Chapter 13

Constrained Partisanship and Economic Outcomes[1]

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The *relative autonomy of politics*, to use an expression slightly out of fashion, as a determinant of social and economic outcomes is yet again in the eye of the beholder. While some see processes such as globalization, deindustrialization, and more recently the Great Recession, as a sign of structural factors overruling the ability of incumbents to pursue their agenda and shape the distribution of winners and losers across society, others see the responses to the financial crisis as reflecting the differences among well oiled and persistent institutional organizations of capitalism. In the former tale, which we refer to in this volume as *economic structuralism*, incumbents quickly turn into irrelevant witnesses of a process of convergence in economic and distributive outcomes. In the latter, which we refer to as *economic functionalism*, incumbents adjust their strategy to preserve the functional needs of organized interests, particularly producers, within their coalitions. Economic outcomes are affected by policies that in turn reflect divergent distributions of interests among producers. Earlier contributions to the volume have already pointed out the limitations of both these approaches and proposed an alternative analytical framework. This chapter focuses on the evolution of economic outcomes in advanced industrial democracies and assesses whether the model of constrained partisanship developed in this book lends any analytical power to understand them.

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In what follows, I make four points. First, while there is some empirical basis to substantiate the notion of relative convergence in economic outcomes among advanced industrial societies, a careful scrutiny reveals deep-rooted differences in terms of economic inequality and labor market opportunities. Second, these differences reflect to a large extent the balance between investment and consumption policies: investment oriented economies generate in the long run more egalitarian societies and better labor markets. Third, those parties ideologically inclined to pursue these goals are constrained by two institutional features largely overlooked by both partisan theory and economic functionalism so far: the level of revenue collection by the state and the ability of organized labor to capture a large share of the budget via consumption policy. Less fiscal capacity and pro-insiders regulations jointly limit the scope of investment policies, thereby shaping the distribution of outcomes and opportunities in society. Fourth, the same conditions mediate the impact of policy choices on income inequality and the distribution of labor market opportunities.

To develop this argument, the rest of the chapter is organized as follows. First, I present an overview of economic outcomes along the lines outlined above. Thereafter, in section two, I present the theoretical argument linking partisan strategies, policy choices, and distributive outcomes. Section three analyzes empirically the link between policy choices and distributive outcomes. Section four concludes.

13.1 Growth and Allocation: Beyond the Illusion of Convergence

A first look at the evolution of growth rates among industrialized democracies seems to lend some support to the structuralist view that advanced economies are undergoing a process of convergence, at least in relative terms. Figure 1 plots average annual rates of economic growth for two time periods, 1970-1990 and 1990-2010. I choose here long time periods to grasp the long-term development of growth patterns, rather than more short-term business cycle effects. The cross-national average growth rate has indeed lowered between the two periods from about 2.1 to 1.9 percent, suggesting that weaker performers in the earlier period tend to perform better in more recent ones. However, Figure 1 also shows that the trend has been far from uniform across countries. Clearly, forces other than structuralist transformations are also at work. Moreover, countries in groups as suggested by theories of economic functionalism, such as the *varieties of capitalism* approach (Hall and Soskice 2001), differ sharply in their evolution. Put simply, the variation in growth trajectories among coordinated market economies is larger than that between coordinated and liberal market economies. Countries such as Sweden or the Netherlands had rather weak growth performance before the 1990s, but show higher-than-average growth in the later period. At the same time, several relatively high-performing coordinated market economies such as Italy, France, Norway, Germany or Finland performed above average between 1970 and 1990, but developed into completely opposite dynamics after the 1990s. While Finland and Norway experienced high levels of growth post-1990, Italy, Japan, France and Germany performed poorly. Hence, in terms of pre-crisis growth trajectories, we certainly do see a large amount of variation that remains unexplained by structuralist and functionalist accounts.

"insert Figure 1 about here"

More importantly, this cross-national variation in *changes in the size* of the pie becomes even starker when we focus on changes in the *distribution of the pie* in advanced industrial economies. Much has been written on the age of rising inequality in the OECD countries (OECD 2009) and its potential social, institutional, and political consequences (OECD 2009, 2011; Bartels 2008; Gilens 2012; Stiglitz 2012). Figure 2 plots the level of income inequality in the mid-1980s against the change in inequality from the mid 1980s to the mid 2000s. Again, figure 2 could support the structuralist notion of a convergent trend driven by the unleashing of capitalism. After all, in all but five countries, income inequality has increased over the observed period. Only France, Switzerland and Belgium kept the same or slightly lower levels of income inequality, while Ireland reduced inequality substantively. In all other countries, inequality increased and it did so above-average in all countries that started out with below-average levels in the 1980s. However, a more careful scrutiny reveals that variation in outcome performance remains very large. The Nordic countries Sweden, Norway, Denmark and Finland, for instance, which had very low rates of inequality in the 1980s, remain at the lower end of the distribution: despite increases of 10 to 30 percentage points, none of these countries level of Gini income inequality exceeds 0.3. The other coordinated market economies of continental and Southern Europe are – again – strongly disparate. Austria, Germany and the Netherlands to some extent close up to the (stable) level of inequality France had in the 1980s already, whereas the Southern European countries start at rather high levels of inequality and increase them moderately. While the coordinated countries thus indeed show some signs of convergence, the liberal market economies have developed in different ways. The UK, USA and New Zealand increase inequality strongly from an already rather high level, whereas Canada and Australia remain stable at relatively high rates of inequality.

“insert Figure 2 about here”

Reviewing these distributions of outcome indicators, I find little evidence for either convergence or for regime stability across forms of organized capitalism. This conclusion is further reinforced when one relates the current level of inequality in disposable income (as captured in figure 2) to measures that, albeit indirectly, tap onto the distribution of economic opportunities and the working of labor markets. Figure 3 explores the relationship between income inequality, the size of the intergenerational income elasticity, that is how well parents income predict their children's position in the income distribution (Corak 2012), and the incidence of long-term unemployment (average levels for the period 1990-2010). A high correlation of income across generations suggests that income mobility levels are low and therefore the distribution of opportunities to improve the relative position within the income distribution is also very unequal. Likewise, high average levels of long-term unemployment indicate that people who fall into unemployment in that society will find it harder to resume work and improve their economic situation. Unsurprisingly, as shown in figure 3 (right panel), this is closely related to the size of the intergenerational income elasticity. The patterns displayed in Figure 3 reinforce earlier findings. First, there is a great deal of variation across countries in terms of the correlation between inequality, the intergenerational income elasticity, and long term unemployment. Second, the variation does not conform with the contrast between liberal and coordinated economies, nor with any other standard conceptualization/categorization in the field. Among the countries with high inequality and high elasticity, we find political economies as diverse as Italy and the United States. At the lower end of the correlation, in turn, we find a more familiar cluster of Scandinavian societies, but in the middle range is again populated by countries as diverse as Canada, Australia, Germany, and New Zealand. Even more intriguing are the patterns in the association between the income elasticity and the average levels of long-term unemployment throughout the period: Canada seems to have more in common with Scandinavia than with the other liberal market economies, whereas countries as diverse as the Italy and the UK seem to have medium to high levels of long-term unemployment along with a rather high inter-generational income elasticity.

