) as well as distinct universes of social intercourse. Without taking the time here to look at the interaction of temporal (or domestic) and spatial (or international) discontinuities and sources of conflict, and without illustrating this vast and somewhat schematic generalization on the basis of the rich evidence available, I believe, in its support by historical sociologists and social historians, let me jump to one conclusion. This conclusion is that in an environment of spatial and temporal discontinuities, as well as class and religious divisions and the pervasive threats and challenges resulting therefrom, any 'winner takes all strategy' does not lead to stable and viable solutions.

People can flee unbearable threats and conflicts, and they have done so in the history of nineteenth and twentieth-century Europe by the tens of millions, with most of them turning to the Americas. But entire societies and states cannot escape by relocating into insular situations or virgin lands. They are trapped in an environment of discontinuity and contest. Nor can they hope to cope with this environment of discontinuities (the most important of which come in terms of nations, social classes, and religious belief systems) by imposing upon it a lasting ('millenarian') and spatially all-inclusive ('imperial') order. The two 'totalitarian' regimes that European history has seen in the twentieth century have served to demonstrate, through the disasters they have caused and the eventual defeat they have suffered, the validity of this impossibility theorem. If discontinuities, conflicts, and diversities (of interests, of identities, of ideas) can be neither escaped from through 'exit' nor repressed through state terror, the only remaining option is to institutionalize some viable form of coexistence of classes, states, and identities. This is the lesson on the learning of which both the history and the territorial situation of Europe have put a high premium since the Westphalian peace settlement—the lesson of bridging, regulating, and constraining domestic and international conflict while at the same time recognizing the legitimacy and inescapability of diversity. There is a European way in which 'diversity itself is handled' and institutionally transformed into 'ordered, limited, and structured diversity' (Crouch 1999:404).

European states to the west of the Iron Curtain, in the course of the second half of the twentieth century, accomplished a great deal in institutionalizing a viable balance between these conflicting challenges. Not only have they created a security regime that makes international war among European states a virtual impossibility.3 They have also, each in its specific national and path-dependent version, managed to reconcile the dilemmas of social order, thereby sharpening a distinctive profile of European political economies. The horns of these dilemmas (seventeen of them in my counting, but we can probably think of more) are well known: equality versus efficiency, collective bargaining versus individual contracting, cooperation versus conflict, rights versus resources, wage moderation versus distributive conflict, supranationalism versus intergovernmentalism, social partnership versus class conflict, proportional representation versus majoritarianism, constitutionalized basic rights versus parliamentary sovereignty, associational collectivism versus individualism, social security versus competitiveness, politics versus markets, modernism versus postmodernism, citizenship versus communitarian politics of difference, consensus versus conflict, corporatism versus pluralism, and status versus contract.

Status, standards, protection

There is a wealth of research conducted in the 1990s on comparative capitalism. In fact the designation of a political economy as 'capitalist' (essentially meaning the dominant role of private firms whose activities are steered by market prices and based on property rights as the institutional locus of production, and the presence of labour markets and the labour contract as the key mechanisms of income distribution) has become to be seen as a universally applicable and hence rather uninformative label. After all, and after the demise of state socialism, what else, other than 'capitalism', can we expect to find as the organizing principles of economic life in 'modern', as well as in modernizing, economies? The emphasis has shifted to the plural: capitalisms instead of capitalism, and the distinguishing historical contexts, institutional features, and record of productive and distributive performance of those varieties of capitalism.

'Capitalism', once viewed as a single species of social and economic organization, is now being rather conceptualized as a zoo full of different species. Of *how many* species, and different *in what respects*? The most finegrained classifications come by sector of industry, country, and decade, i.e. combine cross-sectional and longitudinal comparative perspectives. Here the focus is on, say, US railway capitalism in the second half of the nineteenth century, or French biotech capitalism in the last decade of the twentieth. At the other end of the continuum you have the coarsest distinction of liberal versus 'nonliberal' capitalisms, meaning the AngloAmerican versus the European (*and* Japanese) cases of technologically advanced capitalism (Albert 1991; Streeck and Yamamura 2001). Intermediate classifications follow the convention of 'methodological nationalism' by focusing upon national economic regimes and their pervasive path dependences, or they subdivide the various capitalisms by regional groups of (for example, Scandinavian) countries or political regime types (democratic versus authoritarian). I wish to stick here as close as possible to the distinction of global regions or continents, looking at 'the' European model in contrast to the Anglo-American and (only marginally) the Japanese ones.

One defining feature of (Continental) European capitalism and the social order resulting from it is the prominence of state-defined and stateprotected status categories. In each of the above seventeen pairs of concepts, Continental European capitalism (CEC) tends much more to the respective first alternative than does English-speaking capitalism. By 'status' I mean a positive and statutory (as opposed to merely tradition-based) bundle of rights and duties, standards, licences, mandates, legally prescribed procedures, entitlements, subsidies, and privileges which are attached to virtually every participant in contractual economic transaction and the collective actors representing and governing these participants. The status regime tells you where you stand in relation to others, what to do, what not to do, and how to do it. As a consequence of these statusbased constraints, some economic transactions which might otherwise be voluntarily entered into are ruled out in the name not just of noneconomic concerns of a moral order (such as the ban on child labour or on trading illegal drugs), but in the name of long-term and collective economic interest itself. The measure of the strength of the status component of a capitalist economic system is the degree to which partners to contracts are endowed with non-negotiable entitlements and duties, as well as the degree to which obligations to third parties not immediately involved in economic transaction are stipulated and enforced by law.

This rule of voluntary transactions being constrained by status categories applies to the entire range of economically relevant institutions, including banks and financial markets; trade unions, employers' associations, and the practices of wage determination and income distribution; the regulation and protection of the commercial sector and small enterprise; agriculture; the networks of transport, energy, and communication; vocational training and tertiary education; the role and mission of central banks; the professions; corporate governance; international trade, tariffs, and migration; the tax system; state-controlled and state-subsidized patterns of housing and the real estate market, as well as urban and regional development, including the conservation of physical resources; social security and other welfare state institutions; public sector employment; company-level labour relations; property rights, both in things and in ideas, and their adjudication; and the governance of research, development, and innovation.4

For instance, and as a rule of thumb, in the United States you get paid for what you *actually* do, while in Europe you get paid for what you *can* do according to some certificate obtained through formal training. Similarly, in the United States your level of pay will most often be determined by individual or company-level contractual agreements, while in most European systems trade unions and employers' associations are assigned the collective status right of determining an entire industry-wide pay regime through collective bargaining. In the latter case, the level and kind of reward are tied to regulatory rules of training and licensing which logically precede the market and are relatively immune from market forces. The individual pursuit of economic gain is 'embedded' (this being one of the key terms of the comparative capitalism literature, a term dating back to Polanyi (1944)) in a set of formal (that is, legislated) and informal (moral and culture-bound) institutional patterns which constrain the permissible range of economic transactions, as well as types of participants in contractual interaction. The degree of embeddedness is the greater the more specific and constraining the rules are that limit the pursuit of individual gain in markets (beyond, that is, what general legal rules of criminal and civil law prohibit anyway). Embeddedness refers to the degree to which contractual relations are premised upon a non-negotiable status order governing economic activity, akin to what has been termed 'decommodification' by Esping-Andersen and others (Esping-Andersen 1990). While constraining and distorting the short-term economic outcomes that would result from 'free' markets, i. e. markets exclusively driven by short-term and individual cost and price considerations and voluntary contracts, embeddedness is designed, or at any rate invariably defended and justified, in terms of three standards of collective rationality. These supra-individual rationality standards are temporal, social, and functional; they emphasize future-and-past-regardingness, other-regardingness, and the attention to collectively beneficial, though often non-obvious, functions and side effects they perform.

To illustrate, using the case of trade unionism: if trade unions are strong, owing to a strong status in wage determination assigned to them by Basic Law (or even constitutionally, as in article 9 of the German basic law), and if they represent the work force of entire sectors of industry rather than that of individual companies, the chances are comparatively greater that they will develop some awareness of and consideration for the consequences their demands and strategies entail for the employment prospects of workers in general, as well as for the rate of inflation and their industry's competitiveness. As a consequence of this organizational set-up, they become more readily 'other-regarding' than company unions, owing to their narrow concern for the maximization of the nominal wages of a small percentage of the industry's or nation's overall work force, could ever afford to be. Similarly, and in the *temporal* dimension, the institutionalization of a 'skill rent' as a wage component which is being paid regardless of actual job requirements will encourage the acquisition and continuous upgrading of skills, thus creating, unlike the conditions prevailing in highly mobile 'hire and fire' labour markets, a reservoir of skills which will economize on transaction costs and increase the duration of job tenure owing to workers' enhanced flexibility. Third, high wages and high skills will provide, as a desirable *functional side effect,* a powerful incentive to employers to utilize possibilities for labour-saving technical change, thus increasing the efficiency and competitiveness of production.

Taken together, economic status rights will not only *protect* economic actors (employees, farmers, artisans, small and medium-sized business, banks, the professions, etc.) from adverse market impacts; they can also *contribute* to overall and long-term (economic as well as non-economic) outcomes that are superior to pure market transactions with their blindness to the interests of others, to externalities, and to the past or future.

If there is anything distinctive about the 'European' model of capitalism, it is the insight, congealed in a myriad of economic institutions and regulatory arrangements, that the interest of 'all of us' will be served well if the pursuit of the interest of 'each of us' is to some extent constrained by categorical status rights. This antithesis has been captured by conceptual pairs such as 'shareholding' versus 'stakeholding', or 'efficiency' versus 'X-efficiency' (Leibenstein 1976), or 'the productivity of rules', which, although constraining market forces, will eventually and counter-intuitively (to some) be rewarded by improved market outcomes.

However, it must be noted that the relationship between a market-constraining, state-sponsored order of status and standards, on the one hand, and measures of economic performance (growth, employment, productivity, competitiveness, stability) on the other is at best a curvilinear one. 'Too little' regulation will turn out to be as counterproductive in its consequences as 'too much'. There is no valid presumption of 'the more the better'. It has been said, as a general characterization of institutions, that they are like the force of gravity in that they prevent us from flying, but allow us to walk upright. Institutionalized status arrangements, in other words, open up valued options and at the same time preclude others. This suggests the notion of an optimum level of non-market ingredients and status rights, with further increases of these ingredients beyond the optimum leading to sclerosis and rigidity.

But this notion of rationally optimizing an institutional arrangement by defining the best mix of state-sponsored status components and contractual voluntarism is clearly a 'hyper-rationalist', and ultimately a meaningless project. This is so for three reasons. First, it is not self-evident who should be authorized to *define* that point of equilibrium, as conflicting values (e.g. security versus efficiency) are involved and trade-offs are essentially contested. Who, after all, is competent to determine how much allocative inefficiency is 'worth' how much gain in dynamic efficiency, with a compelling answer becoming even harder to find if the choice is not just between short-term and long-term efficiency but between either of these and values such as security, equity, or social justice (cf. Streeck and Yamamura 2001:4). Moreover, any 'optimal' mix may be short-lived, as optimality is contingent upon changing conditions and competitive relations within the global economy. Second, even if such equilibrium could be authoritatively defined, it is not clear how the blueprint could be *implemented* against the well-entrenched political resistance of those who stand to lose from even incremental change. Third, the mode in which institutions *do* change is not so much the intentional action of designers as the combined and interactive effect of external shocks, contingencies, and challenges, on the one hand, and shifts in the configuration of hegemonic ideas, on the other (Offe 2001).

Philosophies of how best to organize economic life and its institutional framework come in many national, as well as ideological, variants. They differ concerning the agents which are envisaged as the bearers and guardians of status rights (collective actors, as in 'societal corporatism' versus the benevolent developmental state versus the paternalistic company) and the ideological values associated with a socially controlled market economy (with social democratic proponents emphasizing inclusion, security, and empowerment of workers versus the anti-individualistic values of conservatives and Christian socialists). Countries with European-style embedded capitalism also differ in their economic performance. The underlying claim that embedded and constrained versions of capitalism work 'better' than their liberal and 'pure' counterparts holds true in some cases and periods, but not in others. Sometimes (as in the 1980s), Continental European capitalisms perform better than liberal ones; at other times (such as the latter part of the 1990s) the reverse applies. Rather than pursuing the question of comparative performance any further at this point, I wish to address the question of the robustness of the European model and potential causes of its decay.

Challenges to the European model

There are basically two modes in which economic institutions can change. They can lose intrinsic support or they can fail in their instrumental role of achieving desired outcomes (March and Olsen 1989). First, according to a model of *institutional decay,* institutions change if they fail to generate the widely shared support and universal recognition on which they depend. Institutions lose their moral grip on actors, the capacity to orient their preferences and expectations. Relevant actors defect, as it were, from the congruent behavioural routines and habits that institutions require for their viability. Or rival alternative institutions emerge that pose a challenge to existing ones, and compatibility problems result which necessitate compromise and dilution. As a result of either defection or confrontation, institutions cease to 'make sense', or are perceived to become 'too costly' and their maintenance 'not worth the effort'. They are seen to become incompatible with new contexts, and thus become vulnerable to path-departure, dismantling, and innovation. The other model of institutional change follows a *natural selection* model. Institutions change or are abandoned because they are seen to fail in generating expected or promised outcomes. While both of these explanatory models can coincide—actors withdraw their loyalty and support *because* of perceived failure —such coincidence is by no means axiomatic. For as much as actors can stay loyal (for example, by adjusting their outcome expectations downwards) even in the face of manifest failure, the inverse case can also be observed: actors defect not because outcomes are seriously and consistently disappointing, but because institutions have depleted the kind of plausibility and bindingness that makes them something to be 'taken for granted'.

A second intuition and (perhaps debatable) generalization is this. The two styles of capitalism, embedded European and 'pure', or market liberal, English-speaking, are tied to each other in an asymmetrical relation of entropy. That is to say: it is much more likely that a European-style capitalism transforms itself into a liberal model than that the English-speaking model becomes 'Europeanized' (in much the same way as, to quote Walensa, it is easier to make fish soup out of an aquarium than the other way round). 'Embeddedness' is a condition that is more easily lost than gained, owing to its dependence upon supportive dispositions of a cognitive as well as moral kind.

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The challenge of European integration

As noted above, the distinctive feature of European capitalisms has evolved under the impact of the 'logic of discontinuity'. This logic has necessitated the adoption of some state-sponsored status order that protects, according to precepts of a 'social' market economy and 'organized', 'embedded', and 'regulated' capitalism, economic agents from some of the impact of the 'anarchy of the market', while (ideally) at the same time improving market outcomes. The various institutional patterns I have mentioned before are designed for (or can be justified in terms of) the accommodation of conflicting interests, cooperation, bargaining, consensus, the limitation of conflict, and sustainability.

European integration is a project and partial achievement which, in the light of these considerations, allows for two interpretations which radically contradict each other. On the one hand, it can be seen as (and was certainly envisioned by its early protagonists to eventually become) a framework of cooperation and regulation that completes at the transnational plane what had been accomplished at the level of member states, namely a regime of fair and peaceful competition that rules out not only international war in Europe but also hostile economic rivalries, thus establishing, through 'positive' integration, a supranationally embedded political economy which serves the interests of all parties involved evenly. But on the other hand, it can also be seen as a strategy of institution building and extensive as well as intensive market enlargement that involves not the transposition of the more benign aspects of European capitalisms to the transnational level, but, to the contrary and through 'negative' integration, its demolition *at* the national level, and thus works as a device that paves the way for the ultimate triumph of market liberalism on the European continent by enforcing upon member states the adoption of regimes of privatization, deregulation, and fiscal austerity. According to this pessimistic reading of the impact of the new Europeanized political economy (as defined by the parameters of the Single Market, EMU, and Eastern Enlargement), member states will be deprived of their capacity to maintain the kind of protective arrangements and status order that each of them had built up in the course of their national history. According to this latter reading of the integration process, the Europeanized political economy will significantly deviate from the type of European capitalism that prospered under the protection of national regimes (cf. Offe 2000).

It is too early to pass definitive judgement on which of these diametrically opposed interpretations/predictions will come closer to the truth. According to the first and optimistic reading, we would have to expect an effective supranational regime of social protection and status rights to be established at the European level. According to the pessimistic reading, we would expect social and economic insecurity to become more intense; the difference between integration winners and integration losers to widen across social classes, sectors of industry, and regions; social exclusion to become more common; the capacity of national governments to maintain their protective status arrangements to become more limited and precarious as intensified tax competition dries up fiscal resources and the strict stability regime of the European Central Bank (ECB) penalizes budget deficits; nationalist and xenophobic anti-European reactions to play an increasing role in electoral politics; and the horizons of solidarity and cooperation to shrink to relatively small sub-national (that is, regional, sectoral, and corporate) units (Streeck 2000) rather than expand to the inclusive level of an all-European polity and regime of social protection. In sum, and as Michael Dauderstädt, a leading expert of the Friedrich Ebert Foundation, the German Social Democratic think tank, has put it in an unpublished memorandum: 'Will European integration protect or destroy the "European social model"?' And if the latter, he goes on to speculate, 'it could…turn out to be political dynamite when important social groups perceive that their interests are endangered by European policies or rules'. Similar concerns about the 'social quality' of Europe, even more so than related ones about the European Union's 'democratic deficit', rank very high on the research agenda of Europeanists as well as in the normative debates on the future of the integration process (cf. Scharpf 2002). Since market integration has largely been accomplished, 'social' integration is becoming the key issue.

Social protection in a liberal market society

A liberal society consisting of contract-making individuals presupposes a rudimentary institutional framework that endows the prospective players with requisite universal status rights of 'citizenship', or the meta-right to have rights. In the most elementary terms, every ten-year-old must be a fourth-grader, and every citizen has access to a court. It also presupposes means-tested income support for the worst-off, as well as incentives that supposedly will help them to help themselves. The source of these universal status rights of citizenship is a law-making and law-enforcing liberal state, in the absence of which the very notion of a 'contract' becomes insubstantial, or the mere equivalent of private promise making. Law-enforcing and contract-enforcing mechanisms are needed as exogenous prerequisites to get the liberal game *started*.

But, once it has started, a second type of problem emerges, that of enabling people to *stay* in the game. This is the perspective of the social democratic critique of market liberalism. The critique starts with the observation that the game of free contract making is not self-sustaining but inherently precarious and potentially self-subversive. This precariousness is due to the ambiguities inherent in the concept of freedom itself. Elaborating on the insights of German labour lawyers and legal sociologists writing in the Weimar Republic—most notably Hugo Sinzheimer and

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Franz L.Neumann5—four meanings of the concept of freedom, as they apply to a liberal market economy, can be distinguished:

1 The right (including the possession of the legal prerequisites just mentioned) to *enter into* contractual agreements.

2 The right to *use* the tool of free contract making for the purpose of achieving distributive outcomes according to one's assets, skills, and preferences; but also:

3 The right to adopt strategies which are designed to *dispossess others* of their freedom to stay in the market and enter into contracts. An example would be the formation of cartels designed to drive competitors out of the market. A sub-case of this use of freedom for the dispossession of others of their freedom applies in labour markets, where investors' or managers' prerogative of adopting labour-saving technical, organizational, and locational change can involve a corresponding loss of market opportunities for workers.

4 The right to enter into a special kind of contracts, namely labour contracts, which by their nature constrain the long-term freedom of further contract making of those entering into the contract as wage workers.

The latter argument needs elaboration. It runs, briefly, as follows. What workers sell to employers for a wage is not just their present labour power, but more or less significant parts of their freedom to sell anything to anyone in the future, or *their long-term earning capacity*. Wage earners deplete their earning capacity without being able, like capital, to accumulate in compensation for this loss: depletion without accumulation. To be sure, the outcome of losing one's ability to sell anything is involved, as an *ex post contingency,* in any contractual economic activity in reasonably competitive markets. Who knows, after all, whether I, the self-employed businessman, can sell what I have to offer in the market, or can sell at a profitable price, *x* years from now? It is only in the case of labour power, however, that the gradual loss of market options, and hence of the economic freedom of the worker, is an *ex ante certainty*. For 'employability' is a perishable asset, regardless of the ups and downs of demand. In the course of the wage worker's working life, the options of acquiring new skills or of finding alternative employment are typically diminishing. What the worker gives up in exchange for the wage is not just labour power (as well as a substantial part of the civil liberties s/he routinely enjoys outside the factory or office); s/he also enters into a contractual relation that involves the certainty of depletion of earning capacity and alternative sales options—and hence of the actual option to enjoy the freedoms of types 1 and 2 in the future. This depletion is caused by the conditions that labour power is not a 'thing', but an inseparable part of human beings and their life course. Labour power is unique among all economic resources in that it cannot be inherited to others. Labour power, unlike capital, cannot, by it own means, offset depletion through reinvestment of profits and accumulation. It cannot, as capital can, rejuvenate itself by continually starting, as it were, a new life cycle, thereby perpetuating its own earning capacity—unless, that is, wages reach a level that allows savings and investment which in turn yield a significant and continuous stream of non-wage income, in which case the worker would gradually cease to be a wage worker.

The conclusion seemed obvious to the Weimar social democratic political theorists. If freedoms 1 and 2 are to be maintained as the organizing principle of a liberal social order, then the freedom-demolishing freedom of type 3 must be checked (either through anti-trust legislation and supervisory authorities or through the state's selective granting of cartel and monopoly privileges according to some notion of the public interest). Perhaps most important, freedom 4 must be compensated for by arrangements that control and partly neutralize the depletion of the earning capacity of workers. Once labour power is 'commodified', that is, becomes subject to contractual exchange similarly to other commodities, it must also to some extent be 'decommodified', i.e. compensated for the depletion of its wage-earning capacity in terms of status rights and entitlements that flow from other sources than market transaction and sale.

The *liberal* state invests in schools, court houses, and welfare/social assistance programmes to set up the *preconditions* of the liberal game. To *sustain* the game, the *welfare state* (in any of its many versions and normative political origins) is an arrangement of compensatory decommodification. It is designed to offset the 'depletion without accumulation' effect to which only wage labour is exposed through the labour market and labour contract. The liberal state and the (social democratic) welfare state stand in a relationship of uneasy coexistence and do not form a smooth synthesis. But, contrary to a widely shared misunderstanding, neither the liberal nor the social democratic state has much to do with 'equality of outcomes', either normatively or positively. The guiding principle of the welfare state is the security and protection of workers, not equality. Or, more precisely, *longitudinal* equality with *intertemporal* redistribution of income, as opposed to *cross-sectional equality* with *inter-class redistribution*. The rights and entitlements that the welfare state provides to workers are exogenously established and enforced on the basis of statutory or even constitutional status rights, that is, rights not resulting from contractual agreements between parties and not negotiable to either of them.

The welfare state is an accumulation of status rights that must not be earned, but comes as an original endowment of 'social' citizenship. It can be visualized as an edifice that was erected over a period of more than one and a half centuries in what is now the OECD world. Very schematically speaking, this structure of security has three floors and a roof. Each of the floors is—and has always been since its inception—the scene of a dynamic

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process of ongoing remodelling, expansion, partial demolition, reconstruction, and innovation. As a result of these activities, welfare states differ widely across time and space. But the structure and function, as well as (almost) the historical sequence in which the floors were built, stay the same across welfare states, although the size and interior structure of the building and its floors differ across national welfare states. Each floor is designed to deal with a particular security concern of wage labour.

The ground floor6 contains provisions regulating access to labour markets and to jobs and issues of health and safety *at work*. Time-related measures are probably the oldest components, namely the limitation of the working day and the prohibition of child labour. The regulation of unhealthy work environments and of the hazard of accidents were further steps. The procedural regulation of working conditions, such as the speed of assembly lines and work schedules and overtime, through works councils and other forms of co-determination, were later added to the structure of the first floor, as were on-the-job training programmes and organizational innovations such as job rotation. Preventive health measures were also an important component of the work-related regime of safety and security, as are seniority rules and job tenure. All these measures were implemented through statutory law and a public machinery of factory inspectorates and labour courts, on the one hand, and legally mandated forms of co-determination and joint decision making between management and workers, on the other. The common denominator of the myriad of regulations to be found here is the intention, shared to some extent by workers and their organizations, policymakers, and employers, to protect workers from some of the disutility and hazards of the labour process, thereby enhancing not just work motivation and productivity, but also the long-term viability of the worker as a productive agent. This agent must be protected from conditions that would lead to the premature exhaustion and obsolescence of labour power, physical condition, loyalty and motivation, and skills.

The second floor is the scene of provisions pertaining to the ('social') security of the wage worker *outside* work. They consist in either transfer payments replacing wages or in social services, such as day care services. They apply to workers who are temporarily or permanently unable to sell their labour power and thus to earn income. There are two classical standard conditions which cause the non-marketability of labour: recognized *disability* (due either to chronic health conditions or to old age, whichever comes first) and *sickness* (including physical conditions resulting from work accidents). These are covered by social security arrangements, pioneered by the Bismarckian social reforms of the 1880s. They basically consist in a state-mandated and typically also state-subsidized arrangement of forced savings that generates funds out of which the wages of the disabled/pensioners can be partially replaced and health/ability to work can be restored through medical treatment. Alternatively, social security can be financed out of general taxes, with less immediate implications of changing employment and demographic conditions upon the (non-wage) cost of labour. After health insurance and pension insurance, and usually much later, comes the provision of a third risk for which wage replacement is granted, if only for a limited period of time and after a minimum time of preceding employment, namely *unemployment* (though not failure to obtain a job in the first place!). A fourth 'risk' pertains not to the inability to earn, but to the insufficiency of the income earned owing to the presence in the worker's household of dependent children and the additional expenses incurred for their upbringing, and the resulting loss of the household's earning capacity. *Family subsidies* are partly designed (in the form of tax allowances) as compensation for relative income loss (relative to households with no or fewer children and hence greater earning capacity), partly as a flat-rate reward for parent-citizens and the service to the wider community they assumedly perform through the raising of their offspring.

On the third floor, the institutional devices are located which are intended to deal with the decline of workers' capacity to *defend their income,* both in absolute terms of real income (to be defended against inflation) and in terms of relative income (to be defended against productivity increases, which shift the ratio of wages to profits in favour of the latter). The institutional pattern that serves these two purposes is trade unionism and the making of collective wage agreements, including its ultimate weapon of strike action. In order for unionism to become an 'institutional' pattern (rather than a mere fact of labour walk-outs and shopfloor revolts), trade unions must be recognized by employers, as well as by the legal order in general, as legitimate representatives of employees' income interests. In order to gain such recognition, which typically occurs under conditions of either international war or severe economic crisis, two obstacles must be effectively overcome. As trade unions are, from an economic point of view, nothing but supply-side cartels, recognizing them as legitimate representatives means exempting them from 'anti-trust' measures and the general ban on 'combinations' that a liberal market economy is premised upon. Furthermore, and in order to enable them to wield the strike weapon, workers and unions must be exempt from liability for the harm they inflict by using that weapon against employers. Also, the stronger trade unions are and the more they operate at the multicompany level, the more they will be inclined to fight, apart from higher wages, for a more compressed wage scale in order to strengthen a sense of solidarity and commitment among their (potential) members and to boost union density. This effect of collective bargaining, which can be seen as the unions' complement to management's efficiency wage strategies, is today widely believed to interfere with the employment prospects of less productive workers.

Continental European labour and industrial relations systems differ from country to country concerning the complex ways that have been

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developed of endowing trade unions with these licences, collective status rights, and employment externalities, in return for which unions are more or less strictly regulated concerning the procedures that must be observed in raising and settling industrial disputes over wages and conditions.

Finally, the roof of the building. As is in the nature and purpose of roofs, they protect the integrity of the entire building and prevent its lower parts from being damaged. The roof metaphor serves here to summarize a set of policies that are designed to protect and safeguard the various status-conferring and security arrangements just described. These policies, epitomized by what used to be called the 'Keynesian welfare state' model, include labour market and employment policies, together with the monetary, fiscal, trade, and economic policies which are designed to promote and maintain the 'full' employment on which the security of those three security arrangements critically depends. This is so because in the absence of a condition of reasonably 'full' employment, none of the three categories of status rights of workers—rights in the labour process, rights outside work, and rights to defend distributive status through collective action of workers through unions—can be effectively maintained. In a severe and protracted labour market imbalance with an excess supply of labour, the market will be flooded by employment-seeking workers willing, for lack of a better choice, to forgo the protection at work; social security systems will break down under the imbalance of 'too few' contributors and 'too many' claimants; and trade unions will lack the organizational resources and bargaining power to raise real wages in proportion to productivity gains and redistributive goals or even defend current levels of real income.

So much seems uncontroversial among European social and economic policymakers. What is controversial, however, is the logic by which security and (full) employment are tied to each other. The majority of European *social democrats* argue that, in order to *preserve* the core components of the welfare state, full employment must be restored. As a corollary to this argument, it is claimed that all three components of the welfare state arrangement, at least if appropriately revised and 'modernized', will serve as effective *instruments* for the achievement of the goal of full employment through growth. Social protection and economic performance are tied by a loop of circular causation. Status rights, safety nets, and a strong role for trade unions are held to be necessary preconditions for labour market recovery, as these security arrangements facilitate flexibility and the capacity, as well as the willingness, of workers to adjust to changing economic conditions and productivity requirements. Peaceful industrial relations and stable political institutions were positively seen as guaranteed by the arrangement of social security, as it stabilizes domestic consumer demand and imposes a constant pressure upon investors and employers to increase productivity, thus providing an overall boost to the global competitiveness of national economies. Also, it is assumed that the institutional shell of the welfare state structure will keep class conflict from spilling over into the political arena, thus providing for the requisite measure of 'business confidence'.

Market liberals take the opposite view by claiming that, in order to restore 'full' (or rather, to generate 'more') employment, most of the structure of protective and status-conferring institutional patterns of labour regulation, social security provisions and unions' bargaining power must be viewed as obstacles to full employment which must first be *largely demolished,* thereby forcing workers to adjust to market incentives and the imperatives of efficiency and competitiveness. Market liberals do not usually believe that welfare state institutions do greatly contribute to the efficiency of production any longer after the 'Fordist' pattern of mass production in relatively closed economies has largely become a thing of the past. Nor is there any reason, in their view, to fear that political instability will emerge as a result of the demolition of major parts of the welfare state, at least after leftist political radicalism has also become a thing of the past.

Also, a third voice, luckily with much less resonance, is making itself increasingly heard in European politics, a voice which claims that the social security of workers (as well as the protection of citizens from violent crime), on the one hand, and efficiency of production and competitiveness, on the other, can be reconciled only if national borders are sealed to the influx of foreign people, foreign workers, foreign goods, and those praying to 'foreign' gods. Since the mid-1990s, integrating Europe has seen the sometimes sudden and spectacular rise to electoral success of figures such as Pia Kjaersgaard (Denmark), Umberto Bossi and Gianfranco Fini (Italy), Pim Fortuyn (Netherlands), with Jean Marie Le Pen (France), Jörg Haider (Austria), and Carl Hagen (Norway) being among the pioneers of this new field of populist political entrepreneurship. Le Pen described himself in the 2002 French electoral campaign as being a leftist in social affairs, a rightist in economic affairs, and a nationalist in everything else. This formula, which is designed to resolve the tension between liberal market freedom and welfare state status rights by ethnonationalist, xenophobic, and anti-European appeals, is applied by his rightist populist colleagues as well. As to the welfare ingredients of this formula, the protection offered is not the one accomplished through strengthening the status, security, and bargaining power of the weaker side in labour contracts, as in the social democratic tradition. It is through granting benefits and offering paternalistic redistribution to needy members of the national community, such as single mothers, low-income tenants, and family farmers. The emphasis is on the protection of life and property against crime, and particularly crime committed by non-nationals or facilitated by open borders (such as mandated by the Schengen agreement). What rightist populist social policies invoke are the two quintessentially non-contractual, or 'communal', forms of collective life: the family (as opposed to marriage) and the ethnic nation (as opposed to the

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republic or, for that matter, the nascent Euro-polity). In recent years, the electoral fortune of the populist right has been growing in inverse proportion to that of the social democratic left. In some places, it has been able to accomplish the unlikely success of attracting the support both of prosperous libertarian middle-class 'yuppies' (with their opposition to high taxes and social spending and their taste for tightening other people's belts) and frustrated working-class elements who have lost faith in leftist policies and promises.

It is the triangle of reluctant social democrats, aggressive market liberals, and more or less militant rightist populists that forms the ideological space of political contestation and policy debates in the European Union.

Welfare states as nation states

Fully developed European welfare states, with all four of their floors in place, were historically premised upon these states being nation states. Nation statehood is now being superseded and challenged by the bundle of phenomena referred to as 'globalization', of which European integration (including Eastern Enlargement) is a regional and arguably still a rather benign instance. If nation statehood is challenged by Europeanization, as it undoubtedly is, the question is what happens in the process to the four arrangements of security.

Before addressing that question, let us clarify in structural and functional terms what we mean by a nation state. As far as statehood is concerned, its three classical components are a (coherent) territory, a people, and an effective regime. The latter must be able to control the entire territory and population and, in order to do so, must rely on a reasonably centralized apparatus of military, fiscal, educational, administrative, and legal institutions. These institutions allow the sovereign exercise of rule, meaning both external sovereignty (or the capacity to defend borders and to monopolize control in relation to other states) and internal sovereignty (the capacity to enforce the regime's rules and to overcome any resistance to its rule). The capacity to defend its borders in a durable fashion and to control the inward and outward flows of people and economic resources across its borders is the hallmark of statehood. As far as, in addition, the 'nation' state is concerned, some source of cohesion is present that unites the population into a collectivity with a shared sense of its identity, its historical origin and fate, constitutive political principles, a common language and culture, and some widely recognized norm of national solidarity. Both the state's capacity to impose a system of protective status rights *and* the nation's sense of homogeneity and solidarity that supports such an imposition and tolerates its redistributive outcomes are necessary conditions for a fully developed welfare state. The security arrangement of welfare states has in turn been used to maintain and strengthen national solidarity when it was threatened by economic crisis, non-institutional forms of class conflict, or international war. Major breakthroughs in welfare state development have been by-products of wars and their consequences. 'Welfare-warfare states' have triggered social security and service programmes for veterans, workers, and the entire citizenry being prepared for, being involved in, or suffering in the aftermath of, international wars.

If, as a consequence of 'globalization', that is, the increase in international flows of investment, goods, information, and people, the nation state's sovereign governing capacity is declining, what happens to the welfare state and its components which were historically premised upon robust nation states? Three familiar alternative trajectories can be envisaged, corresponding to the three types of political forces mentioned above. First, the architecture of security is gradually demolished, giving way to an (impoverished) version of the liberal equality of rights. According to proponents of this perspective, states must, owing to their definitive loss of 'border control' and in the face of increased factor mobility, lower the ambitions invested in the social security arrangements and retreat into a regime of market freedom which leaves the third and, in particular, the fourth of the above kinds of freedom increasingly unconstrained. Or, second, a populist backlash will be triggered by the repercussions of internationalization, resulting in potentially most illiberal forms of paternalistic protectionism. Third, some functional equivalent of security-enhancing status rights will be transferred from the nation state level to supranational forms of organization.

The latter is the perspective that most European integration policymakers would subscribe to. According to this perspective, Europe is currently in need of, as well as in search of, policies and patterns of political decision making that would allow the diverse welfare state arrangements that have evolved over many decades at the national level to be transferred to the European level. The goal is being envisaged in terms of what to avoid, not what to achieve. What is to be avoided is either of the (mutually invigorating) extremes of a mere market-liberal *'negative' integration* and rightist-populist reactions which would amount to a backlash of *positive disintegration.* Yet the road 'in between', that of 'positive integration', leads through largely uncharted territory. 'Social dumping', 'race to the bottom', 'beggar my neighbour' and the rise of the 'competition state', a fiscally starved state that is reduced to the status of a strategically impotent price taker faced with the uncontrollable dynamics of capital mobility, are some of the catchwords representing the fears that people associate with the 'negative', merely market-making instead of market-regulating form of integration of EU-15, with additional threats of heightened factor mobility, that is, massive inflows of labour and outflows of capital, being associated with Eastern Enlargement and the near realities of EU-25.

It is also widely felt by political elites that in order to maintain popular support for both the deepening of ('ever closer') European integration and the widening of its scope ('Eastern Enlargement'), Europe must present itself to its citizens as a credible project of social security and protection, and certainly not as a threat to established social status rights. At the very least, and after the European Union is still evidently deficient (relative to the member state polities) in terms of its democratic legitimacy, pro-European consensus and identification among non-elites is likely to dwindle, strengthening the forces of populist renationalization, in case a loss is perceived to take place not just in terms of democratic legitimation, but also of social protection and security. Thus, and in order to hold together the component parts of integrating Europe and to pave the way towards wider and deeper future integration, European elites have every political reason to go beyond the negative integration of markets and proceed, visibly and credibly, towards a positive integration of a 'social' Europe. The question is: does Europe have the resources and institutional devices to actually do so?

Yet the transition from market-*making* negative integration through the abolition of tariffs and other hindrances and distortions of competition to market-*constraining* positive integration through the adoption of a Europewide regime of social protection and security is a process that, if anything, will take decades rather than years to conclude.7 This is so because of the extraordinary complexities involved. These can be summarized in seven points.

1. The scope and *level* of generosity of social protection as well as the status rights of collective actors (trade unions, employers' associations) differ from member state to member state. This implies that any European social policy regime that represents an 'average' between the high performers and the low performers would be vehemently opposed by either of them. It would be opposed by (for example, the Scandinavian) high performers because the *political* objection would apply that some of 'our' social achievements are being sacrificed on the altar of European integration. But it would also be opposed by the low social protection achievers (for example, Portugal) for the *economic* reason that 'Europe' forces 'us' to become more generous, thus undercutting the competitive advantage 'we' enjoy owing to our lower cost of labour. The only conceivable way out of this conflict was seen in preventing it from emerging at the European level, a preventive measure known under the euphemism of 'subsidiarity' (article 5, TEC). Yet the actual possibility of member states designing and implementing autonomous policies of social protection has been severely constrained by an EU-inaugurated EMU and Single Market regime with its effective ban on autonomous policies of setting exchange rates, interest rates, and fiscal debt, as well as controlling capital movements and movements of goods and services across borders.

2. The actual growth and employment performance of European economies, as well as their overall level of economic development, varies by country and, in particular, by region within countries, with the better-off

countries being typically the small and medium-sized ones in the west and north of the EU territory. According to the Eurostat data base, official unemployment rates range from 2 per cent and 3 per cent in Luxembourg and the Netherlands in 2001 to between 10 per cent and 13 per cent in Greece and Spain. GDP per person slightly exceeds the OECD average in Belgium and Denmark, while it lags as far behind as 60 per cent (Portugal) or even 58 per cent (Greece). This implies a corresponding difference in the urgency with which national governments will be prepared to make efforts to improve their employment situation as a means to maintain their level of social protection.

3. The *institutional structure* of both social security arrangements and industrial/labour relations systems differs widely among EU member states and their social policy regimes. Benefit levels vary as considerably as the modes of financing the benefits. The same applies to the institutional arrangements of wage determination. It is because each of the member states has a highly developed institutional system in place on the second and third floor of our welfare state structure, and that each of these systems has generated its entrenched interests and peculiar expectations, that harmonization or convergence is so difficult to achieve as a political project and jointly adopted institutional design. Even those who agree that a 'positively' integrated 'Social Europe' must be created in order to compensate for the Common Market's corrosive effects upon national welfare states are unlikely to find it as easy to agree on any particular institutional blueprint according to which 'Social Europe' is to be built. This difficulty does not preclude various kinds of 'spontaneous', as opposed to agreed-upon ones at the European level, adjustments and convergences that are necessitated by capital mobility and competitive pressures. A case in point is the corrosion of systems of multi-employer collective bargaining, which is being replaced by the practice of company-level concession bargaining and government-sponsored emergency measures ('social pacts', Hassel 1998). Such phenomena of de-institutionalized *ad hoc* crisis responses are often summarily and in an alarmist tone referred to as a 'race to the bottom'.

4. At the same time, quantitative and qualitative regime divergences constitute not only robust obstacles to harmonization and 'positive' integration, but also considerable *distortions of market competition*. For instance, the Bismarckian countries which finance their social security systems largely through fixed contributions of employers and employees suffer competitive disadvantage in comparison with countries where social security expenditures are largely financed through general taxation. The presence of these distortions suggests the need for achieving a more unified welfare state regime in the interests of market integration itself, and not just in terms of some model of 'Social Europe'.

5. Such harmonization is also called for as severe fiscal imbalances within national systems of social security, which are all the more likely to

occur as a result of persistent high levels of unemployment prevailing in some of the member states, will force national governments to adopt fiscal measures (that is, budgetary deficits) which are in manifest violation of the Growth and Stability Pact, the fiscal and monetary regime adopted as a disciplinary device to sustain the EMU. If labour market and social protection policies are left to the member states in the name of 'subsidiarity', national policy actors are likely to resort to measures (such as subsidies or budget deficits) that imply severe negative externalities (such as interest rate hikes, decline of the external value of the euro) for other member states or for the EMU as a whole.

6. Thus what appears impossible for reasons 1–3 is widely seen as desirable and even necessary for reasons 4 and 5, as well as a further one which derives from the consideration that some convergence and harmonization is also called for in terms of political integration. In order to maintain the permissive consensus supportive of 'ever closer integration' and to prevent the further spread of anti-European mobilization of the nationalist and populist-protectionist sort, national social security and collective status arrangements must be protected against the perception of being jeopardized by European market integration and threatened by 'social dumping' and a 'race to the bottom'.

7. While everything relating to the ground floor of the welfare state structure (the non-discriminatory regulation of access to labour markets and jobs, the rules governing health and safety at work) is firmly established and equalized across the European Union by European law, it is also well understood by now that the affordability of the various national arrangements at the second and third floors (social security and wage determination) is entirely contingent upon the solidity of the 'roof, that is, the labour market performance of member states. But, lacking any governing capacity and fiscal authority of their own, Commission and Council do not enjoy the authority to boost overall European labour market performance, while member state governments maintain the responsibility for labour market and employment policy in the name of 'subsidiarity'—a responsibility, however, that is largely rendered nominal by the unfettered mobility of both labour and capital, on the one hand, and the constraining EMU ('Maastricht') criteria, on the other. Thus member states have the nominal authority, yet not the effective means at their disposal, to do something about the employment situation which in its turn determines the sustainability of the welfare state edifice. Could it be, then, that European institutions could avail themselves, even in the absence of the formal authority to do so, of the means to shape European-level labour market and employment policies, in the pursuit of which some 'harmonization through the back door' would incrementally be introduced?

I am not concerned here with the substantive developments and accomplishments that the European Union has achieved so far. Rather, I will focus for the rest of this chapter on new methods of 'coordinating' policymaking by which European policymakers have tried to accomplish what 'cannot' be done (owing to 1–3) yet still 'must' be done (owing to 4–6 and under the challenges of 7), if without the machinery of 'direct effect' rulings and other means of authoritative making and implementing of supranational policy.

'Stateless' policy making?

