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# **The Welfare State and Liberal Democracy—A Political Economy Approach**

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# THE WELFARE STATE AND LIBERAL DEMOCRACY—A POLITICAL ECONOMY APPROACH

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**Abstract:** This paper attempts to shed some light on the developments of welfare states in highly developed nations since World War Two (WW2) within the context of a narrative which seeks to combine institutional distinctions, termed “varieties of capitalism,” with the historical regimes of regulation theory in a political economy perspective which puts interested political actors at centre stage. It will be argued that in a liberal democracy, the elite has the framing and agenda-setting power to “manufacture a political will” according to its interests. The welfare state is not the result of a long social struggle on the part of the needy; rather, it results in its general features from the minimal state of meritocratic exigencies. Under the very peculiar circumstances of the post-WW2 era, this even translated into a rise in social welfare spending to more than a third of national income. The particular design of welfare state organisation was the subject-matter of political conflict, and a clear distinction between liberal and coordinated market economies can be attributed to cultural differences and institutional settings. Yet the core of the welfare state conception serves the interest of the meritocracy as much as those who benefit from social programmes and re-distribution. And the neoliberal attack on the welfare state since the 1980s is not a necessary re-calibration due to changing economic conditions or a growing lack of solidarity among the people but an expression of a modified cost-benefit analysis from the elite’s perspective.

**Key words:** welfare state; Keynesian national welfare state; Schumpeterian competition state; elite; agenda theory

## 1. Introduction

The discussion about the welfare state is older than the welfare state itself: will an economy be able to shoulder the cost of a welfare state? Will the welfare state allow the lazy and unproductive to “soak the rich?” Is the welfare state sustainable in the age of globalisation? Is the welfare state adequately adjusting to the challenges of globalisation, ageing societies, and individualisation? Or is it being restructured as an unfortunate consequence of otherwise noble intentions (such as the uniting of Europe) or, perhaps worse, the backlash resulting from the pursuit of vested interests?

Of course, this paper cannot address all these questions. That is neither the objective nor even possible in a research paper such as this. Instead, it attempts to shed some light on the developments of welfare states in highly developed nations since WW2 within the context of a narrative which seeks to combine institutional distinctions, termed “varieties of capitalism,” with the historical regimes of regulation theory in a political economy perspective which puts

interested political actors at centre stage. In this attempt, it extends an earlier paper on the political economy of modernisation (see Heise 2008).

We are aware that this is an ambitious task. Likewise, we accept that many of the ideas advanced in this preliminary attempt to explain a very complex matter can be challenged and, at any rate, require refinement through further research. Nevertheless, we hope the present contribution provides a better understanding of what is currently happening in modern welfare states and the direction in which they seem to be heading.

The paper is structured as follows: In the next part, the welfare state is defined, its origins traced, and a sketch of its quantitative development is outlined. That establishes the groundwork for the second part in which a political economy perspective is elaborated and empirically tested. The paper concludes with an outlook.

## **2. The Welfare State in a Historical Perspective**

Although the welfare state is a fairly new concept, social policies and social provisions are not. Therefore, the welfare state appears to be more than the mere aggregation of social programmes in specific historical circumstances. Social policies and social provisions simply take account of the fact that individuals and families may not—for whatever reason—be able to sustain themselves economically and that, particularly in the absence of feudal relations, society somehow has to step in. In this sense, the “poor laws” (“poor law act” of 1601; see e.g., Frazer 1984) can be understood as the beginning of social policies in the UK and later in the USA; similarly, company-based “family allowances” mark the start of social policy in France (see e.g., Castel 1995), while in the German-speaking world the so-called “social question” (“*soziale frage*”) highlighted the needs of “double-free” landworkers and their families after the end of feudal dependency (see e.g., Pankoke 1970). Social policies and provisions in this sense can be seen as being based on the rationale of natural law, intended to stabilise through policy an otherwise unstable society.