Overall, the evidence shown in figures 1-3 pose an important puzzle about the evolution of economic outcomes in advanced democracies: why are some societies able to combine low levels of income inequality, low intergenerational income elasticities, and low levels of long term unemployment, whereas others display either highly unequal results in terms of both outcomes and opportunities or mixed results, combining moderate levels of income inequality with high levels of long term unemployment and intergenerational income elasticities? In the rest of this chapter I contend that these outcomes link back directly to government's politico-economic strategies in terms of consumption and investment. I proceed in two steps. I begin by presenting a theoretical argument linking partisan strategies, policies, and outcomes. Thereafter, the next two sections offer systematic empirical evidence on the linkages between different politico-economic strategies and distributive outcomes in terms of income and opportunities. Finally, I briefly outline the core implications of my findings.

13.2 Political Strategies and Economic Outcomes

In line with the rest of the chapters in this volume (Beramendi et al 2013, this volume), I conceptualize the fundamental choice by incumbents as one between investment and consumption. I reason from the premise that investment and consumption constitute distinctive politico-economic strategies, linking back to different growth strategies.[2] An investment or innovation based strategy builds on skills

[2] By politico-economic strategy I refer to a combination of employment policy (regulations), fiscal policy (taxes and transfers), and public service provision. In terms of regulation, governments must choose the level of internal protectionism of organized interests there is to be. This has direct implications for the real levels of economic competition and innovation within political economies. In terms of fiscal policy and public service provision, governments must choose how much to privilege consumptive expenditure at the expense of future returns via investments in education, research and development, and child-care.

upgrading in the medium run, aspires to increase productivity levels, and to sustain growth through "leading edge innovations" in Aghion and Howitt's (2006) terms. In contrast, for countries behind the technology frontier growth occurs primarily via capital investments, the import of technologies developed elsewhere, and consumption oriented policies aimed at sustaining high levels of aggregate demand (Acemoglu et al. 2006). In line with this logic and the rest of the volume, I define "investment" widely as the combination of fiscal policy and regulations that contributes to increase the overall productivity of the economy, and that of labor and capital in particular.[3] The term investment refers to the future-orientation of these measures in the fields of education, research and development, childcare, activation and public infrastructure. The goal is to maximize future returns through increases in productivity. On the other hand, I consider consumption expenditures and regulations as policy measures (again, including fiscal policy and regulations) devoted to boost citizens' ability to purchase goods and services in the short run. The balance between these two sets of policy instruments is critical to understand economic and distributive outcomes in the postindustrial world.

In establishing the logic ruling the connection between parties, policies, and outcomes, my argument builds on the following premises. First, parties use policy to build and sustain stable electoral coalitions (Esping Andersen 1985). In doing so, parties face an inter-temporal dilemma that underpins all consumption and investment policies. Consumption provides voters with tangible and quantifiable benefits today. Investments, in turn, generate a significant opportunity cost in terms of consumption and offer benefits that are risky and often accrue to voters well after the election has passed. Second, at the micro level, I assume that when making political choices, citizens care about their net benefits from both the market and the state (final income), including the value they derive from public goods that are often not accounted for in standard fiscal policy measurements (Beramendi and Rehm 2013). Third, in

[3] A slightly narrower distinction between consumption- and investment oriented expenditures has also developed in the welfare state literature (Esping-Andersen 1999, Bonoli and Natali 2012, Morel et al. 2012; Hemerijk 2013).

grappling with the dilemma between consumption and investment, parties face supply and demand constraints when choosing the combination of consumption and investment policy that maximizes their electoral and political returns (Beramendi et al. 2013). The analysis moves beyond conceptions of partisanship focused exclusively on a uni-dimensional definition of left-right ideology (Bartels 2008; Dixit and Londregan 1998, Hibbs 1977, Alt 1985, Huber and Stephens 2001) to understand preferences and strategies as responses to preference sets that include distributive and non-distributive elements (Hausermänn and Kriesi, this volume) and pre-existing legacies that limit incumbents' hands. In what follows, I argue that the variance in economic outcomes identified in the previous section reflects the conditional impact of partisan strategies in terms of consumption and investment under different sets of constraints. Most prominently, I focus on two types of constraints: the legacy of past policy commitments and the state's revenue collection capacity. The interaction works as follows.

Investment policies are costly in the short run and generate uncertain political returns in the medium to long run. They also imply an opportunity cost in terms of the *current* capacity to consume. It is precisely because of these two features that the state's capacity of revenue collection plays, I argue, such a central role as a constraint on the supply side of politics. Critically, the intensity of the trade-off between investment and consumption policies depends on the level of available resources: when political coalitions allow very large levels of revenue generation, there is less of trade-off and egalitarian efforts combining both consumption and investment become feasible. By contrast, without enough revenues to ensure consumption and then entertain investment policy initiatives, the latter do not rank high in the incumbent's list of policy priorities. In turn, at any given time, this list captures pre-existing commitments in terms of the balance between consumption and investment, and their feedback effect on voters' predispositions towards different policy reforms.

In societies where hegemonic political coalitions rest on consumption policy expenditures (most prominently, status and capture oriented ones), the room of maneuver to detract resources from transfers and devote them to investment policies. This is particularly the case in highly dualized labir markets. More dualization implies a stronger commitment of policy (both fiscal and regulatory) towards insiders (Rueda 2007, Gingrich and Ansell, this volume), leaving relatively less resources available for investment policy at any given level of revenue collection. In turn, less dualization, whether via policy, institutions, or regulation, implies that incumbents' hands are less tied by prior policy commitments. In other words, goverments enjoy a broader room of maneuver to alter their policy strategies. The point is not to use policy legacies to predict policy as this could quickly become circular; the point is to think of the balance between consumption and investment as the outcome of past political struggles acting as a constraint today.[4]

To develop the argument in detail, table 1 summarizes the structure of political constraints faced by parties, and links back to the model developed earlier in the book (Beramendi et al., this volume). In what follows I outline how different sets of constraints shape both the ability of parties to pursue different combinations of investment and consumption and, more importantly for the purposes of this chapter, the differential distributive impact of these choices.

"Insert Table 1 about here"

Earlier analyses in the book (Kitschelt and Rehm, this volume) suggest that to achieve a sustained presence in office left-wing parties must successfully forge a coalition between manufacturing workers, low skilled service workers, and high skilled, normatively liberal, service workers (the so

[4] Clearly, such a balance captures past parties' strategies, and channels, indirectly, the impact of electoral institutions, and the organization of labor markets. For earlier contributions along these lines: Hicks and Kenworthy 1998; Lange and Garrett 1985; Alvarez, Garrett and Lange 1991; Rueda and Pontusson 2000; Beramendi and Cusack 2009.

called socio-cultural professionals). By contrast, the ideal coalition of conservative parties includes both workers with traditional values, high wage earners and liberal professionals, and employers, particularly owners of businesses with traditional values. Left parties must design policy, both distributive and normative, to attract and retain high skilled, high paid workers. In turn, conservative parties must use policy, often second-dimension politics, to attract a portion of low income voters. A key insight throughout many of the chapters in this book is that the nature of political competition in each of these quadrants mediates the gap between the parties' ideal political strategies and what they can actually achieve. To the extent that policies are the tool to build and sustain feasible political coalitions (Esping Andersen 1985) the constraints outlined in table 1 matter not only because they condition the amount of resources available but also because they feed back into the structure of political demand. That is, the pivotal groups to which parties respond when competing electorally are themselves a function of previous policy (Esping Andersen 1993; Oesch, this volume). As a result, the politics of inequality varies within each of the four configurations in table 1, shaping, in combination with the supply side constraints, the balance between consumption and investment and their distributive effects.