There is by now a ten-year history of the European Union's attempts to cope with this configuration of constraints and challenges. It starts with Jacques Delors's White Book on *Growth, Competitiveness, and Employment,* which reflects the member states' great difficulties in addressing unemployment and setting the stage for addressing the issue at a European level (Delors 1993). It calls for greater coordination and convergence of employment policy. At the 1994 Essen Council, the first contours of a European Employment Strategy (EES) were worked out. These were then incorporated in the 'employment chapter' (articles 125–30) of the Amsterdam Treaty on the European Communities (TEC), signed in October 1997 and coming into force in May 1999. The policy instruments provided for in this chapter are of a characteristically 'soft' nature: annual review of the EU employment situation at the Council level, formulation of 'guidelines' to be taken into account by member states, annual reports to be submitted by member states on their employment policies, policy recommendations addressed to member states, exchange of information on 'best practice' among member states, creation of an 'employment committee' advising the Council of Ministers. Immediately following the Amsterdam conference, the Luxembourg 'job summit' of 1997 worked out these policy instruments in more detail and included the obligation of member states to submit 'national action plans' which are subject to 'multilateral surveillance'. The development of this set of policy devices was continued at the Council meetings of Cardiff (1998), Cologne (1999) and, most significantly, Lisbon (2000), where the 'Open Method of Coordination' (OMC) that comprises these procedures was defined for the first time.8 As a result, the scope of policy areas to which OMC was to be applied was significantly broadened so as to include issues of 'social inclusion', research policy, the formation of an 'information society', 'entrepreneurial policy', health and pension policy (Stockholm Council 2001), education, Eastern Enlargement, immigration policy, and 'sustainable development'. However, procedures for all these policy areas are still considerably less elaborate and specific than those applying to EES.9

The European Union has no direct way to address issues of wage determination and of the distribution of incomes. In the name of 'subsidiarity', the determination of wages and the determination of levels of social security benefit (that is, developments on floors two and three of our welfare state structure) remain entirely a matter of national politics and institutions. But there are indirect methods of getting hold of these two strategic variables, and these have recently been explored and developed, beginning with the Lisbon summit of 2000. In model terms, wage levels and the wage structure interact with (1) the quantity of *labour supply,* i.e. the activity rate, and, in particular, the employment rate, within the population aged fifteen to sixty-four and (2) the *skills of labour,* with upgrading skills having a positive effect upon both individual income and the employment security of workers and the overall volume of employable labour.

The European priorities, as promulgated above all at the Luxemburg, Lisbon, and Stockholm summits, concentrate on these two dimensions of labour supply, quantity, and skills. They do so in the name of a new normative concept (or rhetoric), that of 'cohesion', the promotion of 'inclusion' and of fighting 'discrimination'.10 The analysis behind this strategy is roughly this. If labour market participation lags behind that actually achieved in other advanced societies, parts of Europe's growth potential will be wasted, as well as transfer budgets strained. Non-participation must be due to either of two causes: people are *prevented* from participation, which amounts to 'discrimination', or they are not motivated or *able* to participate, in which case 'unemployability' is taken to be the cause. Both of them add up to the pathology of economic and social 'exclusion', which must be fought by strategies of 'inclusion', strengthening social 'cohesion'. Inclusion refers to fighting discrimination by race, ethnicity, and nationality, as well as physical handicaps, but, most important, by gender (ECT article 3 (2)) and by age. Integrating the under-utilized supply of female labour and over-fifty-five labour into gainful activity is therefore a key component of all EU policy documents issued by the Commission's Directorate General for Employment and Social Affairs and various Council directives (such as 2000/43 and 2000/78). This antidiscrimination agenda has the dual attraction of (1) being 'egalitarian' in terms of rights and opportunities, without redistributive strings attached, and (2) being instrumental, if implemented, for the viability and sustainability of member states' public pension systems (as emphasized by the Stockholm summit, March 2001) as well as, less explicitly, inducing wage restraint and a downward extension of the wage scale through the mobilization of additional labour supply at the lower range of the wage scale.

Nothing, however, is mandatory, binding, or authoritative in this iterative process of formulating supranational guidelines and monitoring their implementation. Hence compliance on the part of member states is entirely voluntary, concerning both the kind of their policy priorities and the degree of effort with which they are being pursued. While it is too early to assess the effects of this mode of policy making or to causally attribute any success to the OMC, two underlying assumptions of this method of policy making are fairly clear. One of them is cognitive, the other motivational.

Cognition and policy learning

One of the key mechanisms on which the OMC is assumed to operate is cognitive (cf. Jacobson 2002). The key phrases are 'best practice', 'benchmarking', and 'management by objectives', 'peer control', and 'temporal standardization and disciplining'. The background intuition is that 'we' can benefit from learning from how others have managed to succeed. For the purpose of facilitating cross-national policy learning, a substantial fund of €100 million has been set up to conduct research into discriminatory practices and to promote the exchange of information among member states on how to fight them (Council decision 2000/750). But it is far from obvious which practices are actually 'best', given the multitude of evaluative criteria and the trade-offs that apply to them. Extensive use of part-time employment may be the best way to create jobs and reduce unemployment, as the Dutch example suggests. But it may be far from best in stabilizing household income over the life course. And even if some standard of success is unequivocal, chances are that success is not easily attributed to individual measures and programmes which are always embedded in—and whose effectiveness is contingent upon—the entire ensemble of institutions of a member state and its policy regime, with its built-in priorities and constraints. For instance, some member states have a statutory minimum wage, some don't; some have a big tax component in their pension system, some rely almost exclusively on contributory schemes. Should the latter be required to imitate the 'best practice' of the former? If so, successful policy learning would require them not just to adopt new 'practices' but also to 'unlearn' and partially demolish entrenched institutional patterns (such as the trade unions', as opposed to the legislature's, jurisdiction over wage determination in the case of minimum wages or working time).

Such 'unlearning' may in fact be the main purpose of the OMC, or its hidden curriculum. The main purpose of this method of policy making seems to be that of bringing home to member states' political elites and constituencies the need for 'modernization' and 'recalibration' of their hitherto adopted arrangements of social security, industrial relations, and labour market policies. The negative message that 'nothing can stay as it is'does not imply, however, that what is going to replace present arrangements will be a consistent and consolidated Europeanized welfare state.

Thus OMC increases the pressure to view existing arrangements as potentially obsolete, to experiment, revise, and innovate for the sake of 'more employment', on which the sustainability of both national social security and industrial relations systems depends in an increasingly competitive environment. This functionalist and productivist view of these institutional arrangements also implies that what used to be, within the framework of welfare states as relatively self-contained nation states, *exogenously* established and enforced social policy institutions is now *endogenized* into the game itself: status, security, and solidarity themselves become contingent upon contractual voluntarism (Streeck 2000). Accordingly, the game is no longer a game *under* rules, but increasingly one *about* rules. The national welfare state can no longer constrain the market and impose a regime of decommodification upon the market. On the contrary, it is now being left to the market to decide which arrangements are in fact affordable and employment-enhancing, and which ones must be dropped as a competitive liability.

Needless to say, there is nothing wrong with learning, experimentation, innovation, and institutional change—in principle, that is, and as long as learning yields demonstrably superior and fairly distributed collective outcomes, as opposed to being a euphemism for a power relation in which one side is in a position to dictate to others what to learn and unlearn. How do we tell the difference between desirable and perfectly innocent 'learning', on the one hand, and the imposition of new rules mediated by the exercise of social and economic power? Let me suggest two criteria by which this distinction might be substantiated.

First, institutional innovation is driven by social and economic power relations if it is *not formally legislated* into being, but brought about through *de facto* deviations from previously observed institutional practices which, while nominally remaining intact, are hollowed out by individuals' adjustments and moves of opting out. The mode in which welfare state institutions change can be explicit reform and retrenchment. But it can also be inconspicuous and gradual decay. For instance, people may defect from public health and pension systems, trade unions see themselves forced into single-employer concession bargaining, workers resort to unprotected forms of pseudo self-employment in order to avoid social security dues, if not to illegal ('black') forms of employment. Institutions change at the factual level; they cease to govern actual social and economic interaction, and unofficial, informal, as well as highly power-sensitive practices creep in instead. For instance, new patterns of 'productivity pacts' and 'social pacts', which expand the bargaining agenda by making both levels of pay *and* volume of employment conditional upon productivity and profitability targets being met, have been introduced by employers into collective bargaining. Such concessions can be extracted from unions because multinational corporations in which such bargaining patterns have been introduced can practise wage- and productivity-related 'regime shopping', as they enjoy the option of shifting the location of production between countries.

A second indicator of the role of social power in processes of institutional innovation is the degree to which collective actors are being disorganized or weakened through *decentralization*. As a general rule, we observe that the wider the scope of economic interaction becomes concerning trade, investment, and migration, the *narrower* and the *less* encompassing and more disaggregated become the units covered by and involved in the making of contracts and regulations. For instance, much of the focus of German labour market policies has been moved down from federal to regional to local to 'civil society' to individual levels of intervention. A similar pattern applies to wage bargaining, much of which is in the process of being transferred from the sectoral and multi-company level to that of individual companies, if not to departments of companies and eventually productivity measures applied to individual workers. Similarly, changes are under way in many EU member states that are advocated under the innocent label of 'devolution' while actually resulting in the transfer of rule-making competences from the national to the regional level, as in the transition from 'cooperative' to a more 'competitive' form of federalism, as currently suggested by the more prosperous German states.

The vision of promoting policy convergence at the European level by very 'soft' means is highly ambitious indeed, given the very 'hard' facts of national differences and priorities. The European Commission itself, in its White Paper on *European Governance,* relativizes the role to be played by OMC in that 'it adds value at a European level where there is little scope for legislative solutions'. Neither can it equal in its bindingness formal European law nor can it change the *acquis* of European law. In order to enhance its steering capacity and its potential for promoting convergence, the OMC would have to be complemented and 'hardened' by legislative devices, now commonly referred to as 'framework directives' (Commission 2001). In the presence of authoritative framework directives, 'national policy makers could no longer afford to ignore the policy discourses of Open Coordination' (Scharpf 2002:16–17), which in the absence of such directives they are perfectly free to do. Thus Scharpf urges the 'search for solutions [in the social policy field] which must have the character of European law in order to establish constitutional parity with the rules of European economic integration' (*ibid.:* 18). Yet it is exactly the unfeasibility of such directive policies that gave rise to the semi-formal and paralegislative OMC approach in the first place.

Thus the thought of endowing OMC-generated rules with quasigovernmental force clearly amounts to a bootstrapping act of presupposing as given something that, if everything goes well, will be only the outcome of the dynamics of OMC, namely some European authority of coordination. For the time being, OMC outcomes are neither formally binding (as they cannot be enforced against the will of member states' governments) nor can they replace or alter existing *acquis* regulations. The basic question for political theorists, the answer to which is at the same time of immense practical significance, is this: how can voluntary horizontal cooperation generate outcomes that are equivalent in their substantive effect to vertical control through constituted political power? How can 'soft law' be hardened so as to achieve the same degree of bindingness as formal directives?

The answer envisaged by OMC proponents is this. Multilateral information exchange as orchestrated and supervised by the Commission will lead to 'policy learning' on the part of member states' governments. This convergent learning process will be propelled by mechanisms such as the definition of 'best practice', the call for national action plans, specific recommendations, benchmarking, peer review, blaming and shaming, and the use of agreed-upon indicators of performance.

Yet as long as compliance on the part of national governments remains voluntary, the question remains what incentives and *motives* they have to cooperate. For instance, the mechanism of 'shaming' will be viable only to the extent that national constituencies and audiences will actually adopt the standard of the Commission's guidelines, etc., as a yardstick for evaluating their governments' performance. The rather heroic assumption is that national political constituencies will actually hold their governments accountable for complying with the guidelines of the Commission and the summit. That presupposes that European standards, recommendations, benchmarks are not only known to national electorates, but, beyond that, adopted as yardsticks of good policy. Why should 'blame avoidance', the desire to escape being exposed as a poor performer or a laggard in 'policy learning', become an overriding objective of national policymakers, given the perceived (economic as well as political) costliness of compliance? As long as 'benchmarks' and standards of 'good practice' are being perceived within national public spheres as little more than cloudy and ceremonial exhortations of remote Eurocrats, their role as operative yardstick of 'good policy' remains dubious. This objection applies all the more as national governments usually have a rich supply of reasons and excuses ('subterfuge') to invoke as to why conditions beyond their control have hindered them in doing better, in terms of labour market performance or social security finance, than they actually have. Often enough, their scope for action is constrained by national policy networks, configurations of veto players, entrenched interests, as well as the perceived national competitive advantage of non-cooperation. It is thus only if the goal of overcoming social exclusion, social protection, and employment problems at the *European* level were firmly adopted by electorates, collective actors, and political elites at the *national* level that the 'policy learning' dynamic and its motivational underpinnings envisaged by OMC would be likely to bear fruit.

Of course national governments, in trying to achieve the convergence of their policies with those of others through OMC, can try to escape and bypass the potential obstacles located in their national policy arena and electoral politics. Such escape would clearly exacerbate the notorious 'democratic deficit' of the European Union, at least as far as 'input legitimation' through public debate and political representation is concerned. Yet it would arguably increase the effectiveness of policy decisions, or what Scharpf (1999) has termed 'output legitimation'. However, in the last analysis, any trade-off between democratic legitimation versus policy effectiveness, or between the 'by the people' versus the 'for the people' principle, will itself be subject to the (electoral) test of 'input legitimation'—a test which an overly executive-centred method of reaching European convergence is unlikely to pass. This is particularly the case if the standards of 'effectiveness' are themselves open to considerable controversy, as is clearly the case in all policy areas to which OMC is intended to apply.

In order for national policies to converge in terms of policy instruments and outcomes, conditions within member states must be fairly similar in the first place. However, there can be little doubt that there is a still increasing divergence of labour market outcomes by country and, in particular, by the consequences of Eastern Enlargement. The peculiarities and path dependences of national labour market and employment policies, as well as structural and institutional conditions within member countries, have generated vast differences across countries and regions in terms of their labour market performance (for example, in terms of labour market participation rates, levels of unemployment, and average individual duration of unemployment). Dissimilarities are evident not only if we compare countries and regions within EU-15, but even more so if we compare policy areas. The supranational EU regime has been amazingly successful in homogenizing across the European Union monetary and fiscal conditions, but not so the conditions of employment and social protection. The homogenization of the latter has been lagging way behind, in spite of the vast expenditure invested for many years in structural and regional subsidies. As Fritz Scharpf observes: 'Efforts to promote employment and social policy at the level of the European Community have come...late and seem feeble in comparison to the success stories of the Single Market and the Monetary Union' (Scharpf 2002:2). This difference is to be attributed to the fact that the former policies (monetary and fiscal) are of a *regulatory* nature and can be effectively enforced by the Commission and the ECB within the framework of the Treaty, whereas the latter policies are *redistributive* and thus depend for their success on the preparedness of member state governments to sacrifice not just much of the national autonomy they enjoy according to the 'subsidiarity' rule, but also, at least on the part of the better employment performers, to pay with national resources for costly European employment programmes and to forgo potential competitive advantages of their national economies. Evidently and unsurprisingly, there is neither the willingness of member states to do so nor the institutional capacity of European authorities to force them to do so.

It is for this diversity of national policy priorities that, technically, the term 'coordination' in OMC is a misnomer anyway. What the method is intended to lead to is *cooperation,* which is much harder to achieve than coordination among actors with divergent interests. In the (rare) *tabula*

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rasa case of pure coordination, all participants are interested in having a rule ('convention') in place, whatever the rule may be. The typical case of cooperation, however, is one in which preferences differ as to what the rule should be, and also the costs and efforts required for complying with that rule are not the same for all players involved, as some may have to make more painful adjustments than others.
The making of the internal market through competition law, monetary union, and fiscal constraints triumphs over the 'embedding' of this market in European policies of social protection and the promotion of employment. Nor is this disparity coincidental. For it is the rapid success of 'negative' integration that has caused both the still growing discrepancy of national and regional labour market outcomes and the incapacity of national governments to cope with them. To make market integration socially compatible, the voluntary adoption of policies according to OMC is not enough.' "Social Europe" would stand on safer legal grounds if the Court and the Commission could be required to apply a...balancing test to potential conflicts between European internal-market and competition law and national policies promoting employment and social protection.' (*ibid.,* 13). Yet the 'would' in this sentence is logically as compelling as it remains a counterfactual.11
Notes
The author has received helpful comments from Robert E.Goodin, Karl Hinrichs, and Göran Therborn; particularly helpful was the research assistance of Milena Buechs.
1 Just a rather trivial reminder: there is a minority of countries in Europe, as well as a small minority of spaces within these countries, where the following rule does *not* apply. You cannot travel 200 miles (half a day of travel, by modern standards) in any direction without ending up in a different country (with its different history, language etc.), or, for that matter, in salt water. Exceptions to this rule are to be found, within EU-27 Europe, only in France, Germany, and a tiny fraction of Spain.
2 Symptomatically, Switzerland, the least Europeanized of European polities, seems to come closest to the United States in these respects among all European countries; this applies also to being among the few European countries to have escaped a land war on its own territory in the nineteenth and twentieth centuries.
3 Again symptomatically, the only exception to this rule occurs at the margin of Europe, namely the tension over territorial issues that exists—though seems solidly under international control—between the two NATO members Greece and Turkey.
4 A linguistic reflection of the pervasive role of status categories in Continental European capitalism is the ubiquitous presence of collectivist and organicist nouns that most often do not have an equivalent in the English language. They refer to collectivities that are endowed with status rights and the members of which recognize themselves and each other as partaking in these rights and socio-economic identities. Examples from the French and other Roman languages include the terms with the suffix *-at* (or Spanish *-ado,* as in

salariat, artisanat, and *patronat,* not to forget *proletariat*). In German there is the suffix *-schaft* (etimologically akin to the suffix in *citizenship)* widely and frequently attached to virtually every socio-economic role and collective unit. Examples include *Studentenschaft* (student body), *Wirtschaft* (the collectivity of employers/investors), *Ortschaft* (municipality), *Bauernschaft* (the farming community), *Belegschaft* (the work force of a company), *Beamtenschaft* (the civil service), *Gewerkschaft* (trade union), and numerous others, most famously *Gesellschaft* and *Gemeinschaft*. The use of this suffix suggests the internal coherence and external recognition of pre-given, supra-individual, and non-contractual properties of all members of the group as a corporate unit, comparable to the suggestion evoked by the ending of brotherhood (as used in the early North American trade union movement). While the German *-schaft* always denotes a collectivity of the bearers of some status, the English equivalent -ship denotes individual instances of belonging or sharing in group properties, as in citizenship, scholarship, craftsmanship, or membership. To be sure, there is another 'collectivizing' suffix in the English language, namely '-ry' (as in citizenry, yeomandry, soldiery, judiciary, etc.). But it connotes just the belonging of individuals to a social category, without implying some recognition as a collective body with ascribed status rights.

5 On Sinzheimer see Lewis and Clark (1981); Neumann (1957).

6 Below the ground floor there is also a 'basement' where the non-working poor are dealt with through programmes of welfare and poverty relief; this part of the building can be ignored for the purpose of the current discussion.

7 Any speculation on whether the conclusion of this process will still come soon enough to provide European citizens with reasons to support rather than to fear and oppose further integration, and thus the Union as a whole with a measure of political legitimacy, is beyond the scope of the present chapter.

8 The OMC mode of policy making proceeds as follows, according to the Luxembourg process and based upon article 128. First, the summit (European Council) adopts guidelines for employment policy to be observed by member states. These guidelines focus upon the prevention of exclusion, the activation of the unemployed, the promotion of 'entrepreneurial spirit' and start-up enterprises, flexibility, and non-discrimination. Second, each member state adopts an annual national action plan (NAP) specifying the overall guidelines for the particular context of national policy. Third, an annual report on employment, jointly authorized by Council and Commission, is submitted to the summit of the subsequent year as feedback, eventually leading to the revision of guidelines and NAPs and potentially including specific recommendations concerning the policies and performance of individual countries.

9 For the current analysis and debate on these policy methods, see de la Porte and Pochet (2002), Goetschy (2001), Hodson and Maher (2001) and Trubek and Mosher (2001).

10 In quantitative terms, the goal set at the Lisbon summit for the year 2010 is to mobilize labour supply so that an overall employment rate of 70 per cent of the population aged fifteen to sixty-four for the entire European Union is reached, up from the present average of 62 per cent (1999). In order to achieve this goal, female employment rates are to be increased from 52 per cent to 60 per cent and those of the elderly workers (aged fifty-five to sixty-four) from 37 per cent to 50 per cent. This ambitious set of goals is argued for in terms of securing the sustainability of national social insurance systems, i.e. of breaking the vicious circle (made worse by the demographic composition of aging societies) of increasing unemployment→generous allowances for early retirement as a policy response→increase in non-wage social security contributions for pension funds→increase in total labour costs→increasing unemployment.

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11 The text was finalized in October 2002 and takes no account of subsequent events.

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8

The neoliberal ideal and the reality of workplace practice

Shifting axes of political mobilization and new regimes of workplace governance in the United States

Michael J.Piore

The last decades of the twentieth century were marked by a resurgence of neoliberal ideology and a sustained attack on the institutions of the welfare state. A critical question about the complexion of society in this new century is how this process will play itself out. In answering that question, developments in the United States are key. They are key in part because of the pervasiveness of American enterprise in world markets and the competitive pressures which they exert upon other countries. But they are key as well because of the importance of US institutions in generating and disseminating lead technologies and of American cultural institutions in setting style and fashion throughout the world. They are key in a third respect as well: the power and influence the United States wields in international agencies enables us to impose our models upon other countries as a condition for participation in the evolving international trading regimes, and we have demonstrated our willingness to do so.

There is a gap, however, between the actual developments in the United States and the developments which the neoliberal debate would lead one to expect are taking place. The models we are seeking to impose through political and governmental pressure are not exactly the models which we ourselves are actually following—and as a result they are not a good predictor of the competitive pressures American institutions exert through the market place or of the changes that the evolution of technology seems to be producing in the most advanced of industrial countries. The gap is most apparent in the role of collective institutions relative to the extreme individualism which neoliberalism and competitive market models prioritize. It is true that in the last several decades many of the collective institutions in the United States have been weakened and the structures of the old welfare state have been eliminated, but a different set

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of institutions and welfare structures have grown up in their place. The market is not the unrestrained arbitrator of social and economic life as it is often pictured in accounts of US developments.

This chapter has a twofold task. First it attempts to modify the conventional picture of what US developments actually are. Second, it identifies some of the forces that are responsible for these developments and assesses their implications for the long-run evolution of other advanced industrial societies.

The old economy and the new

The welfare state in the United States grew up around New Deal social and economic legislation in the 1930s. It consisted of three major components. First, there were a set of procedural guarantees which effectively created the right of workers to form trade unions and bargain through those unions to set wages, hours, and other terms and conditions of employment. Second, the government provided minimum support for people who were unable to work through a complex system of programmes, including unemployment insurance, old age benefits, public assistance, medical insurance, and in-kind provision of food and housing. Finally, conditions at the bottom of the labour market were governed by a variety of sustentative regulations —most importantly, a minimum wage (Osterman *et al.* 2001; Osterman 1999; Piore 1986).

All of these components of the system, with the important exception of support for the aged, were compromised in the course of the last twentyfive years, and this is the heart of the neoliberal revolution in American society. The most dramatic product of that revolution is the spectacular decline in trade union membership, from 28 per cent of the private, nonagricultural labour force in 1975 to 9 per cent in the year 2000. The basic labour legislation was not changed but the law has been interpreted by the courts and administrative agencies in a manner increasingly less favourable toward unions, and Congress rejected legislation at several critical moments which would have forestalled these developments. The unionized sector, which well into the 1970s set a pattern through collective bargaining which all employers, whether facing unions or not, felt compelled to follow, has come to follow the pattern set by non-union employers responding directly to market pressures. Strike activity and industrial unrest fell to unprecedented low levels. The substantive guarantees for low-wage workers and people outside the labour force were also dramatically weakened. The level of the minimum wage fell relative to the median; enforcement activity declined; the percentage of the unemployed covered by benefits fell; and in 1996 the old system of public assistance was abolished and income support was made time-limited (Ellwood 2000).

The impact of these changes relative to other factors is much debated

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in the scholarly literature, but they coincided with a dramatic increase in the inequality of wage and salary income, both at the lower and upper tails of the distribution (Katz and Autor 1999; Levy 1998; DiNardo *et al.* 1996).

The weakening of the New Deal welfare state has not, however, resulted in a competitive labour market, at least not in the sense that the proponents of the neoliberal reforms envisaged. Underneath the old system of collective bargaining, a new system of institutional regulation had begun to emerge in the late 1960s and 1970s, and as the old system collapsed the new system expanded into the space left behind. Whereas the old system revolved around collective bargaining, operating in a shell of protective legislation governing the procedures for organizing unions and, once organized, the process of negotiations with management, the new system is built around substantive regulation generated by statute, administrative rulings, and court decisions, and given coherence by the human resource practices of large corporations and their personnel handbooks and procedures.

The main impetus behind the new regulatory framework has been equal employment opportunity legislation. Such regulation has a long history in the United States, but the effort to achieve equal opportunities was reinvigorated and for the first time became serious and effective when Title VII of the Civil Rights Act of 1964 was passed under pressure from the black civil rights movement. Through this and subsequent legislation, similar protections were extended to a number of other socially stigmatized and disadvantaged groups, including women, other racial and ethnic minorities, the physically disabled, the aged, and, on local levels, to gays, lesbians and transsexuals (Skrentny 2002). In the 1980s legislation mandating advance notice of lay-offs and family leave was also passed. State courts in this period began to impose limits on the doctrine of employment-at-will which has historically governed individual contracts of employment in the United States (Morriss 1995; Autor *et al.* 2002; Edelman *et al.* 1992). In the 1990s there was a proliferation of employment legislation at the state and local levels, most notably mandating so-called living wages for contractors of local government activities and, more recently, in California, paid family leave (Fine 2003).

In the attempt to negotiate the complex environment these regulations generated, American businesses developed a system of employment relations which has come to be called Human Resource Management (Dobbin and Kelly 2002; Dobbin and Sutton 1998; Kelly and Dobbin 1998). The implications of HRM are far-reaching, but one of its important characteristics has been to generate a set of standard personnel policies and practices which apply to all workers, even those not directly covered by the legislation. Since the purpose of these policies is to protect the company against charges of arbitrary and unequal treatment of workers, they are not easily adjusted in response to changes in the business environment and hence have some of the rigidities present in the old system of collective bargaining. Employers have also attempted, with some success, to circumvent the judicial and administrative processes through which these regulations are reviewed and enforced by creating a system of private arbitration, and this too tends to parallel features of the old collective bargaining system (Stone 1996; Supreme Court 2001).

Understanding the regime change

The old collective bargaining system was generated and sustained by political mobilization around economic identities, i.e. economic class in the Marxian sense of the term, but also craft and professional identities and identities associated with industries and enterprises. Collective bargaining was also organized institutionally around these identities; the bargaining unit was defined in law as a productive unit in which the members shared a community of interest, either as industrial or as craft workers. Unions were certified by a majority vote of the workers in the unit defined in this way.

The new employment rights regime has been driven by mobilization around the kinds of identities that have sought protection under the equal employment opportunity legislation, i.e. race, sex, ethnicity, sexual orientation, disability, and the like. Not all of the laws and regulations of the new regime were generated by pressure from groups of this kind, but many are the product of a similar process, for example the Family Leave Act (Kelly and Dobbin 1999). The mobilization at the state and local level which produced the new living wage laws also developed around these social identities. And identity groups of this kind have emerged within many enterprises and most professional associations pressing for rights and benefits at this level in much the same way as unions pressed for employment benefits historically (Scully and Segal 1999). Domestic partner benefits, for example, spread from one enterprise to another through grass-roots organizations of gay and lesbian employees. The social security system, which is the one income support programme that has managed to survive the period of neoliberal social welfare retrenchment, in fact has been protected by the American Association of Retired People (AARP), organized around the identity of older people, lines very different from the trade union lobbies which created these programmes in the first place and sustained them in the immediate post-war decades. The shift from economic to social mobilization raises the question of where these 'new' groups came from and why they have become so salient and have eclipsed economic-based identity groups in this particular period.

In a sense, American society has always contained within it two very different structures of identity, one based on economic roles, the second based on social categories like race and ethnicity that seem independent from the economy. Varying circumstances tend to bring one or another of these identities to the fore, and the economic and political actors then play upon them in their battles for predominance (Katznelson 1981; Hattam 2004; Cohen 1990; Stein 1998). The Great Depression gave impetus to economic identities and the institutions growing out of that period by recognizing these identities, and, by giving them a functional role, reinforced them. The black civil rights movement of the 1960s gave new emphasis to the second group of social identities: the new institutions which grew out of that period reinforced these identities and created incentives for people to organize around them in the way that the New Deal institutions had reinforced economic identities earlier. The revival of foreign immigration which coincided (perhaps not coincidentally) with the civil rights movement gave further impetus to these new social forms. At the same time, employers tended to use these identities as a way of circumventing the system of collective bargaining, which they found onerous. Finally, unions themselves have been forced to give greater weight to these identities in their organization campaigns and internal structures to counter employer influence.

An important theme in the development of both the old collective bargaining regime and the emergent employment rights regime is how much the collective identities around which mobilization takes place and which the regimes express give rise to *collective,* as opposed to *individual,* rights (Stone 1992; Lichtenstein 2002). How much do they enfranchise and reinforce communities and how much individuals? This is actually a theme which is fairly general in labour law throughout the industrial world. But the more basic question is how much of these developments reflect broader forces present in all advanced developed economies and not simply confined to the United States.

Economic and social identities as contrasting and conflicting

It is not obvious, however, why mobilization around social identities and the legal regime which emerged in response to it should be cast as an alternative to mobilization around economic identities and collective bargaining. How exactly this happened and what it implies for work regulation in other countries or even in the United States at other historical moments is not at all clear. Things certainly did not begin that way. The emergent industrial union movement used ethnic communities, including the black community, as a vehicle for union organization when it emerged in the 1930s; the craft unions of the old AFL, which dominated labour before the industrial union era, were often organized along ethnic and racial lines (Fraser 1993; Korstad and Lichtenstein 1988). The early civil rights legislation, and indeed social security for the aged, were originally part of the legislative agenda of the trade union movement and would never have been passed without labour’s political muscle. The economic agenda of the black community was correspondingly linked to union organization. A. Philip Randolph, the head of the Sleeping Car Porters’

Union, was one of the most prominent spokesmen for the black community; he was chosen as president for his credentials as a black leader, not his credentials as a labour leader. The famous 1964 March on Washington, the turning point in the mobilization for civil rights where Martin Luther King Jr delivered his famous 'I have a dream' speech, was organized in alliance with the significant parts of the industrial union movement (although not, it should be noted, the AFL-CIO); its slogan 'Jobs and freedom' was borrowed from labour and its demands coincided with labour's legislative agenda. Martin Luther King Jr himself was assassinated in Memphis, Tennessee, where he had gone to support a strike of the city's Union of Sanitation Workers (D'Emilio 2003).

But two factors seem to have intervened to separate labour from the black movement and from the other identity groups which organized in the wake of the civil rights movement. One was the Vietnam War. Labour supported the war effort to the bitter end. The black leadership and the rest of the left—what became known as the New Left—opposed the war. The conflict played itself out in a bitter fight for control of the Democratic Party (a fight which belies the notion that America has no labour party) (Miller 1987; Williams 1987; Diggins 1992). In the wake of that fight, conflicts between labour law and the new civil rights legislation were played out in the courts. The conflicts were probably inevitable, but had labour remained united in coalition with the rest of the left, they might have been resolved through negotiation, compromise, and legislative amendment. In the courts, they were resolved in a manner which consistently favoured equal employment opportunity and served to undermine collective bargaining.

The split provoked by the Vietnam War and the fight for control of the Democratic Party was aggravated by divisions within the law which ultimately led the labour and identity movements in two very different directions. The law governing union organization and collective bargaining grew up as a pragmatic response to labour mobilization and worker unrest. Legal protection was extended first—and for a long time confined—to railroad workers, whose work stoppages threatened the basic economic infrastructure. It was justified under the commerce clause of the constitution. It represented a compromise between economic efficiency, promoted by the market and the unrestricted pursuit of profit and industrial peace, and the need to forestall labour unrest by empowering workers to impose limits on unilateral managerial power. The balance between these two opposing forces was continually recalibrated and renegotiated by the unions themselves at the enterprise level through collective bargaining and at the national level through political negotiation and legislative amendment, which in effect altered the power the parties brought to the bargaining table. Unions have of course often claimed the freedom to organize and bargain as a basic right, but that claim has never been recognized as the basis for labour law. And one of the reasons for the deterioration of legal protection in the last decades of the twentieth century was that labour's ability to mount the kind of threat to economic stability, upon which legal protection was actually predicated—within the enterprise and in the economy more broadly—declined. That decline is, in turn, related to the way in which the collective identities in which union organization was initially rooted were converted into individual rights over time. But unions have remained basically grass-roots, mass membership organizations with a dues-paying base that generates the resources which sustain the organization, and a leadership drawn from the shop floor. While that has often meant that the leaders lack the sophistication and broader perspective that comes with formal education, it has also meant that they have a pragmatic approach to economic issues. Civil rights laws are, on the other hand, rooted in universal human rights which are in principle absolute. The legal model for equal opportunity in employment was developed by the same lawyers and institutions which had successfully litigated the integration of the public schools. The justification for school integration was rooted in the constitution, while employment integration was rooted in legislation and administrative regulation, but neither the underlying justification nor the ethos of the organization which developed and implemented the legal strategy lent itself to negotiation or compromise.

The parallels between the labour movement and the civil rights movement were actually much closer in the early campaigns for school integration. These were pursued by the legal arm of the NAACP, which was, like the unions, a membership organization; it was financed by the NAACP dues-paying base and the plaintiffs were drawn from the members. Moreover, because the actual integration of the schools, once a court order was won and enforced, generated enormous hostility, often ending in violence, directed at very young children, the ability to carry through was predicated on the active support of the local black community.

But employment litigation was different, in at least two respects. First, it never generated the organized mass resistance that school integration provoked, and hence virtually no organized community support was required to sustain the process. Second, and in some ways more tellingly, by the time the employment strategy was put in place, the legal organization which pursued it had separated itself from the NAACP to form the NAACP Legal Defense and Education Fund. The Legal Defense Fund was basically an autonomous organization. Its policy was developed by its staff, lawyers whose careers oriented toward the Supreme Court, drawn from the elite law schools. It was financed by foundation grants and corporate contributions. The governing board of the newly independent Legal Defense Fund was autonomous and self-perpetuating and included representatives of major corporations who had no sympathy for the labour laws with which equal employment opportunity came increasingly into conflict.

The difference between the legal regime in which labour unions operated and that which governed equal employment opportunity produced over time a difference in the temperament, the structure, and the strategy of the two social movements which makes it increasingly difficult for them to deal with each other and work together toward the same goals.

The Legal Defense Fund established a pattern which was followed by virtually all of the other identity groups that emerged in the 1970s and 1980s. All of these groups—women, Latinos, Mexicans, gays and lesbians—founded their own legal organizations in that period. Those organizations were modelled on the NAACP Legal Defense Fund, which provided training for their staffs, backing in applications for foundation grants, and in several cases these offshoots were housed in facilities the Legal Defense Fund owned. The careers of the NAACP Legal Defense Fund staff, as successful lawyers and judges, provided a model which enabled them to draw on the best and brightest of their own community as staff and the precedents made it easy for foundations to provide their funding (Greenberg 1994).

From one perspective, the Legal Defense Fund strategy has been an enormous success, even more so for some of the other identity groups—particularly for women—than it has for blacks. But blacks unquestionably gained access through equal employment opportunity legislation to jobs, in fact to whole sectors of the labour market, where they had virtually no representation at all. But the strategy neglected completely those jobs in which black employment was concentrated when the campaign for economic opportunity was conceived. The hostility of young black workers in those jobs might have been channelled into labour organizations and directed at raising the wages, improving the working conditions and increasing the dignity and social status much as the labour movement had transformed industrial work in earlier decades. But, instead, the jobs were left unorganized, and, as the decade proceeded, were increasingly unregulated by minimum wage and other labour standards legislation. Unrestrained by the job security provisions of collective bargaining agreements, employers reacted to the hostility of the black labour force by recruiting immigrants from Latin America and the Caribbean to take their place. The result is a black underclass, without access to the newly opened employment opportunities in the upper reaches of the labour market and, replaced in the jobs they once held, with virtually no employment opportunities at all.

Nonetheless, when one views social progress through the prism of a labour force which increasingly understands itself as new identity groups, and less in terms of traditional economic class, the picture of American society looks very different from that which is drawn in Europe—even from that which we tend to draw ourselves. In terms of the distribution of income among individuals at a moment of time, the inequality in the United States has expanded over the three decades, and one marvels that

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it has been accompanied by so little social protest or unrest. But if one asks how women today compare themselves to the position which their mothers occupied when they were the same age, when one asks how the disabled, or the aged, or gays and lesbians feel when they compare themselves to the preceding generation, there is a sense of enormous social progress. The sense of progress must be equally great for immigrants, whose point of reference is people who stayed behind in the home country and who constitute an increasing fraction of a population which, in the last generation, had virtually no first-generation immigrants at all. Only for blacks, the group which established the pattern of social mobilization and the institutional templates which these other groups have followed, is the picture more mixed. And even blacks are hard pressed to say that they are worse off relative to their parental generation (Lerman 1997, 2003).

General forces

It seems doubtful, however, that the shift in the regimes governing employment relations can be attributed to the particular historical circumstances in the United States or to the peculiarities of the institutional arrangements which prevailed during that period. In at least one important sense, the shift appears connected to a more fundamental evolution in the structure of post-industrial society. Industrial society was built upon a clear model of social organization. Central to that model was a sharp distinction between economic activity and other social activity. Production and exchange were moved out of the home and into the factory or office, and the household was rendered as a separate space reserved for consumption and for private familial activity. The separation of the two realms involved a distinction between the standards and forms of judgements which governed within them. The standards of the economic realm in particular were 'scientific' and 'rational'; the standards governing in the household were 'affective' and 'personal' (Weber 1958, 1978).

The New Deal welfare reforms reflected an even stronger version of this model. Not only were the economic and social realms sharply separated, but each was structured, and the two were connected, in a particular way. The characteristic institution of the social realm was the family; in the economic realm, it was the corporate enterprise. Each was taken to be, moreover, stable, enduring, and well defined. The family was represented in the economy by a single dominant male agent, the family breadwinner, whose earnings were the family's main support. Conflicts between the social and the economic realms could thus be resolved by adjustments in the breadwinner's wage and, since the workplace was also a social setting, the other terms and conditions of his employment. Finally, these breadwinners were organized into, and represented by, trade unions, which thereby came to mediate between the economic and the social structures through collective bargaining with corporate enterprises.

The whole of industrial society had never, of course, conformed to this model, but the model was thought to represent the direction in which the society was evolving and legislation was structured both to be consistent with the movement in that direction and to facilitate it. But the movement came to a halt in the 1970s and the model, in so far as it was embedded in its key institutions, broke down. Many of the cleavages in American politics in the last twenty years are about whether or not that breakdown was a good thing.

One of the reasons why the model seems unlikely to be restored even as an ideal is that each of the factions contending in these conflicts seems to be attracted by one or another element of the model but none is prepared to endorse the structure as a whole.

In the United States, the collapse of the trade union movement in the early 1980s was the most dramatic break in the structure. The other institutions did not dissolve in so sudden and decisive a manner, but in the course of the last several decades both the family and the enterprise have gradually lost the characteristics which were central to the old model of the relationship between the economic and social realms.

In the case of the family, the critical factor has been the progressive rise in female labour force participation, especially of women with small children. An additional influence has been the growth of income supports associated with the welfare state itself. Together, these diversified the sources of family income, weakening dependence upon the male head as breadwinner, and complicating the connection of the economic and social realms. The increasing commitment of women to paid labour and the growth in other sources of income also led ancillary family members, the aged, youth, the disabled, to move out and form their own households (Costa 1999; D′Emilio 1998). The increase in the divorce rate, the rise of children born to single mothers, the growth of separate households headed by the aged, the emergence of gay and lesbian households, all reflected and reinforced these trends. Virtually all of the groups which have displaced trade unions as the locus of social and political mobilization and are not defined by race and ethnicity (i.e. women, the aged, the disabled, gays and lesbians) are connected with these developments.

The declining integrity of the enterprise as an institution is largely the product of the 1980s and 1990s. The crisis in the economy combined with technological and structural developments and changes in managerial practices to undermine the durability of the corporate enterprise. Major corporations were threatened with bankruptcy; some actually went out of business or merged with other enterprises. The traditional boundaries of industries were redrawn as the lines separating different markets shifted, blurred, or disappeared entirely. The most spectacular example is the way the separate industries of communications, office technology, information technology, printing, and photographic imaging have merged. Cross-functional and inter-organizational teams, just-in-time delivery, strategic alliances, and the like have all led to the interpenetration of once distinct enterprises. As the integrity of the corporation has been compromised in this way, the institutions of job security and social welfare which were attached to the enterprise have collapsed, and the ability of the enterprise to serve as a locus of economic identity has been progressively compromised.

The organization of work

The second factor which seems to be involved in the loss of clearly defined economic identities has been the changes in the organization of work. The new model tends to blur professional identities in much the same way that industrial and enterprise identities are being blurred by other developments. This shift is complex, and not easy to explain in a short chapter of this kind, but it is a point which nonetheless seems important to lay out in some detail here because it is a development which is probably not confined to the United States. It is most readily understood against the background of the shift in work organization associated with the initial process of industrialization, and the conventional understanding of industrial work itself.

The pre-industrial model was one in which, as we noted earlier, economic and other human activities were not clearly distinguished from each other. Work was performed in the household, in combination with other domestic activities, and work roles and roles within the family were intertwined. The prototype was the family (or peasant) farm, but it was equally true of the putting-out system in which early industrial activity was organized, and of the craft shop and the merchant house. These household units were grouped into larger, generally hierarchical, units for security and governance. But the household remained responsible for a range of activities extending to education, social security, and custodial care. The rhythm of work was cyclical, following the seasonal pattern of agriculture or the longer biological cycle of human life, and social (and economic) roles and activities shifted systematically over the cycle. Political identity and organization were geographical and/or, to a lesser extent, governed by one's estate (or place in the hierarchy).

The process of industrialization thus involved the separation of work (and economic activity more generally) from the household and its displacement to the factory or office. Work and household roles became sharply distinct. The family unit narrowed and many of its functions (notably in education and social security) were assumed by the state or the enterprise.

The theory of work organization which developed in economics and in engineering to understand industrial work centred on the division of labour, in a sense a further separation within the economy of various work activities. The canonical example is Adam Smith's pin factory in which one worker draws the wire, a second worker cuts the wire, a third worker heads the pin, etc. The division of labour in this way creates the problem of how these separate, specialized operations will be reintegrated. That problem is resolved either internally within the enterprise or through the market in response to price signals.

