

The Rise of Market Liberalism

To understand what might happen in the current circumstances, which are highly unusual, it is useful to review how policy and circumstances interacted in the stagflation episode of the 1970s and in the disinflation, international integration, and market liberalization developments of the 1980s and 1990s. We examine three principal areas of policy change or re-orientation: the search for an answer to inflation, including institutional changes and the move to central bank independence; the deregulation of labor markets as an answer to persistently high levels of unemployment; and attempts to limit the growth of government expenditure and of government debt. In each case we attempt to answer the question about whether the move was driven by international exposure, global competition, and a pressure for institutional emulation. Did market liberalism follow from globalization (and, conversely, might a retreat from globalization necessarily imply a cutting back of market liberalism)?

Bad economic performance and ideological shifts often trigger sharp policy changes. What is now frequently, if perhaps inaccurately, termed “neoliberalism” emerged as a response to the economic and political crises of the 1970s. Reduced growth, high inflation, and the challenge of the oil price shocks seemed to offer a fundamental challenge to democracy, one that was elegantly summed up in Jean-François Revel’s influential study on *How Democracies Perish*. The malaise of the 1970s, a combination of a threat to growth, concern with limited resources, higher inflation, and challenges to democracy, all look quite contemporary again. It is in consequence worth revisiting the experience of the 1970s, at a moment when the world seems to be denouncing, reviling, and moving away from neoliberalism. A famous aphorism of George Santayana holds that “Those who cannot remember the past are condemned to repeat it.” Why did the 1970s generate a new philosophy of public sector management, and what problems did that approach generate?

In a longer-term perspective, the 1970s started the most intense phase of globalization – as measured by the share of trade in output – that the world ever experienced (Catão and Obstfeld 2019). The elements of a new liberalism included combating inflation, deregulation, and a reduction of trade union power. The movement was most dramatic in the US and the UK, and in consequence the outcome was often associated with Anglo-American society; however, continental Europe adopted some of its precepts. Though the turning point is often associated with the highly ideological figures of Ronald Reagan and Margaret Thatcher, in reality the fundamental shift already began under their predecessors, Jimmy Carter and James Callaghan.

The latter told the Labour Party Congress in 1976: “We used to think that you could spend your way out of a recession, and increase employment by cutting taxes and boosting Government spending. I tell you in all candour that that option no longer exists, and that in so far as it ever did exist, it only worked on each occasion since the war by injecting a bigger dose of inflation into the economy, followed by a higher level of unemployment as the next step. Higher inflation followed by higher unemployment.” These programmatic statements anticipate many of the developments of the following decades – until the outbreak of the Global Financial Crisis.

The extent to which there was a rhetorical embrace of the new liberalism varied from country to country. In the United States and the United Kingdom, the initial impetus may have come from the right, but the major parties of the left eventually, in the 1990s and later, took up the new philosophy. Bill Clinton saw the move as part of the process of “triangulation,” taking winning themes away from the other side. In the 1990s in the United Kingdom, Tony Blair and Gordon Brown remade the Labour Party as “New Labour,” and explicitly took up some of the market-oriented themes of Thatcher. In Germany, SPD leader Gerhard Schröder designed a wide-ranging welfare reform.

The practical outcomes of new approaches to a new challenge of globalization, however, were not dissimilar, although there were time lags. A substantial convergence took place, constituting one of the major phenomena of late twentieth century globalization. In all countries, inflation fell, with a broad convergence that by the 2000s included many non-Western countries as well. Countries increasingly embraced trade liberalization. They deregulated many markets, and those countries that hesitated were chastised as laggards. Trade union membership and labor conflicts both fell away.

2.1 ATTACKING INFLATION

2.1.1 Supply Shocks

The inflation of the 1970s, sometimes styled the Great Inflation, is popularly attributed to the oil price shocks, the quadrupling of prices in the last months of 1973 in the aftermath of the Yom Kippur war. The OPEC move occurred against a background of currency disorder: the par value system had collapsed in August 1971, and the attempt to restore it in December 1971 at the Smithsonian conference was unconvincing. Since petroleum prices were conventionally quoted in dollars, oil producers at first wanted to protect the real value of their exports, and then

in March 1973, when the restored par value system finally disintegrated, realized that increasing oil prices could be employed as an economic and also a political weapon. Initially it was tempting to think that the oil producers were “the clear and central villain of the piece.” On this account, a one-time move, even if it was very dramatic, would only provide a temporary surge of inflation, not permanently adjusted expectations. A more realistic view, however, sees the oil price as responding to global supply and demand, and in particular to the general economic expansion of the late 1960s and the early 1970s. The higher oil price might be regarded as the imposition of a new (wealth and income reducing) tax; the industrial countries mostly decided not to adjust immediately. The immediate response in most countries was to accommodate the shock. That monetary and fiscal accommodation pushed inflation, which rose to 11.0 percent in the United States in 1974 (and then, after a second oil shock, to 12.0 percent in 1980), and to higher levels in some other countries: in the United Kingdom, CPI inflation in 1975 was 24.2 percent, and in 1980 18.0 percent.

Some countries chose to take a different path, and to accommodate the shock less. In Europe, especially in France and Germany, inflation was understood largely as imported from the outside, through the international monetary system, and the answer was thought to lie in a move to more European monetary cooperation. In May 1973, the Bundesbank saw an opportunity to end the fixed exchange link with the dollar and to embark on a course of monetary control. The banking sector disliked the move intensely, and feared that there might be bank failures. From 1974, the Bundesbank operated with a target range for central bank money, a narrow measure of the money supply, which it saw as a way of communicating an appropriate inflation goal to markets and to the parties in coordinated wage bargaining processes. Later, with much lower rates of inflation than the United States, and lower interest rates in consequence, Germans argued that the initial success allowed them to treat the oil price increase that followed later in 1973 as a genuinely once-off event, accommodate it, and in consequence experience a milder version of the general world downturn in 1975.

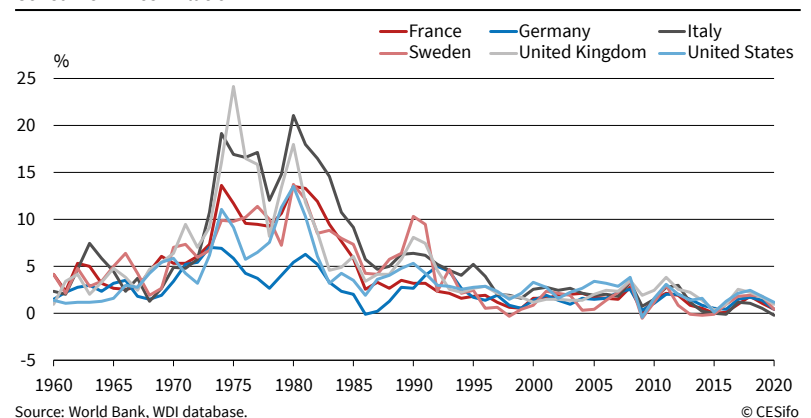
The countries that did not want to adjust immediately to higher oil prices did so not because they wanted higher inflation, but rather because they were gripped by a fallacious analysis that allowed them to downplay the risks of inflation. They fully saw the problem posed by the combination of high inflation with high unemployment and low growth, but believed that there might be a policy solution to the dilemma. The driver of the mistaken policy regime was a widespread belief in the capacity of economic growth to raise productivity, make more growth, and push down prices as a consequence of productivity gains. An influential model evolved by Nicholas Kaldor

looked at the long-term relationship between technical progress and the rate of growth and derived a “technical progress function.” An increased manufacturing sector would lead to a self-sustaining virtuous cycle of higher rates of growth and hence also of higher wages (Kaldor 1957; Kaldor 1967). The influential economist Roy Harrod (1972) then drew the logical consequence that stronger demand growth might reduce inflation. These optimistic expectations were severely disappointed.