Let us consider first the choices over consumption and investment in high revenue, low dualization contexts. To become self-enforced and electorally sustainable, large levels of revenue generation must be understood as part of a broader political exchange between incumbents and highly organized labor and employers. High wage earners and socio cultural professionals only endorse this strategy politically insofar as the benefits they receive via public goods and the fiscal system exceed the costs they pay through different tax tools.[5] Moreover, the strategy's sustainability requires the implicit consent of private investors, as it rests on high levels of both public and private employment. To secure high levels

[5] A large share of the socio-cultural professionals (health and education workers, for instance) are actually public sector employees. This, in turn, facilitates the task of revenue collection. By contrast, a pure transfer state with less public service provision, has a harder time sustaining the support of high wage earners.

of private investment implies governments must reduce the relative share of capital and corporate taxes in the economic policy strategy.[6] In turn, the low levels of dualization reflect the past success of Social Democracy in forging a complex coalition across classes and sectors (Moene and Wallerstein 2002). Once the fiscal resources were in place, Social Democrats enjoyed enough resources to forge the coalition between manufacturing workers and socio-cultural professionals via multidimensional policy strategy: wage compression and progressive and universalistic fiscal transfers ensures the support of the bottom half of the wage distribution, high levels of public employment to absorb the surplus of de-industrialization tailors to socio-cultural professionals, active and passive labor market policies to ease labor market transitions, thus reinforcing low levels of labor market dualization, and public investments in higher education and early child care show high wage earners their taxes' worth. Over time, wage earners meet the cost of a system from which, in the long run, emerge as net beneficiaries. Such an egalitarian strategy targets both outcomes and opportunities, and secures equality as much via the long effects of public investments and taxes on wage compression as through the short run redistributive impact of consumptive transfers (Boix 1998; Pontusson 2005; Steinmo 2010; Esping-Andersen 2010; Huber and Stephens 2013).

"Insert Table 2 about here"

This strategy is built on the combination of high levels of both investment and consumption effort, as summarized in table 2, and has provided the basis for a long- term electoral hegemony of Social Democracy in Scandinavia. Only recently, when the fiscal constraints have become tighter,

[6] In addition, the political support of wage earners, in particular high wage earners, requires tax policy tools not to be too progressive. Otherwise, the net benefits for this pivotal group of voters would be negative, and they would withdraw their political support. The implication is clear: taxes on labor not only bear a larger share of the cost of redistribution, thus reducing the level of progressivity between factors (Cusack and Beramendi 2006); they also become less progressive in their design. Moreover, as the relative importance of labor taxes increases, the internal stability of the social democratic coalition comes into question and governments shifts the burden from producers to consumers (Kato 2003; Beramendi and Rueda 2007; Steinmo 2010). In this context, capital commits to stable investment and long-term growth in return for the government's promise not to tax their benefits to finance the welfare state (Przeworski and Wallerstein 1988).

immigration is paving the way for increased levels of dualization (Lindvall and Rueda 2013), and export oriented high wage service workers are revisiting the balance between their earnings potential and their disposable income, have conservative forces been able to forge alternative coalitions based on the restriction of consumption and progressivity and the limitation of access to services and insurance to nationals. These recent transformations aside, societies able to mobilize large levels of revenue in labor markets with low levels of dualization remain those where the inter-temporal trade-off between effort on consumption and effort on investment seems less acute.

This policy regime translates directly into the distributive outcomes this chapter is concerned with. Wage compression in the labor market and progressive consumption policies contribute to an egalitarian distribution of disposable income. In turn the extensive investment in active labor market policies eases labor market transitions for the unemployed, thus reducing the scope of long-term unemployment. Finally, large scale, universally accessible educational investments facilitate the equalization of opportunities early on, thus reducing the size of the income elasticity. In sum, when revenues are high and dualization is low, consumption and investment operate as complementary mechanisms that reinforce each other to reduce inequalities of both outcomes and economic opportunities. By contrast, as politicians operate under alternative sets of constraints, both the relative effort in terms of investment and consumption policies and the distributive impact of incumbents' policy choices change significantly.

Consider for instance societies where past political struggles have yielded a scenario characterized by relatively lower levels of revenue collection and a flexible labor markets (a scenario we refer to as *competitiveness* throughout the volume). Under these conditions long term commitments by organized economic actors are neither feasible nor credible. Parties approach consumption and investment policy as a realm of its own, relatively less constrained by inter-temporal exchanges, and use them to target the core elements of their constituencies, urban workers in manufacturing and urban sociocultural professionals for the left, and business owners, rural workers, and high paid service workers for the right. Supporters of the left demand expansions in coverage and effort, particularly targeted towards liberal urban professionals (Ansell 2010; Kitschelt and Rehm, this volume). Supporters of the right demand policies, such as higher education tax deductions accruing the upper end of the wage distribution, that ultimately exacerbate pre-existing inequalities of income and opportunities. In terms of consumption, left parties will pursue higher levels of progressivity in both transfers and taxes and right parties will oppose them. In terms of investment, the left will pursue the spread of opportunity to middle and low income voters, whereas the right will underfund public education throughout for the benefit of market alternatives that reproduce and enhance existing income and wealth inequalities. Because progressivity implies a higher share of overall revenue collection on the shoulders of capital (progressivity between factors or classes) and a more targeted allocation of benefits to the lower strata and of the tax burden to the upper strata of the pre-fisc distribution, polarization over redistribution is stronger and the size of the consumption budget is bound to be smaller. Moreover, labor is not organized enough to capture a large share of the budget for consumption transfers and high wage earners and capital coalesce to limit it to boost investment oriented expenditures. By adjusting policy to their electoral constituencies, parties generate policy portfolios that include lower overall revenues, well targeted and relatively small consumptive expenditures, and significant investment efforts (i.e. *low consumption, high investment* in Table 2).

In terms of distributive impact, this policy regime generates a different set of outcomes: the fact that both taxes and consumptive transfers are progressive limits the size the budget at the effectiveness in containing inequality (Korpi and Palme 1998). More interestingly, higher efforts in investment policy may boost rather than reduce income inequality. In democracies with universalistic public services across the life course, access to enhanced opportunities facilitated by larger investment efforts is effectively universal and highly redistributive (Ansell 2010). By contrast, in democracies where the revenue pool is politically constrained, access to investment opportunities are restricted to those able to pursue a full educational career, while at the same time flexible labor markets for low skilled workers open exit options along the way. To the extent that the actual access to expanded investment opportunities remains de facto an option mostly for the upper half of the wage distribution, a stronger investment effort will cause an increase in inequality. At the same time, I expect it to reduce the levels of long-term unemployment by facilitating a better match between the supply and demand of skills. Finally, to the extent that enhanced opportunities are accessed by the children of the well-off, I expect it to have a limited impact on the size of the intergenerational income elasticity.