In the twentieth century the automobile assembly line replaced the pin factory as the exemplar of industrial work. Here, in contrast to the cyclical rhythm of agriculture, the rhythm is continuous. The worker performs the same operation repeatedly throughout the work day (and indeed in principle throughout his or her work life). One of the central roles of the large corporate enterprise was to organize the market so that it was receptive to standardized products, the production of which could be organized in this way.

The immediate historical antecedent of the pin factory and the automobile assembly line is a craft organization. But this too involved a division of labour, one in which the work (and the worker) was organized by specialized domains of knowledge: law, medicine, plumbing, woodworking, etc., what Marx called the social division of labour. The prototypical craft industry in the United States is commercial construction: each construction project is unique and involves a wide variety of different crafts, but the work operation is organized so that the crafts follow each other on the job in sequence. Two crafts virtually never work together at the same time; and while the particular operations which any craft performs vary from project to project, they also draw upon a fund of knowledge and a base of skills that, for each craft, is stable over time. Thus despite the apparent variety and variability of the work itself, it is possible to organize jobs so that there is continuity in the work and in the work process, a continuity similar to that of industrial work.

At MIT we have been engaged in a variety of research projects designed to understand how work organization is changing. The results, which parallel those of several other analysts, suggest that the new economy tends to foster a very different organization, one which might be characterized as *project teams* (Arthur and Rousseau 1997; Castells 1996, 1997; Kunda *et al.* 1999; Boltanski and Chiapello 1999). Like commercial construction (or the craft work of old), it tends to be organized in terms of finite projects. But unlike commercial construction, where different crafts work in sequence, in 'post-industrial' projects, people with different backgrounds and skill sets work together as a team. The projects put an emphasis on interacting across realms of knowledge rather than on the division of labour into well defined specialities. The work is about building something novel, not the reproduction of a standard product or operation.

The canonical work of the new economy is software programming (Brooks 1995; McBreen 2002). The work is broken into components, not because each task requires a distinct set of skills, but because the project is too large to be completed by a single person in a finite period of time.

The critical organizational problem is not assigning the separate components to different specialists, but rather integration, the bringing of the pieces back together to form a whole. In the process of integration, the pieces invariably interact in complex and unpredictable ways to create bugs, and the integration involves a prolonged process of debugging to make the components work smoothly together. That process is minimized by creating a team of workers who share an understanding of the architecture of the program, an architecture which the participants describe not as a blueprint but as an ethos, almost a language, which develops through discussion and debate among the participants early on.

Software projects invariably bring together on the team people from diverse backgrounds. Programmers carry with them not only technical expertise but also experience in applying that expertise in particular sectors (e.g. banking, hospitals, telecoms). The organization of work in software programming is very similar to that in the development of complex, specialized financial instruments (Eccles and Crane 1988) or—another type of work we have been studying at MIT—in product design (Lester and Piore 2004). The division of labour in software is more like it would be in clothing design than in the pin factory. Imagine splitting up the design of a shirt, for example, into the collar, the right sleeve, the left sleeve, the front, the back, the buttons, etc., and assigning each of these pieces to a different worker. When the pieces were brought together, they would be bound to clash in ways which are analogous to the bugs generated in software. For this reason, individual garments are virtually never produced in this way. In fashion houses, the individual garments in a whole collection are, however, often assigned to different designers, and when they are assembled in one place at the end of the design phase, the process of editing the collection is not unlike the debugging of a software program. In clothing, design teams are built through discussion and debate among the members in which common themes are identified and articulated much as the architecture and ethos of a software program develops early in the project. Clothing design like software seeks to bring together initially people with different types of experience and expertise. And here too there is an emphasis on combining backgrounds in particular segments of the market with technical expertise about particular technologies (denim, for example, and the way it is transformed in the laundry or finishing operation) (Piore 2004).

The different types of expertise, however, are not so much 'applied' as shared; and they are shared early in the project, so that when the work on the separate pieces begins, the workers tend to have become more alike, rather than, as in the industrial division of labour, more distinct. The work here is *episodic,* rather than continual, as in industrial work; when the program is completed, the workers are redeployed on a new project in a different team. Because the emphasis is on integrating, the manager who is putting together a team is not looking so much for a set of standardized skills, but rather for workers who bring experience from different domains and are able to share it easily and work well with other members of the group. This makes the matching process central; the matches tend to be idiosyncratic, and, because work is episodic, the matching problem continually recurs.

The literature suggests that workers face a similar matching problem. Their fate in the labour market over time depends on their ability to build a repertoire or portfolio of different competencies as they move from project to project. Workers value a particular job because it expands their repertoire, but its ability to do so depends on exactly what their prior experience is, and that in turn varies from one worker to another.

The churning of workers and jobs thus places a premium on labour market intermediaries. Again, there is a strong parallel here between the post-industrial work and the construction industry in the old industrial model, which also placed a premium on intermediaries in the form of the hiring hall (or placement office). But unlike the craft work of the industrial era, both the competencies which the project requires and those which a given worker brings to it are not easily classified, and hence each job and each worker is in some sense unique. The information required to make a 'good' match tends therefore to be particular, personal, and complex. The intermediaries thus require much greater personal contact with both the workers they are placing and the jobs which they are filling. In the studies we have been doing in the United States, a variety of different organizations, both formal and informal, play this role. The formal organizations include temporary help services and 'head-hunting' and executive search firms. The informal organizations include social networks which range from the alumni organizations of schools and educational institutions to networks of alumni (actually ex-employees) of large companies (AT&T, Citigroup, IBM). The new social identity groups that have served as the fulcrum for social mobilization also function in this role, and in interviews many people explain that this is a major motivation for their participation in them. Whether or not it is true, it certainly gives them a functional role in the new labour market that they did not have in the old. (Although, as noted earlier, many craft unions were organized around ethnic affiliations and embedded in ethnic communities.)

In sum, post-industrial work organization had the dual effect of limiting the role of economic identities around which social mobilization took place in the industrial era and creating a role for identities and affiliations which were previously confined to other realms of experience.

Project teams are hardly the dominant form of work organization today, and much work continues to be organized on the industrial model. But there is reason to believe that project teams will come to be increasingly important in advanced industrial societies over time. The basic reasons are threefold. First, industrial work is susceptible to automation using information technology. Much of the work is routine; the worker has essentially memorized a sequence of operations, and the individual operations lend themselves to mechanization even in the absence of information technology, and the computer makes it possible to combine the individual operations easily into flexible sequences. Craft work has historically resisted mechanization and automation, but, to the extent that it involves the application of a consistent set of rules and principles, these can be programmed into, and applied by, a computer. The work associated with project teams, on the other hand, because it involves the creation of product and the integration across different domains of knowledge, cannot be automated in this way (Levy and Murnane 2004). Here again software is the exemplar: the production (or reproduction) of a software program is trivial, anyone can do it on their home computer. The writing of the software program, however, is, as we have seen, a laborious and complex process. Second, these trends toward the automation of traditional industrial production have been reinforced by trends in miniaturization and the emphasis on quality in manufacturing. Finally, the industrial work which remains is increasingly being outsourced to lowwage, developing countries, leaving behind the kind of conceptualization work which lends itself to project teams.

Conclusion

What are the implications of these shifts for post-industrial society in general? Is this another case of American exceptionalism or are American trends precursors of developments in other countries? Does the movement toward a regime of employment rights driven by political mobilization around social identity, which is so different from a competitive market model, undermine the ability of the United States to impose a neoliberal model upon other countries?

We can sketch out the elements of an answer to these questions by looking separately at each of the factors tending to lead other countries to follow a path of development that the United States has pioneered. Those factors as listed initially are fourfold: direct pressure exercised by the United States in international economic agencies and through trade treaties; new technologies of production and management which originated (or appeared first) in the United States; the diffusion of United States mass culture through our entertainment industry and advertising; and, finally, the competitive pressure of United States enterprises in the international market place.

The contrast between the reality of our own institutions and the institutional models we advocate is at best a debaters' point in the fora governing the world economy. The hegemony which the United States exercises in the critical international institutions is such that the debate is not really determinative of the outcome. What matters is not what we do, but what we advocate. United States foreign policy is concentrated in the hands of the executive branch and insulated from the kinds of domestic political pressure which the new social groups are able to generate. Within the executive, these policies have been developed by an elite group of lawyers and economists committed to neoclassical, if not neoliberal, models of economic organization, who view the so-called culture wars as a distinct debate, separate from the domain of economic policy, and the economic institutions which grow out of that debate as largely inimical to efficiency. The basic thrust of foreign economic policy has been the same both under the Democratic administrations, which have largely favoured policies responsive to these groups in the domestic realm, and under Republican administrations, which have largely resisted them. But a major caveat is in order here: neoliberalism is not the only agenda which the United States has been pursuing in the international arena, a point to which we return shortly.

Technological and organizational trends are more likely to lead to convergence. This is particularly true of the trend in organizational structure away from those characteristics of stability, durability, and sharp definitions which made the corporation key to the construction of the post-war welfare state. The increasing dominance of the 'project team' approach to work organization is working to similar effect, at least in the advanced developed countries. Since part of these trends have been produced by the tendency to send standard, routine production work to lower wage developing countries, one can anticipate a split here between the First and Third Worlds, in which the older economic identities remain robust in the latter even as they fade in the former. But to the extent that the trends reflect shifts in the underlying technology of production, as opposed to its spatial distribution, the forces are likely to be more general.

Whether, as economic roles become more diffuse and less able to serve as the fulcrum for worker mobilization, the social identities which emerged in the United States will take their place elsewhere is a different question. As noted earlier, the tension between the two axes of collective mobilization has always been present in the United States, and the social history of the country can be read as a continuous oscillation between them. The country's pattern of development gives both race and ethnicity a salience in the United States that they do not necessarily have in other societies. The changes in family structure, which in the United States have been associated with the emergence of the other groups that have joined with racial and ethnic identities to form the new axis of mobilization, also vary substantially from one country to another. On the other hand, the increasing role of foreign immigration, including the immigration of racially distinct groups, is creating the kind of ethnic diversity in many heretofore relatively homogeneous countries which created the foundation for social mobilization in the United States.

The hegemony of American mass culture will undoubtedly serve to reinforce trends that parallel those in the United States. American movies, television soap operas, and advertisements for American products have diffused images of social mobilization around the world. The form of fashion may originate in Italy, but the symbolic content of fashion, ranging from blue jeans to baseball caps, tattoos, and ear piercing, originates in the black ghettoes and gay discos of the United States. Even the daily news diffuses images of social mobilization in the United States widely abroad. And social movements among blacks, gays and lesbians, and women, modelled on their US counterparts, have developed in countries which thought of these categories in very different terms. Thus, Brazil has developed a Black Power movement; in southern Europe, a gay liberation movement has emerged; in France, a feminist movement.

But the most important force spreading the American model of diversity may paradoxically be the very competitive pressures which have been thought to favour the neoliberal model of open, unregulated markets: diversity may be efficient. The industries which have been responsible for the resurgence of American companies in world markets—information technology, telecommunications, bio-tech, mass retailing companies like Wal-Mart, the Gap, Nike, etc.—have the most diverse labour forces. This must be partly a composition effect: these are the industries where employment has been expanding and which are hence most open to expanding labour force groups. But there is also a business case for diversity, one that is beginning to be developed in business scholarship and picked up in management by factions trying to justify the role of Human Resource policies responsive to minority groups. The case is built on precisely the new forms of corporate organization that cross traditional boundaries and the project team form of work. These put a premium upon the ability to develop understanding which spans differences, and a diverse work force tends to cultivate such an understanding. Diversity also promotes new ideas, both because it increases the variety of sources from which new ideas might come and because many of these ideas are actually the amalgam of different perspectives. This is apparent in the case studies we have been conducting at MIT: cellular telephones are the combination of radio and telephone technologies; medical devices involve the integration of scholarly technology with clinical practice and intuition; fashion jeans are the marriage of traditional denim and laundering technologies. Finally, the diverse labour force of the United States has a special advantage in penetrating foreign markets, again because it cultivates skills required to move between and interpret different cultures, but also because some of the groups incorporated in this way bring with them direct knowledge of the markets the country is seeking to penetrate. Together, American developments could force foreign firms to diversify their labour forces, and US companies will constitute the most prominent models of how to do so.

Finally, however, the background legal conditions which would lever any incipient tendency for the kinds of social identities which have driven the emergence of the employment rights regime may not be confined to the United States. In the European Union, the European Human Rights Court has in fact been generating a rights-based law covering the very groups which have been salient in the United States: an employment rights system of work governance which conflicts with collective bargaining comparable to that of the United States is potentiated in these developments. The Human Rights Court undoubtedly reflects forces *sui generis* to Europe. But the development undoubtedly reflects as well forces operating in Europe that are similar to those which guided the evolution of the American legal system. Thus, in the United States, the rights approach in the law is linked to the emergence of a federal system; the conflicts of law between the states which federated to form the country are resolved through the promulgation of a higher law which tends to be both absolute and to take precedence over the laws of the separate states. Similar tendencies are working not only in the formation of the European Union but more generally as the process of globalization generates new federations of previously autonomous legal jurisdictions regionally and on a global scale. In the end, however, the human rights approach may be no less the product of American international hegemony than neoliberalism. In point of fact, the United States has been pushing the rights approach in its international diplomacy almost as vigorously as it has been pushing the neoliberal agenda of deregulation, property rights, and the rule of law. In labour law, in particular, the ILO under US pressure has moved, through its core labour standards, to a rights-based approach. The NAACP Legal Defense Fund has been disseminating, with private foundation support, its model of rights litigation abroad much as it disseminated that approach in the United States to women, Latinos, gays and lesbians, and the like. Ultimately, these developments suggest that the rest of the world may be as likely to inherit a rights-based regime of workplace governance from the United States as it is to inherit the market model.

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9

After boom, bubble and bust

Where is the US economy going?

Robert Brenner

The stock market crash that began in 2000 revealed the equity price runup of the preceding years to be a bubble and wiped out $5 trillion in market capitalization. The ensuing plunge into recession1 exposed the flawed foundations of the 'New Economy' boom, and entailed the largest one-year drop-off of investment and GDP growth of the post-war epoch. The subsequent recovery was among the slowest since 1945 in terms of the increase of GDP, investment, and especially of jobs, despite the largest macroeconomic stimulus in US history. Taken together these developments put paid to the hitherto widely accepted view that the rapid expansion of the second half of the 1990s marked an end to long-term slowed growth and set the economy on a new upward path.

According to what long reigned as the official story,2 the US economy, by virtue of its freed-up financial markets and its unmatched entrepreneurial-cum-financial institutions, had, during the 'fabulous nineties',3 accomplished a breakthrough unavailable to its stodgier counterparts in Western Europe and Japan. The US stock market was thus able to hot-house a technological revolution and economic boom by virtue of its ability to single out those companies that promised the best profits due to their technological advance. Institutional investors piled into those firms' equities, driving up their prices, and signalling to bond markets, banks, and equity markets the desirability of lending to them and buying their shares. By virtue of the increased borrowing and stock issuance that was thereby made possible, these same corporations, disproportionately in hitech, were enabled to accelerate investment *in advance of* profits, making for productivity increases and even greater potential returns. More rapid capital accumulation allowed further leaps forward in technology, enabling productivity growth to rise even higher, making possible even higher 'expected' profits, thus more elevated equity prices, thus still more borrowing, stock issuance, and purchases of plant, equipment, and software...issuing in what Chairman Greenspan celebrated as a 'virtuous cycle' of economic expansion.

But this analysis proved upside-down, for the simple reason that expected profits never materialized as actual profits. Rather than setting the economy on a new course, the New Economy exacerbated its fundamental underlying problem—viz. secularly reduced profitability resulting from chronic overcapacity in the manufacturing and related sectors. Freed-up financial markets thus drove a massive *misallocation* of funds into hi-tech paper assets and a parallel *misdirection* of new plant, equipment, and software into long over-subscribed manufacturing lines, while extending overcapacity into the heartland of the New Economy, notably telecommunications. As a result, the stock market soared into the stratosphere and, courtesy of the resulting wealth effect, investment accelerated during the later 1990s, even as the profit rate dropped sharply between 1997 and 2001. But such defiance of economic laws of gravity could not long persist and with the turn of the millennium, bubble and boom gave way to bust and recession.

In the remainder of this chapter, I shall consider what may be expected next for the US economy. I will begin by making clear that, despite the hype, the decade of the 1990s witnessed no break from the long downturn, the extended period of slowed growth that began in 1973. I will then offer a schematic account as to why the long downturn persisted for so very long. Against this background, I will explain why what appeared to be a promising revival of US profitability between 1985 and 1995, based in the manufacturing sector, aborted, and issued instead in the flawed boom and equity price bubble of the second half of the 1990s. On that basis, I will analyse the descent into the recession of 2001, the nature of the recovery so far, and future prospects.

The less than fabulous 1990s: the long downturn continues, 1973-?

As is well understood, the post-war economy has gone through two major phases. During the long upturn between the end of the 1940s and the early 1970s, most of the advanced capitalist economies experienced record-breaking rates of investment, output, productivity, and wage growth, along with low unemployment and only brief and mild recessions. But during the long downturn that followed, the growth of investment fell significantly and issued in much-reduced productivity growth and sharply slowed wage growth (if not absolute decline), along with depression-level unemployment (outside the United States) and a succession of serious recessions and financial crises of a sort unheard of during the post-war boom. Overall, the long stagnation that began in 1973 was significantly worse in terms of economic performance, not only than that of the long post-war boom, but also of the previous extended period of expansion of the years leading up to World War I, so can be seen, in a rough and ready way, as the counterpart of the long downturn of the period between the wars, though entailing of course nothing like the collapse of the 1930s in the United States (see Table 9.1).

Table 9.1 Long booms, long downturns (percentage change)

Variable	*1890–1913*	*1950–1973*	*1973–1996*
GDP	4	4	2.9
GDP per hour	2.2	2.6	1.2
GDP *per capita*	2.1	2.5	1.8
Real wage (manufacturing)	1.6	2.2	0
Gross capital stock	5.4	3.2	–
Gross capital stock per hour	3.4	1.7	–

Sources: Maddison (1991:71, 140, 142, 2003:84–6, 87–9); Bureau of Economic Analysis, National Income and Product Accounts, Table 7.1, BEA Web site; Rees (1961:120); Bureau of Labor Statistics: Hourly Earnings of Production and Non-supervisory Workers; CPI U-RS, BLS Web site

Note: Wages are for manufacturing instead of the whole economy, as wages outside manufacturing are unavailable for earlier periods.

Nor did the roaring 1990s see any break in the pattern, despite relentless mythologizing by business and government. The US economy did slightly improve during this decade, compared to the 1980s. Still, during the first half of the 1990s, the US economy performed less well than during any other five-year period during the whole post-war era. The economic acceleration of the second half of the 1990s did raise performance for the decade-long business cycle as a whole (1990–2000) above that for the previous decade (1979–1990)—especially investment growth. But the fact remains that, despite what the Council of Economic Advisers (2001:23) insisted on terming 'extraordinary gains in performance' between 1995 and 2000, the US economy did not do as well during those *five years* as it had during the *twenty-five* years between 1948 and 1973 (Brenner 2002:221, table 9.1). It was, moreover, obliged to depend for its vitality in large part upon the enormous fillip to both consumption and investment provided by the historic and ill-fated stock market bubble of those years. Even then, US economic performance in the supposedly dynamic 1990s was no better than that of the much-excoriated 1970s, which was far worse than in the 1950s and 1960s4 (see Table 9.2). As to the supposed productivity miracle brought about by the New Economy, the average annual growth of labour productivity (GDP/hour) for the business cycle that ran between 1990 and 2000, at 1.6 per cent, while slightly higher than that between 1979 and 1990, at 1.4 per cent, was still about 11 per cent below that for 1969 through 1979, at 1.8 per cent, and 40 per cent below that from 1948 through 1969, at 2.65 per cent. In fact, *it was a full 30 per cent below the average for the entire century between 1890 and 1990, at 2.3 per cent*. Not surprisingly, average annual real wage growth from 1990 through 2000 was barely positive (Maddison 1991:71, Table 3.13; US Bureau of Labour Statistics 2004a).

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Table 9.2 US economic performance, 1949–2000 (percentage change)

Variable	*1948–1959*	*1959–1969*	*1948–1969*	*1969–1979*	*1979–1990*	*1990–2000*	*1979–2000*
GDP	3.7	4.6	4.15	3.3	2.9	3.2	3.05
GDP per hour	2.9	2.4	2.65	1.8	1.3	1.5	1.4
GDP *per capita*	1.95	3.04	2.5	2.18	1.97	2.04	2
Real wage (manufacturing)	3.4	1.6	2.5	0.8	−0.4	0.4	0
Net capital stock (private economy)	3	3.9	3.45	3.8	3	2.9	2.95

Sources: Bureau of Labor Statistics (2004d); Bureau of Economic Analysis, Fixed Asset Tables, BEA Web site; Maddison (2003:84–6, 87–9); BLS: Hourly Earnings for Production and Non-supervisory Workers; CPI-U 1982–4, BLS Web site.

Note: Intervals correspond roughly to business cycles, sometimes grouped together, peak to peak.

The fundamental problem: the failure of profitability to recover

The most basic reason that the US economy had, as of 2000, still failed to revitalize itself is that its fundamental underlying problem—which first manifested itself between 1965 and 1973, propelling the economy from long boom to long downturn—perpetuated itself right through to the end of the century. This was a major reduction in the rate of return on capital stock. Despite a significant increase of the US profit rate between 1985 and 1995, average profitability for the non-farm economy during the 1990s business cycle failed to rise above the level sustained during that of the 1970s and remained about 17 per cent below that of the entire long boom between 1948 and 1969 (see Table 9.3 and Figure 9.2).

It should be emphasized that the decline in economic performance has not been confined to the United States, but has been even more striking in Western Europe and Japan, where the major macroeconomic indicators have continually deteriorated, decade by decade, since the 1960s. Put another way, US economic performance weakened in absolute terms, but less so than that of Western Europe and Japan (Brenner 2002:47, table 1.10). Even so, the claims of the business press notwithstanding, the United States has not outperformed Europe in the recent period. By the end of the century, a number of West European economies, including France and Italy, had not only closed the once enormous productivity gap between the United States and themselves, but actually raised the *level* of their output per hour above that of the United States. During the decade 1993–2003, moreover, the *growth* of productivity (GDP/hour) in Euroland as a whole was a bit higher than in the United States,5 while the increase of GDP *per capita*6 was virtually the same (Daly 2004:1–3).

Nevertheless, the fact remains that the slowdown of the last quarter of

Table 9.3 US, Japanese, and German net profit rates

Period	*US non-financial corporate*	*Japan non-financial corporate*	*Germany non-farm*
1948–1959	0.119	0.173	0.234
1959–1969	0.133	0.254	0.175
1969–1979	0.096	0.205	0.128
1979–1990	0.089	0.167	0.118
1990–2000	0.099	0.108	0.1045

Sources: US: Bureau of Economic Analysis, National Income and Product Accounts, Table 1.14; Fixed Asset Tables, BEA Web site; Japan: OECD *National Accounts,* Detailed Tables, Volume II; Germany: OECD *National Accounts,* Detailed Tables, Volume II; OECD *Stocks and flows of Fixed Capital;* Carlin (1987). Thanks to Andrew Glyn for making available to me profit rate numbers for the 1990s from German National Accounts.

Note: Numbers for Japan begin in 1952, for Germany 1950.

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the twentieth century encompassed the *whole* of the advanced capitalist world, reflecting the profound interdependence of the system's parts. Resulting from the long-term, *generalized* failure of profitability to return to the high levels that underpinned the long post-war boom even by 2000, the long downturn actually worsened as it lengthened in time. It has been the slowdown in the growth of the aggregate economic pie that has prevented a sustained break by any of the advanced capitalist economies, including the United States itself.

Behind the long downturn: persistent, chronic overcapacity in international manufacturing

What has been responsible for the reduced profitability behind the long downturn has been the quite paradoxical persistence of chronic overcapacity in the international manufacturing sector right through 2000–2001. This originated as long ago as the late 1960s and early 1970s as an extension of the very same process of uneven development—marked by the interaction of an earlier developing economic bloc in the United States and later developing economic blocs in Japan and Western Europe—that had driven the great post-war boom. It has been the further, historic, spatial extension of uneven development to encompass the East Asian newly industrializing countries (NICs) and China, that—as much as any other factor—has made for the perpetuation of overcapacity and thereby the long downturn.

Uneven development initially took the form of a dynamic symbiosis—between the state-interventionist, organized, and investment-cum-exportoriented manufacturing capitalisms of Japan and Western Europe and the relatively liberal, internationalizing capitalism, dominated by multinational corporations and commercial banks, of the United States—and made for the historically unprecedented post-war boom. Nevertheless, this process ultimately proved self-limiting, because *both* the export-oriented growth of the later developers and the foreign investment and commercial banking-focused expansion of the US hegemon directed the increase of output, capital, and employment disproportionally in the direction of Western Europe and Japan at the expense of the US domestic economy. What began merely as relative US economic decline ultimately gave way to manufacturing over capacity and international crisis (Brenner 2002:9–22).

The fall of the rate of profit, 1965–1973

Beginning in the middle 1960s, manufacturers based in the later-developing economic blocs—most notably in Japan and Germany—were able to combine relatively advanced techniques and relatively low wages to sharply reduce relative costs *vis-à-vis* those required to produce the *same* *goods* in the earlier-developing United States. Rather than entailing the growth of complementary productions, uneven development thus took place increasingly by way of the accelerating growth of redundant output. The manufacturers of the later-developing blocs not only succeeded in imposing their relatively low prices so as to dramatically swell their shares of the world market, but were simultaneously able, precisely by virtue of their relatively reduced costs, to maintain their old rates of profit. US producers thus found themselves facing slower-growing prices for their output, but were caught with inflexible costs as a result of their being lumbered with plant and equipment that embodied production methods that had been rendered outdated, as well as relatively high wage levels that could not quickly be squeezed downward. Those capitals that could no longer make the prevailing average rate of profit even on their variable capital alone had to shed productive capital and/or reduce capacity utilization. Others, in order to hold on to their markets, had little choice but to swallow significantly reduced rates of profit on their fixed capital, since they could no longer raise prices above costs as much as they had previously.

The outcome was manufacturing overcapacity system-wide. This struck the United States first during the second half of the 1960s, and, as a consequence of the US economy's overwhelming place within the advanced capitalist world, brought down profitability in both manufacturing and the economy as a whole for the G-7 countries taken together. But Japan and Western Europe did not long remain immune. With the deep devaluation of the dollar, and corresponding appreciation of the yen and mark, that accompanied the international monetary crisis of 1969–1973, Japan and Germany also came to shoulder a significant share of the overall profitability decline. Symptomatically, non-manufacturers across the G-7 economies, shielded as they were from the pressures of international competition, largely escaped the crisis of profitability, despite sustaining much higher increases in unit costs than their manufacturing counterparts. This was because, unlike their counterparts in manufacturing, they were able to raise prices sufficiently to protect profits (see Figures 9.4–5) (Brenner 2002:22, table 1.3).

Worsening overcapacity in the 1970s

In response to the system-wide fall in profitability, employers, backed by their governments, abandoned their relatively accommodating attitude of the previous two decades toward the growth of wages, direct and indirect, which had been conditioned by high profit rates and record economic growth. Launching an ever more implacable assault upon their workers, they succeeded virtually overnight in radically reducing the increase of salaries and benefits, as well as of government social spending—and were ever more successful as time went on. The fact remains that, by the end of the 1970s, despite the sharp slowdown in the growth of wage and social

Figure 9.1 G-7 manufacturing and non-manufacturing net profit rates, 1950–1990
Source: Armstrong *et al.* (1991: Tables Al, A2, A5, A6).

spending costs, profit rates in the United States and throughout the advanced capitalist world, in manufacturing and in the economy as a whole, had actually fallen further (see Table 9.4 and Figures 9.1 and 9.2).

Profitability failed to recover, because corporations across the global economy failed to make the standard responses to oversupplied markets expected by orthodox economics. Many firms, above all in the United States, confronted their problems of competitiveness by seeking to the extent possible to raise productiveness by maintaining established levels of investment in their own lines, even in the face of sharply reduced profit rates, rather than reallocating plant, equipment, and software to new ones. Others opted to sacrifice profit rates in order to sustain market share. These choices made sense, because the manufacturing corporations that dominated the world market possessed huge amounts of 'proprietary capital' that they could not make use of in other industries and would therefore have had to scrap—not only fixed sunk capital, but also ties to suppliers and customers and above all technological capability. But the result of corporations' generalized choice to fight rather than to switch was to sustain output and investment, exacerbating the initial problem of overcapacity.

Simultaneously, the same process of uneven development, entailing the interaction between early and later developers, that had first brought over-capacity system-wide extended itself to parts of the less developed world. Manufacturers based in the newly developing economies—above all East Asia, but also, to some extent, Brazil, Mexico, and others—found that, like

Table 9.4 Employers' offensive: the growth of real wages and social expenditures (percentage change)

Country	*RW 1960–1973*	*SE 1960–1975*	*RW 1973–1979*	*SE 1975–1980*	*RW 1979–1990*	*SE 1980–1985*
US	2.8	6.5	0.3	2	0.4	2.7
Japan	7.7	8.5	2.8	8.2	1.6	3.2
Germany	5.4	4.8	2.5	2	1	2.7
EU-11	5.6	7.6	2.8	4.2	0.9	2.6

Sources: 'Statistical Annex', *European Economy,* 71 (2001), Table 31; OECD (1988:11, 1989:28).
Note: *RW,* real wages; *SE,* social expenditures.

the Japanese before them, they could combine low wages with effective emulation of advanced-country technology, along with rapid learning by doing, so as to enter an increasing number of lines at a profit even in the face of international overcapacity. This naturally made the situation worse. Only the public subsidies to demand that came with Keynesian deficit spending—and the leap in private borrowing that was thereby enabled—made it possible to soak up surplus supply and keep the economy turning over throughout the 1970s. Even then, it was impossible to avoid a still further significant decline of profitability between 1973 and 1979 (see Figures 9.1 and 9.2).

Monetarism, balanced budgets, and the turn to finance

By the end of the 1970s the attempt of manufacturers especially in the United States to invest their way out of their profitability problems had failed dismally, despite unprecedented Keynesian spending, record low real interest rates, and huge dollar devaluation. Instead, historically unmatched public deficits and loose money had brought about runaway inflation and historically unprecedented current account deficits, precipitating a series of devastating runs on the dollar that threatened the dollar's status as key currency. In the end, the US Federal Reserve under Paul Volcker had little choice but to impose upon the US economy the stabilization programme it had long sought to avoid.

Reversing the expansionary policies of the 1970s, the shift to monetarism constituted a major turning point in post-war economic evolution by bringing in ultra-tight credit, a super-high dollar, tax breaks to the corporations, and major steps toward financial deregulation. It was intended, most generally, to push up unemployment so as to further reduce wage pressure, breaking the back of inflation and raising profits. But it also aimed to restructure the economy. Above all, it sought to eliminate over-capacity by shaking out the huge ledge of high-cost low-profit means of production that still held down manufacturing profitability. To pave the way for a new wave of capital accumulation, it aimed, moreover, to directly redistribute income from labour to capital; to reduce the growth of prices in the interest of both profits for creditors and manufacturing competitiveness; and to accelerate the reallocation of resources into the US financial sector from both domestic and overseas sources, while buttressing its profitability (Brenner 2002:35–6).

Nevertheless the immediate result of the sudden upward leap in the cost of borrowing that came with the turn to monetarism was the outbreak of the debt crisis in the Third World. This was accompanied by the worst recession of the post-war era in the United States, which brought the unemployment rate above 11 per cent, threatening depression. The ensuing shake-out both of employees and of plant and equipment, precipitated by Volcker's record-high real interest rates and the skyrocketing dollar, was, from one standpoint, what was desired, and would ultimately constitute an essential precondition for US manufacturing revival. But the fact remains that the blow to investment and consumer demand that resulted from the crises of the first half of the 1980s also set the economy on a frightening downward trajectory. Still, the US government was clearly unwilling to sustain the sort of severe downturn that had, in the past, served to eliminate superfluous means of production and provide the foundation for a new upturn. To right the economy, Keynesianism was reintroduced with a vengeance, in the form of Reagan's massive step-up of military spending and tax cuts for the rich.

The historically unprecedented US government deficits that came to accompany elevated interest rates near the start of the 1980s were indispensable in inciting new cyclical upturns in the United States and across the advanced capitalist countries. This was especially because most of these economies had introduced harsh wage and social spending cutbacks which, in combination with the elevated cost of borrowing, depressed consumption and investment, rendering them increasingly reliant upon exports and, in the last analysis, the stimulus provided by US spending. Nevertheless, the US policy mix also slowed the international shake-out of high-cost low-profit manufacturing plant and equipment and labour that was still required to transcend overcapacity and restore manufacturing profitability system-wide. The price of economic stability was an even further slowdown of economic growth and capital accumulation. To make matters worse, the East Asians' share of world export markets grew substantially faster during the 1980s than it had during the 1970s, making for further downward pressure on aggregate profitability in international manufacturing. With the growth of aggregate demand slowing and productivity increases falling as investment growth declined, profitability failed to rise between 1979 and 1989 and economic performance across the advanced capitalist economies for the 1980s worsened *vis-à-vis* the 1970s, not to mention the 1950s and 1960s (Brenner 2002:47, table 1.10).

With the potential for decent returns from investment in new plant and equipment in the 'real economy' so sharply reduced both by reduced profit rates and by high interest rates, capital lurched sharply in the direction of financial activity over the course of the 1980s. But the financial sector faced a major problem in this era. The US government's moves toward financial deregulation beginning in 1980 did smooth the way for the implied reallocation of capital. But how could lenders and speculators make a killing from firms and households in a situation in which non-financial corporations were producing such sharply reduced surpluses with respect to their capital stock and wage earners were so hard pressed? The US government did provide an assured field for massive profits to lenders, both in the United States and abroad, with its huge increase in borrowing at record real rates of interest. But the difficulty of profiting through purely private initiatives in a period of powerful downward pressure on profits in international manufacturing had already been forcefully brought home in the course of the 1970s, when US commercial banks, facing the drying up of opportunities in the core economies, piled into lending to newly industrializing countries, and ultimately precipitated the catastrophic LDC (less developed country) debt crisis of the early 1980s. The flooding of US savings and loan institutions into commercial real estate, which came in the wake of the deregulation of the thrifts in 1980, followed a similar pattern, leading inexorably to bubble and collapse by the end of the decade (Brenner 2002:85–6).

Nor did the leveraged buyout craze turn out differently. The financial engineers in charge did, at the start, manage to net higher returns by means of massive lay-offs, refusing to invest, and running down the capital stock of non-financial corporations, while breaking contracts with unions and cutting off long-standing relationships with suppliers. But the resulting gains via once-and-for-all productivity increases and reductions in input costs were soon wiped out as more investors tried to get in on the action, as stock prices rose ever higher, and as the cost of buyouts rose correspondingly, while corporate debt skyrocketed (Long and Ravenscraft 1993). Nor is there much evidence that the 'discipline of finance' served to increase the efficiency of production by facilitating technological advance or reallocating capital from unprofitable to profitable lines. On the contrary, it made possible a massive misallocation of credit to non-financial corporations to enable an orgy of speculation in the form of mergers and acquisitions (Crotty and Goldstein 1993). By the time the decade was over, the non-financial sector was immobilized not only by depressed rates of profit that had failed to rise above those at the end of the 1970s, but also by unprecedented, paralysing levels of debt. Meanwhile, commercial banks, which had sought to profit by financing the booms in leveraged buyouts, as well as commercial real estate, found themselves in their worst condition of the post-war epoch, experiencing sharply reduced returns on equity and the greatest wave of bank failures since the Great Depression (Litan 1991:6; White 1992:13). Despite its enormous expansion, the financial sector's profits as a

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percentage of total corporate profits were no higher during the 1980s than in the 1970s. A decade of monetarism, neoliberal deregulation, and further defeat for labour had left both non-financial and financial sectors in weakened condition (Brenner 1998:193, 2002:88–91, figs 2.13–14).

Abortive revival of US manufacturing, 1985–1995: the constraint of the system-wide slowdown

Against the background of still much reduced rates of return and slowed growth internationally, between 1985 and 1995 the US manufacturing sector, and thereby the US private economy as a whole, secured a major revival of profitability by taking a leaf from the book of its leading international rivals in Germany and Japan and achieving a powerful revival of international competitiveness and export growth. It thereby provided, though only temporarily, the basis for a new boom in investment and a broader revitalization of the US economy. In an ideal world of mutually complementary specialized production, the US economic recovery might have ended up propelling the world economy into a new era of growth. But, in the actual world of manufacturing overcapacity and redundant production, the US recovery imparted little dynamism to the world economy and came to a large extent at the expense of the economies of its leading trading partners and competitors, especially Germany and Japan. It therefore turned out in the end to be self-undermining.

Manufacturing-led recovery

US corporations had set the stage for recovery during the extended cyclical downturn of the first half of the 1980s by shedding huge masses of high-cost low-profit means of production, especially labour, and thereby beginning a revival of manufacturing productivity growth without the assistance of investment growth. Over the subsequent decade, 1985–1995, they forced up profits by holding real wages virtually constant, while taking advantage of Reagan administration tax breaks that enabled them to sharply reduce the share of taxes in profits. Meanwhile, they secured a decisive increase in competitiveness as the dollar fell in value by 40–60 per cent with respect to the mark and yen during the same ten-year period. This realignment of currencies was detonated in 1985, when the US government, to save a manufacturing sector that was being savaged by a combination of record high interest rates and a skyrocketing dollar, obliged its main allies and rivals to agree to the Plaza Accord, which called for bringing down the dollar from the heights it had reached during the first half of the decade. Finally, the Clinton administration's turn to budget balancing offered producers further assistance by helping to reduce inflation and in that way long-term interest rates.

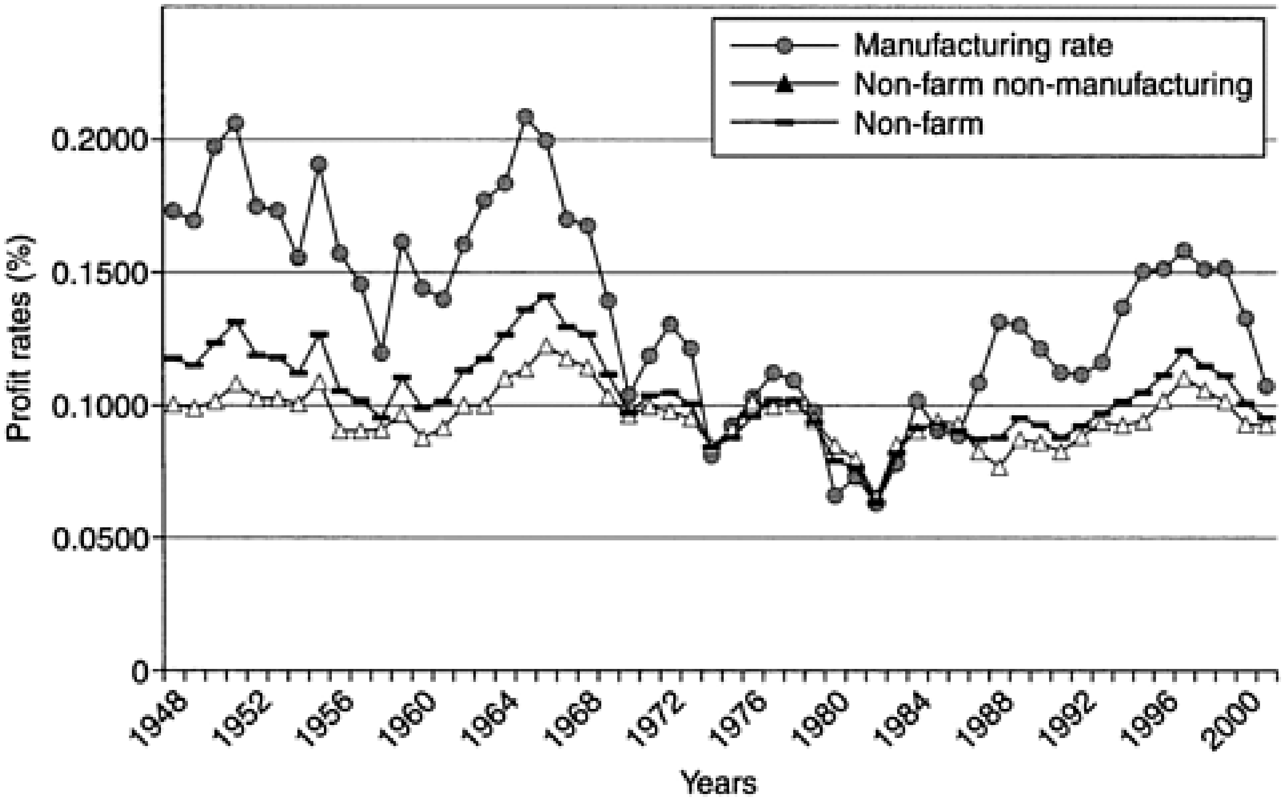

Figure 9.2 US manufacturing, non-farm, and non-farm non-manufacturing net profit rates, 1948–2001
Sources: Bureau of Economic Analysis: National Income and Product Accounts, Gross Product Originating by Industry 1948–2001; Fixed Asset Tables, BEA Web site.

Between 1985 and 1995 the US manufacturing sector managed to increase its rate of profit by an extraordinary 70 per cent. As the non-manufacturing profit rate declined slightly in the same interval, the rise in manufacturing profitability accounted single-handedly for the parallel increase in profit rate for the non-farm economy as a whole by 17 per cent. The level of non-farm profitability thus rose above that of 1973 for the first time in almost a quarter-century. From 1993–1994, in response to rising returns, investment growth sped up and productivity growth leaped forward, amplifying the rise in profitability and detonating the US economic expansion of the 1990s.