Previously, policymakers had supposed there was a trade-off between inflation and growth, defined by a Phillips curve, the relationship identified by the New Zealand economist William Philipps. In the original version, the relationship was between wages and employment. High growth or rising employment would generate a shortage of workers and wage pressure that would be translated into rising prices. An economic shock would reduce the demand for employment and lead to a wage mitigation and a lower rate of price increases. For the world’s major industrial economies, this relationship could be clearly empirically demonstrated through the 1960s. In the 1970s, however, wages continued to move up even though there was substantial unemployment, resulting in stagflation. The prevailing theory depended on irrational or arbitrary behavior of wage-earners, who in the original vision suffered from a “nominal wage illusion:” they did not notice that inflation was eroding their real incomes, and the lower real wages generated higher levels of employment. If the nominal illusion faded with higher levels of inflation, and also plausibly with unionization (discussed below), a new answer would be that wage settlements could only be constrained by discipline by the imposition of guidelines or even controls. The rise of inflation drove down real interest rates below any historic trend, and deep into negative territory.

The 1970s was thus a decade of diverging views about inflation but also of different inflation outcomes in the major industrial countries (see Figure 2.1). Germany looked like an outlier, with only 7.0 percent in 1974. Italy was at 19.2, the United Kingdom at

Figure 2.1
Consumer Price Inflation



15.9 percent, and the United States at 11.0 percent. Even in stability-oriented Switzerland, the inflation rate was higher than in Germany.

The divergence between countries only started to change with a dramatic reorientation of US policy that followed from an intellectual reassessment of monetary policy, but also from the sense that the weakness of the dollar undermined the US position in the world. The major initiative came from the United States. On October 6, 1979, the Chairman of the Federal Reserve Board, Paul Volcker, announced a reorientation of policy “emphasizing the supply of reserves and constraining the growth of the money supply through the reserve mechanism” in order to obtain “firmer control over the growth in money supply in a shorter period of time.” The nominal federal funds rate target was raised sharply from around 11 percent in September of 1979 to around 17 percent in April 1980. The result was a sharp recession, to which the Fed responded with a cut in rates. In 1981, there was a new tightening and another recession, after which the Fed brought the nominal federal funds rate down, from 19 percent in the summer to the 14 percent range by the end of the year. In the summer of 1982, there was a further reduction to around 10 percent.

The United Kingdom, under the new government of Margaret Thatcher, turned in March 1980 to a Medium-Term Financial Strategy in order to squeeze out inflation, with the specification of a series of declining target ranges for the major monetary target (£M3) over a four-year period on the principle that “control of the money supply will over a period of years reduce the rate of inflation.” Both the US and the UK approaches initially prompted widespread criticism, not least because of surges of monetary growth that occurred in the process of disinflation and that followed from financial sector liberalization, with a large consequent expansion of bank lending. Later Volcker (1990) gave a retrospective view of the successes of central banks and monetary policy in promoting stabilization, explaining that “the record is quite clear that, despite varied efforts here and abroad, central banks did not discover any monetarist holy grail. In the end, no country in which inflation had become embedded seemed able to moderate that inflation without a painful transitional period of high unemployment, recession, and profit squeeze.”

When was the convergence complete? Inflation rates were internationally much closer by the mid-1980s, although the rates in Germany and Japan were still substantially below those in France, the United Kingdom, and the United States; especially Spain, Italy and Sweden continued to have higher rates. A second wave of convergence occurred in the mid-1990s, after a period in which the French rate was lower than that of post-unification Germany. The convergence is often ascribed to the constraints imposed by the Maastricht Treaty and its convergence criteria, which included measures of inflation performance as well as

fiscal and debt criteria. But while differences never disappeared completely, the process of convergence is equally discernable in countries which did not join the monetary union but which devised new strategies of inflation management, notably inflation targeting by independent central banks.

2.1.2 Independent Central Banks

The origins of the modern discussion about central bank independence or autonomy lay in clashes in the high-inflation environment of the 1970s, when monetary policy was the subject of acute political controversies. During the 1980s, a substantial academic literature also developed concerning the inflation performance as well as macroeconomic stability and growth. The new consensus suggested that in industrial countries, but also more generally, central bank independence was closely correlated with lower rates of inflation but also with better economic performance. It was already well known that monetary authorities were frequently subject to political pressures that produced higher levels of monetary growth. The newer literature initially developed on the basis of an appreciation that establishing firm commitment mechanisms was an essential element in the establishment of policy credibility. The approach emphasized the contractual element of the position of central banks, and consequently focused on the explicitly defined terms of contracts or laws establishing central banks.

By the 1990s, central bank independence was often thought to be a prerequisite for sound policy. The academic literature as well as the practice of the highly regarded central banks (Germany and Switzerland were at the top in nearly all surveys of central bank independence) led to a widespread recognition that independence would bring improvements in the policy environment. Central banks became more willing to listen to academics, and academics consulted more freely with the central banking community.

The general political climate also mattered in the discussion of the legal position of central banks. In 1989–90 the issue of institutional redesign suddenly seemed an urgent priority for some of the countries making the transition from the planned economy to the market. In the Czech Republic, Poland, and Hungary, central bank independence was a major part of the reform package designed to secure a stable macroeconomic framework. At the same time, in 1989 the Bank of Japan’s position relative to the government was strengthened, and New Zealand in 1990 dramatically increased the independence of the Reserve Bank. These new developments gave impetus to a trend that was already well under way. The struggle for increased independence for Europe’s central bank had already started before the intellectual revolution in economic thinking on the subject in the late 1980s and before the political upheavals of 1989–90 created

a new framework for conceptualizing the relationship of political institutions and rules to political and social processes. In some notable cases, the debate was associated with the beginnings of the European Monetary System (EMS): in particular, the Bundesbank and the Banca d'Italia used the negotiations over Europeanized money in the late 1970s to increase their own political autonomy.

There were additional twists to the Central Bank Independence (CBI) doctrine when put into practice. First, there should be a different approach to a one-off challenge than to persistent or endemic inflationary pressures. At the Bank of England, Mervyn King saw inflation as determined by occasional shocks that needed to be accommodated, with the consequence that what was important was the distribution of inflation outcomes rather than occasional peaks. In this way, the central bank might deliver a better performance than that of an “inflation nutter,” as he characterized the “conservative” central banker (in a paper originally and provocatively given at the very conservative Swiss National Bank). Second, central banks often emphasized that they were acting in conformity with an international trend: this was the action of a coordinated “brotherhood of central banks.” Or, as Mervyn King put it, “It is, after all, easier to lose weight when one’s own family members are on the same diet” (James 2020). Third, advocacy for CBI involved a rejection of what is now known as fiscal dominance, but also of financial dominance. A central bank would have its sole role in monetary policy and should not be involved in financial supervision and regulation, as such involvement might create illegitimate pressure to use expansive monetary policy to aid its client banks: this would be, as the Bundesbank liked to put it, a pollution or contamination of pure monetary policy.

The move to CBI involved a concept of delegation for a specific and narrowly defined purpose – monetary stability – that meant that central banks necessarily had to slough off their former multifunctionality: their long-standing and very traditional engagement in financial stability, but also in industrial policy, which had been a core concern of many traditional central banks as a legacy of the Great Depression era. The logic should also have contained – as it did in Sweden and Norway in particular – a parallel process of delegation for fiscal policy to independent groups of experts, fiscal councils, committed to following a fiscal rule that might (like the monetary target) be set through a political process.

2.2 MARKET STRUCTURE DEVELOPMENTS

2.2.1 Trade Liberalization

Besides macroeconomic developments, structural changes played a role in the liberalization phase of advanced economies. It appears paradoxical that the

oil shock (and other commodity shocks) created more globalization rather than a turn to economic nationalism. One mechanism that drove the new linkages was a financial revolution, which transferred the large surpluses accumulated by oil producers into lendable funds in big international banks. The development of international capital markets, offshore and thus largely free of direct government control, was the major financial innovation of the period. The availability of money made resources available for governments all over the world that wanted to push development and growth, and international demand thus surged. The alternative strategies, such as the proposal of an autarkic siege economy by some parts of the UK Labour Party in the 1970s or by some French socialists in the early 1980s, looked like a mechanism that would cut off access to markets and hence prosperity.