I turn now to consider partisan strategies and distributive outcomes the other two scenarios in table 1, those we refer to as *status* and *capture* earlier in the volume. Policy regimes in both in these contexts reflect the legacy of political struggles where parties tailored to the interests of either industry level unions in the manufacturing sector (the left) or prone-to-order wage earners, self-employed, and small business owners (the right). For the latter, typically Christian Democratic parties, the goal was to secure the wage earner coalition without disrupting society's order. In the spirit of XIX social Catholic and Protestant movements, Christian Democrats see corporatism and social policy as mechanisms to both pool (across industries) and stratify risks (within industries) via insurance systems (Mares 2003; Van Kersbergen 1995). For them, the ideal-type political strategy consists in reproducing market inequalities over the life-course via insurance mechanisms. This implies a large system of transfers with replacement rates such that the inequality of benefits approximates the inequality in earnings, and a design of investment policy of smaller size and with a much lower redistributive clout. By contrast, the Left typically defends more progressive designs of both transfers and revenues (i.e. reducing the importance of social security contributions vis a vis income taxes) for insider manufacturing workers and, over time, larger and more accessible investments in education. The fundamental parameters of the system, though, build a strong consumption bias relative to investment efforts.

Of course the scope of this tension, and the associated distributive consequences, is conditional on the level of revenue collection. And this is no accident of history, but the consequence of different sequences in the formation of welfare states and revenue systems, and the incidence of dualization. As argued above, high revenues result from the working of a cross-class agreement that limits the burden of capital relative to that of workers and consumers, an agreement typically enforced via corporatist arrangements and coalition bargains in the legislature. The Christian Democratic version of this agreement places more emphasis on payroll and social security contributions as opposed to income taxes, but it follows a similar logic.

For a long time, the amount of revenue generated was enough to guarantee very generous insurance schemes for permanent workers and fund investment efforts in education. Social Democracy would put a more progressive emphasis than Christian Democracy, but the tension between consumption and investment was muted by a generous purse. Interestingly, as the socio-demographic transformations analyzed earlier in the book (aging, de-industrialization, and the incorporation of women into the labor force) unfolded, budgetary demands for both investment and consumption increased, as did labor market pressures. Dualization emerges then as a response to both try to maintain the privileges of the core of the labor force, a pivotal electoral group for both the left and the right, and at the same time alleviate the mismatch between supply and demand caused by de-industrialization. Over time, partisan struggles also evolve to conflicts about the scope and design in the adjustment of consumption expenses (Huber and Stephens, this volume), the degree of de-regulation of labor markets, and the size and coverage various investment efforts, but the fundamental balance between consumption and investment remains in place (*high consumption, low investment* in table 2). In terms of distributive outcomes, I expect increasing efforts in investment to translate into lower levels of income inequality through the redistributive effect of public services, but I also expect these effects to me muted by the relative power of insiders in the labor market. The higher the ability of a core of the labor force to monopolize access to public investments, the lesser their egalitarian impact on the distribution of both income and economic opportunities. By contrast, I expect increasing efforts in consumption to contribute very little, due to the minimally progressive nature of insurance based policies, to the reduction of income inequality. Indeed, as the ability of insiders to capture policy in the labor market grows strong, I predict higher efforts in consumption policy to cause marginal increases (rather than decreases) in the levels of income inequality. At the same time, which suggest that high consumption, low investment societies will show relatively higher levels of long term unemployment and income elasticity, reflecting the fact economic opportunities remain highly stratified across generations and sectors in the labor market.

By contrast, in those countries where the protection of insiders precedes the expansion of the welfare state, policy constraints become particularly stringent. By and large, these countries undertook industrialization via imports substitution under autocracy in the late sixties, which in turn imposed early on a core of heavily protected and well organized labor market insiders (Rueda 2007; Wibbels 2012), achieved democratization comparatively late, and only began the construction of the welfare state after the oil-crisis, the abandonment of Keynesianism, and the rise of fiscal and monetary orthodoxy (Maravall 1996; Boix 1998). Born in this new international and ideological environment, these welfare states feature lower levels of state and fiscal capacity by comparative standards (Persson and Besley 2011). This in turn limits considerably the feasibility of large-scale public interventions to correct market outcomes via consumption policy. It also constraints the ability to sustain public investment over time. Social Democrats do pursue public investments (Boix 1998) but to a much lower extent, as they cannot engage in long-term reform strategies with market actors. The right in turn courts small business and the self-employed with favorable regulations and tax treatments. Accordingly, employment gains occur via reforms that exploit the business cycle to generate large amounts of low skill, low quality jobs, with the resulting emergence of extremely dualized labor markets via high levels of employment protection (Altamirano et al. this volume), further empowering organized workers to maximize their consumption share via transfers and small business to secure a favorable tax treatment. As the latter are left untouched by the fiscal system, a disproportionate share of the fiscal burden falls, again, on payroll workers and consumers.

With no resources, rulers' hands are tied and no feasible economic policy strategy is feasible beyond the satisfaction of basic consumption needs. In this situation corresponds incumbents have very little room of maneuver, and policy features low levels of both consumption and investment. Families and the informal sector emerge, or indeed remain, as functional equivalents, further undermining the fiscal capacity of the state. Born under a rather adverse international and ideological environment, these state structures constraint the scope and success of egalitarian interventions. Both tax progressivity and redistributive scope are low by comparative standards, and inequalities in the labor market remain extremely pronounced, only to increase over time. The combination of high levels of employment protection, weak financial capacity, and a relatively underdeveloped, and insider oriented, welfare state yields a scenario in which we observe very low levels of redistribution and progressivity. The fiscal state tends to be both small and regressive, constraining equalization via either investment or consumption by both lack of revenue and design (*low consumption low investment* in table 2). The resulting pattern of distributive outcomes is one in which the marginal effects of increasing efforts consumption if anything exacerbate inequality and increasing efforts in investment, while egalitarian in nature, are hardly feasible due to budgetary constraints. As a result, inequality and long-term unemployment reach peak levels, and the intergenerational income elasticity remains high over time.

To summarize, the argument developed throughout this section suggests that the distributive impact of consumption and investment policies on income inequality and the distribution of economic opportunities in the labor market is mediated by the amount of resources available to incumbents and the relative power of insiders within the labor market.

13.3 Empirical Evidence: Consumption, Investment, and Distributive Outcomes

To evaluate this claim, this section proceeds in three steps. First, I focus on the role of consumption and investment as determinants of the distribution of disposable income in advanced industrial societies. Second, I analyze the impact that these policies have on the long-term unemployment rate, which is taken as a proxy of the difficulty of unemployed citizens to re-enter the labor market within a year. Third, I close the section by analyzing the role of consumption and investment policies in shaping the size of the intergenerational income elasticity across advanced democracies.