The vertiginous ascent of finance

The US financial sector, notably its commercial banks, entered the 1990s in deep crisis, the legacy of the go-go 1980s. But the Fed soon restored their balance sheets, providing the necessary condition for an astonishing turnaround. With the onset of the recession of 1990–1991, Alan Greenspan not only brought short-term interest rates down dramatically, enabling the banks to pursue with ever-improving results their standard policy of borrowing cheap short-term and lending dear long-term. In addition, he allowed banks, in violation of government regulations, to hold on

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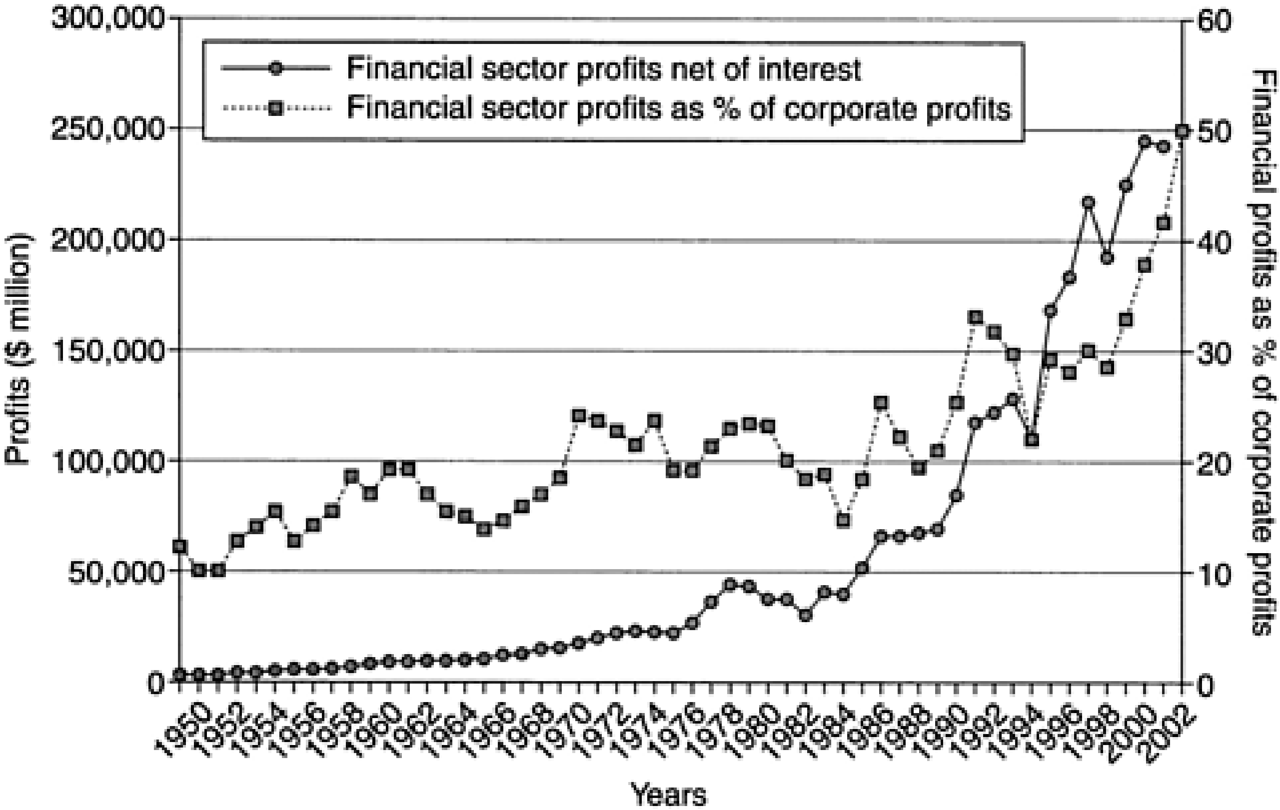

Figure 9.3 US financial sector profits, 1949–2002
Sources: Bureau of Economic Analysis, National Income and Product Accounts: Gross Product Originating by Industry 1948–2001; Table 1.14; Table 6.16D, BEA Web site.

to enormous quantities of long-term bonds without setting aside funds to cover the associated risk (Stiglitz 2002). And these appreciated spectacularly as long-term interest rates declined precipitously. Financial sector profits were restored almost instantaneously and they began a vertiginous ascent that extended into the new millennium.

Every major trend of the 1990s ran in favour of finance. Non-financial corporations boomed, and stepped up their borrowing. Inflation was suppressed, especially as the dollar soared after mid-decade. The Clinton administration pushed banking deregulation to its logical conclusion, opening the way to the rise of huge conglomerates that combined commercial banking, investment banking, and insurance. The stock market bubble offered historically unmatched opportunities to rake in fees and profits for superintending share issues and mergers and acquisitions, while simultaneously managing the explosion of household and corporate borrowing. Finally, as the decade neared its end, the nascent run-up in housing offered still another huge field for raking in profits. Between 1994 and 2000, financial sector profits net of interest7 doubled, and—because non-financial corporate profits net of interest swooned after 1997—accounted for a stunning 75 per cent of the *increase* in total corporate profits net of interest accrued in these years. Already accounting for 30 per cent of total corporate profits net of interest by 1997, financial profits net of interest accounted for 38 per cent in 2000 (see Figure 9.3).

Crises of the manufacturing sector in Germany and Japan

Nevertheless, because the US manufacturing sector secured the increase in its profit rate, as well as the revitalization of the entire non-farm economy, between 1985 and 1995 primarily by means of the falling dollar and flat real wages, as well as reduced corporate taxation—and *without* the benefit of much increase in corporate investment, fiscal stimulus, or even growth of output until very late in the day—it did little to create the conditions for an international turnaround. Indeed, just the opposite. Little consumer, investment, or government demand was generated, so the US market for goods produced by US manufacturers′ leading partners and rivals failed much to increase. On the contrary, in what turned out to be a zero-sum game, US producers raised their rates of return and expanded their output by reducing costs so as to successfully appropriate market share from their rivals, while imposing their lower prices and forcing down their profit rates.

As the opposite side of the coin, from 1985 the manufacturing economies of Japan, Germany, and elsewhere in Western Europe faced an ever intensifying squeeze. Their rising currencies, as well as their relatively fast wage growth, made for declining competitiveness *vis-à-vis* the United States, thus increased downward pressure on already reduced manufacturing profit rates and capital accumulation. Meanwhile, the near-universal turn to monetarism/neoliberalism from the start of the 1980s—plus the commitment to budget balancing that came with the advent of the Clinton administration and the Maastricht agreement in the 1990s—issued in stagnating demand for their goods at home and abroad. Finally, as the slowed growth of purchasing power choked the global economy, the Asian economies (excluding Japan)—most of which benefited profoundly from a deep decade-long devaluation of their currencies, which followed the dollar—tightened the noose by increasing their share of world exports from 11.7 per cent in 1990 to 16.4 per cent in 1995, a stunning 29 per cent in just five years.

In the face of the relentless downward pressure on profits that was resulting from system-wide overcapacity in manufacturing and the slowed growth of aggregate demand, made worse by stepped-up competition from the United States and East Asia, neither Japan nor Germany could avoid intensifying problems. From 1991, both entered their worst post-war recessions, resulting from unprecedented crises of their manufacturing sectors, themselves driven by huge declines in manufacturing profitability that forced enormous shake-outs of both employment and plant, equipment, and software. By mid-decade, as the yen rose to 79 per dollar, its highest level of the post-war epoch, Japanese manufacturers could barely make a profit, and the Japanese economy began to sputter, threatening the stability of the world economy and the US economic upturn.

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Boom, bubble, bust, 1995–2000
The patent inability of the leading capitalist economies to prosper together—manifested in a kind of hydraulic dynamic whereby the gains of one major country or group of them, secured via the devaluation of their currency, came at the expense of others—constituted irrefutable evidence that, even after a quarter-century, the world economy had still to surmount its fundamental problem of manufacturing overcapacity. This pattern would persist, and worsen, through the end of the century. The succession of crises that punctuated the 1990s beginning with Europe's exchange rate mechanism (ERM) collapse in 1993 manifested the same syndrome. By spring 1995, the US government, recently traumatized by the Mexican peso crisis with its associated Tequila effect, felt it had no choice but to come to the aid of the Japanese (and German) manufacturing economies, and it did so in much the same way that the Japanese and German governments had bailed out a crisis-bound US manufacturing economy in 1985—by engineering, in collaboration with the other G-3 powers, new devaluations of their currencies. The so-called Reverse Plaza Accord marked a major turning point for the world economy, as the ensuing ascent of the dollar, as well as of the East Asian currencies tied to it, and parallel decline of the yen and the mark, not only initiated a sharp reversal of the pattern of international economic development that had prevailed for the previous decade by driving down US manufacturing profitability, but set the stage for the stock market bubble, the New Economy boom, the worsening of overcapacity, and the subsequent crash and recession of the world economy.
Declining profitability in US manufacturing, once again
As the dollar began to rise from the latter part of 1995 after a decade-long descent, the weight of international overcapacity shifted once again away from Japan and Germany and back toward the United States, as well as East Asia. The revalued currency thus immediately cut short that extended rise of US manufacturing competitiveness that had underpinned the US profitability revival. In 1996 and 1997 the US manufacturing expansion did manage to sustain itself, as output shot up, productivity growth accelerated, and costs of production fell impressively. Nonetheless, US manufacturing lost vitality, because squeezed between the intense downward pressure on prices that was resulting from the surfeit of international manufacturing supply and its own rise in relative costs that was resulting from the rising currency. Indeed, had US manufacturers not succeeded in actually *reducing* real wages in these couple of years, manufacturing profitability would have started to fall right then. Matters were made much worse for US manufacturers when East Asian manufacturing economies, hit hard by the rising dollar to which their own currencies were tied,

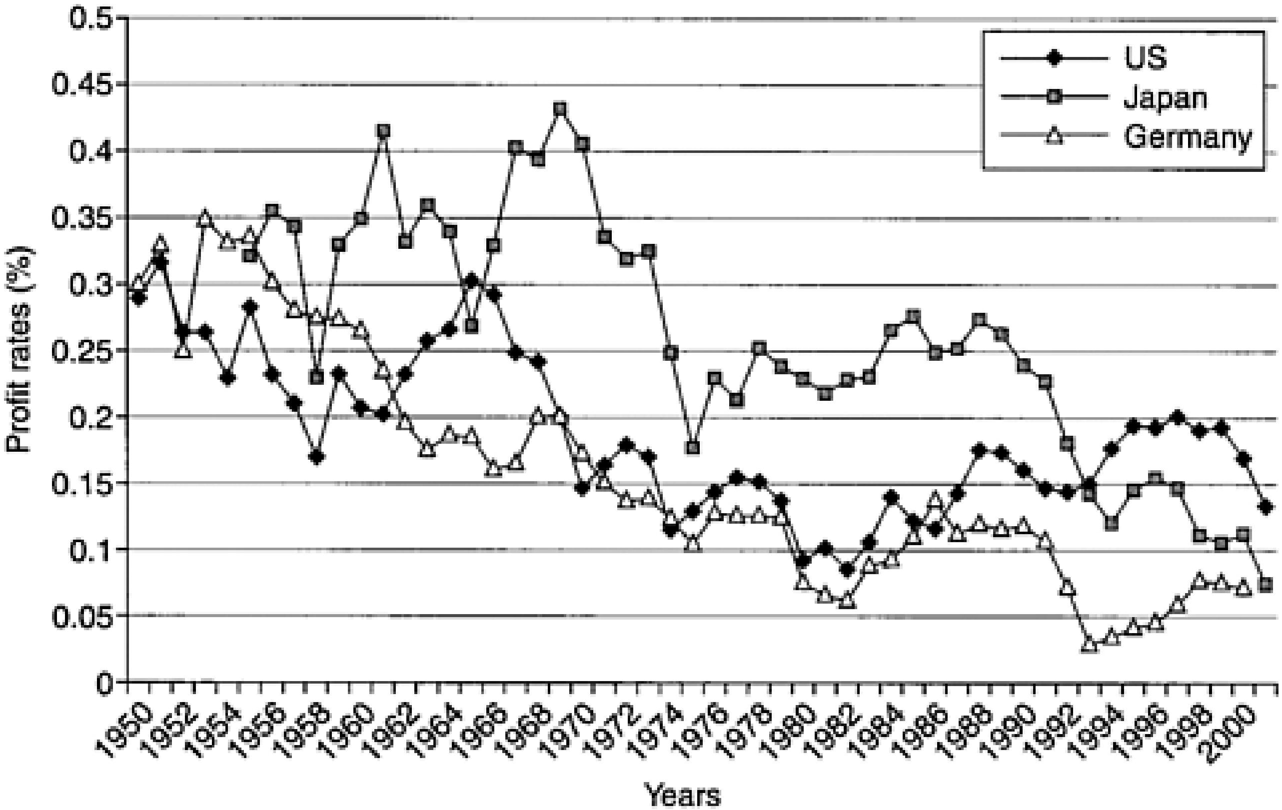

*Figure 9.4*US, Japanese, and German manufacturing profit rates, 1950–2001
Sources: US: Bureau of Economic Analysis: National Income and Product Accounts; Gross Product Originating by Industry; Fixed Asset Tables, BEA Web site. Japan: OECD *National Accounts,* Detailed Tables II; Bureau of Labor Statistics, 'Data on Japanese Manufacturing Capital', 28 February 1996, unpublished series, kindly provided by Edwin Dean of the Bureau of Labor Statistics. Germany: OECD *National Accounts,* Detailed Tables II; OECD *Stocks and Flows of Fixed Capital;* Carlin (1987). Thanks to Andrew Glyn for making available to me profit rate numbers for the 1990s from German National Accounts.

entered into crisis in 1997–1998, leading to the drying up of East Asian demand, the devaluation of East Asian currencies, and East Asian distress selling on the world market. From 1997 through 2000, the US manufacturing profit rate entered into a new decline, falling by 16 per cent. With the manufacturing sectors of the United States and East Asia in deepening trouble, and those of Germany and Japan recovering minimally and belatedly—and failing to compensate—the world economy had lost an indispensable motor (see Figure 9.4).

The equity price bubble

Meanwhile, in 1995, under the terms of the Reverse Plaza Accord by which the G-3 powers had agreed to the great turnaround of the dollar/yen/mark exchange rates, the US, German, and especially the Japanese government let loose a huge flood of funds on to US money markets to drive up the dollar, mainly through the purchase of US Treasury instruments. East Asian governments, as well as hedge fund speculators from around the world, followed suit. As a result, US long-term interest rates fell sharply over the course of 1995, at the same time as the Federal Reserve pushed down short-term interest rates (to help combat the Mexican peso crisis).

The enormous easing on financial markets that thus took place in 1995, as well as the rise of the dollar itself, detonated the great stock market run-up. Hitherto—between 1980 and 1995—US equity prices had risen significantly, but no more than had corporate profits. Up to 1995, in other words, the rise of the stock market had been fully justified by the underlying increase of corporate profits. But, henceforth, equity prices left corporate profits in the dust, especially as the manufacturing profit rate ceased to rise and turned down, and the biggest stock market bubble in US history blew up (Brenner 2002:140, fig. 5.2).

If the international financial shifts of 1995 set off the stock market runup, the US Federal Reserve and the corporations themselves perpetuated it. By late 1996, Alan Greenspan was voicing worry, in public, about the 'irrational exuberance' of share prices. But he was more concerned, in private, about the possible stumbling of the US economy, especially as federal deficits evaporated and the dollar rose, threatening aggregate demand and corporate profits. Aside from a one-quarter point increase in early 1997, Greenspan failed to raise interest rates between the beginning of 1995 and the middle of 1999, with the result that during the second half of the decade the money supply increased at quadruple the rate it had during the first half. Meanwhile, he intervened with ever easier credit at every sign of instability in the equity markets—in late summer of 1997 as the East Asian crisis struck, in early autumn 1998 as that crisis hit the US and financial markets froze up, and in the autumn of 1999 to head off a potential Y2K meltdown. It was investors' belief in the so-called 'Greenspan put'—that the Fed would bail out the equity market come what may—that kept the bubble expanding through the end of the millennium.

The strategy that Greenspan developed during the second half of the 1990s—and has continued to implement ever since—might usefully be called 'stock market, or asset-price, Keynesianism'. In traditional Keynesian policy, demand is 'subsidized' by means of the federal government's incurring rising *public* deficits by spending more than it takes in in taxes. By contrast, in Greenspan's version, demand is increased by means of corporations' and rich households' taking on rising *private* deficits, encouraged to spend beyond their means by the increased paper wealth that is represented by the rising value of their stocks, or other assets. By 1997–1998 the US campaign to balance the budget had reduced deficit spending to zero, and recourse to traditional Keynesianism was ruled out. In order to stimulate investment and consumer demand and thereby counterbalance the worsening decline in manufacturing competitiveness, exports, and profitability, the Fed thus had few other options than to stoke up asset prices.

US non-financial corporations were not slow to exploit the easy money gifted by the Fed. Between 1995 and 2000 they increased their borrowing as a fraction of corporate GDP to record levels. This was as much to cover the cost of buying back their own shares as to fund expenditures on new plant and equipment. Through share repurchases, corporations avoided the tedious process of creating shareholder value through actually producing goods and services at a profit, and directly drove up the price of their shares for the benefit of their stockholders, as well as their corporate executives, who were heavily remunerated with stock options. US corporations were the largest net purchasers on the stock market between 1995 and 2000 (Brenner 2002:149, fig. 5.4).

The corporations' stock buy-backs represented a specific case of the more general self-aggrandizing mechanism by which asset bubbles are puffed up. In this dynamic, entities exploit the low cost of borrowing to purchase assets, which drives up their value, providing greater collateral, which allows more borrowing and equity buying, which forces up equity values even more, and so on. The same sort of process would soon be at work in the housing price run-up of the subsequent era.

The wealth effect drives the boom

The runaway stock market did allow the US expansion to continue and accelerate in the years between 1995 and 2000, even as downward pressure on profit rates came to deprive it of its initially solid foundation. During most of the post-war epoch, US corporations were for the most part self-financing: this meant that, overwhelmingly, they financed investment out of retained earnings. But during the second half of the 1990s, to compensate for the paucity of profits—and to exploit the spectacularly easy access to funds—corporations not only financed investment by way of borrowing to a degree previously matched in the post-war epoch only during recessions. They also turned, to an extent without remote precedent, to raising funds for capital expenditures by means of issuing shares, as those with limited access to the bond market and commercial bank lending found selling their overpriced shares to raise money irresistible. Corporations were thus able to maintain, even increase, the rate of growth of their expenditures on new plant, equipment, and software, despite the diminishing contribution of profits, accruing in the process historically unprecedented levels of debt.

Rich households also benefited from the wealth effect of runaway equity prices. As they saw their paper assets soar, they felt justified in raising their annual borrowing, as well as their debt outstanding, to near record levels as a fraction of household income. They also felt free to raise their household consumption as a proportion of personal income to near

100 per cent, with the top 20 per cent of families by income bringing about by themselves a reduction in the US household savings rate from 8 per cent to near zero over the course of the decade (Maki and Palumbo 2001). Consumer expenditures jumped sharply, helping mightily to soak up the increased output generated by rising investment and productivity. Between 1995 and 2000 a powerful boom took shape, driven by a speedup of investment growth to 10 per cent per annum, which made possible a notable acceleration of productivity, by rapid increase of jobs, and, finally, in the last few years of the century, by a significant jump in the growth of real wages due to low unemployment.

The fact remains, however, that an equity price ascent driven by speculation, far from pointing out the most promising fields for expansion—as it does in the fables of the Federal Reserve, the Council of Economic Advisers and orthodox economic theory—was systematically driving investment into New Economy lines, oblivious to their actual, declining, rates of return. Across the economy, the reduction in the growth of costs that resulted from the increased productivity that stemmed from the accelerating growth of new plant, equipment, and software was more than offset by the fall-off of price increases that stemmed from the outrunning of demand by supply. Consumers thus ended up as the primary—if only temporary—beneficiaries of a self-undermining process that bought inexorably increasing downward pressure on profits. Between 1997 and 2000, as the boom peaked, the rate of profit in the non-financial corporate sector as a whole fell by almost one-fifth...opening the way to the crash of 2000 and ensuing recession of 2001.

The recessionary dynamic: a crisis of manufacturing

The fall into the recession of 2001 manifested a crisis of manufacturing that had been maturing for half a decade, against the background of worsening international overcapacity. The ensuing massive shake-out—most especially of manufacturing employment—constituted a huge shock to demand and set the economy on an accelerating downward trajectory. The government warded off disaster by means of record interest rate reductions and huge fiscal deficits, as well as a major devaluation of the dollar. But it could right the economy only by way of blowing up a series of new asset price bubbles the deflation of which threatened to undermine, if not totally devastate, a none too steady cyclical upturn.

From July 2000, a series of ever worsening corporate earnings reports precipitated a sharp cyclical downturn, both by reversing the wealth effect and by revealing the mass of redundant production capacity and mountain of corporate indebtedness that constituted the dual legacy of the bubble-driven boom. With their market capitalization sharply reduced, firms found it not only more difficult to borrow or issue new shares, but

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less attractive to do so, especially since declining profits and the growing threat of bankruptcy led them to try to repair balance sheets overburdened by debt. Having purchased far more plant, equipment, and software than they could profitably set in motion, they could not think of adding means of production or labour, but were obliged either to reduce prices or leave capacity unused. Either way, they sustained further reductions in their rate of profit. With not only profits, but also loans, so much harder to come by, it was inevitable that the growth of jobs and new plant and equipment would be cut back, undercutting aggregate demand, and detonating a self-sustaining downward spiral that precipitated a sharp cyclical downturn.
To counter their declining profitability, starting in the second half of 2000, firms sought to radically cut costs, driving the economy into recession by sharply reducing the growth of purchasing power. Above all, companies reduced employment—at an average annual rate of almost 2 per cent between the middle of 2000 and the middle of 2003, after having increased it an average annual rate of more than 2.5 per cent between 1995 and 2000. Over the same period they brought down the rise in real hourly wages to an annual average of 1.1 per cent, from 3.8 per cent between 1997 and 2000. As a result of the combination of falling employment and reduced hourly real wage growth, real non-farm compensation—the main component of aggregate demand—fell at an average annual rate of 1 per cent per year between mid-2000 and mid-2003 (US Bureau of Labor Statistics 2004b). Real expenditures on plant, equipment, and software meanwhile fell at an average annual rate of about 3 per cent, after having increased at an average annual rate of 10 per cent between 1995 and 2000. Finally, because the import markets of America's trading partners slowed even faster than did that of the United States as they too fell into recession, US export growth fell with respect to US import growth even faster than previously, with the consequence that the US trade deficit during the same three years averaged more than $400 billion, depressing GDP in growth accounting terms by 1.25 per cent over the interval (US Bureau of Economic Analysis 2004: tables 1–2).
The main, almost exclusive, site and source of the economic slowdown was the manufacturing sector, its profitability decline reaching a nadir. The core of the problem was in hi-tech lines such as telecommunications components, microprocessors, and computers, but traditional industries such as textiles and steel were also hard hit, as were closely related non-manufacturing lines, especially telecommunications and business services. Although by 1995 manufacturing had come to constitute only 29.3 per cent and 32.7 per cent, respectively, of corporate and non-financial corporate GDP, it still accounted for 42.5 and 50 per cent, respectively, of corporate and non-financial net corporate *profits* (before payment of interest). Manufacturing's descent into crisis thus meant crisis for the whole economy. In 2001 the rate of profit in the manufacturing sector fell by

21.3 per cent, to a level over a third down from its 1997 peak, while that of the manufacturing durable goods sector, site of all the hi-tech lines as well as most of the main-line industries exposed to international competition, dropped by 30 per cent and a stunning 46 per cent from 1997. Between 1997 and 2001, as corporate indebtedness rocketed, manufacturing net interest as a proportion of manufacturing net profits rose from 19 per cent to 40.5 per cent, a post-war record. Partly as a consequence, by 2001 manufacturing profits net of interest had fallen a total of 44.4 per cent from their high point in 1997.

It was from the manufacturing sector, and related industries, that virtually all of the downward pressure on the economy emanated, as manufacturing employers cut back mercilessly in order to restore profits. They reduced output by 5.5 per cent in 2001 alone, and by 2003 it had still failed to return to its level of 2000. Above all, they profoundly reduced employment, eliminating 2.8 million manufacturing jobs between July 2000 and October 2003. This was well over 100 per cent of the total of 2.45 million private sector jobs lost in the same period—meaning that the economy outside manufacturing actually gained jobs. From its most recent peak in 1997, the manufacturing sector had lost fully *one-fifth* of its labour force (measured in hours). Largely as a consequence, after having increased at an average annual rate of 3.8 per cent between 1995 and 2000, total real compensation in manufacturing fell at the annual average rate of 3.1 per cent between the end of 2000 and the middle of 2003, thereby accounting for most of the decline in total real compensation that took place in the non-farm economy during that period. Similarly, manufacturing exports fell 12 per cent between 2000 and 2002 and remained in 2003 almost 10 per cent below their level in 2000, thus accounting for more than 100 per cent of the fall-off of total goods and services exports in this period. In the same way, manufacturing sector net exports accounted for the entirety of the decline in US net exports during this interval. Something like the same pattern most probably holds for investment, but cannot be directly confirmed, as relevant data are not yet available. By way of its powerful restraining effect on the growth of aggregate demand, the crisis of manufacturing was the fundamental factor depressing the economy from the time the slowdown began in the second part of 2000 (US Bureau of Labor Statistics 2004c, d).

A bubble-based recovery

Between mid-2000 and mid-2001, GDP growth fell from 5 per cent to −1 per cent per annum and investment from 9 per cent to −5 per cent per annum—faster than in any other twelve-month period since 1945—sending the economy into a tailspin. To stem the plunge, the Federal Reserve, beginning in January 2001, lowered the cost of borrowing with unprecedented rapidity, reducing short-term interest rates on eleven occasions, from 6.5 per cent to 1.75 per cent, over the course of the year ...and then a further 0.75 per cent in November 2002 and June 2003.

Consumption drives the economy

Nevertheless, as the Fed soon discovered, interest-rate reductions are much more effective in reviving an economy in which consumption has been restricted by a tightening of credit—as in all previous post-war cyclical downturns—than in restarting an economy driven into recession by declining investment and employment resulting from industrial over-capacity. Vastly oversupplied with plant, equipment, and software, non-financial corporations had little incentive to step up capital accumulation, no matter how far interest rates came down. The Fed was pushing on the proverbial string. Even by the middle of 2004, real non-residential investment had failed to come back to its level of 2000.

Failing to elicit much investment from corporations already weighed down by recently purchased plant, equipment, and software, the Fed was obliged to rely on households and their consumption to drive the recovery. To make this work was, however, no easy task. Between 2000 and 2003, total real compensation for the work force as a whole, including those working for the government, increased at a rate of just 0.6 per cent per year, real personal income (before tax) only 1 per cent (US Bureau of Labor Statistics 2004a; US Bureau of Economic Analysis 2004: Table 10). The inescapable conclusion was that the private sector on its own was incapable of pushing the economy forward. To overcome the impediments to the revival of private expenditure, the Fed was obliged to fall back on its strategy of the 1990s—of seeking to enable spending by inflating the wealth effect. But rather than relying, as it did during the previous decade, upon pumped-up equity prices to facilitate corporate borrowing and expenditures, it sought to encourage household borrowing in aid of consumption by forcing up the prices of residences and pushing down mortgage rates. And, in its own narrow terms, it surely succeeded.

Thanks in part to the Fed's actions, long-term borrowing costs fell significantly and housing prices rose precipitously. Between June 2000 and June 2003 the interest rate on thirty-year fixed mortgages fell from 8.29 per cent to 5.23 per cent, a total of 37 per cent. In the same interval, housing prices rose by 7 cent per annum, extending and accentuating a trend that originated between 1995 and 2000 (Office of Federal Housing Enterprise Oversight 2004). By taking advantage of the appreciation in the value of their homes, and the fall in borrowing costs, households were able to 'cash out' huge sums from their home equity—by way of home sales, refinancing, and second mortgages—and so to play to the hilt their assigned role of driving the economy by sustaining the growth of consumption. Between 2000 and 2003, household borrowing as a percentage of GDP came to smash all records (US Federal Reserve Board 2004: table D.2). On this basis, real consumption expenditures increased at an average annual rate of 3 per cent in this period, and, in growth accounting terms, explained more than 100 per cent of the rise in GDP that took place (US Bureau of Economic Analysis 2004: Table 2).

While the Fed implemented its monetary stimulus, the Bush administration added what had the appearance of a major fiscal stimulus modelled after that of Ronald Reagan, forcing through Congress enormous cuts in taxation and major increases in military spending. But these measures were less potent than they appeared. Since most of the reduction in taxation was accounted for by the decrease in the levy on dividends, it benefited the very rich almost exclusively. Its effect was therefore much more to increase savings and the purchase of financial assets than to boost consumption, or aggregate demand. Moreover, the fact that tax cuts at the federal level had the effect of reducing revenue to money-strapped state governments, forcing them to cut back on spending and in some cases to increase taxation, counteracted much, though not all, of what stimulus they did impart. Military spending amounted to three-quarters of the increase in federal expenditures between 2000 and 2003, and did help the economy stay afloat. But the fact remains that it brought about a total of just 0.75 per cent of GDP increase during the period (US Bureau of Economic Analysis 2004: Table 2). In view of the recession, Keynesian policies were no doubt in order, and the Bush administration's spending increases and revenue reductions did bring about a gigantic shift from a hefty federal budget surplus in 2000 to a major federal budget deficit in 2003. But, because they were aimed much more at the achievement of particular political goals than at providing a stimulus, they proved only minimally effective in aiding the economy's revival.

A distorted pattern of growth

Thanks to the government's huge subsidy to consumption, the US economy ended up following a paradoxical two-track trajectory. While manufacturing and related industries experienced a profound contraction that had its origins in second half of the 1990s, those sectors able to cater to the continuing rise of consumer spending or to take advantage of falling costs of borrowing and rising indebtedness did ever better, imparting a distinctive cast to US economic development in the new millennium. Benefiting from an historically unprecedented rise in the demand for homes, the construction industry enjoyed a decade-long boom, its rate of profit smashing all previous records for the industry. Meanwhile, directly fuelled by the historic consumer spending spree, retailers also did spectacularly well, their profits further swelled by the extraordinary rise of imports from China, made possible by the high dollar. The hotel and accommodation industry followed a similar trajectory. Finally, the increasingly corporatized

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health services sector registered what has come to look like permanent growth, its profits quintupling between the end of the 1980s and beginning of the 2000s (US Bureau of Economic Analysis, National Income and Product Accounts, Gross Product Originating by Industry 2001).

The parallel ascent of the financial sector was of an entirely different order, assuming revolutionary proportions and transforming the map of the American economy over the course of the 1990s. Nor, amazingly, was finance slowed by the bursting of the equity price bubble and the ensuing slowdown of the real economy. The housing run-up replaced the stock market run-up, and falling costs of borrowing, insured by the Fed, did the rest. By taking in profits from mortgage-related business, as well as bond trading and underwriting, banks and securities firms were able to prosper, even in the face of the huge decline in corporate borrowing. With the Fed *guaranteeing* that it would not raise interest rates, financial institutions could not help but make record-breaking profits with relatively small risk simply by borrowing cheap and lending dear. Between 2000 and 2003, financial sector profits came to constitute, according to Morgan Stanley, some 50 per cent of total corporate profits, accounting for an astounding 80 per cent of the increase in corporate profits that occurred between 2000 and 2003 (Galbraith 2003a, b).

Contradictions of a bubble-driven economy

The Fed's turn to ever easier credit brought a semblance of order to the non-manufacturing economy. But it did so, in large part, by means of—and at the cost of—inflating the value of financial assets across the board, inviting instability. The ensuing real estate and dollar/current account bubbles—along with a new mini-run-up of the stock market—provided the collateral required to support ever greater borrowing so as to keep consumption rising and the economy turning over. But what this meant was that US economic growth between 2000 and the present (mid-2004) was dependent upon increases in demand generated overwhelmingly by borrowing by households against the appreciation of on-paper wealth, rather than the growth of investment, employment, and real wages generated by corporations...leaving it vulnerable in much the same way as was the bubble-driven boom of the second half of the 1990s.

Stock market bubble

Equity prices of course fell sharply from mid-2000. But, paradoxically, their decline failed even to begin to bring stock values into line with underlying profits, because the latter fell just as far. As a consequence, in late 2002 to early 2003, price-earnings ratios were as astronomical as they had been at the stock market's peak. By implication the bubble had never been allowed to burst.

Corporate profits did begin a belated recovery over the following year. But even in mid-2004 the price-earnings ratio for US equities still stood at around 25:1 (Schurr: 2004). This was below its historic peak of 35–40:1 in 1999–2000, but still far above the historic average of 14:1. With its easy money policy the Fed had succeeded in keeping the stock market healthy and the business outlook rosy. But, unless corporate profits growth can *continue* to accelerate (see below), the stock market could easily be subject to a significant correction, which could, by itself, send the economy directly back into recession.

Housing bubble

Still, since 2000, it's been the housing price run-up that's primarily driven the economy, taking over from share prices. As shareholders accumulated wealth via the stock market boom of the second half of the 1990s, they were able to demand more expensive houses faster than the latter could be supplied, detonating the run-up of real estate values. Then, as house prices rose, purchasers became willing to pay ever increasing sums for real estate, on the assumption that values would continue upwards, as they were doing in the stock market. When the stock market crashed and the boom came to an end in 2000, not just the Fed's record interest rate reductions, but also as a major transfer of funds from the equity to the housing market kept the game going (Baker and Baribeau: 2003). As with the stock market run-up, the real estate bubble fed on itself, with increased borrowing facilitated by easy credit making for greater demand and higher real estate values, which provided the collateral for still more borrowing making for more demand and higher housing prices, and so on. Having already risen by about 40 per cent between 1995 and 2000, household wealth in the form of real estate increased a further 27 per cent between 2000 and the first quarter of 2004. Along the way, it more than made up for the 45 per cent decline in market capitalization that had resulted from the crash of equity prices between 1999 and 2003 (Federal Reserve Board 2004: Table B.100).

In the wake of this huge on-paper appreciation of the value of their residences, households were able to extract dramatically increased funds by selling their homes at prices surpassing their mortgage debt and securing even larger mortgages, by refinancing their existing mortgages, and by taking out home equity loans—with enormous consequences for the growth of consumption and thereby GDP. In 2001, 2002, and 2003, total cash raised in these ways amounted, in total, to an astounding 5 per cent, 7.7 per cent, and 9 per cent of US personal disposable income.8 No wonder the real estate run-up was able to play the decisive role in sustaining consumer spending through recession and cyclical upturn, in just the way the stock market run-up did. If one adds residential investment spending and purchases of home furnishing to total mortgage cash-outs, the housing and mortgage markets accounted, by themselves, for no less than *two-thirds* of GDP growth between 2000 and the middle of 2003. This means that, in the absence of these contributions from housing, average annual GDP growth in this two-and-a-half-year period would have been just 0.7 per cent, instead of the 1.9 per cent actually registered.9

Yet it is hard to see how cashing out on anything like this scale can long continue. This is because real estate price inflation seems bound to lose speed, while interest rates, which fell near post-war lows in 2003, seem more likely to rise than fall (unless the economy were to stagger). Home owners' propensity to borrow also seems likely to decline, as the equity held by households in their homes has fallen sharply as a percentage of those homes' value, while their debt as a percentage of income has reached record highs. But if household borrowing were to slow, the growth of consumer spending would be hit, and thereby the main prop of the recovery through 2004.

Current account/dollar bubble

By enabling consumer spending to continue to increase, the Fed enabled US imports to rise further, even as US exports declined as a result of the international cyclical downturn and the resulting hit to purchasing power in most of the rest of the world. As a consequence, in 2003, the US current account deficit set still another record—as it had in 2002—rising above 5 per cent of GDP. Ever-expanding US external deficits thus kept the world economy turning over through recession and cyclical upturn, just as they had between 1980 and 1985 and again between 1995 and 2000. As in those periods, overseas manufacturers took an increasing share of the US market at the expense of US producers so as to drive their own manufacturing-dependent economies forward while undermining US industry. In fact the rise of the US manufacturing trade deficit accounted for almost the entire epoch-making increase in the US current account deficit between 1980 and the present. And since 2000 this trend has reached something of a climax, contributing mightily to the crisis of US manufacturing and the US economic slowdown (see Figure 9.5).

The rise of the US current account deficit has itself depended on the willingness of the rest of the world to finance it. Until the crash of 2000 and recession of 2001, overseas investors were more than happy to do so, making huge direct investments in the United States and buying up enormous quantities of corporate equities and bonds. But as the stock market declined and the US economy slowed, private investors around the world found US assets decreasingly attractive. Purchases of corporate and Treasury bonds, as well as bonds sold by US agencies such as Fannie Mae and Freddy Mac, continued to grow smartly. But equity purchases by the rest of the world and foreign direct investment in the United States both

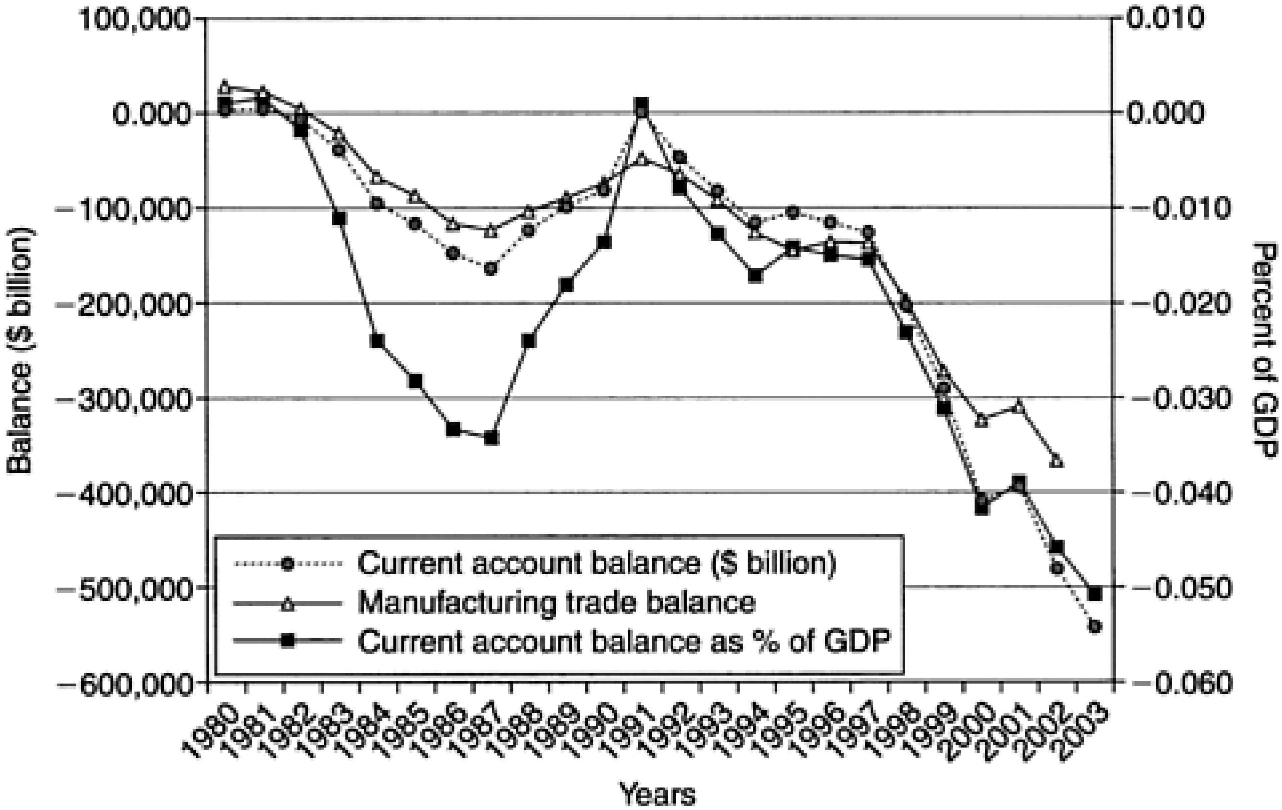

Figure 9.5 US manufacturing trade balance and US current account balance, 1980–2003
Sources: US Office of Trade and Economic Analysis, Foreign Trade Highlights, US Aggregate Foreign Trade Data, OTEA Web site; Bureau of Economic Analysis, National Income and Product Accounts, Table 4.1, BEA Web site.

plummeted. As a result, pressure on the dollar mounted, with the result that the dollar fell by about one-third against the euro between the end of 2001 and the middle of 2004. Were the dollar to continue to decline, the Federal Reserve could be faced with an excruciating choice: either let the currency drop and invite a wholesale liquidation of US properties by foreign investors which would risk an asset price crash, or raise interest rates and set off a new recession.

In fact, through the middle of 2004, the overall decline in the dollar's exchange rate was limited to about 10 per cent, because it took place almost entirely in terms of the euro and to only a small extent in terms of the currencies of East Asia. This was the case, even though trade with East Asia was primarily responsible for the growth of US trade and current account deficits. The reason that the dollar held up against East Asian currencies was that East Asian governments, led by Japan and China, in order to sustain their countries' exports to the United States, entered the currency markets to an entirely unprecedented extent in order to prevent the dollar value of their currencies from rising and recycled their mounting current account surpluses into dollar-denominated assets, especially US Treasury and agency bonds. By 2004 East Asia held dollar reserves worth over $2 trillion. Their purchases held down US interest rates and prevented a precipitous fall of the dollar, in that way sustaining US asset prices. By closing the financing gap that would otherwise have resulted, they enabled the Fed and the administration to pursue hyper-expansionary policies that would, in their absence, almost certainly have come to grief, owing to rising costs of borrowing and a declining currency.

The fact remains that, to the extent that East Asian governments continue to keep their currencies relatively cheap versus the dollar by means of ever greater purchases of US assets, especially Treasury instruments, they will open the way to further increases in the US current account deficit by making possible inexpensive US imports of East Asian goods which are themselves made easier by the availability of the cheap credit, courtesy of the Fed, to US consumers. They will also find themselves obliged to continue to invest their own countries' correspondingly increased surpluses in US-denominated assets, with ominous implications for the world economy. On the one hand, the influx of East Asian funds on to US financial markets, by pushing down the cost of borrowing, will tend, directly or indirectly, to fuel the further expansion of asset price bubbles in equities and real estate, not to mention US Treasury instruments. On the other hand, the essentially subsidized growth of East Asian exports will continue to undermine US industry while exacerbating over-capacity in manufacturing on a global scale. This is, of course, much the same syndrome that has plagued the world economy and its US component throughout the bubble-driven boom, the recession, and the cyclical upturn. It is a process in which the inexorable increase in US obligations to the rest of the world allows the rest of the world to grow through exports at the expense of US productive power...and of the capacity of the US to honour those obligations.

Can the recovery be sustained?

Beginning in early 2001, US economic authorities—with their record interest rate reductions and historic federal deficits, buttressed by a major devaluation of the dollar—detonated the greatest economic stimulus in US history. Still, in 2001, 2002, and the first half of 2003, the economy struggled, increasing at an average annual rate of just 1.9 per cent. Between mid-2003 and mid-2004 the growth of GDP jumped to 4.5 per cent. Nevertheless, a large share of this improvement was attributable to strictly temporary boosts to demand from Bush administration tax rebates and upward leaps in Iraq War spending (Brenner 2004:88–90). Even by mid-2004 the level of real non-residential investment had failed to return to its level in 2000. Manufacturing output was also still below its magnitude at the end of the boom. Above all, the jobs recovery was by far the worst of the post-war epoch, with employment rising a scant 0.3 per cent in the thirty-two months following the recession's November 2001 trough, compared to a post-war average of 7.1 per cent. As a result, total real compensation increased just 5.7 per cent in the same period, compared to the post-war average of 14.2 per cent.10 With the growth of demand so far below normal, and so far short of what was needed, the question that imposed itself with ever greater urgency was whether the hitherto largely dormant corporate sector would henceforth be able to generate sufficient investment and jobs growth soon enough to keep the economy growing as the government's unprecedented stimulus to demand inevitably petered out.