The possibility of increased trade depended on technology as well. The basic innovation that revolutionized international commerce, the standardized container with the possibility of speeding up loading and unloading in ports and then allowing direct transportation to users and distributors, had been introduced in the 1950s. But the traffic in containers only took off in the 1970s: it was 1973 when containers transported more of the US cargo trade than traditional breakbulk ships. And then in the 1970s increased competition, and the pressure of shippers on the carriers, drove down prices. The big surge in size of container ships only occurred in the 1990s, however.

Oil prices and technological change were a major trigger of the wave of globalization that occurred in the last decades of the century. The most obvious and immediate victors of the energy crisis were Japanese automobile producers. A relative outsider to the industry, the motorcycle maker Honda, created a new “stratified change” engine in 1973 that allowed a higher ratio of air to gasoline and thus substantially fueled economies. Japan, a country with a much more obvious energy constraint than the United States, rapidly became the foremost source of fuel-efficient cars, which now clearly outcompeted American “gas guzzlers.” By 1980, 200,000 American automobile workers were unemployed, a direct response to the surge in Japanese imports: from 1975 to 1980 the annual sales of Japanese cars in the United States rose from 800,000 to 1,900,000. In Europe too, Japanese automobile sales took off and eventually spurred the European competitors to modernize in order to compete. Automobiles provided the most obvious instance of the new dynamic: business had to learn to compete effectively in quality and innovation, and that would occur only with open markets. But the same dynamic was evident more generally. By the mid-1980s, the insight about trade liberalization formed the center of the European Commission’s ambitious program realized through the 1986 Single European Act.

A further boost to globalization came from an appetite for market liberalism that led to a considerable reduction in protectionism, as we will see in the next chapter, and also to deregulation of domestic markets.

2.2.2 Deregulation

The first significant push to deregulate came in the United States. The initiative came from the administration of Gerald Ford and was continued by Jimmy Carter. The control policies applied by Nixon were increasingly complex and perverse in their consequences. William Simon, who ran Nixon's energy control program stated that "the kindest thing I can say about it is that it was a disaster." Ford promised action to improve competition and reduce consumer prices in airlines, trucking, railroads, and financial institutions. The push took time, as until 1979 the influential Interstate Commerce Commission was headed by a Nixon appointee opposed to deregulation. The quickest action occurred in aviation, where the Civil Aviation Bureau was more sympathetic and allowed new types of cheap fares that dramatically slashed the cost of air travel. Carter signed the Motor Carrier Act in 1980.

Competition policy was altered in the 1980s by the application of a consumer welfare standard: the argument that bigness did not matter if it resulted in gains for consumers. This was an argument that had already been at the center of anti-trust litigation in the early twentieth century: it was the core of the defense of Standard Oil, which demonstrated conclusively that the trust substantially lowered petroleum product prices for consumers. It was revived in the University of Chicago by theorists of the firm such as Ronald Coase, and above all by the legal scholar Aaron Director, who established the *Journal of Law and Economics* as a way of promoting a new synthesis of the disciplines. The most forthright statement of the case probably came in Robert Bork's *The Antitrust Paradox*.

The European counterpart to the US discussion was the leadup to the 1986 Single European Act, which included major governance reforms but also specific processes to create a genuine single market. The Act included 272 unitary-market mechanisms, provisions for strengthening of its economic and social cohesion (Article 130 of the Treaty) as well as the enactment of standards for workers' health and safety, a launching of European research and technology development strategies, and policies for environmental protection. Article 70 was modified to specify that the European Council "shall endeavor to attain the highest possible degree of liberalization. Unanimity shall be required for measures which constitute a step back as regards the liberalization of capital movements." There was a timetable to achieve that liberalization by 1992. The Act also con-

tained a headline (without further elaboration) on monetary union.

By the 1980s and 1990s, a great deal of the effort at liberalization or deregulation focused on financial markets. The United Kingdom's 1986 Big Bang was a precedent here, with a breaking down of traditional restrictive practices. The move had originally begun as a response to a legal case brought under the Restrictive Practices Act: the London stock exchange would drop fixed commissions, end the single capacity principle that separated stockbroking (for retail customers) from market-making (stock-jobbing), and open itself to competition. The result in 1986 was generally called "Big Bang." Foreign acquisitions of major City firms became a central part of the preparations for Big Bang, and of the aftermath.

In many ways, "deregulation" is a misnomer. There had been little formal regulation while capital movements were controlled and financial functions were specialized. Old-style financial systems relied largely on self-regulation. Stock markets, for instance, had incentives not to be seen to defraud customers and accordingly policed exchange members. In countries such as Great Britain and the United States, where financial activity was split up into specialized functions performed by different institutions (stock jobber and stock brokers, clearing banks, merchant banks, discount houses), each specialized institution had an immediate self-interest in assessing the financial strength and viability of the institutions with which they did business. The rise of large financial institutions raised for the first time in the United States – but not in Europe, with its tradition of universal banking – the possibility of institutions that were too big to fail, and that consequently required more regulation.

In 1986, the direct cost of financial regulation in the United Kingdom was estimated to be GBP 20 million; this rose to around GBP 90 million by 1992 and GBP 673 million by 2014. The compliance costs are generally thought to be four times that amount. In 1979, the number of people employed in bank regulation in the United Kingdom was about 80. The number involved in financial regulation rose five times by 1990, and by 2010, there were around 3,500 financial regulators. Just one rule book relating to one aspect of regulation that was developed as a result of the 1988 Act weighed around two kilograms. In Germany, the financial regulator Bafin, whose predecessor in 1995 employed 490 people, employed 2602 in 2017. As liberalization proceeded, more rather than less regulation was required.

2.3 LABOR MARKET PERFORMANCE AND REFORMS

The interplay of economic and political factors in shaping reform experiences is particularly clear when inspecting the implications and determinants of in-

stitutions and policies in one of the most regulated sectors in all economies: wages and employment conditions are stringently regulated in Europe, and even American antitrust legislation exempts union activities, since the “labor of a human being is not a commodity or article of commerce” (Section 6 Clayton Act, 15 U.S.C. § 17).

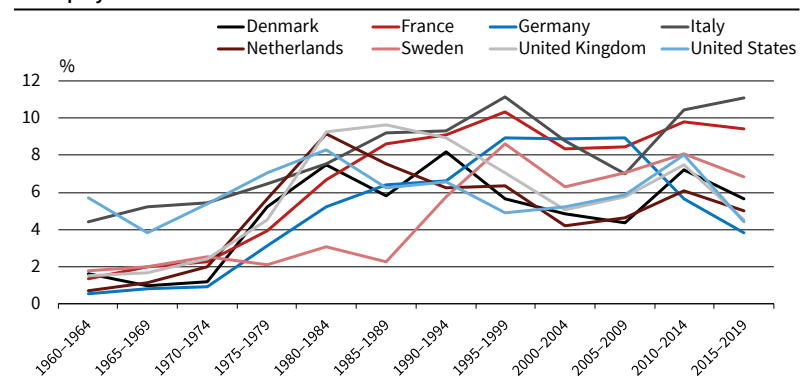
2.3.1 The Rise and Divergence of Unemployment

Figure 2.2 displays unemployment data on 5-year periods for large European countries and for the United States as well as for Denmark, the Netherlands, and Sweden which, as we shall see, had interesting reform experiences. Unemployment and stagflation in the 1970s led to a reassessment and suggested the argument that more competition might create new jobs and more employment.

Employment is in theory and was in practice reduced by collective contracts, as well as by other labor market rigidities discussed below. The push-back against trade union power was originally envisaged, especially in the United States and the United Kingdom, as part of the fight against inflation. Union membership in the United Kingdom peaked in 1980 at 12.2 million. The critical measure in the United Kingdom was the 1980 Employment Act, with restrictions to closed shop arrangements, limit picketing and particularly secondary action, and requirements for balloting the membership on industrial action. A further Act in 1982 provided for more restrictions on closed shops and limits to trade unions’ legal immunities, with the result that they became liable for damages and injunctions. In 1984, existing closed shops were subject to balloting. The critical turning point was the defeat of the coal miners’ strike of 1984–85, possible in large part because of successful legal action that imposed penalties on the union and led to the seizure even of assets sent abroad. The inspiration was the 1981 defeat of the air controllers’ strike in the United States: controllers were given 48 hours to return to work or be sacked. 1,300 out of 13,000 strikers went back. Those who stayed on strike never returned to their former jobs. The union, the Professional Air Traffic Controllers Organization, was decertified. The number of strikes and days lost from strikes fell abruptly. The push against unionization soon became international.

