Globalization and the Squeeze on the Middle Class: Does Any Version of the Postwar Social Contract Meet the Challenge?

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In the years since World War II, the nations of Western Europe, Japan, and the United States have all seen the emergence of large “middle classes.” The growth of the middle classes in these nations has come to be so taken for granted, in fact, that for twenty years scholars have been writing about the emergence of a new postmaterialist age in which class differences are coming to matter less and less. Income gaps between rich and poor have closed, government policies have cushioned the effects of the business cycle on the overall economy and on individuals, and the extended period of prosperity has created increased opportunities for upward mobility. The amelioration of class conflict that followed from these developments has contributed to the consolidation of democratic rule in nations that only recently have experienced political upheaval, and that has led voters to focus on quality-of-life issues like the environment instead of on economic policy—when they care about politics at all.

In the last several years, however, most of these countries have also seen the growth of what could be called “middle-class angst.” Well-paid blue-collar jobs have become much harder to find than they used to be, and even middle managers and public employees have faced layoffs and benefit cuts. Income gaps have begun to grow again, opportunities for upward mobility have been constricted, and government policies aimed at demand management and income support...
have been cut back or rendered less effective. Although there is little
evidence of renewed class conflict on the scale seen in earlier genera-
tions, the growing anxieties among those in the middle class about
their ability to retain their status suggest that Europe, Japan, and
the United States may once again face this challenge.

Everywhere a phenomenon labeled “globalization” is being blamed
for causing this renewed anxiety. The growth of imports and exports
as a share of all of these nations’ economies, the elimination of gov-
ernment and technological barriers to trade [which have made ser-
vice like telecommunications tradable in ways they never were be-
fore], and the free movement of capital across borders have placed
more and more low-skilled workers in the rich countries in direct
competition with low-wage workers in the developing world. This
competition has driven down their incomes even as the expanded
world market has created new opportunities for capital and skilled
labor from worldwide destinations. Globalization has also ampli-
ﬁed the effects of disruptions in the international economy on domes-
tic economies, generating recessions that tend to hurt the poorest
members of society ﬁrst. Governments, meanwhile, have been con-
strained by the same forces from offsetting these unequal effects.

Globalization has made it more difﬁcult for governments to use ﬁscal
and monetary policy to smooth out bumps in the business cycle. It
also created ﬁscal constraints that drive cutbacks in public em-
ployment and welfare programs, and it has forced governments to
implement additional liberalization measures aimed at improving
the efﬁciency and competitiveness of their economies. By reinforcing
the globalization trend, however, these policies expose more and more
citizens to the unequal effects of globalization.

In this chapter, I examine in more detail the common challenge
of globalization to the middle classes of the advanced industrialized
nations, compare the divergent government responses to this challenge,
and offer a preliminary evaluation and analysis of the degree to which
these divergent responses have been successful in ameliorating the
polarizing effects of globalization on class structure. Although eco-
omic theory and the history of the previous period of globalization
between 1870 and 1913 suggest that globalization ought to have simi-
lar effects on all advanced economies, increasing the gap between rich
and poor, and shrinking the middle class, sometimes it is affecting
nations whose middle-class social contracts have evolved in quite dis-

tinctive ways. Whereas the United States has based its contract on
the assumption that a rising tide of consumption will lift all boats,
European nations have built their contracts around the social protec-
tion provided by the welfare state. Japan, in contrast, chose yet an-
other path, basing its contract on elaborate schemes of public-private
cooperation and collusion that are captured in the metaphor of a con-
voi: risk is socialized, so that no one feels and everyone moves up
together.

Globalization has placed all three approaches under strain, but the
rates at which inequality trends have begun to drive a wedge through
the middle classes of these countries have been very uneven. I argue
in this chapter that one of these three approaches—the European wel-
fare state approach—has been more successful than the others at
holding out against globalization’s inequality-inducing effects. The
empirical record summarized in this chapter indicates that the
United States and Britain [which since Thatcher has adopted a policy
proﬁle similar to the American model], along with Japan, have suf-
f ered signiﬁcant erosion in their levels of income equality over the
past two decades. Much less affected so far have been the middle
classes of continental Europe, where after-tax-and-transfer levels of
income dispersion have widened only marginally in some cases and
declined in others.

Nevertheless, my conclusions are necessarily tentative. Income in-
equality is a complex phenomenon that is not a function of trade and
investment patterns alone. Demographic and technological change in
particular have been identiﬁed as additional factors behind recent in-
equality trends. Although the chapter touches on these other factors
in the concluding section, its purpose is to see how far we can get
through a focused analysis of the connections between inequality, on
the one hand, and globalization and social contracts, on the other. If
some nations are doing better at holding out against trends toward
greater inequality, and this pattern corresponds to the way in which
these nations have organized their social contract, that correspond-
ence provides a useful way of looking at how different versions of
the social contract are faring.