A revival of profitability?

The necessary, if not sufficient, condition for the sustained growth of expenditures on new plant, equipment, and software and on new hiring is a dramatic and durable increase in profitability—the critical missing factor in the 1990s boom. The average rate of profit for the cycle of the 1990s did not rise palpably above the levels of those of the 1970s and 1980s, remaining about 20 per cent below the levels of the post-war boom, and proved insufficient to underpin a decisive break from the long downturn (see Table 9.3). For the economy to sustain a new boom by way of lasting increases in investment and employment, the impressive ascent of profitability that began in the mid-1980s but came to grief after the mid-1990s must therefore, in effect, take up where it left off, and go a good deal higher.

In fact, from the end of the recession, profitability rose in accelerating fashion, especially in 2003 and the first half of 2004. Nevertheless, because it came from such a depressed level, it still had a way to go to reach, let alone surpass, its 1990s magnitudes, and could well face increasing difficulty in continuing its ascent. After having already declined by 19 per cent between 1997 and 2000 as the boom reached its apex, the rate of profit in the non-financial corporate sector plunged a further 21.3 per cent in the recession of 2001, or a total of 36.4 per cent between 1997 and 2001, to *its lowest level since 1945* (with the single exception of 1980). By the first half of 2004 the non-financial corporate profit rate had come back to its level of 2000. But that still left it below the average for the whole of the 1990s business cycle and about 20 per cent under the 1997 peak. The failure of the profit rate to sufficiently recover was almost certainly a fundamental factor in accounting for economy's weak response to the government's titanic stimulus programme and the precariousness of the recovery through the middle of 2004.

It is a real question, moreover, whether the ascent of profitability can be sustained. With output growth muted through much of the cyclical upturn, corporations were obliged to restore their profit rates primarily by means of widening the gap between what their workers produced per hour and what they paid them per hour. For 2002 and 2003 the measured growth of output per hour reached 5.6 per cent and 4.6 per cent per

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annum, respectively, while hourly real wage increases were held to just 0.7 per cent and 1.8 per cent per annum, respectively. Unit labour costs thus fell substantially in this interval. As a consequence, some leading economic analysts, not to mention Alan Greenspan, were already asserting that the miracle of productivity growth that never quite materialized in the 1990s was now upon us, with New Economy technology being implemented more speedily and effectively than hitherto. By implication, a path to profitability revival and economic dynamism had been opened up.

But such a deduction is premature, to say the least. Its Achilles heel is obvious: so far, increases in output per hour have taken place in the face of a sharp *decline* in investment growth, i.e. the slower introduction of more and better plant, equipment, and software. Is it really believable that technological advance, suddenly and discontinuously, speeded up so as to yield a rate of productivity growth between 2000 and 2003 that was almost twice as high as between 1995 and 2000, despite the fact that the growth of capital stock was more than 50 per cent lower in that interval? The more plausible explanation is that the recorded gains in productivity represent not so much increased efficiency—meaning more output from the same labour input—as more output from more labour input per hour, i.e. speed-up.

Straightforward increases in the exploitation of labour, such as drove the rise in profitability between 2001 and 2004, *directly* yield not only higher profits, but also—very significantly—higher profit *rates,* since additional profits are extracted without the need to add capital stock. Yet one is entitled to ask whether corporations can go much further than they already have in improving their profit rates by extracting still more labour inputs per hour for less pay from their employees, especially if the rate of GDP growth is to be sustained. Yet, to the extent that they rely on higher investment accompanied by increasing employment to secure gains in output per hour, both productivity and thus profitability increases will inevitably come more slowly, especially as real wage growth will, in that case, likely go higher.

Nor is it clear, finally, how easy it will be to secure a sustained acceleration of investment growth and job creation under any circumstances. A huge number of jobs created over the course of the 1990s resulted from the wealth effect of rising equity prices, so had little hope of being sustained by the continuing growth of demand. High technology industries alone, which constitute a mere 8 per cent of GDP, accounted for one-third of the total increase in GDP during the second half of the 1990s. As a result, a large number of those laid off in hi-tech lines between 2000 and 2003 will never be rehired. Since it is not evident that the New Economy industries that were expected to make the running will be able to do so, an entirely new set of jobs may well have to be created. But where will the demand for these arise, given that hiring has been so slow, and employment creation is itself such a central aspect of demand creation?

Conclusion

At mid-2004 the bubble-driven mechanisms behind the cyclical recovery were showing signs of exhaustion. Above all, the long-term cost of borrowing was rising, abetted by the Fed's initiation of a new round of rate increases, and was threatening to depress the asset prices that, via the wealth effect, had sustained consumption. Equity prices were somewhat down for the calendar year. Housing prices had stagnated since mid-2003. During the first seven months of 2004 the current account deficit had risen at record-smashing speed for still another time, depressing the dollar yet further. Yet, over the same period, the rest of the world's purchases of US assets declined ominously, barely covering the current account shortfall (Karmin 2004). Most perilous of all—and a reflection in part of the slowdown in housing—real consumption expenditures in the second quarter rose at their slowest pace since the recession of 2001.

Whether the corporate sector was ready to take over from households was still unclear. Real non-residential investment had grown solidly for more than a year, but had still failed to regain its level of 2000. Most worrisome of all, job growth, ultimately the key to the recovery, after having finally accelerated from the fall of 2003, had slowed sharply during the second quarter and into the third. Hourly real wage growth had slowed to zero.

At mid-2004 the economy was posing more questions than it was answering, seeming to confront a double bind. Did the decline of the growth in consumer expenditures during the previous months portend a new slowdown of growth, the economic recovery's huge deficit in demand growth finally catching up to it? If so, asset price bubbles across the economy could easily deflate, reducing the wealth effect and destroying business confidence, and threatening another recession. If, on the other hand, more rapid expansion were sustained, would this end up self-destructing, by bringing about inflation and rising costs of borrowing in an economy so deeply dependent upon over-extended households and financial institutions? Would faster growth not also exacerbate the current account deficit, risking a major sell-off of the already declining dollar, with devastating consequences for financial assets of all sorts? Can the economy continue to advance by way of the expansion of a service sector catering mainly to consumption when manufacturing remains weighed down by overcapacity and undercut by ever more potent East Asian competition? Will the financial sector watch its returns dry up as the housing boom is exhausted and the Fed ends its commitment to keep short-term interest rates artificially low, leading to the decrease of interest rate spreads? Will East Asia continue to save the day? In early 2002, Alan Greenspan declared the recession over. But the US economy is far from home free.

August 2004

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Notes
1 The National Bureau of Economic Research declared a recession to have begun in February 2001 and to have ended in November 2001. In this chapter, I use the term 'recession' only in the formal sense of the NBER. Otherwise, I speak of slowdown to refer to the economic slackening that was set off by developments in the second half of 2000 and continued till mid-2003, at least.
2 This was codified in Council of Economic Advisers (2001), as well as the speeches of Fed chair Alan Greenspan (available at the US Federal Reserve Board Web site).
3 Blinder and Yellen (2001).
4 Nobel prize winner Joseph Stiglitz, who as chair of the Council of Economic Advisers presumably had access to government data on the economy, nonetheless joined the chorus of boosters in asserting, preposterously, that 'the height of the 1990s' was a period of unprecedented growth, with 'productivity levels that exceeded even those of the boom following World War IF (Stiglitz 2002). For similar comments see the later 1990s speeches and testimonies of Fed chair Alan Greenspan, available at the US Federal Reserve Board Web site.
5 US GDP *per capita* growth was as fast as that of Western Europe, despite its slower GDP/hour growth, because the growth of US labour force participation and of hours worked per person per year was faster than that of Western Europe.
6 US *manufacturing* productivity growth did increase markedly in the 1980s and especially the 1990s. But, even between 1990 and 2000, it did not clearly out-distance that of its leading rivals: US: 3.9 per cent; France: 4.1 per cent; Japan: 3.7 per cent; West Germany: 3.2 per cent (US Bureau of Labor Statistics 2003: Table 1).
7'Net of interest' means after interest payments are made, meaning in practice after interest has been subtracted from non-financial sector profits and added to financial sector profits.
8 Time series on cash-outs were constructed by Mark Zandi, chief economist at Economy.com, whom I wish to thank for his generosity in making these data available to me (cf. Zandi 2003).
9 This result is based on simulations using Economy.com's macroeconomic model. See Zandi (2003:14 and chart 3).
10 Thanks to Doug Henwood for these figures.

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Part III

Capitalism and social critique in the era of globalization

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10

The role of criticism in the dynamics of capitalism

Social criticism versus artistic criticism

Luc Boltanski and Eve Chiapello

Introduction: the theoretical project

To understand the theoretical project underpinning our research, we must examine the changing fortunes of reference to 'capitalism' in French sociology over the last thirty years. This reference occupied an important place in the literature of the 1960s and 1970s, before declining in the late 1970s, to be practically ignored by the most innovative streams of social sciences in the period 1985–1995.

In the 1960s, this reference to capitalism was inspired, in varying degrees of orthodoxy, by Marxism, which became a dominant paradigm, particularly with the renewal brought about by Althusserism. This sometimes presented itself as a 'back to basics' campaign to restore Marx's thinking in its purest form, and sometimes took hybrid form, combined with other traditions and authors.

The various 'schools' all make a double-edged claim whose contradictory nature is generally neither theorized nor even acknowledged. On one hand, they want to reactivate a positivist concept of the social world and a scientistic view of history. The social world is made up of 'structures' filled with 'laws' and driven by 'forces' of which the actors are unaware, and the course of history itself is not directly dependent on the will of men, who must submit to it. On the other hand, they want to stay as close as possible to the social movements developing over the same period, and to form their critical avant-garde. This means that sociology must be both scientific and critical.

This dual orientation then comes up against the question of moral values and ideals. Its scientific intent, seeking to dig deeper than the actors' consciousness and reveal structures, laws and forces beyond their awareness, can approach moral values and ideals only by treating them as 'ideologies', in other words, from this perspective, more or less hypocritical ways of dressing up a power struggle (generally without actually explaining why such dressing-up devices are necessary). Conversely, the critical intent requires reference to ideals, to be contrasted with the reality that is subject to the criticism.

The same paradox applies for action. The emphasis placed on structures, laws and historical forces tends to play down the role of deliberate action. Things are what they are. But at the same time, the critical intent is meaningless if it is not considered able to influence people's actions, and it is not believed that the actions can themselves change the course of events in the sense of leading to greater 'liberation'. This tension is clear, for instance, in the sociology of domination developed by Pierre Bourdieu, which sets out (1) to uncover the 'mechanisms' by which 'domination', presented as an iron law, operates at any time and any place, and also (2) to advance work on individual liberation.

But if all relationships can in the final analysis be reduced to conflicts of interest or power struggles, and if this is an immanent 'law' for the 'social', why bother to denounce them in the indignant tones of criticism, instead of simply noting them in the detached tones of an entomologist studying an ant colony?

Faced with these contradictions in an environment where social movements were losing strength and Marxism was in decline, some sociology and political science research in the 1980s set out to re-examine the issues of action and moral values (Dosse 1995).

Concerning actions, the aim was to find a language that could describe people's acts not as the realization of a potential inherent in the structures, or as the execution of a predefined programme (which comes down to denying that they are truly actions), but in a way that took account of the options and risks taken in view of the uncertainty of the situations encountered. As for moral values, the aim was to take seriously the normative principles and ideals that people claim to hold, without reducing them to mere ideological masks or evidence of false consciousness. Finally, the same research streams set out to look at the question of social order and how it is constructed, without assuming that it can be reduced to a struggle between forces beyond the control of the actors.

The 1980s sociologies that stressed action and moral values tended to apply a pragmatic analysis of the actions, justifications and criticisms put forward by the people in given situations. They highlighted the steps taken by actors to 'perform' or 'construct' the 'social', to reduce uncertainty in situations, to make and consolidate agreements, to criticize the established arrangements of things, etc. One part of that new sociology was dedicated to the analysis of the critical operations that the actors perform, with the aim of moving away from 'critical sociology' towards a 'sociology of criticism' (Boltanski 1990; Boltanski and Thévenot 1991). Such analyses have been accused of two things: (1) ignoring power struggles and thus promoting an ironic view of the social world, and (2) becoming locked into descriptions of observable micro-situations while simultaneously ignoring the ongoing processes in the broader scheme of things, involving a multitude of actors and taking place over the long term.

The reference to 'capitalism' disappeared from these sociological streams. Stripped of its 1970s status as a key concept, 'capitalism' had been demoted to the rank of a slightly indecent 'rude word', not only because it had connotations of Marxist phraseology which many sociologists wanted to avoid, but because it referred to something too big and too broad for immediate observation and description through one-off examinations of particular situations.

With the benefit of fifteen years of that 'new French sociology', to which we have made many contributions, we have to ask whether sociology can really drop all reference to broad concepts, considered in a long-term perspective, without sacrificing much of the intelligibility it is supposed to confer on the present. A sociology that simply describes the set-up of situations and the way people carry out these existing arrangements may well inspire some kind of 'repairs' to the social fabric on a day-to-day basis by social workers or social 'engineers', but cannot contribute to the construction of wider collective projects, although that has been one of the missions attributed to sociology since it came into being.

In *The New Spirit of Capitalism* (Boltanski and Chiapello 1999) we attempted to construct a framework to unify (1) approaches referring to supra-individual entities with the capacity to affect a large number of people over a long period, that is, approaches following the critical sociology tradition and using the concept of capitalism and (2) approaches originating in *pragmatic sociology,* putting the emphasis on action, on the normative demands in the name of which deliberate actions are undertaken, and in particular on critical operations, that is, approaches belonging to the 'sociology of criticism' current. But rather than describing critical operations in restricted situations examined on a one-off basis, our objective was to bring out the role played by criticism in the dynamics of capitalism, and to construct a model of normative change.

The theoretical framework

The theory of change we have developed has the following features:

1 *It refuses fatalism* and especially materialistic fatalism. History is not made only, for example, by the new information technologies, nor by globalization or the interests of the most powerful. In the Weberian tradition, we pay attention instead to people's actions and the 'good reasons' for the actions of human beings —and of all human beings, not only the most powerful—while remaining aware of the constraints they are under. As has been observed, the mere existence of a technological possibility is not enough to guarantee it will be exploited. The fact that there is domination does not tell us everything about the range of behaviours by the so-called dominated. There is still a margin for freedom. But awareness of the constraints and opportunities faced

by people is not in itself sufficient to understand what people do; the reasons they attribute to their actions also need attention. Pure calculation of interest, or attributing everything to social determinisms, are from this point of view only two ways of denying the importance of the interpretation they apply, the criticism and distancing they are capable of in respect of their experiences, and the reflection, particularly on moral issues, they engage in. These factors are clearly irreducible sources of uncertainty and one of the spaces for their ontological freedom. By placing the criticism and interpretation carried out by the actors at the heart of our understanding of history, we can construct a non-determinist historical model which nevertheless obeys certain general rules.

2 *It is not teleological.* It is very difficult to construct a model of historical change without knowing or fixing the destination point, or having in mind a particular direction for history. We have developed a dialectic model based on conflictuality, in this case concerning the interaction of capitalism and the criticism of capitalism. But this conflictuality does not embody the whole historical movement (a claim often made by models based on the class struggle, for example), and cannot help to predict the future. Integrating the historical uncertainty factor requires development of dialectics with actors having a certain historical autonomy in relation to each other, who are inventive and innovative and thus not entirely predictable.

3 *It is incomplete.* For example, criticism can bring about a crisis in capitalism (as happened in the 1970s), but is not responsible for all its crises. Other factors are involved which are not studied here. Our aim is to cast light on some aspects of the dynamics that have attracted less attention in research, not to produce a totally new theory of how capitalism changes.

The model of change is organized around three key concepts: capitalism, the spirit of capitalism and criticism of capitalism. Each of these concepts is active in the narrative we constructed as a macro-actor making history. Capitalism and criticism of capitalism are represented in real life by many human beings: employers' representatives, executives of big companies, union leaders, local union representatives, writers, etc. The spirit of capitalism can be defined as a result of the interaction between capitalism and its critics.

Capitalism, the spirit of capitalism and criticism of capitalism

Capitalism is characterized by a minimal format stressing the need for unlimited accumulation by pacific means. Capital is cut off from material forms of wealth and can be increased only through continuous reinvestment and circulation. This endows it with a clearly abstract quality that contributes to the perpetuation of the accumulation process.

The second characteristic of capitalism is competition. Each capitalistic entity is constantly being threatened by the actions of competing entities. Such dynamics create a perpetual state of concern. Self-preservation is thus a very strong motivation for capitalists—it is a never-ending catalyst for the accumulation process. Competition does not mean a market with pure and perfect competition. According to Braudel (1981), capitalism does not necessarily require a pure market form: all it needs is the existence of transactions between buyers and sellers.

The last important characteristic of capitalism is wage earning. Many of those who hold little or no capital make money from the sale of their labour rather than from the sale of the fruit of their labour. They own no means of production, and therefore depend upon the decisions of those who do own them.

We have labelled as a 'spirit of capitalism' the ideology that justifies people's commitment to capitalism, and which renders this commitment attractive. In many ways, capitalism is an absurd system: wage earners have lost ownership of the fruits of their labour as well as any hope of ever working other than as someone else's subordinate. As for capitalists, they find themselves chained to a never-ending and insatiable process. For both of these protagonists, being part of the process of capitalism is remarkably lacking in justification. Capitalistic accumulation requires commitment from many people, although few have any real chance of making a substantial profit. Many will be scarcely tempted to get involved in the system, and may even develop decidedly adverse feelings. This is an especially thorny problem in modern economies that require a high level of commitment from their employees, in particular from managers. The quality of the commitment that can be expected depends not only on economic stimuli, but also on the possibility that the collective advantages that derive from capitalism will be able to be enhanced.

Arguably, there has never been any capitalism without a spirit of capitalism. Like any social action, working in a capitalist system needs to be perceived as a sensible activity and, as such, to be supported by a set of values. Although we follow Weberian tradition in placing the ideologies underlying capitalism at the heart of our analyses, our use of the concept of the spirit of capitalism departs slightly from the standard approach. For Weber, the concept of spirit is part of an analysis of the 'types of practical rational behaviours', and 'practical incentives to action', which, because they make up a new ethos, have made it possible to break with traditional practices, develop calculative mentalities, remove moral condemnation of profit and start the process of unlimited accumulation. We aim not to explain how capitalism came about, but to understand how in various periods it has succeeded in attracting the actors needed to generate profit.

Criticism of capitalism is as old as capitalism itself. Capitalism is in need of justification, that is, of a spirit of capitalism, for the very reason that it is criticized. Where there is no criticism there is no need for justification (and therefore no need for anything like a spirit of capitalism). It might even be said that we know more about capitalism thanks to its critics. Marx, who virtually invented the idea that a capitalist system exists, is the most famous example. And the work of economists to counteract and contradict Marxism is a good example of what can be achieved through the need for justification after a strong critique.

We have distinguished between two types of criticisms of capitalism that have developed since the nineteenth century. We label the first 'social criticism'. Here the emphasis is on inequalities, misery, exploitation and the selfishness of a world that stimulates individualism rather than solidarity. Its main vector has been the labour movement. We label the second form of criticism (which Chiapello studied in her previous book, *Artistes versus Managers,* 1998, derived from Grana's book *Bohemian versus Bourgeois*), 'artistic criticism'. This form first emerged in small artistic and intellectual circles, and stresses other characteristics of capitalism. In a capitalist world, it criticizes oppression (market domination, factory discipline), the massification of society, standardization and pervasive commodification. It vindicates an ideal of liberation and/or of individual autonomy, singularity and authenticity.

The concept of a spirit of capitalism allows us to combine within one and the same dynamics the changes in capitalism as well as the criticisms which it has faced. Indeed, we affirm that criticism is a catalyst of changes in the spirit of capitalism. It is impossible for capitalism to avoid being at least somewhat oriented towards the attainment of the common good, as it is this striving which motivates people to become committed to its process. Yet capitalism's amorality means that the spirit of capitalism cannot be solely predicated on what capitalism alone is able to offer, that is, only the capacity for accumulation. So capitalism needs its enemies, people who have a strong dislike of it and who want to wage war against it. These are the people who provide it with the moral foundations that it lacks, and who enable it to incorporate justice-enhancing mechanisms whose relevance it would not otherwise have to acknowledge. The capitalist system has turned out to be infinitely more robust than its detractors, starting with Marx, ever imagined. Yet this is also because it has discovered a road to salvation in the criticisms it has faced. Is it not true, for example, that, along with fascism and communism, the new capitalist order that rose out of the ashes of the Second World War attributes a significant role to the state, allowing for a certain amount of state intervention in the economic sphere? In fact, it is probably capitalism's amazing ability to survive by endogenizing of some of the criticisms it faces that has helped in recent times to disarm the forces of anti-capitalism, giving way to a triumphant version of capitalism.

We insist on the fact that the spirit of capitalism, far from being a simple adornment or 'superstructure' (as Marxist ideology would have it), is central to the process of capitalistic accumulation that it serves, in that it applies constraints to this process (Chiapello 2003). If one were to take these explanations to their logical conclusion, then not all profit would be legitimate, nor all enrichment fair, nor all accumulation (however significant and rapid) legal. Actors' internalization of a particular spirit of capitalism thus serves in the real world as a constraint on the process of accumulation. Second, certain devices are constructed, such as laws and institutions that prevent actors in capitalism from acting 'badly' according to the social norms. A spirit of capitalism approach thus provides a justification both for capitalism and for the criticisms that denounce the gap between the actual forms of accumulation and the normative conceptions of social order.

The content of the spirit of capitalism

As Schumpeter and Marx noted, one of the main characteristics of capitalism is that it is permanently revolutionizing the social order supporting it. As a result, capitalism is capable of taking extremely variable historical forms which continue to be referred to as capitalist because of the persistence of a certain number of central characteristics (wage earners, competition, private ownership, capital accumulation-oriented process, creeping commodification of all social activities, etc.). The actual spirit of capitalism accompanies the capitalist process over a long period, while adapting its content to the different historical forms it takes. It can thus be considered that two levels of justification of the capitalist process are encompassed in the spirit of capitalism at a particular time.

First and foremost, a spirit of capitalism stems from a relatively stable set of arguments, most of which have been shaped by economic theory. There are essentially three types of arguments. Their logic stresses: (1) a type of progress that cannot be dissociated from the current state of technology or the economy; or (2) the efficiency and effectiveness of competition-driven production; or (3) the fact that capitalism is supposed to be an auspicious regime for individual liberties (which can be economic and also political in nature).

Yet some of the explanations that one finds in economics are too general in nature. They do not impel ordinary persons to take up a particular type of lifestyle (i.e. type of profession), nor do they provide people with the argumentative resources that will enable them to cope with the circumstantial denunciations and personal criticisms which they may have to face. A spirit of capitalism will be consolidated only if its justifications are concretized, that is, if it makes the persons it is addressing more aware of the issues that are really at stake, and offers them action models that they will actually be able to use.

Three dimensions play a particularly important role in providing a concrete expression of the spirit of capitalism:

1 The first dimension indicates what is *stimulating* about an involvement with capitalism—in other words, how this system can help people to blossom, and how it can generate enthusiasm. This 'stimulation' dimension is usually related to the different forms of 'liberation' that capitalism offers.

2 A second set of arguments emphasizes the forms of *security* that is offered to those who are involved, both for themselves and for their children.

3 Finally, a third set of arguments invokes the notion of *fairness,* explaining how capitalism is coherent with a sense of justice, and how it contributes to the common good.

The evolution of the spirit of capitalism

When seen in this light, the spirit of capitalism can be said to have undergone a number of historical changes. From the literature on the evolution of capitalism, one can sketch at least three 'spirits' that have appeared, one after the other, since the end of the nineteenth century:

1 The first, described among others by W.Sombart, corresponds to a predominantly domestic form of capitalism. Its main incarnation is the entrepreneurial *bourgeois*. The 'excitement' dimension is manifested by an entrepreneurial spirit; its security dimension by the respect for *bourgeois* morality. In this instance, fairness mechanisms essentially revolve around charity and personal assistance.

2 The second 'spirit' (descriptions of which were found between the 1930s and the 1960s, e.g. in Galbraith's work) focuses on the idea of the large, integrated firm. Its main incarnation is the salaried director. Security is to be achieved through mechanisms such as career development and by the link between private capitalism and the rise of a welfare state. Fairness takes on a very meritocratic form in that it incorporates skills whose certification involves the awarding of credentials.

3 A third form of capitalism began to manifest itself during the 1980s. A new representation of the firm has emerged, featuring an organization that is very flexible; organized by projects; works in a network; features few hierarchical levels; where a logic of transverse flows has replaced a more hierarchical one, etc. This new representation contrasts specifically with the former representation of the firm, one that had focused on an organization which is hierarchical, integrated and geared to the internal realization of activities (vertical integration). This had been a dominant form during the 1960s, praised at the time but subsequently decried (by the 1990s authors) for its excessive 'bureaucracy'. In addition, a new type of commitment has been promised in the economic domain—one that suits the new spirit of

Table 10.1 Three spirits of capitalism

Dimension	*First (end of nineteenth century)*	*Second (1940–1970)*	*Third (since 1980s)*
Forms of the capital accumulation process	Small family firms, bourgeois capitalism	Managerial firms, big industrial companies, mass production, states economic policy	Network firms, Internet and biotech, global finance, varying and differentiated productions
Stimulation	Liberation from local communities, progress	Career opportunities, power positions, effectiveness possible in 'freedom countries'	No more authoritarian chiefs, fuzzy organizations, innovation and creativity, permanent change
Fairness	Mix of domestic and market fairness	Meritocracy valuing effectiveness, Management by Objectives	New form of meritocracy valuing mobility, ability to nourish a network, etc.; each project is an opportunity to develop one's employability
Security	Personal property, personal relationships, charity, paternalism	Long-term planning, careers planning, welfare state	For the mobile and the adaptable, companies will provide self-help resources, to manage oneself

Note: The rest of this chapter talks of the 'first', 'second' and 'third' spirits of capitalism with reference to this table, which concerns only late capitalism. Under no circumstances are we suggesting that the first spirit referred to in this way is the spirit of the original capitalism, the only one of interest to Max Weber.

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capitalism. As opposed to the type of job security that was on offer during the 1960s, involving a meritocratic approach that was based on the achievement of negotiated targets, careers are now viewed as a series of fulfilled projects. Job security is now predicated on the 'employability' that a person develops as he or she gains experience.

How and why the spirit of capitalism changes

In general, the forms in which capital accumulation exists at a given time greatly depend on the type and virulence of the criticism levelled at it. More precisely, we analyse the development of the second spirit of capitalism as a reaction following the economic and fascist crisis of the 1930s and of the Second World War. It developed through the recuperation of proposals coming from the social criticism (welfare state, collective bargaining between employer organizations and unions, control by the state of the allocation of the value added, planning, budgetary control, etc.). Symmetrically, the development of the third spirit of capitalism can be seen as the result of the recuperation by the business enterprises of propositions of the artistic criticism, like individualization of performance evaluation and careers, reduction of direct hierarchical control, etc. This recuperation appeared as a realistic strategy to employers when they had to cope with the governability crisis of the 1970s.

Criticism plays several roles in the change process. First, it produces ungovernability, a situation which naturally encourages changes of method, particularly for business managers, in order to regain the capacity to govern. It can itself produce a crisis, as occurred at the end of the 1960s. (The governability crisis came before the economic crisis, which only happened in 1973.)

It also produces ideas, with the essential part of the reforming vision probably concentrating on the problematic aspects revealed. Some of these ideas will be taken on board and integrated into management practices, maybe because while satisfying the critique they also serve profit, or because they provide a means of motivating people in a change process (even if the change is desired for reasons other than the pressure exerted by the critique), or even because this is the only way to silence criticism when it is persistent and inventive, and its virulence is beginning to undermine employee motivation and cause disorganization in the enterprise. It can thus be said that a successful critique is fated to be taken over and adapted.

Criticism contributes to construction of the normativity that accompanies capitalism, and consequently justifies it while placing constraints on it, making capitalism incorporate the values which formerly served to criticize it. By this shift, capitalism adopts the value system of its enemy to survive, making a compromise between its tendency to accumulation and the necessity to be able to commit enough people to function and so to response satisfactorily to criticism.

Finally, criticism can be a source of displacement, motivating capitalism to 'escape' to another method or location. If the cost of responding to criticism is considered too high, and if capitalism can find another way of making money, organizing production and managing its work force, it will do so. The 'delocalization' of factories to countries with lower wages and social security costs is a typical example of displacement. Criticism can even provide an impetus to this process of displacement. Because capitalism faces more than one stream of criticism, it can escape from certain criticisms by a move which provides a satisfactory response to another kind of criticism. This is exactly what has happened in France with the change of capitalism over the last twenty years. Capitalism experienced certain displacements, conducting a revolution in its way of organizing and thus 'escaping' the social criticism. But it did so with the help of the artistic criticism, which provided the meaning and the grounds for change, guaranteeing widespread commitment to the change process.

We illustrate our model of change in the following sections by a presentation of the change in France from the first to the second spirit, then the change from the second to the third.1 Of course, we are not saying that what has occurred in France is an example for the rest of the world, or that the models which we have built on the basis of the French example possess *per se* any universal validity. Nevertheless, we have good cause to believe that relatively similar processes have marked the development of the ideologies that have accompanied capitalism's redeployment in other industrialized countries—and that our model merits being tested to see whether it can help cast light on other countries' historical circumstances.

From the first to the second spirit of capitalism

To understand the changes involved in the shift from the first to the second spirit of capitalism, we need to start by identifying the reforming ideas developed in response to the economic crisis of the 1930s. At least two currents are important (corporatism and *planisme*), because their spiritual descendants were to be visible in the 1950s among the people who made post-war France what it was. These two reform currents can be seen as variations within the family of social criticism, or more precisely as a compromise between the preoccupations of social criticism and the continuation of a capitalist regime. But although they share the same indignation at the poverty of the workers and the number of unemployed people at the time, they disagree upon the kinds of solution to be proposed. The corporatists were inspired by the traditional organization of work,2 whereas the *planistes* were looking for a more scientifically organized production.

Corporatist doctrine places the collective interest at the centre of society; it is thus in direct opposition to free-market capitalism. Already deeply rooted in European culture (Cotta 1984), this movement must also be seen in the light of the rise of fascism, which took place at the same period in Germany and Italy. Corporatism's big idea was the recreation of corporations, similar to the former guilds *(métiers),* professional bodies made up of individual practitioners of the same craft, regardless of class, i.e. workers and employers together.

These bodies would assume the task of arbitrating industrial disputes, fixing work conditions, controlling prices, and determining the quality and even the quantity of the output. And in a corporatist state a system of professional representation elected an economic assembly that bypassed party politics and strengthened the republic's competence in economic affairs.

(Kuisel 1981:103)

Nevertheless, for corporatists, the state was not supposed to direct the economy, as only corporatist organizations were considered competent to do so.

Corporatism, which stems from Catholic social doctrine and the Christian critique of materialism and individualism, can be seen as a reaction to other concepts of society that were put forward in that period, namely the free-market economy, accused of generating chaos, selfishness and materialistic attitudes, and Marxism, criticized for stirring up class hatred and destroying social solidarity. Trade unionism was no longer considered acceptable, since it expressed the same class struggle. Corporatism advocated replacing the working-class revolution by a spiritual revolution in which the different social classes, once organized, should work together. Turning its back on the impersonal nature of large-scale capital, the corporatist society would be based on the small businessman and his patriarchal virtues: personal responsibility would be directly invested in the job to be done, the capital and the jobs would be in the same hands, and employment relations would be magically transformed by paternalism (Boltanski 1982). The aim was thus to restore social order and harmony within business organizations.

Corporatists were not averse to a certain degree of interventionism—in fact some also subscribed to the planners' philosophy—but the balance between production and consumption, or other economic problems, was nevertheless considered secondary. 'They were social conservatives who wanted to revive such cherished values as hierarchy, family, discipline, class conciliation, religion and work' (Kuisel 1981:102).

This ideological current reached its zenith under the Vichy regime, which 'officialized as State ideology, and in its institutions gave concrete form to, most of the themes dear to the educated Catholics of the nineteen thirties' (Boltanski 1982). After the war some of these ideas persisted, but with profound transformations. From 1950 on, the new ideologies from America reworked these old ideas.

One of corporation's most noticeable impacts during the 1930s lay in the support it provided to restrictive practices and cartels between producers. Rather than being governed by market forces, the economy could be managed collectively in an optimal manner. Cartels were not a new phenomenon under corporatism, but corporatism provided them with justification.3

While corporatism sought to 'overcome the anarchy of individualism' by, as Kuisel (1981:102) puts it, restoring the organism's natural cells, the *planistes* were looking for a way to make the economy work. They wanted to preserve the free-market system by adapting it and reducing the social tensions it generated. They believed that the economic system needed structural reform to combat the violent economic disorder created by market capitalism.

Some form of permanent, rational, economic management was needed to supplement market forces and bring production and consumption into balance.... In essence the *planistes* sought to ground an economic order in a rational, man-made economic budget and an institutional system of direction that was at odds with a market economy.

(Kuisel 1981:98–9)

The main tool of this new order was economic planning. Kuisel (1981) distinguishes two major schools in *planisme*. neoliberalist planners and syndicalist-socialist planners.4 These trends form the basis of the interventionism that took place after 1945.

Technocracy is another expression of *planisme;* the term appeared only after 1945. It refers to a certain concept of decision making (Kuisel 1981) according to which there is only one right solution, and that can be found by experts. This is shown primarily in the desire expressed by certain intellectuals to introduce a 'planned' sector, which would contribute to the efficient regulation of the economy (Coutrot 1936). Management of this sector would be entrusted to a 'body of men governing the pace of the economy without having any personal interest in any of the enterprises, but guided only by team spirit as regards the people under them'. For its advocates, this planning would make it possible to establish 'fair prices', make accurately efficient use of production resources and achieve 'the distribution of prosperity' *(ibid.)*. Taking up a famous phrase, Coutrot says what is needed is to 'replace government of men by administration of things'.

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The development of technocracy and *planisme* in the 1930s continued after the war with French-style planning and the Keynes-inspired policies that were in operation at the time. Cotta (1984) partly explains this as the pursuit of corporatist ideas stripped of the Vichy mantle: 'what is [planning] other than the coordination of the major corporations—whether entire professions or large companies, public or private, or the main administrations—by a public power represented in this case by the Commissariat Général?' But in contrast to the 'back to the land' policies of the Vichy regime, the post-war reformers chose a 'forced march' industrialization model first to rebuild the country, then to catch up with other industrial nations. All production facilities required modernization, to be achieved by means of highly ambitious objectives concerning the investment/consumption ratio, credit and currency control, nationalization or state supervision of businesses that were essential to national reconstruction: energy, banking, insurance, transport, iron and steel and machine tools. *Planisme* and technocracy imposed experts to manage economic affairs.

After the war, the French environment moved towards a 'new liberalism marked with strong statist and technocorporatist features' (Kuisel 1981:187). The ideas were quite similar to pre-war thinking, except that technocracy was now totally converted to Keynesianism,5 and there was massive importation of American concepts of management.

Both currents share the desire to find a third way between economic liberalism, considered to have seriously damaged their society, and Soviet communism, which was an important reference for some of the left-wing politicians of the time.

The transformation of the spirit of capitalism

The spirit of capitalism of a period, according to our definition, promises three things: security, stimulation and fairness. Below we see how these three dimensions were affected over the period studied, generating a significant change in the spirit of capitalism.

The promise of security

In the first spirit of capitalism, security was guaranteed by the very form of the economic fabric, woven from small family-run businesses building on local networks and trust of the kind found in family relationships. Security came about through protection of personal relationships within the family in its broadest sense (if the servant-employer relationship is taken into account). In bigger enterprises, active paternalism by the company director provided the workers with a form of protection.

But this form of security, specific to the first spirit of capitalism, was shattered in the inter-war period, which saw the development of financial

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capitalism and large companies that turned their backs on family-business capitalism, and also the economic crisis of the 1930s, resulting in a significant fall in paternalistic protection. The reformers did not all proffer the same solutions in this situation. *Corporatism* was more interested in the old form of the promise of security, and its proposals were along the lines of the abolition of international, impersonal financial capitalism in order to go back to capitalism founded on small businesses and personal relationships. In contrast, the *planistes* and Taylorian economists thought it was possible to build a new form of security through the rational organization of labour and planning.

The corporatists were the first to win power, and the nature of the promise of security did not change in the short run. But the situation altered after the Second World War: corporatism was completely discredited because of its alliance with the Vichy government and its collaboration with Nazi Germans.

The hopes in the construction of a new form of security through planning took concrete form in the post-war period. The Keynesian state adopted the philosophy of *planisme*. However, the promise of security also developed, becoming much more elaborate in form with the 'Fordist creed' (Boyer 1990), which was extremely important in the 1950s.

The promise of stimulation

The 'first' spirit of capitalism declared its faith in technical progress, and promised fulfilment for the entrepreneur. This promise appears to have remained unchanged in the 1930s, even though, as we have seen, the spirit of capitalism had already begun a transformation in its proposals concerning security. Taylorian engineers continued in the tradition of the Saint-Simonians, referring to previous experiments in French-style management. The enthusiasm of the 1930s was generated by the ever greater progress being achieved by mankind in controlling the world through reason, science and technical knowledge. From this point of view the *planistes* carried a promise of stimulation totally in keeping with the first spirit of capitalism. This ambition to control the world through science, including management science, was much less marked after the Second World War. The horrors of Nazism and the atomic bomb disillusioned the champions of technical knowledge and the liberation of mankind through science. The promise of stimulation had to change in the 1950s. Now, the promised momentum was expected to come from decentralization of responsibilities and personal fulfilment in the workplace.

The productivity missions were one of the most important places where the new promise of stimulation was formed, through importation of American human resource technology.

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The promise of fairness

A dual form of fairness underpinned the first spirit of capitalism. First, emphasis was placed on a market type of fairness (Boltanski and Thévenot 1991), a type of Social Darwinism where the most competitive survives. This form of fairness is coherent with the free-market ethic prevalent in late nineteenth-century and early twentieth-century France. The market was believed to be self-regulating, and underperformers were eliminated. This form of fairness cohabited with a highly contrasting 'domestic' fairness (Boltanski and Thévenot 1991), which emphasized fidelity to tradition and respect for the father figure. People were treated according to their position in the domestic hierarchy and their respect of bourgeois precedence. The dutiful son inherited his father's place because he was the heir, not because he was competent, as an 'industrial' fairness might require, nor because he was the most competitive, which would have been in keeping with market-type fairness.

This curious alliance contained in the promise of fairness of the first spirit of capitalism was greatly affected by the growing criticism of the free-market economy in the 1930s, a great motivation for seekers of the 'third way'. Domestic fairness, meanwhile, was never really challenged—although that was to change significantly in the 1950s.

Over the whole period, a new promise of 'industrial' fairness—characteristic of the second spirit of capitalism—was gathering force. This was built on a hierarchy of competence, selection and promotion of the best performers, an ideal social order capable of legitimizing the new social group formed by professionals and managers, which by definition, could not claim legitimacy by ownership as grounds for its authority.

The period following the Second World War extended this promise, but added to it the affirmation of a more important place for Man in the production process, and associated it with the Fordist creed and its promise of fairer distribution of the fruits of growth.

Analysing the shift from the first spirit of capitalism to the second, we see that the transformation did not happen at the same rate in all dimensions. The first spirit appears to have reached a crisis when its promise of security turned out to be incapable of standing up the depression of the 1930s, and market-type fairness was challenged by the failures of the free market system revealed by the same crisis. The solutions to each of these dimensions placed priority on rationalization systems, whether in the form of Taylorism or in the form of planning. These new systems were seen in the 1930s as capable of calming the newly emerging anxieties concerning security and fairness, while being a natural continuation of the first spirit in their enthusiasm for scientific knowledge and confidence in technical progress. Security by forward planning and fairness by calculation were contemplated, but these proposals were effectively implemented only after the war. It was also only after the war that the promise of stimulation was gradually reconstructed around the central concept of personal fulfilment in the workplace through decentralization of responsibilities, and the break from the first spirit of capitalism was thus finalized.

As far as the shift from the second spirit of capitalism to the third is concerned, we think that it also took place at differing paces for the various dimensions. However, this time, the stimulation dimension has been the most significant, the first to enter the crisis and the first to remould its proposals, while the new promises of fairness and security are taking their time to settle into practical form (Boltanski and Chiapello 1999).

From the second to the third spirit of capitalism

Here again a crisis can be seen as the starting point of the transformation. But this time it is a governability crisis and not an economic crisis as the one of the 1930s.

The governability crisis

From 1965 to 1975 there was a very significant increase in the criticism of capitalism. 1968 was the absolute peak, but this high point lasted for a period of several years. This criticism threatened to generate a major crisis in capitalism. Far from being nothing more than a verbal outburst, the criticism was accompanied by waves of strikes and violence. It disorganized production in such a way as to diminish the quality of industrial goods and, according to some estimates, cause a doubling in wage costs. This high level of criticism alarmed many capitalist institutions' leaders. Employers, in particular, through the voice of their representatives, complained of a 'crisis of authority' and of the refusal to conform to work discipline and/or adhere to a firm's objectives. This was said to be especially rife among the youth of the time.

One significant specificity of the 1968 crisis was that both types of criticism, *artistic criticism* and *social criticism,* were equally important in the process. In previous crises, artistic criticism had been expressed only in circumscribed intellectual circles. This transformation can be attributed to the rapid increase in the number of students during the 1960s, and to the increasingly important role that managers, engineers and technicians (all of whom possess a significant amount of cultural capital) were playing in the production process.

In the French business world, artistic criticism manifested itself mostly through demands for self-management (mainly expressed by the CFDT union), that is, through demands for employee control of firms' management, and for enhanced personal autonomy and creativity. Such demands were voiced for the most part by technicians, engineers and executives. In contrast, traditional social criticism demands were voiced primarily by the

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CGT union (a union that was closely related to the Communist Party, dominated by skilled workers and in the majority on most shop floors).

The reactions to the crisis and the recuperation of the criticism

French employer organizations successively tried two very different ways of exiting from the 1968 crisis. Around 1968–1973 a first exit strategy consisted of strongly rejecting those demands that were related to artistic criticism, whilst remaining attentive to the demands that were related to social criticism. Employer organizations therefore sought to come to terms with the unions through a process that had been established during the 1950s (negotiations within a collective bargaining framework, negotiations at a national level under state control, etc.). And the unions, who were also frequently disorientated by a social unrest that they themselves had not initiated, played the game. These negotiations led to increases in the country's lowest wage levels, a lessening of wage disparities, and to the signing of a number of national agreements that strengthened workers' job security.