"Insert Table 3 about here"

Table 3 summarizes the empirical implications of the argument on the relationship between consumption, investment, and disposable income inequality. To evaluate the conditional effect of consumption and investment on inequality across different scenarios in table 3 I use a time series cross-sectional analysis with 21 OECD countries over the period 1990-2007. The limited time range of the data set reflects the availability of data for the different elements incorporated in the definition of investment.[7] Given the imbalance and short nature of the panel, I estimate the models using OLS with robust standard errors clustered by country. The results are robust to the use of alternatives such as panel corrected standard errors as well as to the inclusion of additional assumptions about the error term showing processes of serial correlation of order 1. I have also performed analyses including country and year fixed effects and the results are robust across specifications. [8] The dependent variable for the analyses is the GINI coefficient for disposable income inequality for the age group 18-65, as reported by LIS and the OECD (2011).[9]

Critically, the identification of the conditional effects of consumption and investment requires to model the interaction between the policy terms, our variables of primary interest, and the conditional variables in a way that most closely resembles the set of constraints highlighted in table 3. To this end, the specifications include, for each set of policy tools (consumption and investment), the estimation of a three way interaction between the level of effort in that particular policy realm and two contextual variables: the degree of employment protection of full time workers, which we take as a proxy for the existing level of dualization, and the level of revenue as a share of the economy, which we take as a proxy of the level of resources available to incumbents. These two indicators approximate the two variables that define the set of constraints under which incumbents operate (table 1 above).

In addition, the specification includes a number of standard controls. The level of pre-tax and transfers income inequality controls for the effect on redistribution of existing grievances associated with the

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[7] Investment refers to the per GDP expenditures on public and private research and development, tertiary education, childcare services and active labor market policies, 1992-1995, 2003-2007, OECD data. Investment-data is lacking for Switzerland and Norway for the 1992-1995 period. Consumption refers to the sum of per GDP expenditures on old age pensions, survivors' pensions, unemployment benefits and incapacity pensions, 2003-2007, OECD data .

[8] These additional specifications are available from the author upon request.

[9] The exclusion of pensioners is motivated by the need to control for market income inequality and the distortive effect the latter have, by virtue of having a market income of 0, on cross-national analyses focusing on the gap between market and disposable income inequalities.

distribution of market outcomes (Lupu and Pontusson 2011) as well as for possible second-order effects associated with previous policy interventions (Ringen 1987). The level of union density controls for the power of labor within the polity (Huber and Stephens 2001). A dummy variable distinguishing federal and non-federal countries and Gallagher's index of disproportionality capture the confounding impact of institutional constraints on redistributive platforms (Iversen and Soskice 2006).[10] Finally, the estimation of the effect of either policy tool includes a control for the budgetary effort on the other. Thus, the analysis of the conditional effect of investment on inequality includes a control for consumption, and vice-versa.

"Insert Figure 4 about here"

The findings reported in figure 4 lend support to our theoretical expectations.[11] When enacted in a context of low employment protection and low revenue collection, that is an environment where resource allocation occurs primarily through market competition, a marginal increase in investment policy is positively associated with income inequality. This suggests that access to investment opportunities are unevenly distributed: the same people who perform well in the labor market gains access to investment policies such as higher education, which end up generating a regressive distributive outcome. By contrast, investment policies in scenarios where public resources allow the provision of services to be enjoyed near universally by a majority of the population has a strong egalitarian effect (top right panel in figure 4). Interestingly, though, the scope of this egalitarian effect is marginally muted as employment protection increases, suggesting that the access to investment opportunities becomes part of the insiders' privileges. In rich, dualized, status-oriented societies, the egalitarian impact of investment policies is muted by the segmentation of access to the very resources provided by these policies.

[10] Data for union density, federalism, and disproportionality were taken from the Comparative Political Database (Armigeon et al. 2012).
[11] The corresponding tables for figure 4 are reported in the Appendix.

The bottom two panels in figure 4 focuses on the impact of consumptive policies on disposable income inequality. Marginal increases in welfare state transfers reduce income inequality at low levels of revenue collection, but only in societies with relatively low levels of employment protection. More transfers imply less inequality in competitiveness oriented political economies.[12] This is hardly surprising as these are the societies where transfer policies tend to be more progressive in their design. By contrast, as employment protection increases, the impact of consumption on inequality reverses. In status oriented and capture oriented societies more consumption implies a stronger effort on either neutral or outright regressive policy tools geared to benefit of labor market insiders, thus marginally contributing to the spread of the income distribution.[13] Put shortly, by altering the constraints faced by politicians to pursue more progressive policy designs, and privileging insiders as the core of any successful electoral coalition, dualization reverses the distributive impact of welfare state transfers, especially in those societies where the fiscal trade-offs faced by politicians are more acute.

I turn now to analyze the joint impact of investment and consumption policy on a different form of inequality, namely the availability of economic opportunities for those worse off in the labor market. I proxy this concept through the long-term unemployment rate, that is the share of unemployed who have not found new employment after a year seeking it. Regarding the specification, I approach the problem with a similar three-way interaction as before, but rather than treating each policy component separately, I employ the ratio of investment to consumption as the main independent variable of interest. I am less interested in identifying the marginal impact of each policy tool on labor market opportunities and more on the impact of adjustments to the relative balance between them, given

[12] A similar finding applies to societies with high fiscal capacity and low dualization, even though the results barely reach the threshold of statistical significance.
[13] This is consistent with recent findings on the nature of insider-outsider inequalities in these regimes Häusermann and Schwander 2012).

existing levels of consumption commitments. Accordingly, the current levels of consumption expenditures is a critical control variable in the specification. In addition, I control for the level of unemployment and the existing level of consumptive expenditures. The former effectively controls for all other determinants of labor market outcomes (Daveri and Tabellini 1997) and focuses the attention on the gap between the unemployment and the long-term unemployment rate. The latter allows me to explore the impact on economic opportunities of increasing the relative effort of investment for a given the level of effort in consumption.

"Insert Figure 5 about here"

Figure 5 reports the core findings.[14] Consistent with the argument in this book, both the level of fiscal resources and the degree of dualization jointly mediate the impact of the investment to consumption balance on the economic opportunities available to the unemployed. In polities with less effective revenue collection systems increasing marginally the effort on investment makes no difference. The scope for budgetary adjustment is too limited and this in turn has very little bearing on actual labor market outcomes. By contrast, such a policy reform seems to be inconsequential in polities with medium to high levels of employment protection (capture oriented political economies). By contrast, an increase in the relative importance of investment vis-à-vis consumption generates significant labor market consequences in high revenue collection societies. In line with our theoretical argument, these consequences are mediated by the level of dualization under which the reform operations. In less regulated, insider oriented contexts, more investment translates, for instance via higher efforts in active labor market policies, in better labor market matching, therefore reducing the scope of long term unemployment. Interestingly, as was the case with the impact of investment on inequality, these positive effects become significantly smaller the higher the incidence of dualization. At the extreme,

[14] Again, findings are robust to the inclusion of country and year fixed effects.

when the protection of insiders is very high, and the latter can secure for themselves access to the benefits provided by increasing investment efforts, more investment works to further enhance the pre-existing patterns of segmentation in the labor market.

Overall, Figures 4 and 5 bring out one central message: *ceteris paribus*, the distributive effect of investment and consumption policy are mediated by the pre-existing legacies on which these policies are pursued. The findings lend strong support to the theoretical argument developed in this chapter and the volume.

Finally, Figure 6 analyzes the predicted income elasticity in the late 2000s as a function of two variables[15]: the average levels of, respectively, investment and consumption for the period 2003-2007 relative to total effort, and the level of disposable income inequality. The idea is to explore the marginal effect of investment policies on mobility holding all other determinants of the level of income inequality constant. The income elasticity reflects the extent to which parents income predicts that of their children. As such it provides a preliminary and imperfect measure of the extent to which opportunities to earn income remain, on average, stacked across generations.