Another reason this study’s conclusions must remain tentative is
that it focuses primarily on a single measure of overall inequality—
the Gini index—and consequently neglects important differences in
the ways inequality can emerge. Some forms of rising inequality [as
when top incomes grow faster but lower incomes grow too] clearly
pose less of a threat to middle-class social contracts than others [as
when a growing portion of the middle class is falling into the ranks of
the poor]. It is possible as well that modest increases in income inequal-
ity in nations starting with egalitarian income distributions may be
good for these societies in that they create incentives for individuals
to make the best of their lives. In focusing in this chapter on the Gini
index as the primary measure of income inequality, and in assuming
first in how the distributional effects of changes in international trade and economic reforms can lead to the emergence of new inequalities. The models used in this chapter are based on the assumption that inequality is a problem that arises from the interaction of domestic factors. However, this assumption is not always valid. For example, in the case of China, the distributional effects of foreign direct investment can lead to the emergence of new inequalities. The models used in this chapter are based on the assumption that inequality is a problem that arises from the interaction of domestic factors. However, this assumption is not always valid. For example, in the case of China, the distributional effects of foreign direct investment can lead to the emergence of new inequalities.

Economic Theory and History

Economists tend to worry primarily about aggregate economic conditions, as these affect the overall well-being of the economy. The models used in this chapter are based on the assumption that inequality is a problem that arises from the interaction of domestic factors. However, this assumption is not always valid. For example, in the case of China, the distributional effects of foreign direct investment can lead to the emergence of new inequalities. The models used in this chapter are based on the assumption that inequality is a problem that arises from the interaction of domestic factors. However, this assumption is not always valid. For example, in the case of China, the distributional effects of foreign direct investment can lead to the emergence of new inequalities.
fore, these effects of increased international exchange, the models tell us, should be greatest when the exchange is conducted between nations with sharply different factor endowments. Increases in trade and investment between developed and developing nations in particular should aggravate inequality in the developed nations.

A few economists have supplemented this prediction about the distributive effects of North-South trade and investment with the claim that even exchange among similarly endowed nations in the North (for example, Toyota investing in the United States) tends to aggravate inequality by allowing more mobile capital to take advantage of a more elastic labor supply. As Dani Rodrik puts it: 'The fact that 'workers' can be more easily substituted for each other across national boundaries undermines what many conceive to be a postwar social bargain between workers and employers, under which the former would receive a steady increase in wages and benefits in return for labor peace.' Labor unions are weakened, growth in labor incomes is more unstable in earnings as it is forced to bear the brunt of economic shocks, and workers are forced to cover a greater share of the costs of benefits and improvements in working conditions.

Although the economic analysis thus far makes quite a pessimistic prediction about the probable effects of increased international exchange on class structure in the advanced industrialized nations, it is still possible that these effects could be mitigated—as noted earlier—through side payments from the globalizers to the workers. In all of these societies, such side payments are provided at least to some degree through certain kinds of social insurance. Most commonly, this social insurance takes the form of government programs, such as unemployment compensation, trade adjustment assistance, income supports, and minimum-wage rules, progressive tax systems, the expansion of (or mandated) public-sector employment, and government subsidies to declining industries. In some places, however, such as Japan, social insurance also takes the form of private-sector arrangements; sometimes organized with the support of the government, these are designed to minimize economic disruptions and pull the losers up with the winners. In both cases, these programs of social insurance also function to provide a built-in countercyclical mechanism (along with other levers of Keynesian demand management, or KDM) to smooth out the ups and downs of the economy and dissipate the inequality-producing impact of boom and bust. Finally, corporatist wage bargaining institutions can mitigate wage inequality by raising all wages in a centralized process. Regardless of how inequality is mitigated, the effects of globalization on the class structures of the advanced industrialized nations depend critically on whether globalization frustrates the ability of nations to maintain and enlarge these social insurance programs, policies, and networks.

Economic theory suggests that, at low levels of trade and with limited capital mobility, nations can sustain quite elaborate social insurance programs and make effective use of fiscal policy as a tool of KDM, even if these impose heavy tax or private-sector social network obligations on capital and labor. Similarly, even with increased trade and capital mobility, such programs can be sustained as long as the trade flows and capital movements are concentrated within the group of nations with similar levels of social insurance and tax systems (especially if exchange rates can be fixed among the primary economic partners, as in Europe). Social insurance arrangements become more difficult to sustain, however, once capital becomes "footloose" and can freely and profitably move to nations that have much lower levels of social protection and lower taxes, and once trade with these nations comes to constitute a growing proportion of the economy. First, capital cannot be taxed (or unduly burdened with social network obligations) because it can relocate in nations that do not impose these burdens. As a result, we should expect more and more of the burden of financing social insurance to be born by labor relative to capital—further exacerbating social inequalities. At the same time, though labor is less mobile and so can be taxed heavily, at a certain point the ability of nations to shift the cost of financing social insurance to this sector will reach its limit. Nations increasingly find it difficult to raise payroll taxes to the rates necessary to sustain elaborate social insurance programs once more and more of their local industries have to compete in markets with labor that is not burdened with the added costs of social insurance.