The growing recognition of these socially critical demands (and of their high economic and symbolic costs) did little to put an end to the crisis. Criticism remained acute, as did the disorganization of production. Around 1975 employer organizations, reacting to lower profits following the first oil crisis, began to adopt a new strategy. This involved the abandonment of established bargaining places and traditional concerns (where social criticism was being voiced), with employers starting to listen to critical demands proceeding from the 'artistic criticism'.

Change was especially apparent in the organization of work. A great many large companies innovated and experimented in an effort to 'improve working conditions'—a phrase that became a general slogan of employer organizations during the latter half of the 1970s. At first these changes were implemented locally and almost haphazardly. Subsequently those that proved to be successful were diffused and coordinated by employer organizations. These organizations, influenced by sociologists and by the new 'kinds' of consultants who came out of the 1968 movement, formed a new understanding of the crisis, interpreting it as an uprising against obsolete (i.e. Fordist) working conditions and traditional forms of authority.

To a large extent, these changes involved acknowledging the validity of the demand for autonomy. In addition, advantages that had hitherto been restricted to executives (autonomous teams, flexible schedules, bonuses, efficiency-related salaries, etc.) were generalized to all categories of management. At the production organization level, similar types of change took place. A succession of transformations broke down large integrated companies into a series of small units that were connected through a network of contracts (temporary work, subcontracting, outsourcing activities that did not belong to the company's core business, etc.).

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In short, this second exit strategy involved abandoning the previous system of industrial relations in favour of a series of *displacements*. These displacements produced a new system (for example, new requirements for operatives, whose ability to communicate became an important prerequisite for their selection). During the 1980s, one of the consultants′ and analysts′ main tasks was to coordinate and make sense of these changes, notably by interpreting them through the language of networks, itself borrowed from the field of social sciences. The second exit strategy succeeded where the first had failed. Displacements gave management the opportunity to control the work force once again. It unfettered capitalism, and helped it to renew its expansion. The new capitalist deployment was greatly facilitated by critics′ silence during this period of time. And to a large extent, this silence was the product of preceding displacements, on two levels at least. Social criticism, usually voiced by the principal labour unions, was disarmed by a form of change it could not interpret. It had been built in an isomorphic relationship to its opponent, the large integrated firm. It therefore lost its ability, in the new process, to exert pressure on employers′ decisions. Artistic criticism, on the other hand, lost its edge for a very different reason. Many of those who had been voicing this form of criticism at the time of the 1968 crisis had become satisfied with the changes that had taken place in the organization of work and, more broadly, in society. The incorporation of many components of artistic criticism into the new spirit of capitalism had deprived earlier critics of reasons for feeling discontented—and rendered them insensitive to the superficiality of the achievements of the so-called liberation movement. Moreover, in the socialist era that has been France′s hallmark during twenty years since 1981, many supporters of artistic criticism have been coop ted into the power elite.
Capitalism′s renewed growth during the 1980s was largely due to its ability to overcome the constraints that were a part of the second spirit of capitalism, and render them obsolete. Changes in the organization of work, and silence from disoriented critics, enabled capitalism to spread once again, freeing it from most of the constraints that it previously had to face. One outcome of this process was that the wage/profit ratio again began to benefit capital. The cost was rising inequality, precarious working conditions, and the impoverishment of many wage earners. Worsening conditions for a great many individuals brought criticism back to life in the 1990s—as shown by the wave of strikes that hit in late 1995. Criticism′s current renewal is mostly apparent in the field of social criticism, with artistic criticism remaining silent or becoming standardized (hence inefficient). This renewal of social criticism raises the question of how the new capitalist system can be tamed and rooted in new regulations—one of the main concerns being the way in which flexibility can be structured.
Of course, this is the history of France, a country characterized by almost uninterrupted Socialist rule from 1981 to 2001, and therefore a

society that has handed power over to those who in 1968 had been demonstrating in the streets under the banner of artistic criticism. The history of Great Britain is a very different one, having been marked by the Thatcher revolution. Indications are that different organizational models and spirits of capitalism will ultimately prevail in each of these two countries: that they will be more market-oriented in Great Britain (in the sense that our justificatory regime analysis lends to this term) and more network-oriented in France.

To complete our account of the change model we developed, we must conclude by presenting a notion central to the whole model and to the relationship in this analysis between the macro level of the changes in capitalism and the micro level of what actual changes took place in the organization of work: the concept of trial.

The concept of trial

Definition of the concept of trial

The concept of trial (*épreuve* in French), refers to the social arrangements organizing any testing of people's abilities resulting in arranging tested people in order. This order makes it possible to allocate social goods (money, power, the authority to issue orders, etc.).

Significant trials relating to the distribution of social goods generally have claims to legitimacy because they organize and create the social system that, to be long-lasting, should not be called into question too easily. The term *institutionalized trial* refers to a trial that is considered to be important for the distribution of social goods within a society and that, for this very reason, has claims to legitimacy. If there is a certain amount of agreement about the way it is conducted, these claims result in belief in its legitimacy. The institutionalized trial is therefore also a *legitimate trial,* i.e. it has claims to legitimacy and it is organized in such a way that there is agreement on this organization (which gives it the claimed legitimacy). Finally, because it is legitimate, the legitimate trial tends to confer legitimacy on the social system instituted by it.

The first requirement for a trial to be considered legitimate is to present itself as a *test of something* that is precisely defined before the trial. Examples are supplied by academic examinations and sporting contests. Persons entering them are measured in terms of their strength in French or mathematics, the javelin or the high jump. Imagine how little credibility an academic examination would have if nothing was known about it in advance: neither the subject nor the programme, the evaluation criteria, the qualifications of the examiners, the place or the duration. Is it conceivable that society would enable its future elite to be selected on this *ad hoc* basis and that the people under their control would agree to be governed by people chosen almost at random in this way? If a trial is to be legitimate, the strengths upon which it focuses must undergo a process of *qualification* and *categorization*. The case of sporting trials provides a good illustration of this process. As Elias and Dunning noted, 'The history of each sport is...fundamentally the history of the formation of sets of rules of an increasingly detailed and precise nature, which impose a unique code on forms of play and confrontation previously on a strictly local or regional basis' (1986:16). In this case, rules are intended to specify the type of strength applied in the trial and the way the trial should be arranged in order to reveal this type of strength and not others. This aims at preventing competitors from applying other types of strength and therefore equalizing all contestants' chances, so that success or failure can be attributed to their merit alone.

But rule making does not cease as soon as the discipline is clearly established in its own right. The contestants' efforts to win result in the introduction of modifications to the techniques used, frequently of a subtle form, whether in using their bodies or in deploying the implements used (bars, bicycles, javelins, etc.). These changes may not be noticed for some time and be conducive to victory, but after a while, they become subject to rules. This mostly results from the criticisms of unsuccessful contenders who have not benefited from the changes, and who consequently consider that losing was unfair, since the conditions of the trial were unilaterally modified. For example, in 1956 a Spanish athlete, Érausquin, introduced a new way of throwing the javelin, described as 'rotating', inspired by a traditional Basque sport in which treetrunks were thrown. His success was striking. However, the technique was prohibited fifteen days before the Melbourne Olympic Games on the grounds that (1) it was 'dangerous' (it was easy for the javelin to leave the set course and to hurt spectators) and that (2) it radically modified the 'physical abilities previously expected' of a javelin thrower (Vigarello 1988).

Therefore, changes in sporting rules are to a great extent due to the meritocratic requirement to equalize opportunities. The trial should be arranged in order to reveal the merits of competitors on as individual a basis as possible, while limiting inequalities resulting from chance or random factors as far as possible. For the same reasons, contestants should be of approximately equal strength before the event. In sports where success is determined by unchangeable physical characteristics, such as height or weight, this is brought about by introducing categories (as in the case of boxing) or, more generally, by organizing a selection procedure including successive sets of trials; only those ranked best in the previous trials being admitted to the final contest.

Regarding the social selection process in general, the existence of an organized sequence of trials also has a practical aspect: it limits the number of contestants in each event. Thus the 'judges' are not overwhelmed by a large number of contestants, between whom it would be physically impossible to judge, for reasons of mental overload or simply of time.

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The major problem associated with any institutionalized trial is the impossibility of designing a trial that is completely perfect and valid over time. This means that the organizers of the trial are required to modify it on a continuing basis, in order to take account of its criticized unfairness. A trial can be regarded as legitimate only if its arrangement specifies its purpose and if its implementation is controlled in order to prevent its illicit exploitation by unknown or at least unexpected forces. Criticism reveals what is unfair in the trials, namely the abilities mobilized by some of the examinees without the knowledge of others, giving them an unfair advantage. In such cases, the most frequent claim and aim of criticism is to have the fairness of the trial increased (by what is referred to as a 'tightening of the rules'), through increased standardization and/or the extension of its regulatory or legal framework. Other less frequent strategies of criticism towards fairness will be examined below.

The concept of trial described above integrates two concepts of trial developed by French sociologists over the past twenty years. The first is the 'trial of greatness', according to Boltanski and Thévenot's meaning (1991). In their work, a trial is what makes it possible to settle a dispute on the 'merit' (value) of individuals in a given situation. The protagonists agree on an arrangement that will enable them to test this merit, the outcome of which will settle the dispute. A trial of greatness makes it possible to compare particular individuals using *equivalence conventions* that take into account only a single aspect of their existence. A particular individual is declared to be 'equivalent' to another individual in terms of his/her productivity at work, for example. The exercise of judgement assumes a two-way flow between a level occupied by specific individuals in all their variety and disparateness and an abstract and conventional level (the level of the values). This conventional level defines the criterion of judgement (in the above example, the productivity measure).

The second concept is the 'trial of strength' as worked out by Latour (1984): the trial of strength is what happens when forces meet. Latour's concept of trial is associated with a representation of the world as a network. One major characteristic of this concept is the desire to remain, as far as possible, at the level of singularity and therefore at the level of the multiplicity of individuals and relationships. In a world of this type, there is *a priori* no overhang position and every event or relationship is always situated on a more or less local level. We are in 'the plane of immanence' (in the meaning of Deleuze), within a single-level space; what happens in the trial and the subsequent movements cannot be justified in general terms, as in Boltanski and Thévenot's conception above. According to Latour's approach, actors referring to values, laws, equivalence conventions, etc., are viewed as mobilizing resources to gain advantage6 in trials of strength in which they are involved. The world is represented only through strengths, with justice being just one of them. There are only relationships of strength and the very idea of the legitimacy of a social trial is nonsense.

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The concept of trial as constructed by Boltanski and Chiapello (1999) therefore aims to combine the two concepts of 'trial of greatness' and 'trial of strength': it regards all trials as trials of strength within the meaning of Latour but it considers that some of these trials, which aim at legitimacy, tend to be clarified, organized and regulated so as to approximate to the ideal of the trial of greatness. It is therefore possible to refer to *institutionalized* trials (as in the case, for example, of political elections, academic examinations, sporting events and negotiations between employers and trade unions), which are defined and recognized as such. Those involved in them cannot be unaware that their judgements and/or actions in such situations have lasting effects. However, as noted above, no institutionalized trial can claim to be so well regulated that no unknown force occurs in it. It is always possible to find elements which support a description of the trial, not in Boltanski and Thévenot's terms, but in those of Latour. Criticism arises precisely along with the strengths which are not 'filtered' by the existing rules of the trial, and therefore undermine fairness.

Latour's concept of trial also makes it possible to define as trials moments of confrontation that are not institutionalized, controlled, codified or regulated but in which something none the less happens and results in the transformation of the confronted entities. These are not legitimate trials but moments of pure testing of strength. The everyday life of organizations is packed with this type of trial. A particular manager gives a talk on a particular subject on a particular day. It has not been established in advance that the day in question will be a key date for the rest of his/her career. In his/her opinion, his/her career will rather depend on his/her ability to fulfil the targets imposed on him/her by his/her boss at the start of the period. Moreover, no one around the table realizes what is happening, not even those who will actually decide on the manager's next appointment. However, s/he is so brilliant (or awful) that his/her future will be transformed as a result. There has been a confrontation; it is difficult to define what happened, but everyone's position has been redefined.

Highly formalized trials have advantages but also drawbacks in relation to everyday life disputes. By limiting the number of participants involved and making the protagonists agree on the challenges and the aspects to be evaluated, they make it easier to avoid violence, exit from dispute and return to agreement. On the other hand, they place constraints on the individuals, who have to define and limit the grounds of their disputes and, therefore, have to sacrifice everything that is vague, ambivalent and uncertain. Categorization activities occur at all levels in the transformation of a trial into a trial of greatness: these activities specify the classes of entities allowed to participate in the trial (cf. weight and age categories in sport) as well as the classes of abilities, the application of which is allowed, and those prohibited. Furthermore, measuring the outcome of the trial itself presupposes the application of categories of judgement.

Trials of this type are also permanently open to improvement and therefore to criticism. The work of refinement is actually without end, because the relationships in which individuals may be apprehended are ontologically unlimited. Since it is still possible to unveil an element perceived as unfair in the running of a trial, in practice trials can be placed in a continuum between a 'pure' trial of greatness and a 'pure' trial of strength.

The role of criticism in the change of trial systems

As mentioned above, criticism is responsible for continually keeping an eye on a society's main trials, ensuring that institutionalized trials are run according to the agreed format (and that deviance is denounced). The level of criticism applied to a trial does not depend exclusively on its characteristics. Criticism is socially constructed and the outcome of a particular period of history. As we saw, some periods of history, like the 1970s, were dominated by an extremely high level of criticism, while others, such as the 1990s, were marked by a very low level of criticism. Some trials at the workplace that were criticized in the 1970s would perhaps no longer be criticized today. Furthermore the level of criticism varies between companies; it particularly depends on local trade union activity. Not all companies experience the same level of conflict. The local presence of a structured and well established industrial movement is one condition for an increase in criticism, since such a presence 'consolidates' reasons for discontent that would otherwise only result in a weaker form of criticism. Some individual factors also determine the intensity and type of criticism: for instance, the personal history of individuals, their place in networks (which favours social comparison, and then equity perceptions), their opportunities, etc.

Criticism may take the two main forms identified by Hirschman (1970): exit or voice. The form of critical expression chosen by the people involved depends on many factors: opportunity for external mobility, belief that one will be listened to, relative position of strength, personality, loyalty to the company, etc. A third form of criticism may be considered: this is the 'weak' criticism of people without the power either to leave or to protest without risk. They may take refuge in a form of resistance, a wait-and-see attitude, or cynicism, which pose real threats to the social system even though they are less visible than other types of criticism. As such, we can consider that there are two ways of criticizing trials.

The first has a *corrective* purpose. The criticism unveils that which during the trials in question has transgressed the fairness requirement, and more particularly, the strengths that some of the protagonists, unknown to the others, have started to mobilize (thus gaining an undeserved advantage). The purpose of criticism in this case is to improve the fairness of the trial (we would say, to tighten it up); to ensure that the trial is rooted in widely accepted conventions; and to enhance the regulatory or legal framework within which it is encased. Institutionalized trials such as political elections, scholastic examinations, sporting competitions, face-to-face negotiations between social constituencies, etc., are other products of a type of work in which fairness is enhanced through a process of 'purification'. Their aim is to admit only those strengths that are deemed to be consistent with that particular type of trial. Nevertheless, such trials must continually undergo further improvements and are therefore subject to criticism. The purifying process is in fact an unending one, in as much as ontologically there are an unlimited number of relationships that can be used to judge the people involved.

A second way of criticizing trials might be termed the *radical* method. Here the challenge is no longer to correct the trial so as to make it fairer but to eliminate and possibly replace it with another one. This time it is the very validity of the trial itself (and thus the factor that conditions its very existence) that is being contested.

At this point, we should discuss possible outcomes for corrective criticisms of any given society's central institutionalized trials. The consequences of criticism are multiple and in all cases result in difficulties in governing. Too many people resigning can disrupt work organization and leads to costly hiring, training and induction of new personnel, not to mention the loss in expertise of those who have left. Too much resistance and bad spirit fundamentally undermines the company's efficiency. And the expression of protestations frontally attacks the legitimacy of the order in place.

When a particular trial is strongly criticized, its legitimacy and, further, the legitimacy of the associated social system are undermined, causing problems for at least two types of protagonists: (1) the protagonists who have successfully completed the trial in question, (2) the organizers of the trial. The legitimacy of the former depends mainly on the preservation of the legitimacy of the trial, while the latter feel responsible for the general acceptance of the trial and of the social order 'produced'. Therefore, if a trial is strongly criticized, the risk in terms of loss of legitimacy and of authority (refusal to be dominated, in Weberian terms) is likely to be perceived as high enough to suggest a reaction. Moreover, if the trial being criticized is considered to be legitimate (i.e. if its justification revolves around the same normative positions as those invoked by criticism), the administrators of the trial cannot be unreactive to the critical comments.

The first reaction possible is to *ignore* the criticism. Obviously, if the criticism is recurrent and concerns lots of people, this reaction can be dangerous. However, it is not rare and generally those exposed to criticism choose the remarks they prefer to ignore and those to which they will respond.

When criticism is recurrent and potentially damaging, the trial's organizers must respond to it, for the legitimacy of the trial to be maintained.

They can try and show how criticism is wrong, and provide convincing evidence. This operation aims at *denying* any basis to the criticism. For example, the protesters may be told they do not have a global vision of the situation and that with additional information there are no grounds for an injustice argument.

The third type of reaction consists of *tightening up* the trial, cleaning it up in such a way as to restore its coherence with the underlying fairness model. This is what happens, for example, when, following a series of criticisms, an examination originally revealing the names of the people being tested becomes an anonymous one.

Finally, there is a fourth possible reaction to criticism, in the form of trying to circumvent, instead of answering, it. It may be in some actors′ interest for the trial to lose some of its importance, i.e. for it to become relatively marginalized. This is the case when it becomes too difficult to respond to constant and renewed criticism, which sustains permanent tightening up and, further, increased cost. This type of reaction involves a *displacement,* which leads to temporarily disarming criticism by presenting it with a world that it does not know how to interpret.

Displacement consists of establishing alongside the trial under criticism another set of trials not recognized as such but the importance of which gradually becomes central to the debate, without actually having been formally identified as such by the criticism. The latter concentrates on the former trial which falls into disuse without the fact that the rules of the game have changed being realized. The new set of trials is often not instituted, not visible and thus not very fair. An example of this type of displacement is the evolution seen in France over the past twenty years in the remuneration and selection methods of manual workers. Training seminars have progressively become new hunting grounds for recruiters, without becoming explicitly acknowledged as such. They have been used to reveal workers possessing good oral and written communication skills, i.e. skills hitherto not essential, have suddenly acquired a new significance. Workers who did not come up to standard in these training sessions were rapidly put on the redundancy list. These new trials, centred around the identification and evaluation of new skills (and thus not featured in the old trials) lead to a change in the composition of the work force over a period of time and to a social order based on a new type of legitimacy. Critics, and in particular unions, until then occupied in different struggles, were myopic on this point. This example clearly shows that one of the primary tasks of criticism should be to identify the main trials of a given society, and to clarify and/or incite protagonists to clarify the principles underlying these trials, in order to carry out effective criticism—depending on which options are available at the time, and on the strategies of the persons involved.

Naturally, nothing prevents the answers to those who criticize the trials from being multiple. Some criticisms are taken into consideration and lead to a strengthening of justice (tightening), others are ignored or denied, whilst at the same time new trials not well instituted or controlled (displacement) appear alongside. To begin with, these new trials are closer to the 'trial of strength' end of the continuum than the 'trial of greatness' end.

Broadly speaking, changes in trial systems seem to involve groups of actors trying to free themselves from whatever keeps them from enjoying and increasing their privileges. They do this by looking for new ways to succeed and to gain recognition without having to take currently legitimate trials. Such actors tend to avoid established trials by experimenting with random, local and often low-key *displacements*.

When they are successful, these displacements gradually modify the trial system. They substitute new, less formalized and less acknowledged trials for previous ones that (being well established, prominent and often constrained by legal regulations) have been increasingly subject to criticism. In a given society, these displacements increase the relative importance of trials of strength with respect to legitimate relationships based on institutionalized trials.

Yet new legitimate and institutionalized trials may emerge if at least one of the following two conditions is fulfilled:

1 If the people who have enacted these displacements think that they have strengthened their position and feel that they are entitled to a specific acknowledgement, they may claim to have contributed, each in his/her own way, to the common good.

2 When the displacements that these people have carried out (shifts that others had heretofore deemed to be individual, circumstantial or marginal in nature) start to be seen as something that is generally effective. These behaviours will then be subjected to criticisms that will equate these new devices (stemming as they do from previous displacements) to new trials that have not yet been identified or categorized.

3 Actors to whom such displacements have been beneficial can then develop, both for themselves and for others, a value (a 'greatness') that will convey their hold on the world. Moreover, by so doing, they can inject an autonomous moral dimension into their situation. They turn these new trials into something that is justifiable.

Along with this legitimization process, norms are established (quite often through legal rules) so as to differentiate between morally acceptable and morally unacceptable and abusive (i.e. selfish) ways of making use of new resources.

Applying the model to changes in France between 1968 and 1995

From 1965 to 1975 the significant increase in the level of criticism of capitalism concerned almost all the established trials upon which the legitimacy of the social order had been based. These criticisms included:

• Trials that served as a foundation both for the salary/profit breakdown as well as for the way in which the value added was being shared between shareholders and wage earners.

• Trials that legitimized power asymmetries and hierarchical relationships (not only in the workshop but also in schools and even in families).

• Trials that served as a basis for social selection (scholastic examinations, professional recruitment, career planning, etc.).

Criticism unveiled those elements that, in the most prominent of these trials, were infringing upon social justice. It especially unveiled those hidden forces that disrupted the trials by pointing out the unwarranted advantages that were accruing to certain protagonists.

The first exit strategy consisted of strongly rejecting those demands that were related to artistic criticism, whilst remaining attentive to those demands that were related to social criticism. As for trials involving the selection of people and the allocation of authority, criticism ultimately led to the creation of trials that were fairer, in that they were closer to the meritocratic ideal. This was achieved through the modification of trial mechanisms, which were altered in such a way as to avoid any mobilization of strengths that did not belong to the trials' official definition. Criticism thus had the effect of making the trials, in our vocabulary, tighter. A tighter trial penalizes those actors who had previously found themselves in a privileged position, that is, who had had easy access to the different resources that, in the various trial situations, could give them an advantage over their competitors.

On the contrary the second exit strategy involved the abandonment of established trials (where social criticism was being voiced), with employers starting to listen to new critical demands proceeding from the 'artistic criticism'. Change was especially apparent in the organization of work.

In short, this second exit strategy involved abandoning the previous system of established trials in favour of a series of *displacements*. These displacements produced new trials. Yet these new trials were difficult to identify *per se* by the people whom they affected, in so far as they had not yet been subjected to any qualification, categorization and regulation initiatives.

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Conclusion

In the research project that was briefly summarized in the present chapter, we tried to offer an interpretation for the transformation of French capitalism since the 1930s. The concept of a *spirit of capitalism* is key in this study. It allows us, as we have seen, to dynamically articulate the two other central concepts upon which our analyses are based: *capitalism* and *criticism*.

However, the research carried out so far was not only intended to provide a credible and novel description of this period. Our intent with the present historical examples was also to propose a more general theoretical framework, thus enabling greater understanding of how the ideologies that are associated with economic activities can be modified.

We may be criticized for having used a local example (France over the past thirty years) to exemplify a global change. We certainly do not feel that the French example can in and of itself recapitulate all of the transformations that capitalism has experienced. However, as we have been far from convinced by the approximations and imprecise portrayals that are usually heard in discussions on globalization, we have tried to build a model of change that is based on pragmatic analyses, i.e. on models that are capable of accounting for the various ways in which people commit themselves to an action, their motivations and the meaning that they give to their acts. Now this sort of initiative remains, essentially for reasons of time and resources, basically undoable at a global level, or even at a Continental one, given the way in which national traditions and political situations continue to affect the orientations of economic practices (and the accompanying forms of ideological expression). In all likelihood, this is the reason why global approaches often end up by attributing a preponderant role to explanatory factors (usually technological, macroeconomic or demographic in nature) which are dealt with as if they were forces that exist outside the human condition, and out of the reach of nations who are subjected to them, much as people are subjected to a storm. In this historical neo-Darwinism, 'mutations' happen to us much as they happen to species—and it is up to us to adapt to them or die. Humanity, however, does not only submit to history—it creates it. We want to see how this works.

Notes

1 A longer description of the first shift can be found in Berland and Chiapello (2004), and of the second in Boltanski and Chiapello (1999).

2 In fact, corporatism shares certain themes with a third type of criticism of capitalism, the 'conservative critique'. The conservative critique is a criticism of the Enlightenment, the French revolution and capitalism. It stems from nostalgia for medieval society with its social hierarchy, religion, patriarchal family model, communities and social stability. In capitalism, this critique particularly

dislikes the destruction of traditional ways of life, and the introduction of wage relationships which replace personal relationships governed by tradition and mutual obligations. This critique was very active from the mid-nineteenth century to the mid-twentieth century, and made many compromises with the more modern social criticism, one of which was corporatism.

3 During the depression, industrialists reacted by setting up agreements for the control of production and prices. In particular, their aim was to organize the limitation of production, and this attitude was fiercely criticized, together with an accusation that they were intensifying the fall-off in activity. 'Operative cartels numbered in the thousands in 1939, and import quotas, among other restrictions, protected the home market for hundreds of industrial and agricultural products' (Kuisel 1981:94). The true level of competitivity within the system had fallen close to zero in 1940.

4 'While the first embraced planning to perfect capitalism, the second did so to build socialism' (p. 105). These two currents had several points in common: reason, controls and planning were to replace the natural mechanisms of the market. Neoliberal *planisme* attracted managers, engineers and high-ranking civil servants, people who valued forecasting, controls, self-discipline and cooperative networks. Socialist trade unionist *planistes,* on the other hand, were in favour of nationalization, rigorous interventionism and trade unions.

5 1945 saw the establishment of the Ecole Nationale d'Administration (ENA), designed to replace the Ecole Libre des Sciences Politiques as supplier of high-ranking civil servants. Meanwhile in economic teaching, Keynesian ideas were taking over from the doctrinaire free-market ethic (Kuisel 1981:215).

6 In Latour's terms, the winner 'reduces', 'translates' the loser; s/he can now 'speak in his/her name' and 'represent' him/her.

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11

Globalization and loyalty

Who are 'we'?

Gunnar Geyer and Thomas Straubhaar

while we understand a lot about market failures and bureaucratic failures, more research on the distinctive forms of social capital failure would be an important antidote to romantic illusions about Gemeinschaft.
(Adler and Kwon 2002:35)

Globalization means growing mobility. Loyalty means a common value—the 'we'—of people who see locations as the basis for long-term growth. The connection between globalization and loyalty is the application of the concept of social capital to mobility. Social capital is not a new concept; indeed, only the analysis of economic and social externalities under the assumption of social capital as a property right, combined with the increasing mobility of people, seems to be new. Classic growth theories imply that any restrictions on the mobility of human capital lead to market failures and to non-optimal factor allocation. But in the case of social capital as a complement to all other economic resources, unrestricted mobility can also lead to market failure, due to under-investment in social capital. The existence of market failures does not necessarily mean that the government has to intervene. On the contrary, we propose that the best solution to the problem of underinvestment in social capital is a non-governmental, liberal solution.

This chapter emphasizes the significance of social capital as a property right for the economic well-being of societies, or as Portes states 'as a property of collectivities such as cities or nations' (Portes 1998:10). However, processes of globalization involve the risk that social capital may decline with increasing mobility. Social capital is difficult to transfer, and its formation is a very specific investment. This asset specificity is of particular concern for *ex post* transaction costs. At least there is a trade-off between growth resulting from mobility and growth due to attractive social capital. Therefore, the key question arises as to how to enhance the willingness of highly qualified people who are mobile to invest into location-specific social capital activities. We show that an understanding of loyalty as an inherent element of social capital, of how loyalty can then

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arise and how it might stimulate institutional change and facilitate reforms is a necessary precondition for understanding the conditions under which globalization will improve the efficiency of economic and political systems. Our argumentation is inspired by the New Institutional Economics theory.

At first we point out the various facets of mobility relating to globalization and then illustrate the social capital approach. We define social capital as a property right whose quality determines the transaction costs within a society. A detailed definition of loyalty leads to the discussion of our core conclusion: completely free mobility does not necessarily mean optimal mobility. Globalization requires a 'we' identity. Loyal behaviour is the key to this concept. We hope that this economically based antidote supports the romantic illusion of *Gemeinschaft* in times of globalization, as well.

Globalization and mobility

Economically, it makes no difference which factor is mobile, so long as one is.

(Lucas 1988:16)

It has recently become apparent that real capital, i.e. real assets or finance capital, and natural resources do not exclusively constitute the total capital stock of a society. The endowment of human and social capital has a significant influence for the well-being of a nation (cf. OECD 2001). Globalization is characterized by the increasing trade of goods and services and simultaneously increasing factor mobility. With respect to the growth effects of international integration, classical economics argued from the basis of real capital, which included natural resources. Immobile factors were the basis of this approach, according to Mundell. 'The classical economists generally chose the special case where factors of production were internationally immobile' (Mundell 1957:321). The age of the industrial economy was at the same time the age of physical capital. Since the transition to the knowledge society, the factor of human capital has entered the scientific discussion (Schultz 1961; Becker 1962).

This factor is becoming highly mobile, owing to the progress of technologies in the transport, information and communication sectors. Globalization means increasing exit options and therefore the functional and physical mobility of human capital. In other words, the exit costs are decreasing. Functional mobility is the dissociation between living and working space. With respect to migration, we can see another dissociation: between home country and workplace. Firms can locate their principal office and their centre of production in different places. In short, 'There will be a (functional) mobility without (personal) mobility' (Straubhaar 2002:65, own translation). Finally, there is no spatial congruence between

(1) tax or social insurance liabilities, (2) the use of public services and (3) other economic and social benefits, such as investment and general quality of life resulting from the behaviour of inhabitants. Individual preferences are influenced only by functional criteria because of increasing exit options. Administrative, national or technological boundaries are irrelevant.

On the one hand, using the term *competition of locations* makes sense owing to increasing options for mobility. It is impossible to compete for immobile resources. On the other hand, some immobile resources determine the relative attractiveness of a location and its successful competition as a location. That does not mean natural resources, which are indirectly mobile in the form of trade with commodities or preliminary products. Non-transferable resources or resources whose transfer generates a complete different economic performance at the destination, are crucial. In 1990 North analysed the relationship between institutions and different economic performance in a brilliant manner (North 1990). In addition, by taking into account the relevance of informal institutions, it becomes apparent that the same formal institutions do not necessary yield economic convergence. This becomes particularly clear with regard to the effects of globalization. For this reason, social capital moves increasingly into the limelight not only of economics, but of political science (Putnam 1993; Fukuyama 1995) and of sociology as well (Coleman 1988, 1990).

Mobile human resources do not look only for traditional locational advantages in the form of natural, or real capital and complementary human capital. Social capital influences the decisions of mobile individuals in respect of locations as well. The people who are mobile ask: 'Where should we go?' The people who are unable to move, i.e. the locations, have to ask: 'What should we do to attract gainful human capital?' Social capital influences the relative attractiveness of locations, with corresponding consequences for growth. In an age of good governance and corporate governance, social capital is the specific local factor which supports a society. The social-capital point of view identifies the assets of a society based on social transactions as an essential condition for economic transactions.

The extreme importance of social capital is highlighted by a comparison of the identified factors, i.e. natural resources and real capital, human and social capital, with respect to their mobility and the resulting externalities. Externalities occur, according to our theoretical basis, New Institutional Economics, if property rights are not clearly specified. This includes two conditions, following Furubotn and Richter '(1) a sufficiently clear specification of property rights and (2) freedom for their exchange' (Furubotn and Richter 2000:90). If these two conditions are achieved, externalities can become internalized and this results in increasing economic efficiency because:

All that is needed for internalization in either case is ownership which includes the right of sale. It is the prohibition of property right adjustment, the prohibition of establishment of an ownership title that can thenceforth be exchanged, that precludes the internalization of external costs and benefits.
(Demsetz 1967:349)

As we have elaborated, *natural resources* such as commodities and land are clearly location-based, but trade makes them mobile. The transfer of natural resources or products is not linked with negative externalities. Resulting externalities are only pecuniary. So far, such trade takes place in markets whose benefits and consequently property rights will be specified. Natural resources like clean air, water or climate are an exception. Here, externalities certainly will arise and internalization appears to be extremely difficult. The analysis of these resources does not make sense within the analytical framework of mobility versus externalities suggested here. Clean air available worldwide cannot be assessed with regard to mobility.

With respect to *real capital,* such as finance capital or investments in productive equipment, the evaluation of its mobility can no longer be separated from the existing institutional framework. Real capital is completely mobile under the assumption of equal formal institutions, or the guarantee of ownership with an almost identical economic performance, or rate of return. The international financial markets and the foreign direct-investment flows between the developed countries provide daily evidence. Even if the negative effects of financial crises due to the unlimited mobility of finance capital were large, the transfer of real capital would cause fewer externalities. As long as the mobility of financial capital confines itself to a homogeneous institutional realm, no externalities will arise. In contrast, the clear specification and the guaranteed mobility of property rights ensure the best possible use. The efficiency of allocation suffers at this moment if investment decisions are affected by state interventions instead of by market forces. Negative externalities result then, owing to massive disinvestment followed by relocation.

Primarily, *human capital*—or individual skills and knowledge—is based on the individual. The determinants of human-capital mobility in the absence of social capital(!) are the availability of complementary real and human capital. In this respect, most of all highly qualified human capital is highly mobile if the locational conditions with regard to complementary real and human capital are identical. Externalities of human-capital mobility depend on the institutional arrangement of its formation. The benefits of human capital can be mainly ascribed to private ownership. Enormous sunk costs emerge with respect to the migration of highly qualified people, even if the formation of human capital is understood and therefore financed as a public good. This is called the brain-drain effect.

The more private education is, and the more clearly property rights resulting from investment in education are specific to the investors, the fewer the mobility externalities.

As opposed to human capital, *social capital* results from the connections between people, for instance social networks and their implications. Social capital is dependent on the quality of the social relationship with other individuals. Briefly, the Rolodex of a person represents his social capital (Glaeser *et al.* 2000:4). Therefore, there seems initially to be nothing to be said against the mobility of social capital. Networks can be organized globally as long as the address book is there. In contrast, however, we think that social capital primarily means locationally fixed networks and thus its mobility is very limited. Local, physically present people, as opposed to 'virtually' existing individuals scattered throughout the world, make up the largest proportion of active contacts in an individual's address book. Social capital is reduced by mobility: weekend friendships, for example, may be given up, or contact with school friends and fellow students disintegrates. With respect to social capital, negative externalities because of mobility result from the suspension of the clear specification of property rights.

The movement of people differs from the movement of goods and services because people create attachments. They tend to feel closer to those with whom they share social capital—including customs, values, language, history and culture—and they interact with them at lower cost. Consequently, migration generates externalities.

(Schiff 1998:21)

The relationship between mobility and globalization with respect to the presence of social capital is analysed below more exactly, but first the idea of the social capital must be defined more precisely in the following section. As a first presupposition we have to note that economically, it makes a difference if mobility occurs and if it does which factor is affected.

Social capital

not I'll do this for you because you are more powerful than I, nor even I'll do this for you now if you do that for me now, but I'll do this for you now, knowing that somewhere down the road you'll do something for me...

(Putnam 1993:182)

The increasing research into the topic of social capital following the work of Coleman and Putnam has led to conceptual confusion. No representation of all the facets of the social-capital concept is possible or even attempted here, nor would any scientific benefit for future research or for our analysis arise from such an attempt. Therefore, we have extracted from many other works the aspects of institutional economics, and define the social-capital approach in terms of these. We define social capital with the help of the property-rights approach and the theory of transaction cost.

Opening remarks

A very illustrative definition of social capital goes back to Coleman. A social network consists of network nodes and the connections between the nodes. These connections within the network are the relationships of the people involved. To illustrate the point, take the example of a neighbourhood. If we take the social network, neighbourhood, as an example, it consists of neighbours as network nodes and their relationships to each other or the interactions between them such as conversations, helping one another, common activities or disputes. The connections and relationships between the individuals are the social capital of the neighbourhood (Coleman 1990:395). Social capital refers not only to a quantitative element, the number of social relationships in the network, but also to the qualitative element, i.e. the *rules* and *enforcement arrangements* underlying the *network*. The value of social capital results from a 'set of obligations, expectations, and mutually developed norms and sanctions which evolved from prior social interactions' (Starr and MacMillan 1990:85). Woolcock defines the concept succinctly as follows: 'social capital refers to the norms and networks that facilitate collective action' (Woolcock 2001:9).

Social capital causes economic effects (see below). These consequences of social capital can be influenced only by the design of social networks, or its rules and enforcement arrangements. It is absolutely essential to distinguish between the sources and the consequences of social capital (Portes 1998:5; Woolcock 2001:7–9). To avoid a possible tautology, we analyse social capital only with regard to that which it is and not what it does (Edwards and Foley 1997:669). We greet with scepticism the often described equation of trust with social capital (Fukuyama 1995; Putnam 1995). To be clearer as to the term social capital 'We invest in the networks and social institutions that produce trust, not in and of itself (Woolcock 2001:9).

The following different *sources of social capital* have been discussed in the academic community up to this point. Coleman refers to 'obligations and expectations, information channels, and social norms' (Coleman 1988:95). The OECD defines 'shared norm, values and understandings' as social capital (OECD 2001:41). According to Brehm and Rahn, closed ethnically homogeneous networks, as well as 'the web of cooperative relationships between citizens that facilitate resolution of collective action problem', are social capital (Brehm and Rahn 1997:999). Turner extends the term *social capital* to citizenship (Turner 2001:193) or, to put it even more simply, to culture. We then propose to add to the discussion that, in times of globalization, loyalty is a further source of social capital.

Social capital as a property right

Property rights in the sense of the property-rights approach are sanctioned ownership rights in material and immaterial things or claims from contractual obligations or noncontractual obligations There exist (a) property rights in the legal sense, and (b) in the non-legal sense.

(Furubotn and Richter 2000:492)

These property rights in material and immaterial things, or claims from contractual obligations, are the features of *economic transactions*. As a rule, economic property rights are protected by formal institutions such as contracts or law. Demonstration of these property rights is displayed through the ownership of *economic capital* in the form of natural resources and real capital, i.e. commodities, finance capital, real assets or claims from deliveries.

The value of *human capital,* or cultural capital in the formulation of Bourdieu (1986), particularly depends on its formalization, or on its objective and institutional guarantees. Accumulated knowledge is undoubtedly a property right if qualifications are recognized officially and therefore could lead to higher income.

Social transactions are characterized by the specification and exchange of property rights in these immaterial things or claims from non-contractual obligations. Social property rights are predominantly based on informal institutions such as norms, conventions and traditions. The value of these property rights, the mutual expectations and obligations, are the asset of *social capital*. The essential difference between social relationships and economic relationships via markets is the discontinuity of value and time between investment and benefit, the problem of enforcement and consequently the protection of the property rights. As Portes puts it, 'transactions involving social capital tend to be characterized by unspecified obligations, uncertain time horizons, and the possible violation of reciprocity expectations' (Portes 1998:4).

The substantial value of economic capital and therefore the value of the property right can be determined easily. It can be exchanged directly for money, if it is not available in this form already. In contrast, for the determination of the substantial value of human and social capital, an exchange rate exists to economic capital and vice versa. We will come back to the determinants of this exchange rate later. Two essential elements are as follows (Bourdieu 1986:252):

1 All forms of capital can be exchanged for each other.

2 Every economic transaction is based on property rights resulting from primarily social capital and human capital as well.

Now, we combine our general definition of social capital as a social network and its underlying rules and enforcement arrangements with the definition of social capital as a property right:

1A property right has a value only if exchange partners exist who subjectively rate this resource as a surplus. This is the *network* of social relationships.

2The value of the property right decreases if this property right is not clearly specified or an exchange is impossible. It becomes worthless under these circumstances. Therefore, *rules* about the specification and the exchange of property rights are necessary.

3The value of the property right also decreases if the rules which concern specification and exchange are not enforceable or are difficult to manage. The existence and the design of *enforcement arrangements* is essential.

The formation of social capital

Three corresponding aspects explain the formation of social capital. First, *opportunities* for the formation of social capital in the form of social networks, their norms and enforcement arrangements have to be given. A number of network nodes have to exist which can be connected. For Robinson Crusoe, the social-capital question did not arise. Essentially, the value of social capital is dependent on the esteem and on the engagement of other individuals. Social capital as a property right emerges only in an environment where interaction is made possible bilaterally or multilaterally.

Second, individuals must have the *abilities* for the formation of social capital. Ability means the competences of and resources at the network nodes regardless of whether groups or individuals form these nodes (Adler and Kwon 2002:26). The abilities determine whether individuals are able to ameliorate their existing social capital or even create new social capital, and vice versa if the existence of opportunities is given. Social capital requires an individual investment decision, like membership in an organization or simply interaction with a neighbour. 'The relation network is the product of individual or collective investment strategies which are turned towards the creation and preservation consciously or unconsciously of social relations which promise an immediate use sooner or later' (Bourdieu 1986:249). Therefore, social capital formation is the result of an individual investment strategy which is dependent on investment opportunities. Social capital enables a person 'to reap market and non-market returns from interactions with others' (Glaeser *et al.* 2000:4).

Third, it requires *motivation* to behave in a manner in which social capital emerges. Independently of the discussion about whether individuals behave rationally and what rational behaviour is, the question why rational individuals should make an uncertain capital investment has to be asked. It is indispensable to invest in social capital because, as Bourdieu states, 'there are some goods and services to which economic capital gives immediate access, without secondary costs; others can be obtained only by virtue of a social capital of relationships (or social obligations)' (Bourdieu 1986:252).

Portes (1998:7–9) distinguishes internalized and collective norms according to two kinds of motivation for social capital investment. Internalized norms and values are experienced exogenously *(consummatory motivation)* by learning within the social environment *(value introjection)* or based on common fates *(bounded solidarity)*. Collective norms result from active behaviour *(enforceable trust)* or from mutual expectations *(reciprocity change)*. The latter are rather accessible to an economic analysis based on the property rights approach. For our concept of loyalty we concentrate on the mutual expectations emerging from social capital and forming social capital simultaneously.

Social capital depends on the opportunities, abilities and motivations for the accumulation of mutual informal obligations. Bourdieu notices that the:

apparently gratuitous expenditure of time, attention, care [has] from a narrowly economic standpoint...to be seen as pure wastage, but in terms of the logic of social exchanges, it is a solid investment, the profits of which will appear, in the long run, in monetary or in other form.

(Bourdieu 1986:253)

Property rights are created. This behaviour is rational for two reasons. First, it is expected that the obligations will be 'paid' back completely in the future. Therefore, the value of the property rights does not decrease. Second, the creation of such property rights is profitable. Doing someone a favour results in increased value, since 'it is of intrinsically more value to the recipient than to the donor'. Or, simply put by Coleman, 'When I do a favor for you, this ordinarily occurs at a time when you have a need and involves no great cost to me' (Coleman 1990:309).