Figure 2.3 shows declines of union density starting in the 1970s. It was low to begin with in France, where union contracts cover almost all employment throughout, but even there it declined in the 1980s and 1990s. Union membership fell persistently across most countries, and in countries where it remained high, wage bargaining became less centralized. Workdays lost due to strikes declined dramatically starting in 1990 in the United Kingdom, Ireland, Italy and other countries where they were previously high; in France, a lesser decline started only after 2000 (OECD 2017).

Figure 2.2
Unemployment Rate

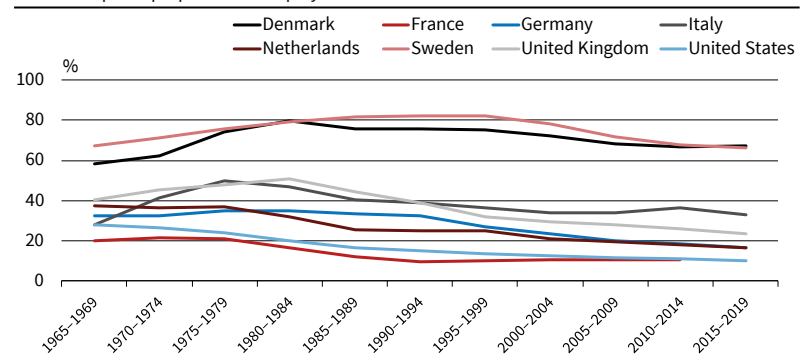


Note: Five-year period averages of available data.

Source: AMECO.

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Figure 2.3
Union Density
Membership as a proportion of employees



Note: Five-year period averages of available data.

Source: OECD.

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2.3.2 The Mechanics of Labor Market Regulation and Deregulation

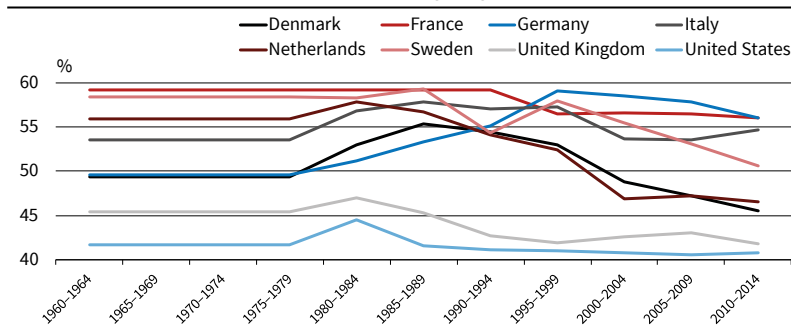
Other aspects of labor market regulation also imply higher unemployment for low productivity workers. When unemployment or disability benefits or early retirement are available, or labor taxes are high, the net market wage can easily fall below the reservation wage of workers at the bottom of the pre-tax wage distribution.

A vast empirical literature in the 1990s used institutional information, in particular that collected and harmonized by the OECD, to try and explain unemployment patterns, specifically the contrast between its low and declining trajectory in English-speaking countries and continental Europe’s high and persistent unemployment (Bertola, Blau, and Kahn 2002). Figures 2.4, 2.5, and 2.6 display the institutional indicators used by Blanchard and Wolfers (2000), updated to more recent periods by Bertola (2017). Available policy indicators are mostly those collected and homogenized by the OECD Economics department, which in the 1990s advocated deregulation as the most promising cure for unemployment in member countries. Because the data is not available every year, the observations are averages over 5-year periods. These are unavoidably imprecise and imperfect

Figure 2.4

Labor Taxation

Proportion of income taxes and contributions at average wage

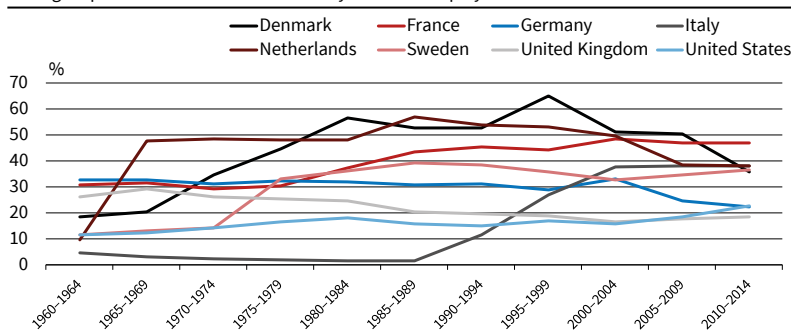


Note: Five-year period averages of available data. Source: See Blanchard and Wolfers (1999) and Bertola (2017) for details of computations on various OECD data series. © CESifo

Figure 2.5

Unemployment Insurance Benefits

Average replacement rates over the first 5 years of unemployment

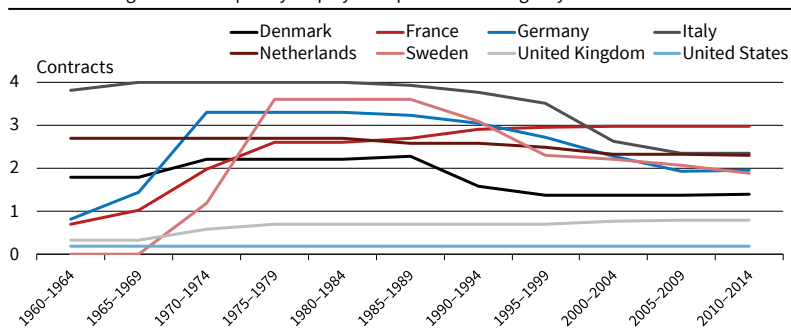


Note: Five-year period averages of available data. Source: See Blanchard and Wolfers (1999) and Bertola (2017) for details of computations on various OECD data series. © CESifo

Figure 2.6

Employment Protection

Indicators of regular and temporary employment protection stringency



Note: Five-year period averages of available data. Source: See Blanchard and Wolfers (1999) and Bertola (2017) for details of updates using recent OECD data series. © CESifo

indicators and employment protection is typically reduced only for new and non-standard contracts, so as not to perturb the democratic majority of employed regular workers.

Labor market regulation – along with macroeconomic conditions – affects employment, wage inequality, and productivity. Union-bargained or legal minimum wages increase the level and decrease the inequality of wages and hence increase unemployment, especially that of low-productivity workers:

to bring productivity up to wage aspirations, training programs need to be deployed, as they expensively are in Nordic countries. Labor taxation increases labor costs and reduces employment. Unemployment insurance reduces search intensity and increases unemployment. Employment protection slows down reallocation and adjustment to aggregate shocks, reducing employment at given wages, with ambiguous unemployment effects as both hiring and firing flows decline.

Observed labor market performance can indeed be explained by labor market regulation over time and across countries: in regressions, the coefficients of institutional indicators have the sign predicted by theory if each varies and all else remains fixed. Other relevant factors do vary in the data, both across countries and over time: a negative relationship between wage inequality and unemployment can only be detected when they are measured as deviations from country means and interactions of institutional differences with demographic and economic growth trends and shocks play a particularly relevant empirical role. Unemployment increased and employment declined in labor markets that had become rigid when growth was taken for granted at the peak of the post-War Golden Age, but proved unable to cope with difficult macroeconomic conditions and with the reallocation required by technological innovations and international trade.