"Insert Figure 6 about here"

The combined effects of investment and consumption policies on inequality and long term unemployment translate quite directly onto the cross-national variation in terms of the size of the income elasticity, as revealed by the geographic patterns displayed in Figure 6. In line with the

[15] Because I am using the data computed by Corack (2012) there is only one cross-section of observations available for this analysis. Therefore, I prefer to capture the balance between investment and consumption through the ratio rather than increasing the number of variables in such a limited context. Moreover, the level of consumption is a component of the accounting implicit in the measure of income inequality. Given the low number of observations, multi-collinearity becomes a concern as a result.

findings in figures 4 and 5, investment, by reducing the levels of both income inequality and long term unemployment, has a strong negative effect on the size of the income elasticity. Accordingly, the size of the elasticity is particularly low in societies with low levels of dualization and high fiscal capacity, such as Finland, Sweden, and Denmark; extremely high in capture oriented societies such as Portugal and Greece, and mixed in political economies where incumbents are constrained by either status or competitiveness. In the former group, the positive effects of investment on the income elasticity are downgraded by dualization. In the latter, the virtuous consequences of investment in the labor market cancel out with the exacerbation of income inequalities, and the uneven access to opportunities for income mobility (Corack 2012).

Similarly aligned with previous results are our findings on the relationship between consumption policy and the size of the income elasticity. An overview of the patterns displayed in the right panel of figure 6 suggests that, to the extent that it becomes an important budgetary item, consumption effort increases the size of the income elastiticy in status and capture oriented societies, provided further evidence on the segmented nature of the distribution of economic opportunities. By contrast, stronger efforts in consumptive policies complement investment in reducing the size of the income elasticity in nations with low levels of dualization and high levels of revenue collection. Universal access to services and progressive transfers reinforce each other in limiting the scope of inequality, long-term unemployment, and the size of the income elasticity.

13.4 Discussion

This chapter has analyzed the relationship between policy strategies and distributive outcomes in advanced capitalism. I have shown that the balance between consumption and investment policies, as developed under different sets of supply and demand constraints, is a major predictor of the observable differences across democracies in terms of income inequality, long-term unemployment, and the size of the income elasticity. These findings lend considerable support to the model of constrained partisanship developed in this volume and challenged the empirical expectations following from competing structuralist and functionalist accounts.

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Figures

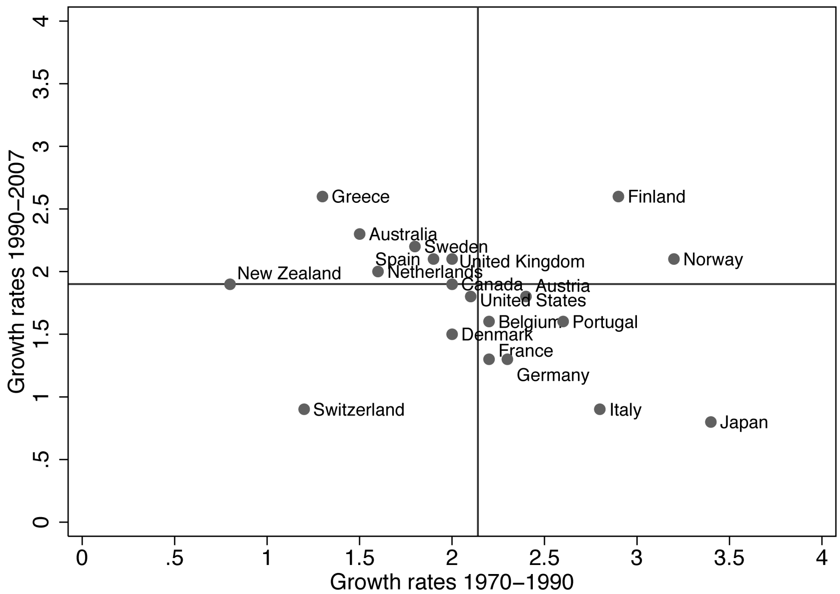

Figure 1: GDP growth rates 1970-1990 and 1990-2007 (UN Data)

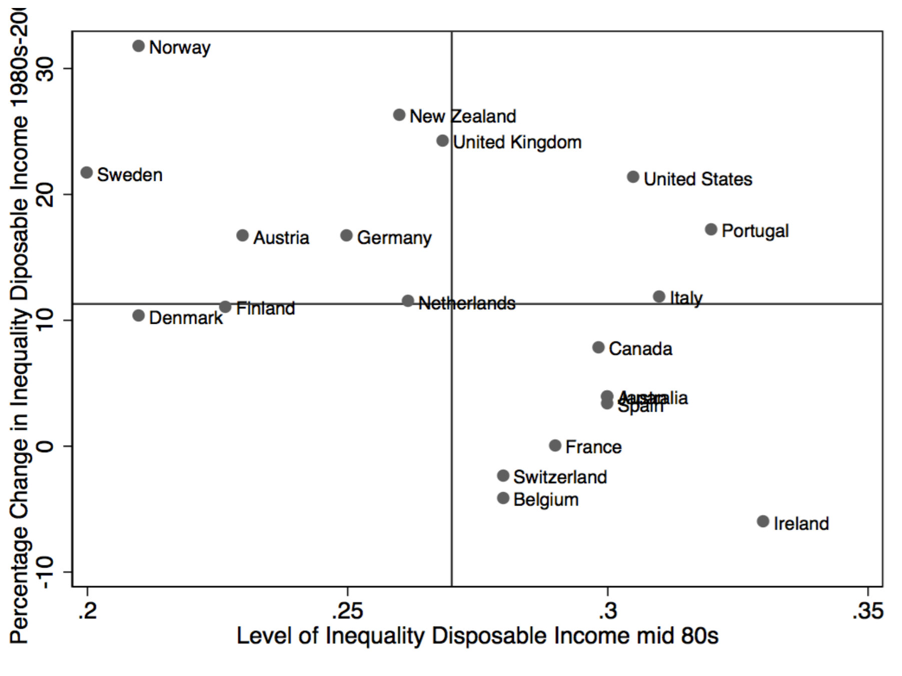

Figure 2: Levels of inequality in disposable income in the mid 1980s and percentage change in inequality between the 1980s and 2000s (LIS data)