### **2.1. What Is a Welfare State?**

The welfare state, which in reality developed only after WW2 in most highly developed countries of the Western world, is not merely the extension and development of such just-mentioned social policies in the modern context. Rather, it is the summation and institutionalisation of all such policies designed to provide (and to finance) social public goods, to collectively interfere in the free market transactions of individual agents in order to change market outcomes (particularly income distribution), and to democratise economic relations. The welfare state, thus, comprises social policies to collectively (as opposed to individually) insure against systemic risks to life such as sickness, unemployment, old age, and poverty (financed via taxes and social contributions) as well as employment regimes covering labour markets, collective bargaining, worker participation systems, and macroeconomic policies designed to maintain high levels of employment.

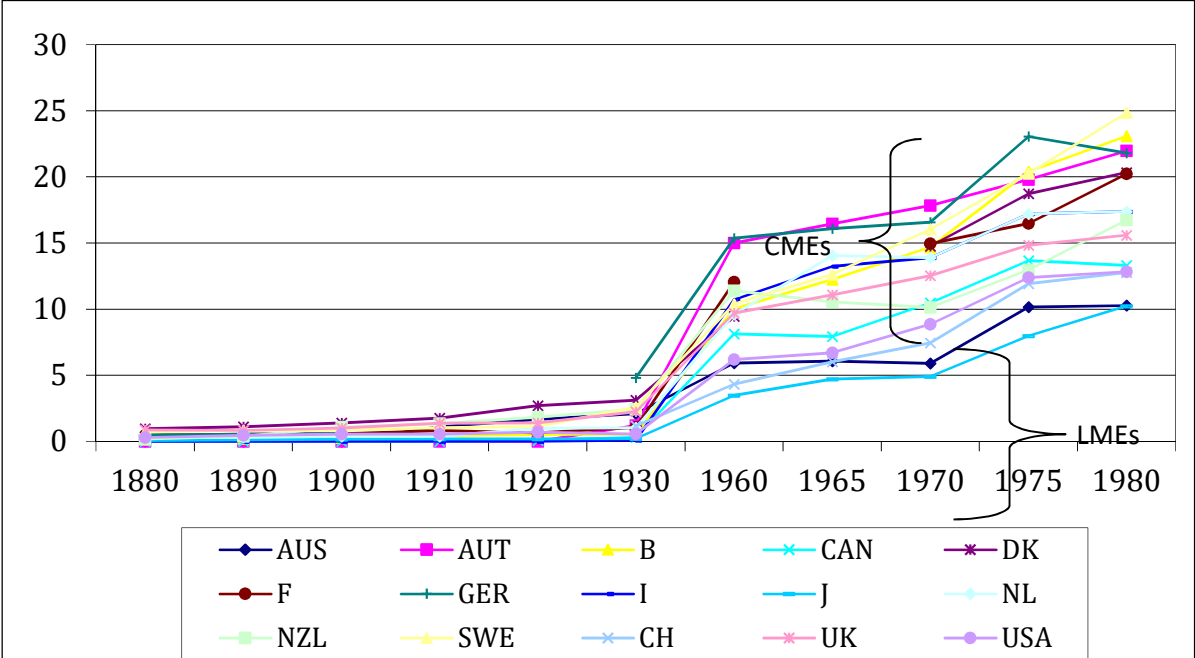
Different varieties of welfare systems developed following differing institutional and cultural paths. The most common types have been categorised as Esping-Andersen’s (1990) “three worlds of welfare capitalism,” which distinguishes a social democratic, a continental, and a liberal model and as Peter Hall and David Soskice’s (2001) binary distinction between a liberal and a coordinated economic system. For the sake of simplicity, we base the following on the Hall/Soskice model: the liberal market economy (LME) combines a fairly meritocratic orientation with a firm belief in the virtues of flexible, unregulated markets and only very limited interventions of any kind. The focus is on allocative optimisation with few distributional objectives. The coordinated market economy (CME) is concerned more with productive

optimisation,<sup>1</sup> which requires some encompassing organisations in the process of collective bargaining, a higher level of generosity regarding social public goods, and employee relations founded on participation in exchange for effort and commitment. In comparison with the liberal model, the production possibility frontier is pushed outwards, but at the same time income distribution is more equal.