In the 1970s the United States had higher unemployment than the European countries shown in Figure 2.2, despite its lower unionization, due to its relatively poor economic performance at a time when Germany (and Japan) were heralded as technological and socio-economic world leaders. Low unionization and a more competitive and flexible labor market explain why the United States also had higher wage inequality, as shown in Figure 2.7. In the 1980s and 1990s, new economic circumstances plausibly contributed to rising unemployment in Europe and rising inequality in the United States (Krugman 1994). Technological progress and international integration of financial, goods, services, and labor markets plausibly increased the dispersion and reduced the mean of labor productivity in all advanced countries. Declining unionization did make wages easier to adjust, especially at the low end of the earnings distribution. However, the extent to which union-bargained wages are binding for workers who are not members of the union depends on government legislation, such as the provision in France that the wage agreements bargained by unions with a membership as low as in the United States apply to all workers. This differs across countries, as do other union activities: in Scandinavia and in the Netherlands, unions administer unemployment insurance schemes and negotiate wages at the national level with employers and the government, which can ease adjustment to country-level shocks.

2.3.3 Determinants of Labor Market Regulation

The employment outcomes of labor regulation may be the consequence of a political decision to shift the distribution of employment and income. Unions do not increase wages aiming to increase unemployment: they mean to obtain higher worker welfare as the higher income of employed workers more than compensates their smaller number. The labor taxes and contributions that reduce employment can fund unemployment benefits, which dampen the income implications of job loss and, decreasing the search effort and increasing the reservation wages of the unemployed, prevent wages from falling in response to negative shocks. Employment protection legislation reduces job destruction by declining firms and sectors and job creation by expanding ones, and collective wage-setting between broad unions and employer confederations (rather than at the firm or individual level) reduce the extent to which wages may fluctuate in response to local shocks.

Such employment and wage rigidities together increase and stabilize labor income, make profits and other non-labor income flows lower on average as well as more volatile, and reduce productivity as they prevent replacement of low-productivity jobs with high-productivity jobs. Rigid labor markets that imply high and stable labor incomes have obvious political appeal for the many households that draw most of their income from labor. That appeal, however, also depends on their side effects on productivity, which can be more or less serious in different circumstances.

Income stability is beneficial when underdeveloped financial markets and incomplete social insurance make it difficult for workers to make consumption smoother than labor income. Tradition and administrative capacity may determine whether labor market rigidities are introduced by constraining private employment contracts or by administering taxes, contributions, and subsidies. The appeal of labor market regulation also depends on macroeconomic conditions and market structure. The productivity losses caused by rigidity are less affordable in poorer countries and larger when more frequent and larger shocks call for intense reallocation. Because financial market access reduces the appeal of labor income stability, US workers are as familiar with credit card debt as with frequent job changes, and financial deregulation was very much an element of Thatcher's reform strategy.

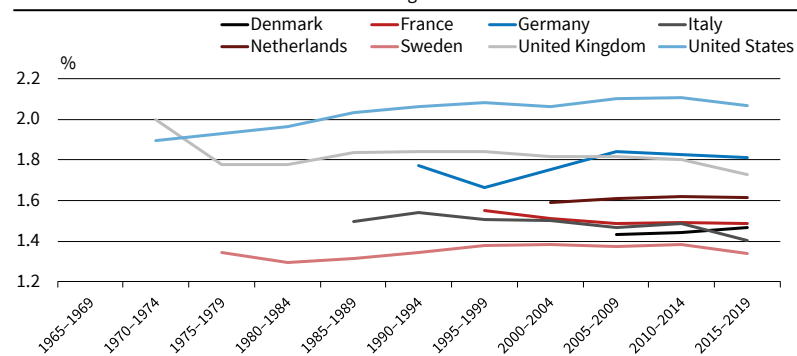
2.3.4 Patterns of Labor Market Regulation

Because structural characteristics of the economy influence the costs and benefits of rigid labor markets, new developments can trigger reforms. The wave of deregulation that started in Margaret Thatcher's United Kingdom and Ronald Reagan's United States in the 1980s had political motives, but alongside those

Figure 2.7

Wage Inequality (Median to 10% Ratio)

Ratio of the median to the first decile of the earnings distribution



Note: Five-year period average of available data.
Source: OECD.

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leaders' strong personalities poor economic performance did play a key role in easing liberalization. Without the same ideological emphasis, many other countries' reform trajectories in the 1990s responded to changing circumstances.

Not only political but also economic factors explain why labor markets are more regulated in some countries than in others and why many economists' advocacy of deregulation is not equally well received everywhere. Between the 1960s and 1970s tighter regulation was plausibly driven by Golden Age prosperity, which made productivity slowdowns more affordable and empowered workers in democratic countries. Later, globalization and European market integration, driven by development of transport and communication technologies (de facto) or complementary trade liberalization policies (de jure), made labor demand more elastic. Technology also can make labor demand more elastic, as some workers become more easily substitutable by machines. Flatter labor demand worsens the trade-off between higher wage and lower employment, reducing the positive (for workers) effects of labor market policies, and the productivity effects of labor market rigidities are more damaging when the economy needs to adjust to trade shocks. Hence, international economic integration should in theory lead to labor market deregulation (and more inequality) or worse labor market outcomes (at given levels of regulation).

While plausible, this "race-to-the-bottom" perspective on the determinants of labor market regulation is certainly not its only explanation and is difficult to empirically detect it in data where all else is never equal. The desirable and side effects of regulation change over time and are different across countries in ways that are very hard to control, as potentially relevant factors are more numerous than country-level observation. The indicators plotted in Figures 2.4, 2.5, and 2.6 suggest that deregulation was neither widespread nor pervasive in decades of increasingly strong trade integration. For indicators other than union density, period-specific averages vary little over time, and considerable cross-country

dispersion dwarfs the effects of country-specific reforms, which do not always tend towards deregulation. A pattern of decreasing employment protection and increasingly generous unemployment insurance, as in Italy, may be an attempt to preserve worker welfare in a changing environment, where “flexicurity” unburdens firms exposed to international competition from the productivity losses entailed by protecting their workers from job loss.

The choice between rocks and hard places is political, often myopic, and depends very much on country-specific circumstances. Policy trajectories followed by specific countries suggest that deregulation incentives are stronger for countries experiencing worse economic performance and/or more elastic market responses to relative policy differences. Countries do not always heed those incentives, however. The case of Italy offers a useful illustration of the interplay of global and European integration and the need for unimplemented reforms. Italy’s stagnation since the early 1990s is largely due to slow structural adjustment, rooted in political support for status-quo policies and institutions that could not cope with technological and economic integration challenges (EEAG 2019). Throughout decades when European integration and globalization required structural changes, the increasingly apparent inefficiency of labor market rigidities was addressed in Italy by temporary employment in traditional sectors, rather than business expansion in new sectors. A political majority that still enjoys a good standard of living easily disregards the need for change, unless made obvious by a crisis, and prefers waiting for better times to return to enacting reforms perceived to be adding risk to an already complicated situation.

The Netherlands in the 1980s shows a decline of unemployment as sharp, if not sharper, than that observed in the United States and the United Kingdom. When that country found itself the smaller partner of an essentially complete economic and monetary union with Germany, it was logical for it to adopt wage moderation and deregulation implemented by the 1982 Wassenaar agreement, which is apparent in the declining labor taxation and unemployment insurance generosity in the figures above. Availability of plentiful natural gas revenues made it possible to compensate redundant workers with generous benefits. North Sea oil played a similar role in Thatcher’s 1980s reforms, which decreased unemployment insurance and labor taxes while employment protection remained low. The German “Agenda 2010” reform framework only took a similar path in the first half of the 2000s, as shown by declining employment protection and unemployment insurance after the country’s reunification, euro adoption, and Eastern enlargement had changed the trade-off between high wages and idle labor on the one hand, and better competitiveness on the other.