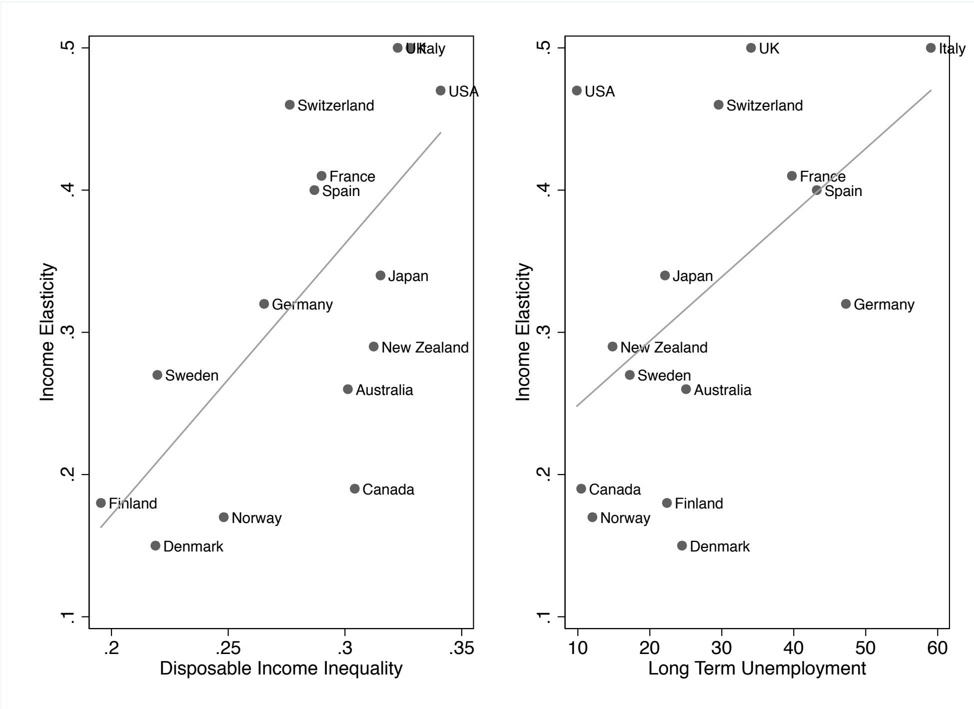

Figure 3: Income Inequality, Intergenerational Income Elasticity, and Long-term Unemployment