It is important to recognize that social insurance programs and social network obligations that provide interclass transfers will be squeezed the hardest by globalization. As long as a social welfare program is providing a service that workers need to secure in one way or another—such as health insurance or pensions—labor in countries where these services are provided through the state will not necessarily price itself out of competition with labor in countries where these services are purchased through private markets. British industry gains in competitiveness because the National Health Service delivers care more cheaply (as a share of GNP) than does the American medical system. However, where labor in traded sectors is asked to bear, in addition to the cost of its own social insurance, a disproportionate share of the costs of social insurance and transfers to the lower classes, it increasingly finds itself at a disadvantage in competition with nations where traded-sector labor is responsible only for
its own welfare. As a result, the economic logic detailed here leads us to expect that globalization will shrink first those welfare programs [such as AFDC in the United States] that provide the most direct transfers between rich and poor, leading to a reduction in inter-class side payments exactly when globalization is creating a need for increases in these transfers to offset its unequal effects on society.

A brief look at an earlier period of globalization, applying some of the insights from economic theory developed here, can help us better understand the effects of this phenomenon on class structures. The last major period of globalization—one with interesting parallels to current trends—spanned the years between 1870 and 1913. During this period, the cost of transportation, which had constituted a major barrier to the trade of bulk commodities such as grains, fell dramatically; for example, the price paid in Liverpool for grain imported from the American Midwest fell from 60 percent above the Chicago price in 1870 to just 15 percent above that price in 1912. This drop in transportation costs ushered in a period of rapidly increasing trade between land-rich, labor-poor areas such as the United States and labor-rich, land-poor areas in Europe. In addition, international labor migrations between the same regions led to a 37 percent surge in the size of the workforce in the labor-short New World, even as the Old World labor force shrunk by 18 percent.

Each of these developments, our economic model tells us, should have had distributive effects on the affected societies. Increased trade, as noted earlier, tends to reduce the income of relatively scarce factors while raising the income of abundant factors. Labor migrations have the same effect. During this period, therefore, rapidly increased trade and the migration of unskilled workers from surplus to shortage areas should have had the effect in the New World of reducing the incomes of unskilled labor [the scarce factor] and increasing the incomes derived from land and skilled labor [the abundant factors]. In the Old World, in a reversal of this effect, increased trade should have raised the wages of unskilled labor relative to incomes derived from land and skilled labor.

The historical record, the economist Jeffrey Williamson argues, confirms these predictions. "In the New World," he writes, "the ratio of wage rates to farm rents plunged . . . [while] in the Old World the reverse occurred, especially where free trade policies were pursued." Furthermore, the shifts in the ratios were quite dramatic: the ratio of wage rates to farm rents fell to half its 1870 level in the United States, while in Britain and Ireland the ratio rose by factors of 2.7 and 5.5, respectively. Because landowners in both the Old and New Worlds began the period near the top of the income distribution scale, these shifts in the ratios brought on by globalization meant that New World nations like the United States suffered from widening income gaps even as Old World nations, like Britain, Ireland, Sweden, and Denmark, saw reductions in their [still substantial] levels of income inequality.

Williamson sees a possible warning in the record of this earlier period of globalization. This era was followed, after World War I, by a broad retreat from the liberal trading system, owing in part, it seems, to the reaction against growing inequality in nations like the United States. Although the surge in protectionism [and immigration restrictions] that marked the period between 1913 and 1950 did stem the inequality trend in the United States and elsewhere, and perhaps even contributed eventually to the rise of the middle class there, it also helped produce the Great Depression and World War II. This historical precedent makes it all the more imperative that we examine closely the effects of the current round of globalization on the class structure of advanced industrialized nations.

**Globalization and the Postwar Social Contracts**

In the early years after the war, the architects of the postwar international economic system worked to create a system that differed dramatically from the one that had existed in the earlier era of globalization. The advanced economies would work to gradually open their markets, but they started with high levels of protectionism in light industries and strict limits on capital mobility. Rather than leaving market forces free to carry economies wherever they might go, they constructed a system of "embedded liberalism" that allowed free trade rules to be bent when they threatened the predominant social purpose: maintaining domestic economic and political stability. Furthermore, as they gradually opened up to trade and foreign investment, the nations of Europe, Japan, and North America developed social contracts that cushioned affected sectors from the short-term negative effects of market forces, providing more citizens with the economic security of life in the middle class. Through these efforts, all of these nations came to experience not only high levels of aggregate economic growth but also improving levels of income equality that reflected the widespread sharing of the benefits of this growth.

By the late 1970s, however, the trade and investment patterns of the advanced economies had begun to reach levels seen during the earlier era of globalization. Just as the falling cost of transportation sharply reduced the cost of trade in bulk commodities during the late nineteenth century, reductions in the tariffs on manufactured goods
in developed countries from 40 percent in the late 1940s to 7 percent after the Tokyo Round dramatically lowered the cost of trade in industrial goods. Moreover, liberalization of the regulations restricting capital movements have combined with further reductions in the cost of transportation to lead multinational firms to invest heavily in newly industrializing countries (NICs) in recent years. With NICs incorporated into global production networks, barriers to trade in industrial sectors such as electronics have been virtually eliminated. Finally, technological change as well as moves toward liberalization and privatization (driven in part by the effects of increased trade competition) have led to dramatic reductions in barriers to trade in services such as telecommunications, finance, and insurance.