Higher wage inequality and lower employment could both be avoided only by “active” labor market

policies meant to increase the productivity of workers, albeit at the cost of higher public expenditures (as in Denmark, Sweden, and other Nordic countries). The relevance of macroeconomic and public finance factors is well exemplified by Sweden’s reaction to its crisis in the 1990s: a housing market and banking market collapse preceded by a period of overheating and strong wage growth. Generous unemployment insurance and a decline in labor taxes contributed to debt accumulation in the crisis. As it became clear that the welfare model was not financially viable, reforms of these policies and (especially) of active labor market policies expenditure played a role, alongside the cyclical upswing, in the decline of public debt in the latter part of the period. This was not without cost in terms of the wage inequality that labor market policies are meant to keep under control. If the United Kingdom achieved low unemployment and high employment by accepting higher wage inequality in the 1980s, Sweden followed a similar path (around its different labor market configuration parameters) during the 1990s. More generally, along the 1980–2000 public debt and interest-rate stabilization cycles the debt service burden, interacting with country-specific policy indicators, was sensibly associated with labor market policy changes (Bertola 2010b). When in debt, governments reduce the generosity of unemployment benefits, and the fact that unemployment is nevertheless higher is due to bad macroeconomic developments. Labor taxes were positively related to government indebtedness, inducing a negative relationship between high debt and low employment. Reduction of employment protection was often accompanied by more generous unemployment insurance to preserve worker welfare and motivated by increased exposure to product- and capital-market competition not only domestically, but also internationally.

2.4 THE SIZE OF GOVERNMENT

At the beginning of the Thatcher revolution, the government argued that public spending was “at the heart of Britain’s economic difficulties.” A follow-up white paper on spending explained that the government was “determined not merely to halt the growth of public expenditure but progressively to reduce it.” Did those and similar views in other countries actually result in smaller governments?

Figure 2.8 provides a long-run perspective on the issue displaying government revenues as a percentage of GDP for a few countries and for the OECD as a whole (government expenditure follows similar trends aside from public debt developments; both are discussed below).

While the starting point in the mid-1950s was roughly the same, during the 1960s and 1970s governments grew everywhere at different paces, resulting in different public sector sizes that fit the classification of welfare regimes discussed in the political

science literature based on Esping-Andersen's (1990) classification of welfare regimes: the government's role is most pervasive in Scandinavian countries, where the ratio of social transfers to total government expenditures is generally much higher than in Continental Europe and very much higher than in the United Kingdom and United States, where the government's role is limited.

Over recent decades there has neither been convergence at the top or the bottom of the government's size distribution across countries. EEAG (2019) examined public sector size across all EU countries and similarly found that little convergence occurred, except for an upward trend among Eastern European countries where economic growth made public service more affordable and useful in richer and more complex economies. Figure 2.9 supports our discussion of phenomena explaining other country-specific developments displaying 5-year averaged government expenditure as a percentage of GDP for the same countries discussed above. In the 1980s the size of the government's budget did stop growing but, despite the rhetoric about shrinking government that is often thought to be at the core of the neoliberal turn, there was no general reduction of government taxes and expenditures since then. The United Kingdom shows a clear downward trend in the 1980s, partially reversed in the 1990s, and Italy has had an upward trend over the period.

Changes in the size of government can be attributed to policy decisions and ideological preferences, cyclical developments, the increased demand for public services as societies became more affluent, changing demographics, as well as international pressures. We discuss each in turn below.

2.4.1 Political Shifts

Politics do matter: in the United Kingdom, the public employment-to-population ratio lost 4 percentage points when Thatcher and then Major were in power, recovered 2 percentage points in the 1996–2011 Labour governments, and as Conservatives regained power had again lost more than 2 percentage points by 2018 (Authors' calculations based on the Office for National Statistics 2019). But changing needs and trade-offs are key to understanding broad and country-specific trends. We proceed to inspect them for the same countries considered when examining labor regulation developments, aggregating the relevant data over 5-year periods to reduce the impact of cyclical variation in GDP and automatic stabilizers on the revenue and expenditure sides of government budgets.

2.4.2 Macroeconomic Fluctuations and Government Size

The stability of public sector sizes at different levels can be explained by the interplay of political and ideo-

Figure 2.8
Government Revenues

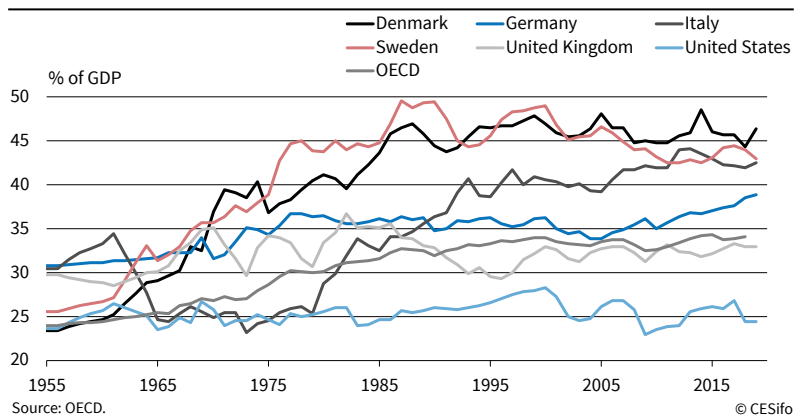
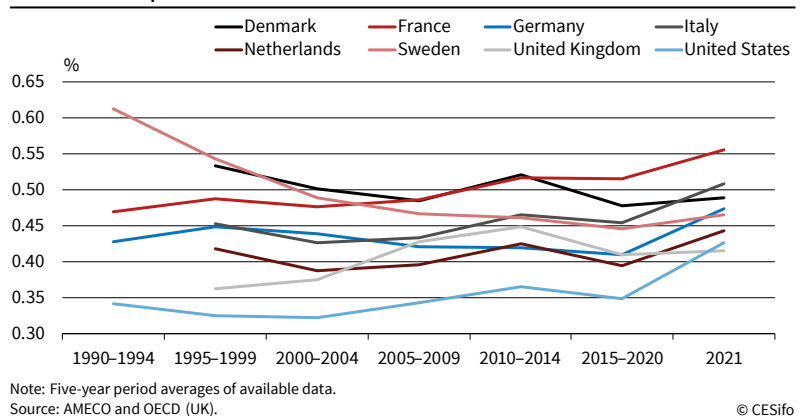


Figure 2.9
Government Expenditure-to-GDP



logical factors with cyclical developments. In the most ideological years of the Thatcher revolution the UK government's revenues remained almost constant as a share of GDP during 1980–85, also because the denominator shrank in the recession of the early 1980s. The ratio fell sharply after 1985, in part because Chancellor of the Exchequer Nigel Lawson launched an inflationary boom that substantially raised GDP. The Danish, Swedish, and UK ratios all rise considerably in the deep recession of the early 1990s. For many of these countries, government expenditure-to-GDP ratios kept on growing after 1980 and spiked upwards in the Great Recession and in the Covid-19 pandemic. The exceptions are Denmark and Sweden, where the ratio fell substantially from its very high level at the beginning of the 1990s. Other dynamics have contingent explanations: the German ratio grew in response to the challenge of German unification.

It is much more interesting, however, to examine the evolution of structural factors in recent decades. A changing structure shaped the government's size and role in advanced economies because policy choices depend not only on political preferences, such as inclination to privilege the cons over the pros of regulation and redistribution, but also on needs and trade-offs implied by the economic environment in which those choices are made.

2.4.3 Supply and Demand of Public Services

A larger government may be more useful and affordable in more sophisticated and richer economies, which can afford to produce public luxuries and administer taxes and subsidies that diminish incentives to work. The idea that demand for publicly provided services (for example, health) is stronger at higher income levels, known as the “Wagner effect,” implies that expenditure should have grown over time as a share of GDP. If it did not, it can be that it was offset by political shifts.

But economic growth, which over the period of interest was more or less intense in developed countries, has implications for the supply of as well as the demand for public “luxuries.” Providing services such as defense, health, and education becomes relatively more expensive over time if productivity growth is slower in those sectors than in the rest of the economy. Then, a constant supply of public goods and services in real terms would require an increasing share of expenditure, a phenomenon known as “Baumol’s cost disease,” and an increasing rate of taxation. Of course, digitalization has had beneficial productivity effects in all sectors, including those administered by governments, and other forms of technological progress have undoubtedly reduced the cost of, for example, health services (which, whether publicly or privately provided, tend to increase anyway because of the Wagner effect). While it is not easy to measure productivity in the public sector, where much output is by lack of better alternatives valued at cost, available data do suggest that while public provision

of services has been roughly constant as a share of nominal GDP, it has declined in real terms since the 1980s in most of the countries shown in Figure 2.10 (and in many others), though not in the Netherlands (since the mid-90s) and in Germany.