**2.2. The Welfare State as the Outcome of Class Conflict?**

Social policies and programmes in the early period of capitalist development were rarely established through revolutionary actions on the part of the poor and underprivileged. Instead, they have been conceded by the ruling elite in order to appease the people and to integrate them into the power structure that eventually became the modern state. The earliest, embryonic version of a welfare state—Reichschancellor Bismarck’s *Sozialstaat* (welfare state) of the 1870s—was a piece of *realpolitik* (real politics) designed to weaken the emerging social democrats and to offer the growing working classes and their trade unions a position in the newly formed Deutsche Reich.

Figure 1. Total Social Expenditures as % of GDP 1880–1980



Source: Data from 1960 to 1979 corresponds to estimates based on OECD (1985). Data before 1930 corresponds to Lindert (2004).

A brief history of the development of welfare states must explain the extraordinary increase in welfare spending during and after WW2 that occurred in almost every country and particularly in the highly developed democratic nations in the West. As shown in Figure 1, social welfare spending quadrupled in Germany and Austria and increased more than a hundredfold in Italy between 1930 and 1980.

<sup>1</sup> We need to elaborate a bit more on the distinction between “productive efficiency” and “allocative efficiency.” “Allocative efficiency” refers to the static logic of short-term equalisation of prices and marginal utility/marginal productivity via timeless quantity adjustments. “Productive efficiency,” on the other hand, refers to the dynamic logic of long-term output/income maximisation via regulatory and institutional incentives and complementarities (see e.g., Estevez-Abe, Iversen, and Soskice 2001). The trade-off between both efficiencies manifests the background to the different types of institutional embeddedness of economic activities that has been termed “varieties of capitalism” (see e.g., Hall and Soskice 2001; Hancké, Rhodes, and Thatcher 2007).

Basically, there are two ways to explain this development: a functional one and a realist one. The functionalist account argues that the transformational change of industrialising economies and societies demanded and, due to a growing similarity of working and living conditions and the insurability of similar life risks, facilitated the emergence of social programmes and is, therefore, “the root cause of welfare development” (Wilensky 1975, 35). The welfare state, according to this view, is the systemic answer to the needs of functionality. As always with functionalist theories, this one is difficult to falsify and, at any rate, must somehow be translated into political action.

The realist account puts emphasis on political factors, arguing that the development of the welfare state directly mirrors class conflicts or, more indirectly, political partisanship in representative democratic societies.<sup>2</sup> The implication is that the higher the power resources of the needy are—in terms of a strong labour movement with strong trade unions (Huber and Stephens 2001; Korpi 1983, 2006; Korpi and Palme 1998, 2003) and with leftist political parties winning elections—the better endowed and re-distributive the welfare state will be.

With regard to conflicts, two main types of class conflict have been identified (e.g., see Edlund and Lindh 2015): *political conflicts*, that is political skirmishes between classes within the parliament, and *social conflicts*, which are based on tensions outside the domain of parliament, such as strikes and lock-outs within the labour market. As Edlund and Lindh (2015) argue, the welfare state shifts the power struggle from a social to a political conflict. In other words, with the establishment of welfare state arrangements, the power struggle of different classes or socio-economic groups is injected into the democratic decision-making process. In this interpretation, the foundations of welfare states extend back to social conflicts in the first place, which transform into political conflicts which, in turn, shape the development of the welfare state and must be able to explain the differences in welfare state endowments in terms of the outcome of the political conflict: countries with longer spells of leftist governments must clearly produce stronger welfare states than countries under more conservative (“rightist”) rule. However, neither the inter-war years nor the early years after WW2—i.e., those periods which must be regarded as giving birth to the modern welfare state—record large-scale social conflicts despite economic and social hardship for many people after the Great Depression and the devastating effects of warfare. Moreover, Table 1 clearly shows no distinct correlation between governmental partisanship and the opulence of the welfare state: although long spells of leftist governments in Sweden seem to correspond with the partisan theory of the highly endowed and highly re-distributive welfare states, this is obviously not the case for the USA or Germany: in the former, leftist governments produced only a “meager” welfare state, and in the latter, rightist governments shaped one of the best endowed welfare states. Moreover, in the UK—as in the USA—the conceptual foundations of the welfare state enacted by “leftist” parties—the “Beveridge Plan” put into practice by the Labour government of Clement Attlee in the UK and the “New Deal” enacted by the Democrat president Franklin D. Roosevelt in the USA—were not the ideological weapons of staunch fighters for the underprivileged but rather the ideas of liberal economists (John Maynard Keynes and William Beveridge in the case of the Beveridge Plan) and intended to serve “business interests” (for the “New Deal” see e.g., Henry 2018, 8). Therefore, while partisanship—representing the intensity of political conflict—may be helpful