The result has been a surge in trade overall as well as a surge in trade between developed and developing countries. Merchandise exports grew as a proportion of the economies of industrialized countries from extremely low levels in 1950 (4.4 percent in Germany; 2.0 percent in Japan, 3.3 percent in the United States) to levels that had almost doubled by 1996 (22.1 percent in Germany; 8.9 percent in Japan; 8.2 percent in the United States). Although much of this trade was carried out between developed nations, merchandise trade between these nations and the developing nations, especially the NICs, has surged in recent years. This trade began gaining momentum in the 1970s: the NICs’ share of world manufactured exports rose from 1.9 percent in 1966-65 to 8.7 percent in 1983. The greatest surge in imports from developing nations, however, has come only in the last decade: between 1990 and 1996, such imports grew by 60 percent for Japan, 46 percent for the United States, 71 percent for Britain, and 52 percent for Germany.

International competition in service sectors, meanwhile, has expanded to the point that these sectors exceed merchandise trade in some dyads. Finally, the years since capital liberalization began in the 1970s have seen an explosion in the volume of short-term capital movements, with the sum of money flowing in through currency markets reaching the level of US$1.2 trillion a day by the early 1990s and the volume of bank loans across borders reaching the level of US$3.6 trillion. Both of these levels were double those of just a few years earlier.

The economic theory summarized here and the historical record of the earlier era of globalization give us good reason to be concerned about the effects of this recent surge in international capital flows. Improved levels of income equality that were achieved during the first postwar decades, when international transactions were much more limited. According to the theory, increased trade and investment, especially with developing nations, can be expected to widen income gaps between the rich and the poor in all of the advanced industrialized nations, shrinking the middle class in the process. Unskilled workers (the relatively scarce factor) are predicted to see their incomes decline even as skilled workers and owners of capital (the relatively abundant factors) are expected to see their incomes rise. Globalization, the theory predicts, can be expected to drive a wedge through the middle classes of the advanced economies, pushing less-skilled workers down and more-skilled workers up out of a class that had for a few decades been home to both.

What stands out in the view of global consumption and these theoretical predictions are the postwar social contracts that were designed to cushion the effects of market forces as economies were liberalized. Before we can explore the degree to which various manifestations of the social contract have been able to ameliorate the polarizing effects of globalization on class structure, we first need to review the differences between the social contracts that helped grow the middle classes in the advanced industrialized countries. All employed Keynesian demand management to smooth out the troughs in the business cycle, and all created some form of social insurance, but the emphases differed enough that we can identify three quite distinct models.

First, in the United States the middle class grew out of a political economy organized around mass consumption. Corporations worked out arrangements with industrial labor unions designed to win labor peace for exchange for high wages, and these wages in turn gave workers the purchasing power necessary to propel growth. Social insurance was largely occupational in the sense that health care and pension benefit levels varied depending on an individual’s employer. The state had a minimal role in all of this, using KDM to keep the economy running at full employment so that most citizens could earn their own incomes through work and with a minimal safety net. The elements of that safety net that dated back to the Great Depression, as well as the elements constructed as part of the Great Society project in the 1960s, were designed not so much to redistribute income as to make sure the poor did not starve. The ideology behind the U.S. approach, in fact, emphasized the need to keep benefit levels as low as possible for working-age adults to avoid creating a sense of dependency on the state and to maintain incentives to work. Britain, notably, has moved sharply toward this model since Margaret Thatcher took power in 1979.

On the continent of Europe, in contrast, the state was much more involved in growing the middle classes by providing, either directly or through mandates, more generous social wages, more universal social
protection, and a generous safety net. In much of northern Europe, corporatist networks functioned in such a way as to pull up the wage levels of lagging sectors along with those that were most competitive internationally. The huge proportion of workers employed by the state or working in service sectors sheltered by regulation from market forces were also able to claim generous wage increases and benefits that made them the core of the new middle class. Meanwhile, where the state did not offer social insurance directly through universal programs, it imposed strict requirements forcing firms to provide extensive benefits and job protections. There were certainly important differences in the composition of programs across the European states, but they had in common a universalistic approach to social protection—enforced by the state—that was distinct from the U.S. and Japanese models summarized here.

Finally, Japan, though slow to construct traditional redistributive government programs, gradually converted its system of "convoy capitalism"—built to propel the nation's economic advance—into what functioned essentially as a redistributive support system for uncompetitive and declining sectors of the economy. Internationally competitive firms like Toyota and Toshiba paid higher prices for steel, cement, and flat glass than they could have found on the world market in order to maintain their commitment to domestic business partners. These and other firms paid workers more in order to cover the higher costs of food, consumer goods, and housing that they had to pay in order to maintain employment in agriculture, retail, and construction. And large firms maintained lifetime employment commitments to worker stakeholders even at the expense of profits. Together, these networks made it possible for Japan to maintain extremely low levels of unemployment even during slowdowns and to limit wage differentials between white- and blue-collar labor—effectively redistributing income from the globalization winners to the globalization losers. The state role in all of this, however, was much more informal than in the European model. The state served as a regulator and broker dedicated to helping firms avoid market disruptions so that they could keep the convoy moving steadily ahead, but it provided only a minimal safety net, employed only a relatively small segment of the labor force, and allowed firms to provide benefit levels that differed sharply depending on size.