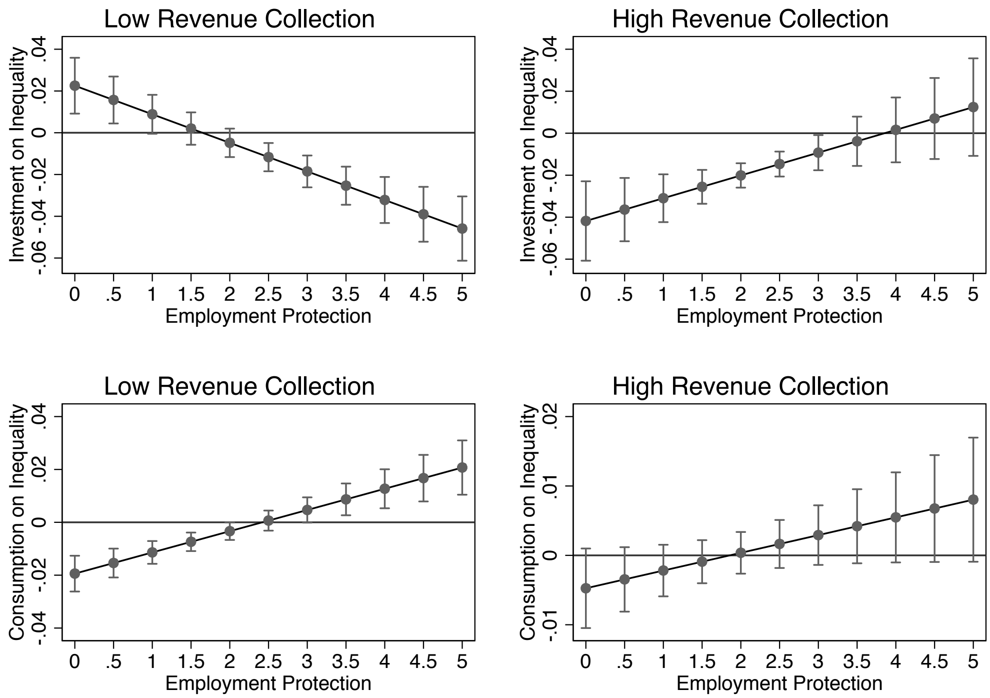

Figure 4: The Impact of Consumption and Investment on Inequality

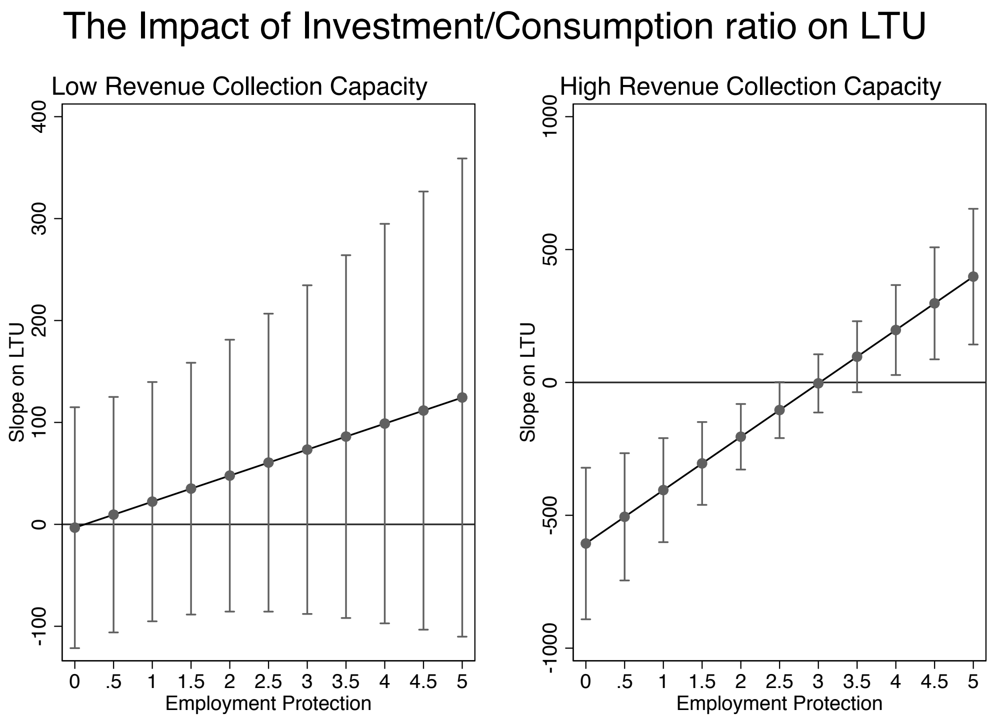

Figure 5: The Impact of the I/C ratio on long-term unemployment

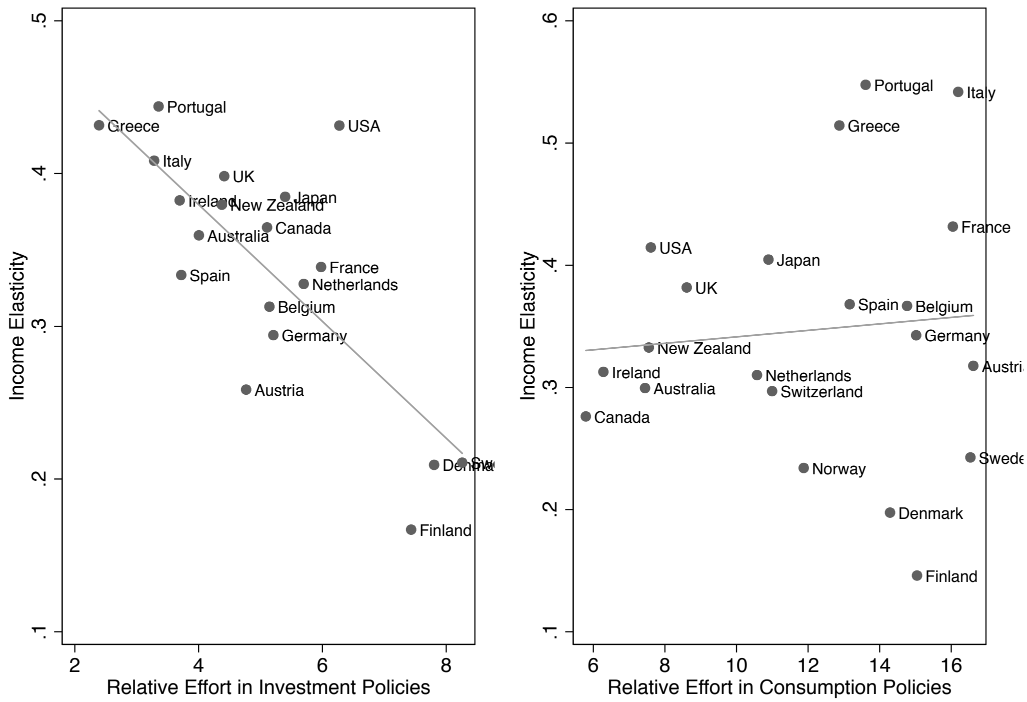

Figure 6: Investment, Consumption and Income Elasticity

Tables

	Revenue Collection		
Dualization		**High**	**Low**
	High	Status	Capture
	Low	Equality	Competitiveness

Table 1: The Structure of Political Constraints

	Revenue Collection		
Dualization		**High**	**Low**
	High	High Consumption Low Investment	Low Consumption Low Investment
	Low	High Consumption High Investment	Low Consumption High Investment

Table 2: Policy Configurations across different sets of constraints.

	Revenue Collection		
Duali-zation		High	Low
	High	$\frac{\partial DPI}{\partial C} > 0$ $\frac{\partial DPI}{\partial I} < 0$	$\frac{\partial DPI}{\partial C} > 0$ $\frac{\partial DPI}{\partial I} < 0$
	Low	$\frac{\partial DPI}{\partial C} < 0$ $\frac{\partial DPI}{\partial I} < 0$	$\frac{\partial DPI}{\partial C} < 0$ $\frac{\partial DPI}{\partial I} > 0$

Legend: I: Investment; C: Consumption; DPI: Disposable income inequality; LTU: Long term unemployment

Table 3: The Distributive Implications of Consumption and Investment Policy on Inequality

APPENDIX[16]

Table A.1: Determinants of Disposable Income Inequality (Investment)

	Model 1	Model 2	Model 3
Investment	0.0868*** (0.024)	0.0868*** (0.022)	0.0775*** (0.0227)
Employment Protection	0.1328** (0.060)	0.1328*** (0.050)	0.1309*** (0.0448)
Tax Revenue	0.0085** (0.0040)	0.0085** (0.0034)	0.0082** (0.0034)
Investment x Employment Protection	-0.0382*** (0.0103)	-0.0382*** (0.0086)	-0.034*** (0.0083)
Investment x Tax Revenue	-0.0026*** (0.00069)	-0.0026*** (0.0006)	-0.0022*** (0.0006)
Employment Protection x Tax Revenue	-0.0035* (0.0017)	-0.0035** (0.0015)	-0.0036*** (0.0013)
Employment Protection x Investment x Tax Revenue	0.001*** (0.00029)	0.001*** (0.0003)	0.0009*** (0.0002)
Federalism	-0.0065*** (0.0018)	-0.0065*** (0.0018)	-0.0077*** (0.0022)
Disproportionality	-0.00001 (0.0002)	-0.00001 (0.0002)	-0.0002 (0.0002)
Union Density	-0.0005*** (0.0001)	-0.005*** (0.0001)	-0.0008*** (0.0001)
Consumption	-0.0012* (0.0006)	-0.0012** (0.0006)	-0.0017** (0.0007)
Market Income Inequality	0.1928*** (0.0515)	0.1928*** (0.0315)	0.1164*** (0.0240)
N	212	212	212
R-Squared	0.8628	0.8628	0.9485

[16] Throughout this section Model 1 refers to OLS with robust standard errors; Model 2 refers to standard PCSE; and Model 3 refers to PCSE with an assumed common serial correlation on order 1 in the error term. All models include a constant.

Table A.2: Determinants of Income Inequality (Consumption)

	Model 1	Model 2	Model 3
Consumption	-0.0340*** (0.0090)	-0.0340*** (0.0081)	-0.0250** (0.0115)
Employment Protection	-0.1552*** (0.0483)	-0.1553*** (0.4673)	-0.0804 (0.0554)
Tax Revenue	-0.0074*** (0.0025)	-0.0074*** (0.0023)	-0.0047 (0.0031)
Consumption x Employment Protection	0.0134*** (0.0040)	0.0135*** (0.0038)	0.0083* (0.0051)
Consumption x Tax Revenue	0.0006*** (0.0002)	0.0006*** (0.0002)	0.0004 (0.0003)
Employment Protection x Tax Revenue	0.0025* (0.0013)	0.0025* (0.0013)	0.0009 (0.0015)
Employment Protection x Consumption x Tax Revenue	-0.0002** (0.0001)	-0.0002** (0.0001)	-0.0001 (0.0001)
Federalism	-0.0066*** (0.0020)	-0.0066*** (0.0020)	-0.0091*** (0.0024)
Disproportionality	-0.0006** (0.0002)	-0.0006** (0.0003)	-0.0005 (0.0003)
Union Density	-0.0005*** (0.0001)	-0.0005*** (0.0001)	-0.0009*** (0.0001)
Investment	-0.0169*** (0.0019)	-0.0169*** (0.0019)	-0.0076*** (0.0014)
Market Income Inequality	0.2114*** (0.0477)	0.2114*** (0.0317)	0.1299*** (0.0250)
N	212	212	212
R-Squared	0.8537	0.8537	0.9432

Table A.3: Determinants of Long-Term Unemployment

	Model 1	Model 2	Model 3
Investment to Consumption Ratio	599.7142*** (105.1133)	382.0214** (133.6511)	599.7142** (220.0094)
Employment Protection	66.4182*** (13.9073)	50.5716** (17.1535)	66.4182** (24.1705)
Tax Revenue	6.8308*** (1.0419)	5.0243* (1.3379)	6.8308*** (2.3104)
Investment to Consumption Ratio x Employment Protection	-149.7843** (44.5155)	-89.9625*** (53.7871)	-149.7843** (71.2623)
Investment to Consumption Ration x Tax Revenue	-24.1191*** (3.3203)	-16.0576*** (4.2275)	-24.1192*** (6.9620)
Employment Protection x Tax Revenue	-2.413*** (0.4209)	-1.7929** (0.5007)	-2.4128*** (0.7673)
Employment Protection x Investment to Consumption Ratio x Tax Revenue	7.0126*** (1.4013)	4.6459*** (1.6282)	7.0127*** (2.2606)
Unemployment	1.6907*** (0.2250)	1.6263*** (0.2368)	1.6907** (0.6090)
Consumption	-0.2828 (0.5063)	-0.7584 (0.5085)	-0.2828 (1.3697)
N	259	259	259
R-Squared	0.6402	0.6706	0.6402