The types of social capital

The interdependent relationship between the behaviour of the individual and on a group level within a formal or informal institutional framework defines the social capital of a person or a group as a relational variable. With this conclusion, we adopt the classification of social capital into *bonding* and *bridging* as horizontal and *linking* as a vertical dimension (Aldridge *et al.* 2002:11; Woolcock 2001:10):

1 *Bonding* social capital means the closest social relationships, the strong bonds within families, ethnic groups or between closest friends. The *bonding* function focuses primarily on the internal structure, the cohesion within a collective or a group as social capital (Adler and Kwon 2002:19–21).

2 *Bridging* social capital means the weaker social relationships with business partners, friends of friends, to other ethnic groups. The *bridging* function focuses on the external connections of individuals to other networks or connections between networks and the resulting social capital. Such relationships are the 'connections between people who share broadly similar demographic characteristics' (Woolcock 2001:10).

3 *Linking* social capital means the 'connections between those with differing levels of power or social status' (Aldridge *et al.* 2002:12). Formal institutions determine the value of *linking* social capital, while *bonding* and *bridging* social capital is related to informal norms. Independent from the individual asset of *bonding* and *bridging* social capital such forms of *linking* social capital as access to citizenship, residence and work permits, and political office defines the official social status of an individual within a society.

On the one hand social capital is both individual and collective capital. The opportunities to act and the social behaviours available to the individual always depend on those of his group or other related groups, and vice versa. On the other hand, a balanced mixture of all types of social capital is essential. The largest negative outcomes of social capital result from a lack or an over-preponderance of at least one of the three types of social capital (*bonding* without *bridging or bonding/bridging* without *linking*).

Social capital as capital

The attractiveness of the social-capital concept results from the embedding of an obviously non-monetary form of capital in the economic discussion (first Bourdieu 1986). Several characteristics show the interdependences between social capital and capital in the economic sense and furthermore the relationship between social and economic transactions (Adler and Kwon 2002:21):

1 Social capital as a property right increases the effective *assets* of an individual or a group (Furubotn and Richter 2000:84). This asset consists in the expectation of a perhaps uncertain future benefit. Therefore, there is no difference between a social capital investment and an investment in real or human capital.

2 Another characteristic of social capital is its *alternative usability* and its *convertibility* into other resources or economic advantages. Indeed, an exchange rate exists between economic (substantial and financial goods) and social capital (Bourdieu 1986). Economic capital can be exchanged directly with money if it is not available as finance capital. An exchange-rate loss according to the transfer of these property rights is excluded. In contrast, social capital cannot be converted into

economic capital without greater effort. The same applies to the reverse transaction as well, according to Bourdieu: 'The different types of capital can be derived from *economic capital,* but only at the cost of a more or less great effort of transformation' (Bourdieu 1986:252, accentuation in the original).

3 Social capital is *substitute for and complement* to other economic resources. Substitute means that social capital can fill in or replace blanks in financial or human capital. Many jobs are allocated to individuals through 'relations', although the abilities of the individual do not necessarily correspond to those required at the moment for the specific job. In this example the complementary character of social capital also becomes clear. Both employers and employees save information and search costs, thus transaction costs. In general, social capital resulting from social relationships can act as substitute for and complement to market and hierarchical relationships. Social capital supports the construction of goods and services which cannot be offered at all, or only at prohibitive transaction costs by markets, organizations or the state (cf. Arrow 1969:62).

4 Social capital needs 'maintenance' and is *dependent upon its social environment*. On the one hand, social capital, like every other form of capital, is subject to deterioration when not in use or misuse. On the other hand, the depreciation rate of social capital is not measurable for two reasons. First, the asset of social capital, like human capital, does not decrease with use and can indeed increase. Depreciation turns into appreciation or conservation of value. Second, social capital is a very specific investment, owing to its strong interdependence with the social environment. Possibly the value of the social capital can therefore become zero if the social environment changes. The investment in social relations with an individual has to be deducted fully if the person leaves the relationship or the network. The benefit of social capital equal to its return on investment within a network is an essential function of the number of members and their behaviour. 'To possess social capital, a person must be related to others, and it is those others, not himself, who are the actual source of his or her advantage' (Portes 1998:7).

5 The quantitative measurement of social capital and social-capital investment is (still?) difficult. It is almost impossible to exactly pinpoint inherent assets of social capital as a property right. Therefore, the clear specification of property rights in social capital to individuals and groups also suffers or is completely impossible. Accordingly, social capital is not amenable to economic transactions directly, although it is certainly a kind of good (Furubotn and Richter 2000:84). To this point, Arrow states that:

Trust and similar values, loyalty or truthtelling, are examples of what the economist would call 'externalities'. They are goods, they are commodities; they have real, practical, economic value; they increase the efficiency of the system, enable you to produce more goods or more of whatever values you hold in high esteem. But they are not commodities for which trade on the open market is technically possible or even meaningful.

(Arrow 1974:23)

The latter is maybe the only argument that could put forth the notion of social capital as capital and property right. Nevertheless, we agree with the conception that 'social capital falls squarely within the broad and heterogeneous family of resources called "capital"' (Adler and Kwon 2002:22).

Social capital as a club good

Social capital is *not a private good* because its value is determined by networks and relationships. Therefore, the property right called social capital is never specified completely and clearly.

Social capital has the character of a public good. This thought can be traced back to Coleman. 'A property shared by most forms of social capital that differentiates it from other forms of capital is its public goods aspect' (Coleman 1988:119). Any investment in the social network also provides benefits for those individuals who are not involved in the transaction or simply externalities. First, this means that a specification of property rights is related to prohibitively high specification costs and therefore makes no sense and so ceases. The internalization of externalities does not work. The consequences are free riding, adverse selection, moral hazard, rent seeking, the tragedy of the commons and a non-optimal quantitative provision. How can we, however, call it a property right if it is not possible to acquire a property?

In the same way, just as social capital does not represent a purely private good, it is *not a purely public good* either. In principle social capital is exclusive. Access to networks can be limited, whether by parents who determine more or less the (marriage) partners of their children directly, and consequently have control over *bonding* social capital or even citizenship (Straubhaar 2003a) or by the use of work permits as an exclusion criterion for *linking* social capital. Therefore, social capital satisfies the criteria of a *club good* (Aldridge *et al.* 2002:12). Thus, the motivation to invest in social capital is assured. Property rights can sufficiently be specified by the existence of the exclusion principle. A part of the benefits resulting from social capital is amenable to private ownership.

The economic relevance of social capital

Social-capital research has identified clear positive and negative outcomes of social capital (for a survey see Aldridge *et al.* 2002:15–26). A part of these outcomes derived from theoretical analysis has been confirmed empirically even if the representativeness of some methods and indicators is not satisfactory (see for example the review of Putnam 1995 by Paxton 1999).

In the context of our analysis of social capital as a property right, its economic significance can be understood more precisely. The basis of our concept is the relationship between the specification of property rights and therefore the possible emerging of externalities, and transaction costs. The level of transaction costs fundamentally determines the efficiency of an economy which is based on exchange, whether economic or social transactions take place or not. Transaction costs are costs of running the economic system' (Arrow 1969:48). The definition of property rights determines the efficiency of an economy if transaction costs exist (Furubotn and Richter 2000:85). Contracts, and accordingly the specification of property rights, are necessary because transactions are not free of charge.

We apply the insights of transaction cost theory to the social-capital concept with regard to the relationship between transaction costs and economic performance. Williamson described transaction costs as 'the economic equivalent of friction in physical systems' (Williamson 1985:19), so it is essential to strive for the minimization of transaction costs. We see social capital as 'an important lubricant of a social system' (Arrow 1974:23).

The exclusion costs are primarily important to our analysis as a kind of transaction cost (Arrow 1969:60). *Exclusion costs* result from 'the costs of specifying and assigning and the costs of monitoring and enforcing full or restricted property rights' (Furubotn and Richter 2000:85). Again, the connection becomes important between social capital as a network of social relationships based on corresponding rules and enforcement arrangements, on the one hand, and social capital as a property right on the other:

1 The design of *rules* about the assignment and the exchange of property rights determines the costs of the specification referred to herein as *specification costs*.

2 The *enforcement arrangements* affect the level of costs of monitoring and enforcing of property rights referred to herein as *enforcing costs*.

Thus the specification of the social-capital investment as a property right is not without cost. Furthermore, the maintenance, involving the monitoring and the enforcement of the return on the investment, is not free of charge either. Therefore, social capital means paradoxically the emergence of transaction costs. How then can social capital increase the efficiency of an economy if, according to New Institutional Economics, the path to a healthy economy should always include the minimization of transaction costs? Social capital has a *positive economic outcome* if a transaction is cheaper with its help, despite exclusion costs, as opposed to carrying out the same transaction without social capital. I use my asset of social capital at a time when an economic transaction in the market would be more expensive owing to arising transaction costs. Getting a job with the help of friends and business partners instead of using the official labour market is an example of that. The special importance of social capital arises if a transaction cannot be realized alternatively, for example via the market. With respect to transaction costs, Arrow shows that a 'Market failure is the particular case where transaction costs are so high that the existence of the market is no longer worthwhile.' Unaware of the term social capital, Arrow concludes further that 'norms of social behavior, including ethical and moral codes...are reactions of the society to compensate for market failures' (Arrow 1969:62).

Negative economic outcomes result for two reasons. First and most obvious, using social capital means higher transaction costs than using the market. Second, social capital prevents the emergence of markets and therefore alternative opportunities for transactions, owing to too much social capital. It has always to be taken into account that social capital has the potential to limit competition and liberty. Adam Smith already referred to this: 'People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices' (Smith 1979:232). Social capital is the most important source of insider-outsider problems because 'The ties that bind may also turn into ties that blind' (Powell and Smith-Doerr 1994:393). A socially intolerable transaction cost level for outsiders as a result of the excluding and rent seeking of insiders is the negative outcome of closed networks with strong internal relationships.

In addition, isolation, which represents the lack of new external information, leads to a reduction of network efficiency and to increasing transaction costs. In terms of the information within the network a tragedy of the commons can appear (Adler and Kwon 2002:31). Furthermore, the danger of the dominance of networks passes because of an enormous potential of intra-group social capital, and following alternative opportunities for the formation of other social capital fail. As mentioned above, economic transactions could not occur without a certain degree of social capital. But a lack of market mechanisms generates non-optimal social outcomes in the form of negative externalities by carrying out social transactions, or as Adler and Kwon state: 'There is no invisible hand that assures that the use of social capital resources in competition among actors will generate an optimal outcome for the broader aggregate' (Adler and Kwon 2002:31).

We summarize the economic relevance of social capital as follows. The more precisely social capital can be specified and the lower the enforcement costs of the social capital as a property right are, the more positive are the economic outcomes regarding the reduction of transaction costs. The partial character of social capital as a public good causes externalities. As long as positive externalities arise, this too is related to positive economic outcomes. Negative economic consequences result if the enforcement of the social capital as a property right is expensive, and if a high level of mobility prevents the social capital investment due to high exclusion costs. This connection between social capital and mobility is the object of the next section. At the same time, we would like to show the necessity of a theoretical expansion in the sense of institutional economics and the testing of the neoclassical hypothesis of absolute factor mobility. Because the expectation 'that somewhere down the road you'll do something for me' makes sense only if your neighbour will still be your neighbour tomorrow as well.

Social capital and mobility

Mobility, like frequent repotting of plants, tends to disrupt root systems, and it takes time for an uprooted individual to put down new roots.

(Putnam 1995:74)

It had already been suggested in several studies that mobility has negative effects on the formation of social capital. Increasing mobility is one of the four reasons for the declining social capital in the United States, according to Putnam's findings. Mobility increases the transaction costs within a society, or as Schiff states, 'A higher degree of mobility tends to weaken social ties, and transactions among less familiar agents are likely to result in more cheating, less trust, and higher transaction costs' (Schiff 1999:4). Generally, three facts describe the emergence of negative effects of mobility in the presence of social capital. (1) Mobility in the form of migration destroys existing social networks and causes sunk costs. Social capital built up in the past is partly or completely lost. (2) At the same time effort and costs are incurred in building up new social capital in the country or location of destination. (3) Existing social capital in the host country or location is possibly influenced negatively by immigrants, and the individuals who are unable to move have to pay the costs of integration.

In short, costs arise from the destruction of previous social relationships, the construction of new ones, and the disturbance of those which currently exist. Additionally, individuals who are mobile have to compensate for their loss of social relationships by economic transactions. Therefore, a vicious circle starts, which results in more and more destruction of social capital. Accompanying this, the costs of the maintenance of social capital as a property right increase with increasing potential mobility. Mobility leads to both individual and collective loss of social capital.

Based on our theoretical approach, the following proposition results.

In principle, the property right of social capital involves uncertainty as to when and with what degree of reciprocity the obligations and expectations will be fulfilled. The formation of social capital is a very specific investment. A high level of specificity means a high degree of uniqueness and correspondingly a low degree of exchangeability and reusability. (For the concept of specificity see Williamson 1985.) If they were built up with a particular intention to particular individuals, social relationships are useless in other cases. In the extreme example, the level of specificity is so high that the termination of the specific social relationship results in total depreciation of the social capital investment. The value of the property right becomes zero. Potential or existing mobility increases the specificity of a social capital investment because the probability of a return on investment decreases.

The exclusion costs may become prohibitively high owing to mobility. It does not make sense to invest in social capital as long as the resulting property right cannot be specified and is not enforceable in the long run. Consequently, the property right does not exist because it is valueless. Social capital as a property right exists as a *resource* only if (1) individuals with obligations such as donors, investors in social capital, and (2) individuals who accept and demand these obligations are connected through social relationships. It is essential that for the donor the *asset of social capital* means a property right only if the recipient as the *source for this social capital* exists (Portes 1998:6). The donor's motivation in the form of his decision on a social-capital investment is a function of the exclusion costs.

Once again, let us summarize the negative externalities of social capital in connection with mobility resulting from its character as collective good and capital. If individuals are globally mobile and thus social relationships become unstable:

1 The value of the social capital as a property right decreases owing to increasing uncertainty about the future benefit of the social capital investment with regard to reciprocity and time of repayment.

2 The alternative usability of social capital and its exchange rate in relation to other forms of capital become less, and therefore the specificity becomes higher.

3 The opportunities of minimizing transaction costs by social capital and corresponding existing and efficient social relationships decrease.

There are two opportunities to respond to increasing transaction costs and the concomitant decreasing efficiency. Either the transactions are organized differently, e.g. as economic instead of social transactions, or the rules and enforcement arrangements underlying the transactions are checked and changed if necessary. With market transactions, more incomplete contracts and consequently increasing transaction costs lead to more hierarchical transactions, as in enterprises or via governmental regulation. This is the clear point of Coase's 'The nature of the firm' (1937). However, market rules can also be checked and extended in the form of voluntary commitments, minimum standards or third-party certification. Always the task is to initiate and to create institutional change with the objective of better economic performance. This can result in the creation of new or the improvement of existing institutions.

The same basic concept also applies to social transactions and social capital if social contracts become more incomplete, since their enforcement is more difficult. On the one hand, we have shown that there is a significant difference between the mobility of people and the mobility of other factors, with respect to their effects on economic performance owing to the existence of social capital. On the other hand, we have made it clear that social transactions mean a complement to and a substitute for economic transactions and therefore they cannot be completely replaceable. Abandonment of a certain asset of social capital is not possible. That is why there is an essential need to optimize the social network, its rules and enforcement arrangements underlying the social capital as a property right. The quantity and quality of social relationships must improve. One way to succeed is the promotion of repeating interaction, because the accumulation of social capital itself is a process of repeating interaction. Loyalty could make this easier in times of globalization where mobility is preferred. Loyal behaviour could help to prevent negative externalities caused primarily by the migration of highly qualified human capital.

Loyalty

Loyalty to one's country, on the other hand, is something we could do without, since countries can ordinarily be considered to be well-differentiated products. Only as countries start to resemble each other because of the advances in communication and all-round modernization will the danger of premature and excessive exits arise, the 'brain drain' being a current example. At that point, a measure of loyalty will stand us in good stead. Also, there are some countries that resemble each other a good deal because they share a common history, language, and culture; here again loyalty is needed more than in countries that stand more starkly alone.

(Hirschman 1970:81)

Our approach was inspired by the 'exit-voice-loyalty' concept of Hirschman and is expressed in the above quotation. The German translation (1974) is called *Abwanderung und Widerspruch,* which means *Exit and Voice* only. From the original title *Exit, Voice, and Loyalty,* the loyalty had curiously disappeared. In the following, we would like to define our approach to the concept of loyalty, starting from Hirschman and the analysis built upon his concept. By combining the analysis given above as to the term 'social capital', it is here also possible to describe the term *loyalty* more precisely. This is the last component needed to be able to discuss the relationship between globalization, social capital and loyalty, in accordance with our central thesis.

Hirschman analyses the opportunities of individuals to respond to a 'deterioration of performance' in their environment. Deterioration of performance means dissatisfaction as a customer of a firm or as a member of an organization. We extend and generalize the term 'deterioration of performance' as follows. A deterioration of performance arises if all or some conditions change negatively that affect the individually assessed quality of a location, whether it is the location of a firm, a place of residence or a homeland. We study the response of individuals to a deterioration of performance of the state and its subsystems in times of globalization, and therefore address the third part of the Hirschman concept hitherto neglected: *Exit, Voice, and Loyalty. Responses to Decline in Firms, Organizations, and States*.

Exit, voice, loyal behaviour and/or no reaction in the form of apathy and resignation are responses to a deterioration of performance. We will leave the latter out of consideration here, though we expressly point out that resignation and no reaction are not the same as loyalty. No reaction is a passive behaviour, while, in contrast, loyalty is an active one. Furthermore, it has to be taken into account that exit does not mean only physical movement away from a region or a country. For example, an individual who is no longer ready to accept a too high degree of disparity between tax payment and a corresponding supply of public goods does not need to move into the domain of a different fiscal law, necessarily. He can also make use of tax-avoidance strategies. Once again, physical mobility can be replaced by functional mobility. In respect to the application of 'pay as you go' financed social security systems, Straubhaar states that 'exit is a response to the breach of the equivalence principle' (Straubhaar 2003:333, own translation).

Exit means self-determination. According to Märkt it is the 'opportunity of individuals to choose their favourite institutional arrangement' (Märkt 2002:11, own translation). Exit is a bipolar decision, in that an individual has only the option to stay or to go. Exit represents a typical market mechanism. In market relationships functional problems are typically solved by exit, as Geyer and Venn state (Geyer and Venn 2001:27). Therefore, Hirschman classifies exit primarily as an object of investigation of economics. In contrast, Hirschman sees *voice* as 'political action par excellence' (Hirschman 1970:16). Voice as co-determination means, according to Märkt, the 'opportunity of designing the institutional framework at the given place' (Märkt 2002:11, own translation). For Hirschman voice 'is a far more "messy" concept because it can be graduated, all the way from grumbling to violent protest' (Hirschman 1970:16). Mechanisms for the solution of functional problems in hierarchical relationships are based on voice, if such a mechanism is permitted. *Loyalty,* as the third opportunity to respond to a deterioration of performance, functions in connection with exit and voice. Hirschman concludes that 'as a rule, then, loyalty holds exit at bay and activates voice' (Hirschman 1970:78), and accordingly that loyal behaviour is the prerequisite of functional social relationships.

Historically, loyalty meant that an individual was to be law-abiding and obedient to the sovereign. Loyalty was analysed only in the context of relationships that are hierarchical, and contained coercive elements. Loyal behaviour resulted primarily from *restrictions* from the environment that are beyond the influence of the individual. We transfer the phenomenon of loyalty into social and mutual relationships. In our opinion, loyal behaviour is rational, voluntary and internally motivated. Loyal behaviour is an essential prerequisite for institutional change and can be integrated smoothly into the *subjective preference system* of an individual. Loyal behaviour is the fundamental source of social capital. This is the new view of loyalty which we would like to propose.

Loyal behaviour is rational. Loyal individuals activate voice first, and keep exit at bay. From the view of an objective observer, loyal people accept a greater degree of deterioration of performance. Nevertheless, this increases the individual's utility. Loyalty is linked with an expectation which justifies itself by opportunities to have an influence. Voice emerges and increases owing to the fact that it has real chances to contribute to performance improvement, particularly if the exit option is still feasible. Therefore, loyalty is not only hope for but also the rational expectation of the chances of staying and activating voice, always based on the possibility of voice (Hirschman 1970:78). Finally, Hirschman concludes that loyal behaviour, and with that 'the decision to remain a member and not to exit in the face of a superior alternative would thus appear to follow from a perfectly rational balancing of prospective private benefits against private costs' (Hirschman 1970:98). The same mechanism which affects the individual decision to behave loyally determines the decision to invest in social capital. It is the expectation that this behaviour will yield increasing utilities or that some transactions can be realized more efficiently in the future.

Loyal behaviour is voluntary. In our opinion, the essential condition for promoting loyal behaviour is the opportunity for an exit almost free of charge, and a high probability of successful voice. Staying has to be more attractive than 'voting with one's feet'. The historical definition of loyalty contained a coercive element. Our proposal is that loyalty cannot be forced. The probability of being loyal as against a chosen alternative is more likely the higher the utility of this alternative appears, especially in times of deterioration of performance. The individual benefit from choosing an alternative is higher when the costs of choosing it are lower. That is to say, there must exist the possibility to choose, and therefore alternat-

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ives, and they must be achievable at the lowest possible costs. (On the social psychological basis of the *value of freedom* see Schlicht 1984:75.)

The decision and long-term costs of choosing an alternative are determined by the degree of free choice. The lower the exit costs, and the higher the probability of successful voice, the more likely the discussion of loyal behaviour appears. According to Kirsch:

loyalty causes the option of exit to be inhibited despite low exit costs, and therefore a high probability of success and little coercion [and] that despite cost-efficient opportunities to resist and a relative high probability of success, resistance is kept in check temporarily

(Kirsch 1997:52, own translation)

The lower the number of predetermined alternatives there are, the higher the coercion linked with choosing an alternative is. Both exit and voice entail prohibitive costs and maximum coercion if the number of 'alternatives' is zero.

Loyal behaviour is internally motivated. Loyalty cannot be enforced by authoritarian sanctions like the denial of the citizenship or the loss of life. External forms of motivation also result only in a rapid decreasing of loyalty. As Schlicht puts it, 'The general finding is that the intrinsic motivation to do certain things is lessened if a reward is given to these activities' (Schlicht 1984:67; see also Frey and Osterloh 2000). External motivation is an element of market relationships in the form of higher wages for more performance, and hierarchical relationships like the claim for performance by coercion, authority or restrictions. In social relationships, e.g. with my neighbour, these instruments of motivation do not exist. I maintain contact with my neighbour and behave loyally to him because it is my preference. No external restrictions affect my behaviour. Loyalty resulting from internal motivation is the reason that sometimes stay and voice become more attractive.

Loyal behaviour is functional. Exit as a possibility is important but a rash, direct exit on a massive scale prevents constructive institutional change. Hirschman shows that 'loyalty, far from being irrational, can serve the socially useful purpose of preventing deterioration from becoming cumulative'. This purpose is important because 'creativity always comes as a surprise' and 'Loyalty then helps to redress the balance by raising the cost of exit' (Hirschman 1970:79). In this sense Hirschman defines loyalty as essential for 'the discovery of new ways of exerting influence and pressure toward recovery' *(ibid.),* thus possibly more constructive than voice. Therefore, it is indispensable in social relationships to have time for the discovery of new opportunities. In the absence of social capital, loyal behaviour, according to Wohlgemuth and Adamovich, prevents 'the rational choice of alternatives at given preference orders' (Wohlgemuth and Adamovich 1999:25, own translation). As a response to the deterioration of performance, the most rational behaviour in the context of economic logic would be immediate exit, provided that the exit costs are no higher than the costs of not doing so. A different utility function arises in the presence of the positive economic effects of social capital. The exit costs increase relatively to those of loyal behaviour in the social logic characterized by individual behaviour within the collective and by the expectation of repeated interaction. In addition, by using a dynamic approach, preference orders of individuals are not fixed. A learning process to improve products, organizations or governance is no longer possible without loyalty. Moreover, loyal behaviour is the key to voice because it allows individuals to think about exiting, but not to do so immediately. The function of loyalty becomes clearer in the formulation of Wohlgemuth and Adamovich because loyalty creates 'thresholds for the economic and political exit to competitive alternatives. This makes an exchange of information and opinions ("voice") possible; this is the base for necessary time-consuming processes of discovery and reform within economic and political organizations' (Wohlgemuth and Adamovich 1999:26, own translation).

Here, a clear analogy with North's concept of institutional change becomes evident. According to North, institutions always need a certain degree of variability to be able to optimize despite their function of providing stability. In the long run, only those societies whose institutions offer the maximum possibility for the improvement of their rules and norms will be the most successful in institutional competition and institutional change with respect to resulting economic performance. In the words of North, 'The society that permits the maximum generation of trials will be most likely to solve problems through time' (North 1990:81). In this sense, and as Märkt states, trials mean the 'opportunity of designing the institutional framework at the given place' (Märkt 2002:11, own translation), thus to hold exit at bay. That society which is able to give its citizens the feeling that every deterioration of performance can be adjusted within its institutional framework is likely to have the most loyal individuals. This feeling is nothing other than a high asset of *linking* social capital.

Loyal behaviour as preference. Loyal behaviour means the preference for long-term benefits from social interactions. The long-term costs of a rash exit are greater than the short-term benefits of this defection under the assumption of existing social capital. This cost-benefit analysis is neither predefined exogenously nor determined exactly, and therefore a restriction. It results from the subjective utility expectation of the individual only. Any delay of exit and every investment in voice is costly, and the benefits can be calculated only with uncertainty about the time and the level of reciprocity concerning repayment. This is the essential characteristic of every social transaction. As Portes states, 'if a schedule of repayments exists, the transaction is more appropriately defined as market exchange than as one mediated by social capital' (Portes 1998:7). The individual prefers loyal behaviour within his preference order if he ignores this uncertainty.

Loyal behaviour as a source of social capital. Loyal behaviour is the basis of the formation of social networks and their stability. It is precisely these social relationships that are social capital according to our definition. Coleman describes the personal relationships and networks combined in social capital as the prerequisite for the 'embeddedness of economic transactions in social relations' (Coleman 1990:302). Further, social capital 'is embodied in the *relations* among persons' and emerges 'when the relations among persons change in ways that facilitate action' (Coleman 1990:304, emphasis in the original). Loyal behaviour changes the relationships among persons by preferring voice instead of exit, and therefore with regard to the chances to identify a deterioration of performance and to retract it.

The simple main *rule* of social transactions supported by loyalty is the following: Voice instead of Exit. Simultaneously, this increases the probability of the enforcement of property rights resulting from social relationships. Loyal behaviour enhances the quality of the *enforcement arrangement*. Loyalty fulfils the above-mentioned claim to optimize social networks, their rules and enforcement arrangements underlying the social capital as a property right. It becomes clear that loyal behaviour can prevent sunk costs and minimize exclusion costs with regard to its economic relevance. Also, loyalty affects the exchange rates between the forms of capital (Bourdieu 1986). The higher the level of uncertainty as to the specification and enforcement of social capital, the lower its exchange rate will correspondingly be. Only a guarantee of social capital improved by loyal behaviour can stabilize the exchange rate.

As already mentioned, social capital is not internalized completely and therefore is not private property, but it is nevertheless a property right. It is, however, dependent on the engagement of other individuals. The same applies to loyalty, although the individual can decide whether he will be loyal or not. However, perpetually loyal unilateral behaviour does not make sense either. Moreover, each delay of exit and each investment in voice can be understood as a social-capital investment as well. The same characteristics are valid for property rights applied to loyalty in connection with social transactions, even for the general definition of social capital. One can define such relations as property rights because one acquires the right to helpfulness, loyalty, faithfulness and honesty. In this sense these attributes are called social capital as well. These rights are relative rights rather which can be asserted only to such persons with whom interaction occurs for any length of time.

(Göbel 2002:67, own translation)

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What happens if these rights are less valuable owing to increasing mobility and declining probability of repeating interaction? This requires a binding power which holds exit from a (social) interaction at bay and increases the probability of repeating interaction. In addition, an incentive has to be created to solve interaction problems that arise constructively by voice instead of by a destructive exit. Loyalty can fulfil both functions. The motivation for social-capital investment is raised crucial by loyalty.

Globalization, social capital and loyalty

social capital is important because it constitutes a force that helps to bind society together by transforming individuals from self-seeking and egocentric calculators, with little social conscience or sense of mutual obligation, into members of a community with shared interests, shared assumptions about social relations, and a sense of the common good.

(Newton 1997:576)

This chapter summarizes each individual argument discussed above to better visualize the link between globalization and loyalty. The following thesis should have emerged from the previous analysis:

1 *Globalization* decreases exit costs and thus means more opportunities for mobility.

2 *Social capital* as a factor of locations increases the economic efficiency of transactions. Too much mobility compromises the asset of social capital within in a society owing to its immobility. Negative externalities arise for both the people who are unable to move and those who are mobile.

3 To minimize these negative externalities it requires an influencing of mobility, that means a delay of exit and an increase of voice by *loyalty*.

To benefit from the positive outcomes of social capital despite globalization and increasing mobility, it is necessary to correlate the sources of social capital with mobility. The most important source of social capital as a property right is the social network between persons with obligations resulting from social interaction and persons who accept these obligations. This property right has to be specified and enforced at the lowest possible cost, which means the rules and enforcement arrangements must be defined. In contrast to economic transactions, the obligations resulting from social transactions cannot formally be enforced. However, the relative closure of a social structure can minimize the uncertainty as to the value of the property right. In this sense Coleman states:

Closure of the social structure is important not only for the existence of effective norms but also for another form of social capital: the trustworthiness of social structures that allows the proliferation of obligations and expectations. Defection from an obligation is a form of imposing a negative externality.

(Coleman 1988: S107)

Increasing opportunities for exit due to globalization make leaving the social relationship more likely. The value of the property right for the donor who is unable to move decreases if the individuals who are mobile are those who accept these obligations.

A problem results even if the individuals who are mobile appear as donors. Individuals who are mobile can avoid possible sunk costs and high exclusion costs only through a limited social-capital investment. Another possibility is to settle down. DiPasquale and Glaeser have demonstrated empirically that individuals with high wages accumulate less social capital. At the same time, they show that the social capital of home owners who are obviously unable to move is larger. It can be concluded that the positive externalities due to social capital decrease in a world oriented towards mobility, irrespective of general problems of assessment, upon which we do not comment here (DiPasquale and Glaeser 1999). The macroeconomic effects are an underinvestment in social capital and a deterioration of local advantages. This is the trade-off between growth resulting from mobility and growth due to attractive social capital.

How can this trade-off be solved? For this purpose, it is necessary to avoid or to internalize the negative externalities of social capital resulting from the mobility of human capital. A prerequisite for growth in the absence of social capital is total mobility of human capital, which means migration costs are zero. Merely increasing negative externalities due to excessive physical mobility could seem growth-restrictive, e.g. through more pollution by more traffic. An internalization of these negative externalities according to the 'polluter pays' principle increases the migration costs concerning the factor allocation of human capital. This leads to a restriction of migration and to a possible equilibrium. The negative externalities of migration are significantly higher owing to the presence of immobile social capital as a local advantage. Two opportunities to respond exist, assuming that social capital presents a growth factor, and mobility destroys social capital in a significant manner:

1 The arising negative externalities of mobility by the presence of social capital become widely internalized.
2 The arising negative externalities of mobility by the presence of social capital is prevented generally, for example by the restriction of mobility.

Reaction 2 is not feasible for an economy and location that owe their wealth to the more efficient allocation of all factors owing to globalization and mobility. Furthermore, social capital would decline owing to redundancy within a closed society, and negative economic effects would arise. This is the outcome of too much *bonding* instead of *bridging* and *linking* social capital. Therefore, mobility cannot be generally prevented. Reaction 2 must be realized and this means nothing less than holding exit at bay without limiting the opportunity for exit. Is this impractical? No, it is the answer to the following question by means of the concept of loyalty. What incentives are indeed necessary to make highly qualified people who are mobile willing to invest in social capital in the long run? Only such investment can compensate for the negative externalities to the people who are unable to move. An unstable economic policy causes more costs resulting from decreasing planning reliability in the long run than benefits from contemporary responses in the short term. The same applies to the benefits of social capital in an environment of unstable social relationships. Therefore, Bourdieu states, 'social capital of relationships (or social obligations)...cannot act instantaneously, at the appropriate moment, unless they have been established and maintained for a long time' (Bourdieu 1986:252).

First of all, it has to be analysed how such an internalization of the negative externalities induced by mobility can be managed successfully. Social capital as a property right has to be easily enforceable, and has to be clearly specified. In other words, social capital as a property right has to be exclusive without ignoring its character as a collective good in the form of the underlying network of social relationships. The exclusion costs, or, in the words of Demsetz, 'the great cost of preventing nonpayers from "stealing" benefits' only decreases with the opportunity of exclusion (Demsetz 1966:67).

Another impractical postulation? No, transparent and stable social relationships on the basis of repeated interaction are one solution. The feeling of 'we' should not only be worthwhile morally and in the short run. It has to be worthwhile materially in the long run as well. This is possible by the formation of clubs (for example, see Straubhaar 2002). This seems reasonable because social capital also represents a club good. Clubs are a voluntary association of individuals with common preferences. The voluntary perception of individuals of partial homogeneities defines the membership, not coercion through a government oriented at territorial, administrative borders, for example. The incentive to join a club primarily for the people who are mobile is the mixture between free will and stability. Free will means that individuals choose their favourite, most suitable club without abandoning the exit option. Stability emerges from transparency and social control. The constitution of clubs and the characteristics of a club good guarantee that, according to Portes, 'the expectation of repayment is not based on knowledge of the recipient, but on the insertion of both actors in a common social structure' and 'the collectivity itself acts as guarantor'

(Portes 1998:8). Rights and responsibilities are fixed, and therefore so are the rules about the specification and assignment of the property rights as well. The club members and the rules of joining and leaving the club are also well known. In addition, repeated interaction is certainly expected. Therefore the enforcement arrangement is transparent, and so the uncertainty about the enforcement of the property right is calculable. The improvement of the enforceability of obligations is directly related to the quality of the social relationships within the club. According to Coleman's statement above, clubs provide closure of social structures as a prerequisite for reducing the uncertainty in social relationships. In the words of Portes, 'Closure means the existence of sufficient ties between a certain number of people to guarantee the observance of norms' (Portes 1998:6). For the individuals involved the advantage of creating a club good is a significant reduction of the uncertainty of emerging negative externalities, for example undesirable redistribution by free riding. Therefore Portes sees 'bounded solidarity…as an effective antidote to free riding' (Portes 1998:8). The control of possible free riding is only necessary within the club owing to the application of the exclusion principle against outsiders. In addition, loyal behaviour, which means the solution of problems like deterioration of performance by voice instead of exit, makes social transactions more efficient within the club. Furthermore, the consolidation of the optimal size of a club can be managed more efficiently owing to loyal behaviour. The optimal size of a club has been modelled by Buchanan theoretically (Buchanan 1965). Furthermore, the value of the property rights within the club becomes more stable if the optimal club size is guaranteed.

On the one hand, stability and the guarantee of social relationships are an essential prerequisite for loyal behaviour. On the other hand, a social relationship becomes more stable by loyal behaviour. Therefore, loyalty increases social capital investment. The specification of property rights makes sense only if they are enforceable. From an economic point of view, we prefer the concept of clubs in connection with loyalty as a possibility to correct market failures by social-capital investment. This follows from the features of social capital as a property right mentioned above. This is the bridge between the people who are mobile and the individuals who are not, because transparent social relationships, rules and enforcement arrangements increase the expectation of certainty for both. Therefore, there is an incentive for both sides, and for the mobile particularly, to form and to maintain social capital by membership in clubs.

Conclusion

The shock of growing mobility resulting from globalization has to be managed with respect to growth and wealth. Woolcock proposes that the basis for successful management of this shock is the identification of social

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capital as an asset (Woolcock 2001:25). The value of social capital as an asset of a society becomes a subject of analysis if social capital is defined as a property right. The better the specification and the enforcement of property rights work, the greater will be the inherent value of a property right, owing to the internalization of externalities, at least theoretically.

In practice, growing mobility partly causes increasing negative externalities of social capital resulting from its character as a public good. If more and more individuals are mobile, a social-capital investment is not worth while, owing to the fact that the benefit from this accumulation of obligations to others is completely uncertain. However, loyal behaviour, which means the integration of people who are mobile into associations like clubs, is the incentive to invest in social capital.

With respect to the fact of increasing exit opportunities, pessimists, not to mention anti-globalists, are worried about the individualization of society due to growing mobility resulting from globalization. The interdependence of liberalization and globalization, which is not denied, is equated with the liberty of 'me' only. Of course, we appreciate that the decline of social capital has led to the weakening of 'we' identities in some parts of society. Referring to the relationship between globalization and mobility, we have explained how the positive externalities of social capital can change into negative externalities.

Nevertheless, we are optimistic and argue for globalization despite the existence of social capital. Individual freedom does not exist. Individual freedom is an outcome, if a collective, a social group or even a club guarantees it. Palmer describes this concept as follows: 'Just as a building is not a pile of bricks but the bricks and the relationships among them, society is not a person, with her own rights, but many individuals and the complex set of relationships among them' (Palmer 2003:22). The identity of particular individuals is always an outcome of their environment. Individuals operate within their environment with the help of social transactions, which are based on social capital. Perhaps the much mourned loss of social capital exists only within a man-made, defined, static area like within national borders, or municipal areas, etc. Through defining new borders with a dynamic point of view in the form of clubs, we have shown clearly that a net loss does not arise. The apparent social-capital loss exists as a basis of other social transactions. In contrast, the reduction of limits of behaviour can lead to a rise of social capital. This is the clear relationship between liberty and cultural identity or diversity (cf. Palmer 2003).

Globalization does not mean the end of collective action. Globalization changes collective action. The boundaries of a club as an expression of collective action no longer correspond with national borders. Identities are no longer confined and restricted by national governments and their national borders; rather people define their 'we' identities for themselves through the identification of common tastes for public goods (Cooper 1977:43). This is clearly demonstrated by the clubs of anti-globalists who, ironically, are connected by worldwide networks. There exists a 'we' identity due to common preferences and stable social relationships independent of a nation state. The transformation of governmental coercion to individual liberty and voluntary collective action is associated with that. The greater the degree of free will that underlies a decision, the greater the benefits of that decision, and the more likely is loyal behaviour in the future. In times of globalization 'we' means a club of individuals that solves the problems of collective action on the basis of common preferences related with voluntary loyalty instead of coercive regulated identities such as geographical boundaries.

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12

Invasions of the market

Steven Lukes

Social life and politics are everywhere—West, East and South—increasingly market-driven. This is in part the result of the impersonal pressures of the global economy, in part the outcome of political policy making inspired by neoliberal ideology, encouraged and assisted by such bodies as the World Trade Organization and the International Monetary Fund. It has been well said that 'neoliberalism's ascendancy has been associated with the political *construction* of markets, coupled with the deliberate extension of competitive logics and privatized management into hitherto relatively socialized spheres'.1 Non-market areas of social life are transformed into markets, and this involves commodification and profit making. This marketization involves a series of transformations. Goods or services are reconfigured so that they can be priced and sold. People are induced to want to buy them. The motivation of the work force producing or providing them is redirected from collective aims and a service ethic to profit seeking and market discipline. But if politics is ever more market-driven, the market is, in turn, politically driven. Neoliberalization is itself state-sponsored, and in some cases, notably the United Kingdom, when capital moves into a previously non-market sphere, risk is underwritten by the state.

These developments have been met with resistance, local and global, but it is not always clear what the grounds for that resistance are, or—more to my purpose here—what they should be. In this chapter I propose to explore the bases for such resistance by asking a basic question. When and why is the market out of place? What harm, or rather harms, does market exchange do and to which goods and services and spheres of life is it therefore inappropriate? Why do people think that this is so? When and why are they justified in so thinking?

Criticism of the market comes from all points along the left-right spectrum and from beyond it. Thus neo-Marxists since Lukács speak of commodity fetishism and reification and those influenced by the Frankfurt school of the colonization of the life-world. Some policy-oriented social democrats like Richard Titmuss and cooperative socialists like Marcel Mauss speak of the market driving out altruism. Communitarians speak of

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the 'morality of the bazaar' (Walzer 1983:109) and republicans of the erosion of public institutions and the corrosion of public virtues. Feminists see the market in gestational surrogacy as degrading to women and argue with intensity about whether prostitution oppresses and entraps women or expresses their economic freedom. Tradition-minded right-wingers resent the way in which markets disrupt hierarchies; racist and anti-immigration movements oppose open labour markets. And, beyond the left-right continuum, supporters of green politics defend the objective value of protecting the environment against the anthropocentric view of well-being as consisting in merely human preference satisfaction.2

To address the question before us properly, some ground clearing is necessary. First, the question of when and why market exchange is invasive is independent of the question of what practically follows, of what is to be done. That depends entirely on the available and feasible institutional alternatives. There may be none. Maybe the only alternative to a given undesirable market is an even more undesirable black market. And if there are alternatives, these may range from various degrees and kinds of regulation to prohibition. I want to focus only on the question in what respects markets can be harmful, leaving open the question of what can be done about them.

Why speak of 'the' market? There are, of course, different kinds of market in different goods and services with different features that are beneficial and harmful in different ways. I write of 'the' market in order to focus on the ways in which the market form of allocation functions in these different contexts. What damaging effects can be attributed to this form, as distinct from the harm or illegality attached to the goods or services so allocated? Addictive drug markets or markets in weapons or in diamonds that finance civil wars or in looted art may be bad but not, or not only, because they are markets. Conversely, good and even sacred things, like Bibles, can be marketed without causing trouble. The question is: what harms result from marketing and from rendering marketable, or marketizing, certain goods and services in specific contexts? Moreover, the context in which it occurs can make a difference, increasing or accentuating the harm in question. For example, it has been suggested that under the conditions of contemporary hi-tech, flexible capitalism 'job apprehension has intruded everywhere, diluting self-worth, splintering families, fragmenting communities, altering the chemistry of workplaces' (Walzer 1983:109).

By 'the market' I mean institutions involving regular and frequent exchange, buying and selling, that is, trading with enforceable and enforced contracts that is, unlike gift-giving, conditional upon future payment. I leave open whether the payment must be in money (it generally is and I will have nothing to say about barter) and I will try to discuss markets independently of whether they are capitalist, that is, oriented to the production of goods and services for private profit (which will be difficult to the extent that one thinks of market socialism as unfeasible or inherently unstable). Markets can certainly function without private ownership, or even private provision, as when, within capitalist societies, public authorities seek to allocate collectively owned resources by market pricing (though whether these should be seen as real markets is a further question: in practice they are perhaps better described as oligopolistic providers making deals with monopsonist customers) (Crouch 2003).