Inequality Trends Today: How Do They Differ and Why?

Economic theory and the history of the period between 1870 and 1913 suggest that inequality should be increasing today in all advanced industrialized societies in response to globalization. This time, however, these nations have constructed much more elaborate social contracts designed to cushion the effects of market forces, giving us reason to wonder whether one or more of the three approaches is succeeding in holding out against the tide. In this section, I briefly review the empirical evidence on inequality trends and then offer a preliminary analysis.

Comparing income inequality across time and countries is not a simple exercise. There are multiple ways of measuring income and multiple indices for inequality, the figures often vary sharply depending on which is chosen, and sometimes differences in how governments and scholars keep statistics across nations make meaningful comparison almost impossible. The study that has worked hardest to overcome these limitations is the Luxembourg Income Study (LIS). Unlike other studies that are based on data that exclude substantial segments of the population, the LIS reports comparable income data for all households, excluding only those employed in the military, the homeless, and the institutionalized. The LIS also requires all participating nations to use identical definitions of income. Because of the rigorous standards of comparability, however, this database excludes one of the countries of interest to us [Japan] and reports data for only a few scattered years. Nevertheless, the data do show some interesting differences in inequality trends between 1979 and the present (see figure 13.1).

These figures show that inequality in household disposable income worsened most dramatically during this period for the United States and Britain, with the Gini coefficient for those nations shifting from 0.39 to 0.55 for the former and from 0.37 to 0.54 for the latter. These trends have been confirmed by a large number of studies. Frank Levy's study of inequality in the United States, for example, found that the Gini coefficient for household income (before taxes and transfers) worsened from 0.39 in 1969 to 0.43 in 1989 and 0.45 in 1996. Paul Ryscavage, reporting U.S. inequality data for broader measures of income and taking into account the cash value of employee health benefits and capital gains (which worsen the Gini index) along with taxes, transfers, and the cash value of welfare services (which improve it), shows that the trend line worsens on a parallel, if somewhat less unequal, track. Putting these numbers into terms more easily absorbed by those unaccustomed to inequality statistics, Levy concludes that "the middle class" (defined as households earning between $30,000 and $80,000) in 1997 (U.S. dollars) contracted sharply from 63 percent of prime-aged households in 1973 to 51 percent in 1996. Other studies have confirmed the LIS observation of a...
way allows us to see whether inequality grew mostly because of a growing dispersion near the middle—not necessarily a problem—or because of movement at the upper and lower ends of the scale. The data for the United States and Britain shows clearly that income inequality in those countries grew mostly because families at the upper end greatly expanded their share of national income while those at the lower end saw their income shares contract.

In contrast, the income distribution data for continental Europe featured in figure 13.1 and the appendix show much less deterioration. Indeed, the LIS data for Italy show an improvement—that is, the nation went from having one of the most unequal distributions of income among the study group in 1986 to a much more equal distribution in 1991. National data sources for Italy presented in the appendix, covering the years 1967 to 1998, confirm that the longer-term trend has been toward an improvement in levels of inequality. They also indicate, however, that there has been a modest deterioration over the past decade. The LIS data for France show that it experienced an improvement too between 1979 and 1984, but that it has since seen a deterioration roughly parallel to that in Britain. Data for Norway and Sweden show a deterioration of 2.0 and 3.0 percentage points, respectively, over this period—much less of a rise in inequality than in the United States and Britain. Peter Gottschalk, manipulating the same LIS data set to focus on the labor market earnings of prime-aged, full-time male workers, found that Sweden experienced the smallest increase in inequality, while France and the Netherlands experienced an increase that was only one-quarter that seen in the United States. Richard Freeman and Lawrence Katz similarly found that wage differentials declined or remained unchanged in France, Germany, Italy, and the Netherlands while growing somewhat in Sweden. Several data sources for a variety of continental European nations thus concur in observing much less of a rise, and in some cases a decline, in inequality.