2.4.4 Demographic Trends

A third important structural development is demographics. Public expenditures are strongly age dependent (the young require care and education, the old health services, pensions, and care). Hence, unchanged provisions at a given age produces a constant expenditure share only if the age composition of the population is constant. Other things being equal, an increasing number of young (old) will increase expenditures and vice versa. If expenditures are constant and the number of young (old) is increasing, it follows that there is a decline in provision seen from an individual perspective. Likewise with aging populations, if expenditures are constant, it may be considered equivalent to a retrenchment. On average, for developed countries since 1960 the dependency ratio has shown a declining trend, and these developments are roughly the same across all OECD countries. For given total expenditures, the demographic developments have made it possible to increase per capita expenditures for the youth and elderly age that benefit most from public activities. But this general demographic tailwind is now turning into a headwind for governments (see Chapter 4).

2.4.5 Public Debt Dynamics and Implications for Government Size

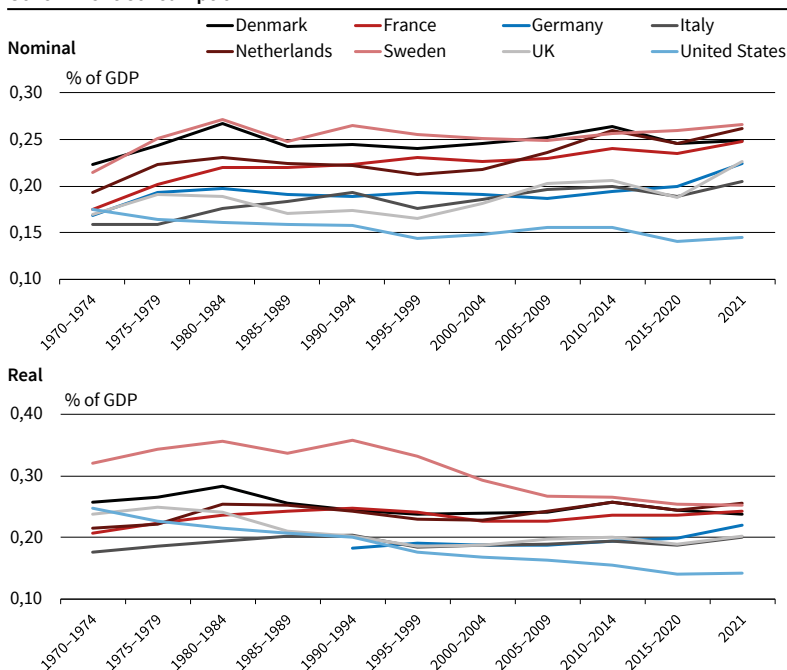
Government debt in industrial countries on the whole shows no tendency to fall in the period when there is often supposed to have been a retreat of government. The overall tendency is a constant rise.

But there are some examples of national debt consolidation. The most dramatic occurred in the United Kingdom, from 1978–83 at the beginning of the Thatcher administration, when gross government debt fell from 50.5 percent of GDP to 42.2; in the United States with the peace dividend at the end of the Cold War and in the Clinton presidency (often considered to have been neoliberal) from 1993–2001 with a fall from 70.2 to 53.0 percent; in Italy, as part of the fiscal consolidation that preceded and accompanied initial membership of the Euro in 1994–2004, falling from 117.9 to 100.0; and in Germany in the period of the *Schuldenbremse*, from 2010 to 2019, from 81.0 to 59.2. Apart from that episode, German debt saw a more or less continuous rise, with only a very short consolidation phase in 1988–89, on the eve of German unification.

For other countries, including some smaller economies that were often hailed as stars in terms of fiscal and economic performance, there have been

Figure 2.10

Government Consumption



Note: Five-year period averages of available data.
Source: AMECO (linked series).

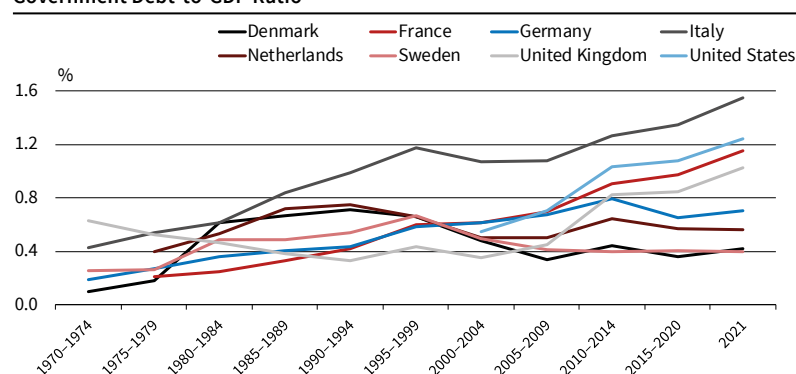
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some successful episodes of debt reduction, driven by a mixture of fiscal consolidation and high growth and occurring over relatively long time periods: Sweden from 1996 to 2008 (falling from 84.4 to 36.7 percent), or the Netherlands in a similar time frame, 1993–2007 (78.5 to 42.4 percent), as shown in Figure 2.11. The most dramatic of these small country adjustments was Ireland, from 1994 to 2006, with a reduction from a dangerous 94.1 percent that would not qualify for membership in the currency union to 25.0 percent in 2006: the latter figure was the product of strong growth, foreign direct investment, and of a wild property boom that pushed up real estate tax revenue.

These consolidations were in large measure owed to an increase in the primary balance, which, however, is not the only way out of high public debt. The debt-to-income ratio can also be lowered by periods in which growth exceeds the interest rates and also by a stock flow adjustment (when debt is in a foreign currency and there are exchange rate alterations; or after debt defaults or restructuring). In recent times, the only debt reduction by restructuring occurred in the case of Greece in 2011. But historically, high rates of inflation in which the real interest rate is low or negative contribute significantly to lowering the debt burden. The most dramatic incidents of this type in the chart occurred in the United Kingdom in 1969–75, when the gross debt to GDP ratio fell from 82.8 percent to 46.7 percent, with surging inflation; and a milder variant of the same experience in France 1970–74, with a fall from 50.5 to 42.2 percent. These 1970s episodes are only the tail-end of a long historical development since 1945, when exceptionally high levels of debt built up in the Second World War were reduced to sustainable levels: debt to GDP for the United States in 1946 had been 121.2 percent, and in the United Kingdom 269.8 percent. In contrast, German debt had been largely wiped out by the currency reform, and in 1950 the gross debt level stood at 17.8 percent of GDP and rose consistently after that date.

These extraordinarily high levels in the United States and the United Kingdom were gradually reduced in the so-called Keynesian period, or the “golden years” (in France *les trente glorieuses*, and the German *Wirtschaftswunder* and Italian *Miracolo Economico*) when strong growth brought down the debt ratios. But there had been other factors at play. The United Kingdom was still reducing its debt significantly in the 1970s, with very high rates of nominal GDP growth but much lower real rates, and in this case it was inflation not growth that was doing most of the heavy lifting in reducing debt. These episodes bring very substantial debt reductions, with much sharper declines than in the case of fiscal adjustments increasing the primary balance, particularly when inflation is unexpected and market participants do not realize the extent of their likely losses on fixed income

Figure 2.11
Government Debt-to-GDP Ratio



Note: Five-year period averages of available data.
Source: AMECO.

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securities (and when they are constrained by restrictions on capital movement).

The market-oriented policies of the 1980s and 1990s included liberalization and internationalization of financial markets, which allows mobile capital to flee from low real returns, and accompanied by disinflation which, if not immediately credible, increases real rates and at least partly explains increasing public debts: debt reductions through an effective inflation tax are less likely in the resulting environment. In Italy, high real rates on government debt included a hefty risk premium, and only the credibility achieved with the euro made stabilizing the debt possible without very high primary surpluses, which were politically unsustainable and gave way to some fiscal profligacy and (again) high interest rates due to default risk premia.