Clearly, the question of what can make markets invasive is a loaded question, asked against the background of well known and widely accepted benefits that market exchange brings: dynamism, capacity for innovation, communication of information unavailable by any other means, enhancement of choice and success in promoting long-term economic growth. These features all appear to be vindicated by the world-historical triumph of market over command economies and over the latter's various failed attempts to simulate the market. There are also three basic respects in which market exchange can, in theory, claim superiority over all hitherto known alternative mechanisms. The first is *efficiency in generating Pareto-optimal outcomes,* leading to an equilibrium in which no one can be better off without someone else becoming worse off. 'Efficiency' here means responsiveness of the system to consumers' revealed preferences subject to the limits of technology. But note that such efficiency, or optimality, is guaranteed under only ideal conditions: notably, of perfect information and of the existence of many markets, each of them being a market for a single homogeneous product. Where these conditions do not obtain (for instance, where there is asymmetrical information between buyers and sellers), there is no guarantee of efficiency. Externalities, imposing costs on others than direct consumers, also generate sub-optimal outcomes. It is often claimed that that these can be dealt with by market-based solutions, but this requires that transaction costs are zero, and they rarely are. The second claim for market superiority is the securing of *liberty,* markets ideally exhibit voluntary exchange, revealing individuals' preferences, expressing their consent and cooperation in the face of diverging values. The third respect in which markets are held to be superior is that they promote certain kinds of *equality:* they enable relations between strangers, and they dissolve hierarchies, with a formal right of exit, thereby alleviating extreme inequalities.3 So what is the case against the market? When and what do markets invade?

Consider first the economists' view of the matter. By economists I mean classical, neoclassical and especially welfare economists. Their approach offers not an answer to the question under consideration, but rather a change of topic. For the issue for economists is, precisely, sub-optimality, not harmfulness. Their concern is with the failure of markets, not with their inappropriateness when successful. The question they address is, what are the reasons why markets fail? Markets fail when reality fails to live up to theoretical requirements. They fail by failing to exhibit the idealized conditions under which they would otherwise succeed. One central reason they typically fail, as we have seen, is summed up in the concept of externalities—costs imposed on uninvolved third parties. (But what counts as an 'externality'? Deciding this relies upon a moral theory which economists never make explicit. What harms amount to a cost? Does harm to others include offence to others? Why not?) Moreover, when economists apply their theory to real world markets, it soon becomes evident that the typical causes of market failure—asymmetrical information, natural monopolies and monopoly power in general, non-zero transaction costs, economies of scale, outright coercion and social norms incompatible with efficiency—are not merely familiar but widely prevalent. As Elizabeth Anderson has well said, the theory of market failure is 'a theory not of what is wrong with markets, but of what goes wrong when markets are not available: it is a theory of what goes wrong when goods are not commodified' (Anderson 1995:192).

Within the leadership of New Labour in Britain today, the question of where markets are appropriate is highly controversial. In February 2003 Gordon Brown, the Chancellor of the Exchequer, gave a speech to the Social Market Foundation in which he stressed the need for 'courage to recognize where markets do not work' and so advanced what is, for the most part, the economists' case against marketizing health care: against 'viewing health care as akin to a commodity to be bought and sold like any other through the price mechanism'. As things stand, he argued, 'the standard conditions for a market to function are, to varying degrees, lacking'. The 'insurers often have poor information on which to base their risk assessment of the customer', leading to 'serious inefficiencies in private pricing and purchasing'. Hence the need for public funding. But there should also, Brown argued, be public provision, because various features essential to a properly functioning market are absent. First, there is 'chronically imperfect and asymmetrical information' on the part of consumers, who are, therefore, not sovereign, combined with 'the potentially catastrophic and irreversible outcome of healthcare decisions based on that information'. Second, 'local emergency hospitals are—in large part—clusters of essential medical and surgical specialties and have characteristics that make them akin to natural local monopolies'. Third, there are economies of scale and scope that make it difficult to find market solutions. And fourth, it is, as the US health care system demonstrates, 'difficult for private sector contracts to anticipate and specify the range of essential characteristics we demand of a health care system'. If you combine these classic bases for market failure with a policy putting profit maximization by hospitals at the centre of health care, you will get a twotier health care system based on the ability to pay rather than on clinical need. Furthermore, Brown argued, trying to overcome all this by market regulation, even were it feasible, is doomed, since 'public provision is likely to achieve more at less cost to efficiency and without putting at risk the gains from the ethic of public service where, at its best, dedicated public servants put duty, obligation and service before profit and personal reward'. In short, in health, 'price signals don't always work, the consumer is not sovereign, there is potential abuse of monopoly power, it is hard to write and enforce contracts, it is difficult to let a hospital go bust [and]... we risk supplier-induced demand' (Brown 2003:15–19).

But the problem is that the spreading marketization of the world that we are living through precisely consists in overcoming such problems where possible, turning non- or failing markets into markets, in reconfiguring goods and services that are not commodities into commodities, so that they can be priced and sold, and in inducing or encouraging people to want to buy them, while redefining the work force of service providers as producers of commodities, converting 'services' into 'industries', and 'duty, obligation and service' into 'profit and personal reward'. In his recent excellent book *Market-driven Politics,* Colin Leys has described the massive transformation of services, weaning 'consumers from services into consuming material goods and providing the labour component themselves' and traced in particular the story of the developing commodification of health care in the British National Health Service (he does the same for public television), summarizing his findings as follows:

The hospital service is stripped of its role as a provider of care and 'reconfigured' as an increasingly industrialized provider of treatments; more and more NHS functions are privatized and commodified; the boundaries between it and commercial medicine are blurred and increasingly breached. While clinical services remain formally free and universal, they are no longer all publicly provided, and further instalments of 'marketization' are confidently expected by the commercial health-care industry. (Leys 2001:212)

So we need to pose anew the question before us: namely, where are markets out of place, and why? We need to consider not why markets fail, but where, to the extent that they succeed, they are harmful and why, and why, in such cases, they should, where this is feasible without creating greater harm, be regulated or prevented. There are, I suggest, three broad distinct answers to this question. All have force, though they are not equally compelling; nor are they necessarily mutually coherent.

Commodification

One widely favoured answer focuses on a notion to which I have already alluded: commodification. This term expresses an internally complex idea which can be seen as part of the long history of critical reflection upon the effects of market institutions: of money, which Shakespeare's Timon of Athens called 'Thou common whore of mankind' (Act IV, scene III), of trade and of what the French came to call *commerce*. One principal source of both the term and the idea is Marxist. Marx, indeed, quoted Timon's epithet in his early Paris manuscript on money, which he, in turn, called 'the bond of all bonds' and 'the universal agent of separation' (Marx 1963:191–2). Marx and Engels famously wrote in the *Communist Manifesto* that, as the 'constantly expanding market' spreads over the surface of the globe, all that survives is 'callous "cash payment"': men are drowned in the 'icy waters of egotistical calculation', 'all fixed, fast-frozen relations, with their train of ancient and venerable prejudices and opinions are swept away, all new-formed ones become antiquated before they can ossify' and 'all that is solid melts into air, all that is holy is profaned, and man is at last compelled to face with sober senses, his real conditions of life, and his relations with his kind' (Marx and Engels 1957:51–3). And Marx devoted a section of *Das Kapital* (chapter 1, section 4) to analysing what he called 'commodity fetishism', which in turn influenced Georg Lukács to develop the idea of reification. 'Commodification' has come to be widely used by non-Marxists but its meaning continues to recall its origins.

Margaret Radin has given us a useful breakdown of what she calls its component 'indicia' (Radin 1996:118). Goods or services are commodified when they exhibit the following features:

1 *Objectification,* treating persons and things instrumentally, as manipulable at will.

2 *Fungibility,* when they are fully interchangeable with no effect on their value to the holder.

3 *Commensurability,* when their values can be arrayed as a function of one continuous variable or can be linearly ranked.

4 *Money equivalence,* where the continuous variable in terms of which they can be ranked is monetary value.

If these are the features which render goods or services commodified, the question then arises: what harm is held to flow from these features? The answer is, I suggest, twofold. On the one hand, certain goods and services are said to be debased or distorted by being commodified, that is, treated as marketable. Call this the *corruption argument*. By 'corruption' I mean to adduce the general idea of *pathology:* the thought that the impact of the market is to distort, impair or degrade otherwise well functioning and potentially flourishing activities or relationships. The standpoint from which this thought arises is sometimes Kantian, sometimes Aristotelian, sometimes both. People should be treated as ends, not means; as subjects, not objects; as having dignity, not price; and they can flourish as fully human only in certain favouring contexts, or through realizing goods internal to social practices4 to which market motivations are a threat.

The general idea is this: that among the goods that people value there are some which have the value they do in part just because they are not up for sale and, if they do start to be bought and sold, or are even seen as saleable, their value is debased. And to this idea a second, expressed in the quotation above from the *Communist Manifesto,* is often adjoined: that, once this process begins in respect of one such good, other such goods are infected and the contamination spreads, across persons and across goods. Changing for a moment the metaphor, this has been called the 'domino effect' by Margaret Radin. According to this argument (to change the metaphor yet again), there is 'a slippery slope leading from any sales of something to an exclusive market regime for that thing, and there is a further slippery slope from a market regime from some things to a market regime encompassing everything that people value' (Radin 1996:99–100). The idea here is that certain exchanges should, if possible, be blocked to prevent the corruption that markets allegedly cause from spreading. Call this the *contagion argument*.

How, then, are we to recognize where corruption and contagion occur? When do the processes which commodification describes do their distinct damage? Which goods and services are at risk? Michael Walzer, in his *Spheres of Justice,* advances a relativist or conventionalist version of the corruption argument. Walzer argues that the various items he lists as defining his spheres—notably security and welfare, office, kinship and love, political power, and so on—are to be protected from what he calls the tyranny of 'market imperialism'—the dominance of the sphere of money and commodities, because our 'shared understandings' require it. ('The market is a zone of the city, not the whole of the city' (Walzer 1983:120, 109)). But the problem is that 'we' do not have a single, shared map. Our understandings of where these boundaries should be are not sharply drawn and, worse, 'we' disagree about where they lie. On the contrary: they are confused, inconsistent and contested. Moreover, they reflect unequal power relations, in which some voices prevail and others are silent. Walzer's own idea of social justice requires that *commodities* are exchanged through bargains, not commands or ultimatums, that no such exchange be 'desperate', and that 'the welfare state underwrites the sphere of money when it guarantees that men and women will never be forced to bargain without resources for the very means of life' (Walzer 1983:121). But such an understanding of what is just is, in the present US context, far from shared and it is wishful to suppose that it is. So can we find an objectivist, non-relativist argument in order to recognize and thus avoid corruption and contagion?

One such is provided by Elizabeth Anderson. According to her, market norms come into conflict with social norms that govern the social settings individuals require in order to develop and express their freedom and autonomy by valuing different kinds of goods across a significant range of options. Her central idea is that markets are suitable

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only for the allocation of 'pure economic goods'—goods that are merely means to other individual ends and are 'traded with equanimity for any other commodity at some price'. They are appropriate to the allocation of goods which are subject to 'a lower, impersonal and exclusive mode of valuation' and are thus unsuitable for allocating goods that are 'higher, personal, or shared'—goods that are valued intrinsically, as unique and irreplaceable or valued for their attachment to oneself and goods whose value depends on sharing the same item according to shared understandings of what it means. Market norms, she argues, are impersonal and instrumental (each party to a transaction treating the other as merely a means to the satisfaction of ends defined independently of the relationship and of the other party's ends), egoistic, exclusive, want-regarding and oriented to exit rather than voice (Anderson 1995:143–7 and chapter 7 *passim*).

So corruption happens when market norms are applied improperly. Goods or services are corrupted, or distorted, when they are mistakenly treated as purely economic. So, for instance, gift giving becomes corrupted if it becomes minutely calibrated to ensure that the prices of gifts received and given are equalized (though, if giving were to be made conditional upon receiving equal value, one may ask whether that would be a gift). Gift giving involves reciprocity but excludes commensuration to secure equivalence: mutual relationships resist the balancing of accounts. Marcel Mauss in *The Gift* wrote of 'obligation and spontaneity in the gift' and of 'our good fortune that all is not yet couched in terms of purchase and sale': we might, he optimistically thought, 'once again discover those motives of action still remembered by many societies and classes: the joy of giving in public, the delight in generous artistic expenditure, the pleasure of hospitality in the public or private feast'. He even imagined a welfare state in which contributions were not equated with receipts, a future in which '[s]ocial insurance, solicitude in mutuality or co-operation, in the professional group and… Friendly Societies' exhibit the principles of 'honour, disinterestedness and corporate solidarity', so much better than 'the mean life afforded by the daily wage handed out by managements, and better even than the uncertainty of capitalist savings'. We must become, he thought:

> in proportion as we would develop our wealth, something more than better financiers, accountants and administrators. The mere pursuit of individual ends is harmful to the ends and peace of the whole, to the rhythm of its work and pleasures, and hence in the end to the individual.
>
> (Mauss 1954:63 ff.)

For Richard Titmuss the giving of blood exhibits the altruism that, he claimed, selling it extinguishes. For the:

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paid seller of blood is confronted...with a personal conflict of interests... Because he desires money and is not seeking in this particular act to affirm a sense of belonging he thinks primarily of his own freedom; he separates his freedom from other people's freedoms.

(Titmuss 1970:240)

And there are other 'higher, personal and shared' goods that are, on this argument, unsuitable for selling. So, according to Georg Simmel, in prostitution:

the stake of the woman is infinitely more personal, more essential, encompassing more of her ego than that of the man, and for which, therefore, a money equivalent is most unsuitable and inadequate, the giving and taking of which means the extreme abasement of the female personality.

(Simmel 1978:379)

Is the same true of the sale of reproductive services? And what about the sale of kidneys and other body parts?

How compelling are these examples? And how far can they be extended? To fencing off and charging for entry to beaches and cliff walks, or to museums and art galleries? To the commercialization of the arts? To the marketing of cultural goods in general?5 To the buying and selling of medical services and of educational services?

In order to answer these questions, we must attend to the structure of both the corruption and the contagion arguments. What they claim is that the mode of allocation of goods and services has a specific causal impact on the mode of their enjoyment: specifically, that features that comprise commodification of certain goods and services exclude, by a sort of psychological Gresham's law, the realization of their intrinsic value. It is not clear whether this applies to one, some or all four of the features of commodification, but in any case the claim is that, where corruption holds, commodification drives out what is intrinsically valuable about a given good or service for given individuals, and where contagion occurs it drives out what is intrinsically valuable for others, and perhaps for other, even most or all, goods and services. So, Titmuss suggests, selling blood crowds out altruism. And if contagion occurs, it diminishes the scope for giving it and perhaps other worthwhile things in society at large. As he famously put it, 'private market systems in the United States and other countries... deprive men of their freedom to choose to give or not to give': the commercialization of blood has the effect of 'discouraging and downgrading the voluntary principle. Both the sense of community and the expression of altruism are being silenced' (Titmuss 1970:239, 157).

Or, to give another example, suppose that sex were to be fully and openly commodified: suppose newspapers, radio, television and billboards advertised sexual services as imaginatively and vividly as they advertise computer services, health clubs or soft drinks. Suppose the sexual partner of your choice could be ordered through a catalogue, or through a large brokerage firm that has an 800 number, or at a trade show, or in a local showroom. Suppose the business of recruiting suppliers of sexual services was carried on in the same way as corporate head hunting or the training of word-processing operators. (As the age of the Internet and cable and satellite television proceeds, are we really so far from realizing this state of affairs?) Then, Radin speculates, perhaps:

its commodification of sex would be reflected in everyone's discourse about sex, and particular about women's sexuality. New terms would emerge for particular gradations of sexual market value. New discussion would be heard of particular abilities or qualities in terms of their market value. With this change of discourse, when it becomes pervasive enough, would come a change in everyone's experience, because experience is discourse dependent.

(Radin 1996:133)

Is this claim plausible? There is, I think, no general, overall answer: it can be answered only case by case. Thus the marketing of Anderson's 'pure economic goods' can, plainly, have a direct, deleterious effect upon both the incidence and the distribution of goods that are 'higher, or personal, or shared'. Here is an example. In April 2003 the chocolate manufacturer Cadbury launched a £9 million campaign to persuade children to buy 160 million chocolate bars, containing two million kg of fat, in exchange for 'free' sports equipment for their schools, claiming that the initiative would help to tackle obesity. Cadbury Schweppes has, in fact, one of the worst portfolios for products in terms of children's well-being. The British Dietetic Association spokesperson commented, 'We are running an Eat to be Fit campaign at the moment warning children of obesity. Our research shows 31 per cent of children are overweight and 17 per cent are obese' (*Guardian,* 29 April 2003).

But there are general grounds for some scepticism. Consider just two of the features of commodification: objectification and commensurability. Must Titmuss's 'personal conflict of interests' always be resolved by suppressing one or the other?6 Do people not endlessly contain contradictions and exhibit ambivalence? Are experience and discourse so malleable and is experience so 'discourse-dependent'? And why should there not be alternative, coexisting distributive mechanisms for blood without one driving out the other? Is it really true that viewing and treating others as means to individual ends, and seeing the world in impersonal and quantifiable terms, are incompatible with altruism, reciprocity and the realization of values that are 'higher, personal and shared'? Mary Douglas has persuasively argued that goods are to be seen as 'ritual adjuncts' and their consumption as a 'ritual activity', which 'uses goods to make firm and visible a particular set of judgments in the fluid process of classifying persons and events'. In an individualist weak-grid, weak-group modern capitalist society, market behaviour will, on this account, be amenable to anthropological interpretation as a mode of 'fixing public meanings' (Douglas 1979:43, 45, 43).

Moreover, are there not indeed many contexts, especially in modern urban living, in which instrumental relationships, and seeing the world in anonymous and commensurable terms, is much to be valued, indeed an essential precondition for, and counterpoint to, mutual relationships in more intimate settings? You want your doctor to have a bedside manner, but you also want patients to have hospital numbers and medical resources to be rationally allocated on objective grounds, whatever these may be. Indeed, it is not even obvious that treating people as objects and as a means to some end is always a bad idea. It must depend on the end and on who is doing what in pursuing it. According to his biographer, Beethoven was 'filled with a deep conviction as to the significance of his work and his art' and in 1801 referred to two of his friends as 'merely... instruments on which to play when I feel inclined... I value them merely for what they do for me' (Solomon 1977:86).

As for commensurability and incommensurability, why should we assume that we cannot both know the price of something and know that it is priceless? On the one hand, we adhere to the notion of the sacredness and absolute value of the individual, which, as Simmel noted, arose out of Christian doctrine and negates 'the ideal basis of blood money and slavery':

Over and above all the details, relativities, particular forces and expressions of his empirical being, stands 'man', as something unified and indivisible whose value cannot possibly be measured by any quantitative standard and cannot be compensated for by more or less of another value.
(Simmel 1978:360)

On the other hand, we make insurance decisions and pay medical administrators and policymakers to allocate resources and plan the siting of airports on the basis that alternative options involve the statistical certainty of deaths and injuries that we expect to be costed on a rational and systematic basis that puts a (regularly updated and commercially based) value on human lives.7

Commodification may sometimes, even often, constitute a harm done when marketing and marketizing certain goods and services distorts or debases their nature, and that harm may be amplified through contagion, for instance by market ideology and rhetoric. But some scepticism and questioning is in order. We certainly need a better understanding of the

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mechanisms that allegedly generate corruption and contagion.8 Furthermore, in asking what harms markets can do, we need to look beyond the direct effects of markets upon goods and services seen in abstraction from social and political relationships. We need to ask to what extent and in what ways these can in turn be adversely affected by certain markets. And we need to know where to centre our concerns: upon markets and their effects, or upon the social and political relationships they mirror and reinforce.

Inequality

A second answer to our question when markets are invasive is that they reflect and exacerbate inequalities of various kinds. Obviously, market allocation is, in a trivial sense, inherently inegalitarian, delivering, as supply responds to demand, unequal outcomes in the form of unequal goods, income, wealth and, indeed, status and power. It is also, equally trivially, at least in its textbook version, inherently egalitarian, presupposing equal consumer sovereignty, and equal access to entry, information and opportunity to compete, and equal rights to exit. On the other hand, real world markets are not 'spontaneous orders' but norm-governed institutional orders. As Amartya Sen has put it, 'market forces can be seen as operating *through* a system of legal relations (ownership rights, contractual obligations, legal exchanges, etc.)' (Sen 1981:166). Real world markets exhibit asymmetrical information and unequal power, which derive from the massive and organized power of corporations *vis-à-vis* 'natural persons' or individuals, from the unequal endowments and exchange entitlements actors bring to the market and from the operations of the market itself. To seek to rectify the latter, market regulation can be introduced.

Markets respond, and are supposed to respond, to preferences expressed in effective demand, not to concerns about the urgency of need. So it is not surprising that they have unjustifiably or harmful inegalitarian consequences when, as a result of their functioning, individuals or whole categories of individuals fall below a baseline level of deprivation, where 'deprivation' signifies poverty and social exclusion and, in general, a failure of basic capabilities, understood as people's inability to satisfy certain crucially important functionings up to certain minimally adequate levels. Clearly this baseline will be subject to historical and cultural variation, and it will correlate imperfectly and variably with inadequacy of income. But it will obviously include access to a range of basic goods and services such as food, clean water, electricity, shelter, life-saving drugs and some level of medical care, education and basic security. Where, under conditions of low economic development, or in the absence or failure of effective social rights (or an adequate and universally accessible insurance market), people are dependent on access to these goods and services through markets, then if such markets function in such a way as to deprive individuals or categories of individuals of the ability to command such goods and services they are plainly harmful.

Markets also reproduce and enhance pre-existing inequalities, operating differentially to the advantage of those with greater resources and greater power. These latter are relatively insulated from the impact of market forces and are able to exercise market power, and the right to exit, even in the absence of monopolies. Satz (2004) cites the example of asset sales of livestock and land at 'fire sale prices', which regularly happen in drought-stricken areas in poor countries. Even where there is no element of monopoly in the operation of these markets, they set in motion processes of dispossession of assets by the poorest and accumulation by the richest. And consider, for example, the amplifying effects of the housing market, when asymmetrical residential housing patterns result from the unhindered play of market forces, thereby reinforcing ethnic and class inequalities. Low-income, unskilled or unemployed workers and those from low-status ethnic groups will, even in the absence of discrimination, restrictive mortgage lending, zoning regulations, public housing policies, etc., be unable to move out into the suburbs or into middle- or upper-class neighbourhoods. In this way, the housing market serves to reinforce economic and status inequalities, and those who live in poorer neighbourhoods also have to accept poorer schools, lower-quality public services and higher crime rates.

Inequality, of resources and power, in fact, offers an illuminating perspective within which to revisit some of the examples of markets that were considered in the previous section, abstractly, as instances of commodification. Are not many of the concerns typically expressed in terms of the corruption and contagion arguments actually worries about inequality and subordination? How many people would sell their kidneys and how many women would sell their reproductive capacity under conditions of greater equality of condition? Under such imagined conditions, what exactly would be the objection? Consider the notorious case of baby M in which Mary Beth Whitehead, who gave birth to the child, was judged by the lower court not to be a mother but merely a contractually agreed means to the gratification of the sperm donor—a decision properly reversed on appeal. What went wrong here? Is the lesson of the story one about 'what happens when people treat people like things' or is it that contract motherhood is 'an inherently unequal relationship involving the sale of a woman's body and a child' (Pollitt 1994:68, 78)? Isn't the central troubling worry about the case that, if the first judgement had been left standing, it would have reproduced and reinforced a negative stereotyping of women? For, as Radin suggests, 'under current circumstances surrogacy can readily be culturally interpreted as reinforcing gender hierarchy, because it allows an exception to

file:///C|/Users/Marco%20Rosa/Desktop/0415349001/files/page_310.html [30-08-2010 19:44:53]

the general prohibition of commissioned adoption, and the exception privileges the male line' (Radin 1996:161).

Is the case against prostitution parallel? Is the primary objection commodification or is it inequality? Simmel makes both objections. On the one hand, as we have seen, he argues that the woman's personality is maximally suppressed. On the other hand, he goes on to write:

What is important here is not that prostitution means polyandry, but that it means polygyny, which degrades the personal value of women and causes the woman to lose her scarcity value. Viewed superficially, prostitution combines polyandrous with polygynous features. But the advantage of the person who gives the money over the person who provides the commodity grants a tremendous superiority to the male and determines the character of prostitution as polygynous.

(Simmel 1978:379)

Radin suggests that it is scarcely worth asking 'whether "pure" commodification, absent any other worrisome features such as maldistribution or wrongful subordination, would trouble us'. This issue, she thinks, is 'a professor's hypothetical', since commodification occurs in market societies in which inequality and subordination are inherent: she suspects that 'this hypothetical disconnection of commodification from subordination is not a fruitful avenue of inquiry' (Radin 1996:161–3). But, professorial or not, asking this question is helpful, indeed essential, if we are to address the question before us, namely, what makes markets invasive—the answer to which (it should be obvious by now) is by no means obvious. For one thing, it is not clear that the same answer applies to all cases. For another, it surely matters a great deal, if different kinds of inequality can be combated and reduced and if the effects of markets can be avoided, or limited by regulation, to know where we should direct our attention and political energies.

For example, what are we to say about the buying and selling of Anderson's 'higher' and 'shared' goods? What exactly is the objection (assuming there is one) to charging for entry to museums and galleries, beaches and cliff walks? Is the problem here *distortion* or *exclusion*? Where charging occurs, the enjoyment of the goods in question remains, it would appear, as intrinsic as ever, albeit restricted; the point is that its availability is effectively rationed on an irrelevant class basis. Of course, to the extent to which such goods are 'positional goods',9 their intrinsic value actually requires exclusion. To the extent that such enjoyment consists in the expression and reinforcement of class distinctions,10 the class-based exclusion involved in their being commodities—as in the art market or the market for luxury residences—adds to their value, rather than distorting it (or perhaps we should say that such addition constitutes distortion? But how would we justify saying that?).

What are we to say of the commercialization of health services? I have quoted Gordon Brown arguing that the introduction of profit maximization leads to a two-tier health care system based, not on clinical need, but on the ability to pay—a straightforward inequality argument. But, abstracting from its consequences for inequality, is there anything intrinsically objectionable about private medicine? Is the commodification of medical services inherently harmful? Bernard Williams once advanced the argument that it is a necessary truth that 'the proper ground of distribution of medical care is ill health', that 'needs are the ground of the treatment' and that 'the situation of those whose needs are the same not receiving the same treatment' is 'an irrational state of affairs' (Williams 1979:121–2). But, Robert Nozick famously objected, why should the 'internal goal' of doctoring (curing the sick) 'take precedence over, for example, the person's particular purpose in performing the activity?' For, presumably, then:

the only proper criterion for the distribution of barbering services is barbering need.... If someone becomes a barber because he likes talking to a variety of different people, and so on, is it unjust of him to allocate his services to those he most likes to talk to? Or if he works as a barber in order to earn money to pay tuition at school, may he cut the hair of only those who pay or tip well? Why may not a barber use exactly the same criterion in allocating his services as someone else whose activities have no internal goal involving others? Need a gardener allocate his services to those lawns which need him most?

In what way, Nozick asks, 'does the situation of a doctor differ? Why must his activities be allocated via the internal goal of medical care?'

why is he less entitled to pursue his own goals, within the special circumstances of practicing medicine, than everyone else? So it is *society* that, somehow, is to arrange things so that the doctor, in pursuing his own goals, allocates according to need; for example, the society pays him to do this. But why must the society do this? (Should they do it for barbering as well?) Presumably because medical care is important, people need it very much. This is true of food as well, though farming does *not* have an internal goal that refers to other people in the way doctoring does.

(Nozick 1974:233–4)

A different way of arguing for the independent harmfulness of commercial medicine derives from the economist William Baumol's idea that there are services that resist commodification because they are services 'in which the human touch is crucial, and are thus resistant to labour productivity growth': they resist standardization because 'treatment must be tailored to the individual case' and 'quality is, or is at least believed to be, inescapably correlated with the amount of human labour devoted to their production' (Baumol 1997:513). Baumol's original examples were the performing arts but he extended the analysis to, among other services, teaching, doctoring and policing. But, as Leys argues, in the medical field as elsewhere, Baumol:

underestimated the constant resourcefulness that capital displays in its efforts to resolve the problems it confronts—including its ability to wean consumers from services on to consuming material goods and providing the labour component themselves [and] finally, consigning any residue to small 'high-end' markets, or leaving them to (increasingly beleaguered) state provision.

(Leys 2001:94, 95)

But then the question arises: what exactly is objectionable here? In Britain, for example, the commodification of medical services has involved the splitting up of different services, not all of which are Baumol-like in resisting productivity increases, while enlisting patients in the provision of the service is not always a bad idea. On the other hand, the growing consumption of drugs and pain-killers, the speeding up of the examination of patients and the very fragmentation of services point in the other direction. We need to discriminate between what is negative and what is positive in the commodification of doctoring.

What about the commercialization of cultural goods? Are these, by being commodified, distorted and debased, whether directly or indirectly?11 This question invites an extended and complex debate. Some areas of culture and the arts, such as opera, usually require protection from market forces, through patronage or subsidy, in order to flourish. Others, such as popular music and the cinema, have flourished because of mass availability through the market. Yet others have suffered a serious diminution in quality as the market has taken hold. Colin Leys tells the disturbing story of the effects of the dramatic expansion of commodified television on public service broadcasting in Britain, which he treats as a case study in marketization, in which we see 'the conversion of services into commodities; the creation of a demand for those commodities; the conversion of the labour force into one willing to produce profits; and the intervention of the state to lower the risk of investment' (Leys 2001:136). To consider why this is so, and what harm is involved, we must turn to the third and most compelling answer to the question of what makes markets invasive.

Citizenship

This is that markets can conflict with the requirements and preconditions of citizenship. One possible approach is to see the question in the light of the corruption argument. It is sometimes said that market relationships, and the associated language of buyer and seller, producer and consumer, industry and enterprise, have corrupted the public domain and what Gordon Brown called 'the ethic of public service'. But such an assertion does not advance the argument and begs too many questions. We need to remind ourselves what citizenship consists in and what its relevant requirements and preconditions are.

Citizenship in capitalist liberal democracies can be seen as embodying a central political core, which, as T.H. Marshall argued, in Europe and in Britain especially, expanded its scope into a set of social rights to basic services in the course of the twentieth century. The core consisted and consists in civil rights—'liberty of the person, freedom of speech, thought and faith, the right to own property, and to conclude valid contracts, and the right to justice' and political rights—'to participate in the exercise of political power, as a member of a body invested with political authority or as an elector of the members of such a body' (Marshall and Bottomore 1992:8). These can be seen as embodying the requirements of citizenship: entitlements that are inseparable from the status of citizen and so non-transferable, and therefore not available for sale and purchase. In practice, some of these rights, notably votes, have been bought and sold, but the rationale for the core of citizenship—representative democracy, in which citizens are presumed to be equals electing legislators who are responsible to them—makes it clear why such a practice is illegitimate. Of course the effective exercise of rights of citizenship has always been unequally distributed but the equality of citizenship status has always made it clear why their transferability and thus marketability were out of the question.

As Marshall argued, the first half of the twentieth century saw the acquisition by citizens of a range of basic services to which they could claim entitlement as citizens, services funded and provided by the state and thus excluded from the scope of the market. These are sometimes seen as constituents of 'social citizenship' but they can, equally, be seen as supplying the preconditions for core citizenship by enabling citizens to acquire and maintain the capacities needed for its equal exercise. The content of these services varied in different places and times, but it has generally included as a minimum the provision of education to ever higher levels in the course of the century, health care and financial support in case of unemployment, injury, ill health and old age, but also in some fortunate places legal aid, citizens' advice, access to public spaces, public libraries, public broadcasting, and so on. In this way, the reach of the market was resisted by an ethos, whether based on social democratic or Christian ideals, of welfare, publicly funded and publicly provided. In several European countries these arrangements were stabilized in various welfare regimes after the Second World War.

In the latter third of the twentieth century, the story that Marshall told took a new turn. The age of economic growth fuelled by industrial production peaked by the 1970s and capitalist firms began to abandon manufacturing and increasingly sought to make their profits in the service sectors, including health, education, legal and other professional services. As Colin Crouch has written, this has raised a problem:

Some potentially very profitable services are those of the welfare state, protected from private ownership and the market as part of the midcentury citizenship package. So long as the welfare state survives, potential areas of profit-making are excluded from capital's reach. Post-industrial capitalism has therefore started to try to undo the deals made by its industrial predecessor.

(Crouch 2003:6–7)

The activities of the WTO and the worldwide spread of neoliberal ideology, encompassing governments of the centre-left, have further encouraged this trend, opening up health services, education, public utilities, transport and broadcasting to marketization and privatization. Against this background, we can see how and in what ways the market has come to invade the domain of citizenship: how both the requirements of core citizenship and the provision of its social and cultural preconditions have come under threat from the inexorable expansion of the market.

The requirements of citizenship in representative democracies most obviously exclude the use of market power to buy political influence in the electoral process. The private financing of political campaigns and the corporate domination of mass media is thus in direct conflict with these. This has long been a problem in the United States, but it has now arisen as such in various other capitalist countries, most obviously in Italy. But a further direct conflict with the requirements of core citizenship is a direct result of the recent expansion of the market into public services described above. For as privatization and contracting out of services has proceeded, the essential link between elector and representative (national or local) is severed. Marketization has enabled politicians to divest themselves of responsibility and, crucially, accountability for the provision of public services. The government contracts with the supplier but citizens can no longer hold their representatives accountable for service delivery, which has been rendered faceless by being consigned to anonymous forces of the market. In this way, as the story of rail privatization in Britain shows, contractors engage subcontactors and the market in services proliferates, and the provision of once public services moves out of the citizens' purview and control.12

Finally, I turn to the all-important question of the preconditions of citizenship: the various services that generate and sustain the capacity of people to function as good citizens of representative democracies. There is scant reason to believe that all these will be provided by market forces alone. In particular, there is a case for arguing that where markets invade the spheres of educational provision and public broadcasting, some of the capacities needed for equal citizenship are likely to be impaired and undermined. It is worth analysing in some depth why this is so to see how strong that case is.

Let us assume that among such capacities the cognitive capacity to process information and achieve a rational understanding of one's environment is both basic and crucial. It is a precondition of the effective pursuit of one's interests, however egoistic or altruistic these may be. It is also a necessary condition of the self-protection of citizens against tyranny and corruption and of the genuine, autonomous consent that can accord legitimacy to a regime that claims to be a representative democracy. The prevalence of this capacity among citizens requires a context of institutions that foster and favour rather than stunt or impair it. What are the prospects of the market in this connection?

An expression that is often cited in discussions of these matters is 'the marketplace of ideas'. It is suggested that the best way of arriving at truth is through the free competition of ideas in an open market. So, in a classic formulation of this thought, Justice Holmes wrote in 1919 that when:

men have realized that time has upset many fighting faiths, they may come to believe even more than they believe the very foundations of their own conduct that the ultimate good is better reached by free trade in ideas—that the best test of truth is the power of the thought to get itself accepted in the competition of the market.

(Goldman 1999:192)

And Frederick Schauer's book *Free Speech* states the argument that just:

as Adam Smith's 'invisible hand' will ensure that the best products emerge from free competition, so too will an invisible hand ensure that the best ideas will emerge when all opinions are permitted freely to compete.

(Schauer 1982:16)

But, as Alvin Goldman has most perceptively argued, we need to make a distinction between the market in the *literal, economic* sense and the market or market place understood *metaphorically or figuratively*. The latter:

construes the marketplace of ideas as a market-like arena, in which debate is wide open and robust, in which diverse views are vigorously defended. This kind of debate arena may or may not result from an economic market mechanism. Under the second version, moreover, what counts is the scope of the resulting debate, not the mechanism that produces it. If a diverse set of views is vigorously aired, this quali-

fies as an open marketplace of ideas even when governmental action is required to secure this state of affairs.
(Goldman 1999:192)

Bernard Williams has supplemented this by stressing that in the metaphorical market:

the competition will be not a commercial interaction between entrepreneurs but an intellectual interaction between people advancing various ideas, and the 'market forces' that operate on the ideas will consist of processes that are truth-acquiring relative to the question at hand. [These practices will] 'standardly be such things as careful argument, attention to empirical inquiry, sifting of evidence, and so on', but the 'model should be of real people working within a structure that could be socially realized, working in a way that brings about competition between theories, suggestions, and so on (which may or may not also be a competition between people)'.
(Williams 2002:214)

But now two questions arise. First, to what extent does the literal market approximate the condition of the metaphorical market? And second, to what extent does the latter, in any case, promote the cognitive capacity of citizens? Addressing the first question, we can see that there are decisive theoretical reasons for doubting that it will. For, as we have seen, the efficiency of the market consists in its responsiveness to consumers' preferences and those preferences may not favour the advancement of truth. As Goldman has put it:

if truth (knowledge) is *one* thing people value, but they are willing to substitute other commodities (such as entertainment or titillation) for truth (knowledge), then economic theory says that they will get the amount of truth such that the marginal rate of substitution between truth and these other commodities equals the marginal rate of transformation in the technology between producing truth and producing these other commodities. If consumers don't value truth very much (relatively speaking), perfect competition will efficiently ensure that they don't get very much truth as compared with other goods.
(Goldman 1999:197)

But, in any case, perfect competition presupposes perfect information or knowledge as a *condition* of its efficient functioning and there is no reason to think that, in its absence, the competitive market would generate such knowledge.

Nor, still addressing the first question, are there empirical grounds for supposing that literal markets are, as such, knowledge-promoting. On the contrary, observation of the market in messages on proliferating television channels, radio and the Internet provides no basis for optimism on this score. Commercialization typically brings with it 'dumbing down' and the favouring of entertainment over news. Where public broadcasting is only marginally present in a predominantly commercial environment, there are no countervailing mechanisms to resist the movement towards ever more trivialization and fragmentation. As Bernard Williams has observed, the:

literal market generates a high level of noise. Everyone knows that in modern conditions of communication messages compete for attention and cancel each other out, and that they are picked out for reasons that need have nothing to do with their truth. Moreover, the system fails to provide, typically, any structured context for understanding messages. The hearer may know at some level what message each sentence conveys, but not what the messages mean.

(Williams 2002:215)

What about the metaphorical market? Are there grounds for believing with John Stuart Mill that 'since the general or prevailing opinion on any subject is rarely or never the whole truth, it is only by the collision of adverse opinions that the remainder of the truth has any chance of being supplied' (1946:46). The answer is: only given various, rather stringent preconditions. Mill's 'collision' as such guarantees nothing, for, as Goldman observes, the:

mere fact that more viewpoints are expressed or broadcast in some public forum does not ensure that more of these will receive even roughly equal attention by potential listeners. Diversity of speech does not guarantee diversity of reception. When a glut of messages fills the airwaves, listeners may increasingly tune in [to] only those messages they want to hear and filter out those they don't.

(Goldman 1999:212)

More seriously, there is the problem of corporate media power. The producers of messages have differential power: some have far greater incentives, resources and skill in the framing of messages than others, so that, in the absence of regulation, public debate is likely, in Owen Fiss's words, to be 'dominated, and thus constrained, by the same forces that dominate social structure' (Fiss 1991:2100). From which we can conclude that, if it is to generate Mill-like effects, the metaphorical market must be managed and regulated, in ways that both favour a 'structured context for understanding messages' and maximize access for the marginalized and excluded.

Public broadcasting (of which there are several alternative models) is the only feasible institutional context that contains mechanisms and procedures that have a prospect of achieving such an outcome. But, as markets and marketizing proliferate, we appear to be witnessing a general decline of public broadcasting. In his study of current threats to public broadcasting in Britain, Colin Leys quotes Rupert Murdoch's succinct definition of the public interest as 'offering the public what interests it' and concludes with the forlorn thought that, as things have been going, 'the idea of television as a medium of the public sphere, a forum for the "main conversation of society" would come to seem as quaint and outdated as the stagecoach' (Leys 2001:163). Consider, for example, the consequences of market-driven media, as opposed to adequately regulated public broadcasting, during national crises, such as wartime.13

Leys's conclusion is as follows:

Public services are defining features of a civilized society, which capitalist market production, if it persists at all, should exist to pay for, and to which it should be subordinate. Many of the things that are primary requirements of genuine democracy (as opposed to a cynical conception of democracy as the sale to voters by political elites of 'political products', to be marketed like all other commodities) are goods that markets will not provide, such as general education, objective information, universally accessible media of communication, public libraries, public health and universal health care. Markets provide these things at best unequally, if at all, so they have to be provided collectively instead. They are anything but secondary.

(Leys 2001:220)

Indeed they are not secondary. The issue of how important they are acquires a new urgency in face of the constant, unrelenting expansion of the market into services once thought of as immune or resistant to it and into sectors hitherto protected by political guardians of the welfare state, whose confidence in its principles can no longer be taken for granted. There is a valuable academic tradition of research and reflection on the economic, social and cultural conditions for well-functioning representative democracies, or polyarchies.14 Given the way the world is going, the question of where and how the market impedes their provision deserves ever closer attention.

Notes

1 Peck and Tickell (2002:395). They go on to write that even 'if it may be wrongheaded to characterize neoliberalization as some actorless force-field of extra-local pressures and disciplines—given what we know about the decisive purposive interventions of think-tanks, policy elites and experts, not to mention the fundamental role of state power itself in the (re) production of neoliberalism—as an *ongoing ideological project* neoliberalism is clearly more than the sum of its (local institutional) parts' (p. 401).

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2 See Keat (2000: ch. 2).
3 See Satz (2004).
4 For this Aristotelian interpretation see Maclntyre (1981, ch. 14).
5 See Keat (2000).
6 Contrast this with the characteristic approach of Simmel, who wrote of the 'disintegrating and isolating effect of money' as the 'general precondition and corollary of [its] conciliatory and unifying quality', so that 'under specific historic conditions, money simultaneously exerts both a disintegrating and a unifying effect' (Op. cit., p. 345).
7 For further elaboration of this idea, see Lukes (1997).
8 I am grateful to Natalie Gold for showing me the first chapter of her forthcoming study of this intriguing question.
9 See Hirsch (1977).
10 See Bourdieu (1984).
11 See Keat (2000).
12 See Freedland (2001).
13 Contrast the effects of commercial pressures on US media in the treatment of the second Gulf War of 2003 with the independence of the BBC, whose Director General commented on the fragmented character of the US media market: 'Many of the large television news organizations in the States are no longer profitable or confident of their future. The effect of this fragmentation is to make government—the White House and the Pentagon—all-powerful, with no news operation strong enough or brave enough to stand up against it' (*Guardian,* 25 April 2003). And compare the condition of radio (as of 2003) in the United States and the United Kingdom.
14 See, in particular, the later writings of Robert Dahl, notably his *Polyarchy* (1971).

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