Japan has chosen not to participate at all in the Luxembourg Income Study, and so data on Japan that are strictly comparable with data for the other advanced industrialized nations surveyed here are not available. Nevertheless, a number of the national studies that have been conducted are consistent with LIS data at least in their definitions and measurement over time. The most widely cited data source on inequality in Japan is the Family Income and Expenditure Survey (FIES), but some scholars prefer to use the Ministry of Health and Welfare's Income Redistribution Survey (IRS). Most critically for our purposes, both show that Japan experienced quite a dramatic increase in income inequality over the period 1980 to 1997 (see figure 13.2).
First, the IRS, which is based on a sampling of a much broader proportion of the total population of households than is the FIES, shows that Japan's Gini coefficient grew from 31.4 in 1981 to 36.5 in 1992. The latter rate placed Japan near the levels of income inequality found in the United States, which according to the LIS had a Gini coefficient of 36.8 in 1994. The trend line documented in this study also placed Japan with the United States and Britain as suffering one of the most severe deteriorations over time. As Tachibanaki Toshikazu and Yagi Tadashi conclude in their analysis of this data, "We would claim that no other major industrialized country had such a drastic increase in inequality of income distribution during such a short period." Although Tachibanaki has not yet published Gini coefficient data based on the IRS data for more recent years, data on the income of the poorest quartile of the Japanese population as a share of average income (published by the Ministry of Health and Welfare and based on the same survey—see figure 13.3) show that the trend continued in the 1990s. Note that in this figure a line sloping downward indicates rising levels of inequality.

The other widely cited measure of inequality in Japan, the FIES (shown in figure 13.2), covers a smaller segment of the Japanese popu-
on the observed correlation. The ability of European societies to re-
tain previous levels of equality or at least to slow down inequality
trends suggests that the mix of activist state policies that are at the
heart of European postwar social contracts have proven most effective
at mitigating the effects of globalization on inequality. In contrast,
the rapid increases in inequality in the United States, Britain, and
Japan suggest that approaches relying on consumption-led growth and
convey capitalism have not proven sufficient to maintain previous
levels of equality.

As noted at the beginning of this chapter, however, the causes of
inequality are too complex for us to jump to this conclusion so
quickly. Although the pattern is suggestive, the correlation on its
own does not provide enough evidence to give us confidence that dif-
fferences in the nature of postwar social contracts across these soci-
eties are the primary cause of differences in their inequality trends.
First, since it is plausible that the contrasting outcomes are due to
differences in other factors affecting levels of inequality, we cannot be
confident that the nature of the postwar social contract is the critical
factor until we more fully explore alternative explanations. Second,
the posited conclusion is less convincing absent a more elaborate
logic explaining why the European approach has been better able to
maintain levels of equality in the face of globalization while the other
approaches have not. Finally, that more elaborate logic will require
confirming evidence. Although space limitations prevent me from
undertaking these tasks here, I conclude this chapter by offering a few
thoughts on each step in this research agenda.

Alternative Explanations of Income Inequality Across Societies

Although most studies of recent inequality trends in the advanced
industrialized societies assign significant causal effect to factors re-
lated to globalization and the mix of policies and practices we have
called postwar social contracts, they also point to the importance of
factors such as family living arrangements and technological change.11
According to studies of income inequality in the United States by
Paul Ryscavage and Frank Levy, up to two-fifths of the recent rise in
inequality in that nation may have been caused by social and demo-
graphic changes such as the rise in female-headed families and the
recent tendency of high-earning women to marry high-earning men.12
Studies of rising income inequality in the United States have also
highlighted the role of technological changes, such as the growing use
of computers, in generating a skills bias in wage levels.13

Although studies of other nations have examined the role played
by these factors, the available evidence does not suggest that technol-
yogy or marriage patterns vary across nations in ways that mirror the
uneven pattern of rising inequality described here. For example, Japan
has experienced a much smaller increase in female-headed house-
holds than the United States but has seen inequality rise just as fast.
Similarly, although the United States seems to have been the first to
embrace some types of technology (for example, personal computers
and the Internet), a technology gap seems unlikely to explain why
Japan and Britain have experienced greater increases in inequality
than the nations of Scandinavia, France, and Italy. Data assembled
under the auspices of the Luxembourg Income Study, supplemented
by similar data on Japan, should allow scholars to begin sorting out
which factors—globalization, postwar social contracts, or the alterna-
tive factors identified here—can best account for variations in in-
equality trends across nations.

A More Elaborate Logic Explaining the Relative Success of the
European Approach

In the first few decades of the postwar period, the United States, Ja-
pan, and the nations of Western Europe all found ways to reduce in-
come disparities and establish relative social peace anchored by large
and inclusive middle classes, but the evidence summarized here sug-
gests that the approach adopted on the continent of Europe has been
better able to sustain this contract in the face of globalization. Why?
The explanation I offer is based on the collective action problem in-
volved in “providing social peace” through social protection and re-

distribution. These tasks constitute a collective action problem be-
cause, although all members of societies that enjoy social peace
benefit from it, some segments pay a disproportionate share of the
costs to support this effort. Following scholars who have emphasized
the role of corporatist wage bargaining in sustaining more egalitarian
income distribution,14 I propose that more centralized processes of re-
distributing income and providing social protection are more resilient
in the face of globalization than those that rely on a decentralized
collection of subnational governments, firms, and labor unions.