High public debt-to-GDP ratios and tight budgets, whether due to market pressure or legal obligations such as the Maastricht criteria, might in principle have implications for the size and structure of the public sector. Deficits are often politically attractive for all incumbent governments, but the resulting debt constrains future incumbents: total expenditures less debt servicing equal the expenditures on popular core activities of the public sector (education, health, transfers), tight budgets resulting from previous accumulation may in fact be tools of a political agenda to attain a leaner public sector. However, it is difficult to detect a clear negative relation between debt service and the size of the public sector, which is rather stable for most countries even as debt-to-GDP ratios vary substantially over time. The simple view that generous welfare policies are associated with debt financing is also not apparent, because not only benefits but also taxes and contributions are high in countries that provide generous benefits: the Nordic countries known for their extended welfare states have some of the lowest debt levels.

Tight budgets may also bias public activities away from forward-looking investment and towards more (politically or economically) urgent spending

needs, such as pensions. High debt and debt servicing costs may crowd out some expenditure types for a given size of the public sector measured by total expenditures or tax revenue. For countries like Italy, Greece, and Hungary, expenditures on debt servicing exceed those on education. This is suggestive that debt may have implications for the structure of the public sector.

2.4.6 International Integration

Increased international market integration, especially since 1990, influenced government policies in two distinct ways. On the one hand, it generally improves aggregate efficiency but, in the absence of compensatory transfers, impoverishes some workers, and exposes many to new cross-border shocks: this may lead open countries' governments to be more deeply involved in economic matters (Rodrik 1998). On the other hand, international market interactions make it easier for individuals and firms to escape taxation and seek subsidies, hence making it more difficult for

policies to shape individual choices differently from what would be implied by unavoidably imperfect market mechanisms. Depending on whether demand or supply influences dominate, integration may in practice increase or decrease the intensity of collective redistribution and other interferences with laissez-faire markets at the country level.

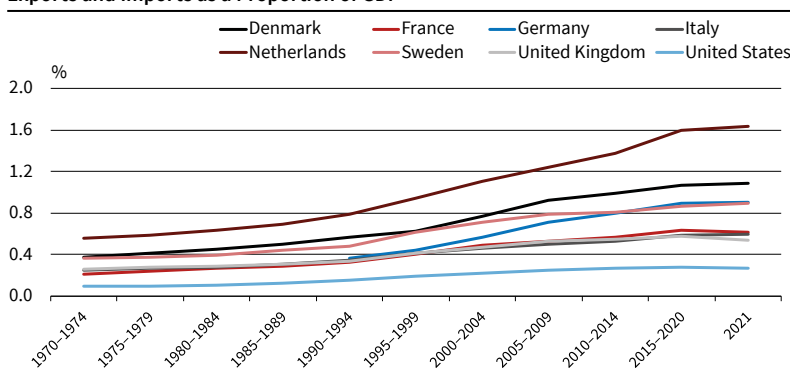
There is no doubt that since the 1980s international market integration increased very strongly, especially after 1992 in the European Union (see for example the 5-year averaged data in Figure 2.12). It is, however, difficult to detect the role of international market integration in determining government size, both because more intense trade is itself endogenously determined by country-specific policy choices, and because countries are heterogeneous in many difficult-to-measure and interrelated dimensions. In cross-section, countries have larger or smaller governments for historical, political, and structural reasons, and there is no particular relation to average trade openness, which depends on size and geography. On average, Nordic countries offer much more and Mediterranean countries much less social protection but there is no particular relation to openness within and across these groups.

Also in time-series data a negative impact of internationalization on government powers to interfere with market mechanisms is theoretically plausible and subjectively clear to many citizens and politicians, but empirically elusive. It is difficult to establish causal relationships in data where variation of globalization and spending indicators is driven by a variety of factors, including fluctuations of the output measures that normalize both. The panel regressions of Dreher, Sturm, and Ursprung (2008) include a number of control variables and find no evidence of an average relationship between globalization and social spending.

Government size is driven by many partly offsetting factors (aging, political shifts like in the United Kingdom, real estate booms and crises, unsustainable public debt). As the need for government action is increased by aging and instability, but action is more difficult in the absence of international coordination, the net effect can be small and statistically insignificant even as at least some segments of society feel that governments should do much more but are constrained by international competition.

Different countries have persistently different levels and composition of government expenditure – over time for each country government size is plausibly associated with international economic integration in periods when globalization and market liberalism are the main source of policy variation. Figure 2.13 illustrates the 5-year averaged data of Figures 2.9 and 2.13 in the 1990s and 2000s plotted against each other, subtracting from each its country-specific means for continental EU and Scandinavian countries.

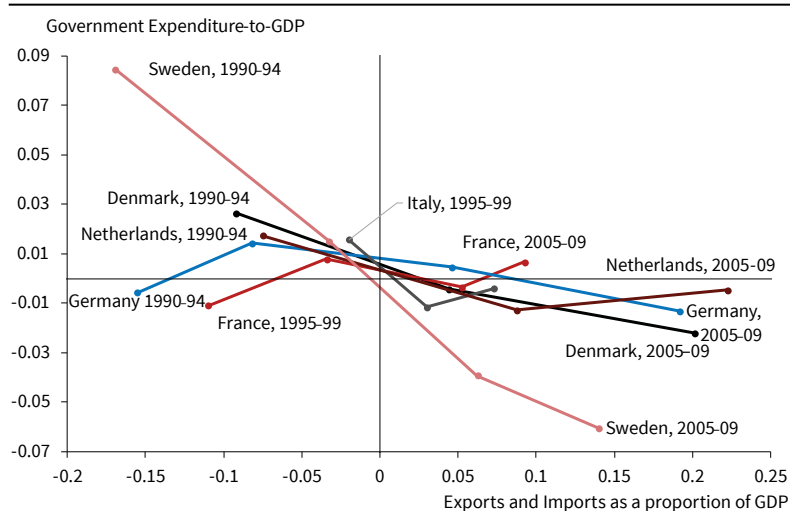
Figure 2.12
Exports and Imports as a Proportion of GDP



Note: Five-year period averages of available data.
Source: AMECO.

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Figure 2.13
Government Expenditure and Exports and Imports from 1990-95 to 2005-09



Note: Deviation from country mean of the data in Figures 2.9 and 2.12 for Denmark, France, Germany, Italy, Netherlands, and Sweden. Five-year period averages.
Source: AMECO and OECD.

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Large increases of international market integration are associated with changes in government expenditure that are very small, except for Sweden, but broadly negative overall and in each country (with the exception of France, where the size of government grows slightly over the period). Government expenditure is broadly stable but still negatively correlated with changes of total imports and exports for the countries shown as examples, and more broadly, in a period when globalization and EU market integration greatly increased international trade. It is possible that a taste or demographic shock, or just the realization that a generous welfare state is not affordable in the aftermath of a crisis, shrinks the portion of the non-tradable sector that is directly produced by the state. This releases labor and other factors to the tradable sector, resulting as in Sweden in growing exports and imports at the same time as government activities shrink. Also, 5-year periods do not completely smooth out GDP movements in this period (and certainly fail to do so in periods when they are deep and prolonged, as in the Great Recession and the Covid-19 pandemic).

It is, however, plausible that this pattern is at least in part a consequence of the state's limited power in more open economies. The theoretically ambiguous but plausible role of economic integration is more clearly apparent when comparing otherwise similar countries that did and did not join the euro area in the 1995–99 and 2000–04 periods (Bertola 2010a). The tighter economic integration implied by “One Market, One Money” was significantly associated with substantially faster deregulation of their product markets, some deregulation of their labor markets, and lower social policy expenditure. As a result, disposable income inequality grew faster in countries adopting the single currency, and these differences were completely accounted for by differences in social policy and other policy indicators, rather than by economic integration directly. These uneven developments, and evidence that social spending decreased, and inequality increased when EMU tightened economic integration across some European countries, are relevant to the next Chapter's discussion of populist backlash against liberalization and international economic integration, perceived as a cause of instability and blamed for the financial crisis and the Great Recession.

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