Even when social protection and income redistribution are pro-
vided and managed by nation-states and corporatist bargains are
struck at the national level, globalization presents a challenge. Cen-
tral organizations representing industry, when faced with growing
competition from foreign firms operating from countries where they
face less of a redistributive burden, are likely to demand that the welfare state and labor market institutions be restructured so that domestic industry is at less of a competitive disadvantage. Tax competition may place states under fiscal pressure to scale back social benefits, cut the salaries of public workers, or accelerate the pace of privatization.14 As long as these decisions are made at the national level through a political process, however, the pace at which redistributive programs are abandoned is likely to be slower than when key decisions are made by subnational governments or individual firms. When decisions are made politically at the national level, the many beneficiaries of social programs are given opportunities to mobilize to defend the status quo. Nations, moreover, have more flexibility with their finances than do firms.

The American and Japanese cases show us how the process can be accelerated when smaller units are provided with opportunities to reduce their contribution to social peace. The U.S. model, as summarized earlier, relied on firms like General Motors to offer generous wages that provided workers with the consumption power to increase purchasing volume, that increase in turn helped firms maintain competitiveness and earn profits by improving their economies of scale. This approach worked as long as the Big Three automakers all practiced the same strategy and faced few outside competitors. Once Japanese automakers entered the U.S. market in volume, however, each of the Big Three faced pressures to cut costs to compete. Once one began cutting, the others had to follow or face bankruptcy. Their inability to overcome collective action problems when faced with foreign competition thus broke the beneficent circle that had earlier helped improve levels of equality in the United States.

In Japan, equality was enhanced in part because the globalization winners [such as Nissan] redistributed some of their gains by keeping their employees on the payroll in slow times and agreeing to pay higher costs for domestic inputs such as steel, petrochemicals, and construction. The collective action problem among firms was mitigated, furthermore, by lax antitrust enforcement and government assistance designed to sustain the nation’s “convoy” approach to capitalism. Nevertheless, the Japanese model remained reliant on voluntary redistribution by firms that—especially when whole industries were threatened—could not bear the full burden of a policy serving such a broad social purpose. Once globalization compelled more and more firms to cut costs to remain competitive, even firms that enjoyed much more government protection than their U.S. counterparts had no choice but to scale back the proportion of workers covered by the social contract.

Confirming Evidence of the Logic Explaining the Resistance of Some Inequality Trends to Globalization

In the limited space of this chapter, I can do little more than show a simple correlation and put forward a basic logic and a few stories like those just summarized to link the uneven inequality trends of the advanced industrialized countries to differences in how their social contracts have held up in the face of globalization. If I am correct, however, I would expect to find confirming evidence in two places: in a more detailed analysis of income distribution trends, and in a close examination of changes in the features of each nation’s social contract. First, I expect that an analysis of income data would confirm a pattern that Gottschalk has already suggested: that wage levels in nations without centralized wage bargaining institutions (most notably the United States, Britain, and Japan) have experienced the greatest degree of divergence in response to greater international competition with low-wage countries.15 Second, I expect this data to show that taxes and transfers do the most to ameliorate the effects of unequal before-tax incomes in cases where programs are run at the national level [not by subnational governments or firms]. Finally, I would expect to find that governments have resisted fiscal and political pressures to cut back on state-run redistributive programs (such as pension programs) more effectively than have firms and industry associations that in the past supported firms and workers in less productive segments of the economy. I cannot explore evidence related to each of these points here, but this list of expectations provides an agenda for further research.

Conclusion

Economic theory gives us reasons to expect that increased international trade and capital flows, especially when they involve nations with sharply differing factor endowments, will tend to redistribute income in ways that aggravate inequality in advanced industrialized nations. Those individuals who have capital and skills that are in high demand can command much higher salaries in this increasingly global market, even as those with fewer skills face more competition from low-paid foreign workers. Although all of the advanced industrialized nations developed institutions and policies over the postwar period that were designed to provide social protection from market forces like globalization and to moderate the inequalities associated with a market economy, economic theory also tells us that the same
global economic forces can be expected to challenge the ability of nations to maintain these social contracts.

This chapter has shown that we have more than just theoretical reasons to worry about the effects of globalization on social contracts. Almost all of the advanced industrialized nations have in fact become more unequal to one degree or another over the past two decades, stimulating an erosion in the old social contracts or their inability to compensate for the starker distributional effects of growing international commerce is behind this trend. This finding should be a major cause for concern. According to the inequality statistics cited in this chapter, the middle classes in most advanced economies are shrinking. Some individuals are moving up into the upper-middle class, but many are slipping down into the ranks of the poor. Moreover, the institutions and policies that previously worked to grow middle-class assets and dampen the frustrations of the poor through tax and transfer policies, government- and firm-provided social benefits, and micro- and macroeconomic intervention are not functioning as well as they used to.

Fortunately, not all societies have experienced this trend to the same degree. The sharpest increases in inequality have occurred in the United States, which relied on fluid labor markets and policies designed to maintain steady consumption-driven growth through arrangements like the "treaty of Detroit," and in Britain, which since Thatcher has moved toward the U.S. model. Japan's rate of deterioration is almost as steep, suggesting that its model of convoy capitalism, which relies on government macroeconomic intervention to help firms avoid bankruptcy and instability in exchange for their role in maintaining stable employment and subsidizing lagging sectors, is no longer capable of cushioning workers from market forces. In contrast, the rise in inequality has been slower in most European countries, some of which have actually seen improvements. This finding suggests that states may still be able to counteract the effects of globalization if they are willing to centralize the process by which wages are set, run tax and transfer programs at the national level, and rely largely on the state (rather than firms) to redistribute income. Though further work remains to be done to establish more clearly the connections between globalization, social contracts, and inequality, the overall correlation holds out the hope that the European approach is a viable way of maintaining social peace in our societies, even in the face of recent economic changes.

Notes

Japanese names appear with last names first, even in English language publications.


22. See Ogilvie [this volume].

23. Esping-Andersen, for example, in The Three Worlds of Welfare Capitalism, draws a sharp distinction between the Scandinavian social-democratic approach and the conservative-corporatist model found in Germany and much of the rest of Europe.


27. For income figures, see LIS data presented in Atkinson, Rainwater, and Smeeding, Income Distribution in OECD Countries, 49, and Timothy M. Atkinson and Peter Gottschalk, Understanding Income Inequality: How Great Is It and What Can We Learn from It? Focus 19, (Summer-Fall 1998): 16. These figures are for disposable income, after taxes and transfers. The Gini coefficient is the Composite Lorenz curve based on a nation’s Lorenz curve plotting the cumulative share of total income of population segments from the poorest to the richest. The coefficient is equal to the area between a straight forty-five-degree line, representing a completely equal distribution of income, and the concave Lorenz curve as a share of the total area of the triangle below the straight line. A large coefficient thus reflects a Lorenz curve that is extremely concave, with poorer segments of the population receiving much smaller shares of total income than the richest.


30. Levy, The New Dollars and Dreams, 162. He defines “prime-aged” households as those headed by an individual between age twenty-five and fifty-four. He found that this spending out of the distribution of household income involved an increase in the number of wealthier families (those making over $80,000 grew from 13 percent of all households to 20.7 percent) as well as an increase in the number of poorer households (those making under $30,000) from 23.8 percent to 28.3 percent.


34. Evaluating the evidence for Germany (which, according to the LIS data reported in figure 13.1, experienced a sharp deterioration in levels of inequality between 1984 and 1994) is complicated by the reunification of that nation that took place in the interim. The national data are for many in the appendix to this volume, examining the trend over time in the area of the former West Germany, show remarkably flat trend lines for the income shares of quintiles in the period since 1970. Though the share of the richest quintile has been rising very gradually at the expense of the lower quintiles over the past ten years, the data suggest that the deterioration in the former West Germany has not been anywhere near the magnitude seen in the United States and Britain.

35. Tachibanaki Toshiaki and Yagi Tadashi, “Distribution of Economic Well-being in Japan: Toward a More Unequal Society,” in Gottschalk, Gustafsson, and Palmer, Changing Patterns in the Distribution of Economic Welfare, 112–13; Tachibanaki Toshiaki, Nihon no keizai sanka (Tokyo: Keizai no shokuryoku to shisan kara kangaeru) [Economic Inequality in Japan: An examination based on income and assets] (Tokyo: Iwanami shinsho, 1998), 5. Although Japan’s IRS data set is not strictly comparable to the LIS, the two data sources are similar in two key respects: both report data for a broad, almost universal, population of households, and both of the Gini coefficients cited in figures 13.1 and 13.2 and in the text are for disposable income (after taxes and transfers).


37. Ibid., 111–12.

38. This ratio, also based in this case on disposable income, is calculated by dividing the percentage of the median income of a household at the ninetieth percentile by the percentage of the median income of a household at the tenth percentile.

39. These studies generally refer not to globalization in the abstract but to more concrete measures, such as increases in trade, foreign investment, and immigration. Similarly, although none of those studies refer to war social contracts per se, they do emphasize more concrete policies and practices, such as government tax and transfer policies and labor market institutions.


41. Burtless et al., Globophobia, 83–84; William R. Cline, Trade and In-
Europeanization of Social Policy: A Reopening of the Social Contract?

Bo Öhngren

During the first three decades after World War II, the nations of Western Europe experienced a period of steady economic growth and low unemployment. New forms of the social contract were negotiated and put into force. As earlier chapters have shown, the expansion of the middle classes was both an important product and a key component of that process. These new social contracts varied in important ways from that developed in the United States during the same period. While the U.S. social contract rested to a great extent on the expansion of consumption and an inclusive middle class, the social contract in most of the European states depended not so much on making the middle class inclusive as on increasing working-class incomes and adding social protection. In Europe, the state was much more involved in developing the postwar social contract and took a more comprehensive approach to social protection. In short, this period witnessed the birth of the modern European welfare state.

According to Gosta Esping-Andersen, the ideal of the welfare state was social citizenship and universal solidarity. Full employment, the redistribution of wealth, and the dismantling of class boundaries were seen as fundamental prerequisites for a stable liberal democracy. However, because of their unique economic and political histories, nations pursued these goals in different ways and provided varying forms of social protection. These structural differences also shaped the ability of each system to adapt to change.

The welfare state had its heyday from the end of the Second World