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<sup>2</sup> The dominant theory of political economics, interestingly, does not recognise the category of “class conflict” as it deals only—since it is based on methodological individualism—with individual actor’s choices. The resulting median voter theorem—the political equivalent of the representative economic actor—however, fails even to explain why rational voters vote in the first place and, secondly, fails to explain the “paradox of re-distribution”: under the ordinary assumption of a positive correlation between income inequality and the skewness of income distribution towards the top income earners, the median voter theorem predicts higher re-distribution of welfare state measures with increasing income inequality, whereas evidence reveals the exact opposite (see e.g., Persson and Tabellini 2000, 121). Therefore, this kind of mainstream political economics is not considered here.

in explaining differences in social protection and particular programmes, it cannot explain the rise of the welfare state at the end of WW2.

Only recently has war received attention as a determinant in the development of the welfare state. On the demand side, war-related social needs (e.g., family support for war casualties) and health costs caused by war injuries created direct welfare claims. Moreover, at least indirectly, the pervasive uncertainty during wartime has been made responsible for calls for comprehensive social protection (see Dryzek and Goodin 1986). And finally, welfare state arrangements can be seen as an offer to share the burden of warfare more equally and as a compensation for those in military service by the rest of society. Conceding that the exorbitant growth in social protection coincides with the activities associated with WW2 and taking into account the fact that war-related social spending nowhere exceeded a third of total social spending (see Obinger and Schmitt 2018), the relation between waging war and the expansion of the welfare state is still open to discussion. It is likely not a fundamental cause (how could the development of the Swedish welfare state otherwise be explained? see Table 1). Yet warfare created the environment in which welfare states could flourish. This is clear in the emergence of societal solidarity and with that a commitment to accept high levels of taxation and income re-distribution; the emergence of antagonistic political and economic systems; and, as a result of massive destruction of durable consumption and capital goods and the ensuing need to replace those translating into greater propensity to consume and greater incentives to invest, such high growth rates turned the post-WW2 period not only into the “golden age of capitalism” but, at the same time, into the “golden age of the welfare state.”

Table 1. Political Partisanship, Warfare, and the Welfare State

Country	Political partisanship of government in years during the period 1945–1980					Index of war intensity	Social expenditure in % of GDP in 1980	Re-distribution <sup>+</sup>
	Right	Middle-right	Middle	Middle-left	Left			
France	10	5		7	3	4.7	20.23	2.25
UK	18				17	5.3	15.58	1.32
USA	16			19		1.8	12.84	1.43
GER	17	3		11		8.8	21.79	2.33
SWE			4		31	0	24.85	2.85
AUT	4		17	4	10	8.5	21.59	2.19
AUS	1		27		7	2.5	10.27	1.04
NL	5		23	7		5.0	23.26	2.57

Notes: Conservative/nationalistic parties are rated as “right,” liberal parties as “middle,” labour parties as “left,” and coalitions as “middle-right” or “middle-left,” depending on the leading party in the coalition; grey shading indicates a dominance of parties in the conservative-liberal political spectrum and below average of respective indicator; yellow shading indicates a dominance of parties in the middle-left to left political spectrum and above average of the respective indicator; + = expected benefit index at the end of period according to Scruggs with 0 as minimum and 3 as maximum.

Source: Obinger and Schmitt (2018, 505); Scruggs (2006); own calculation.

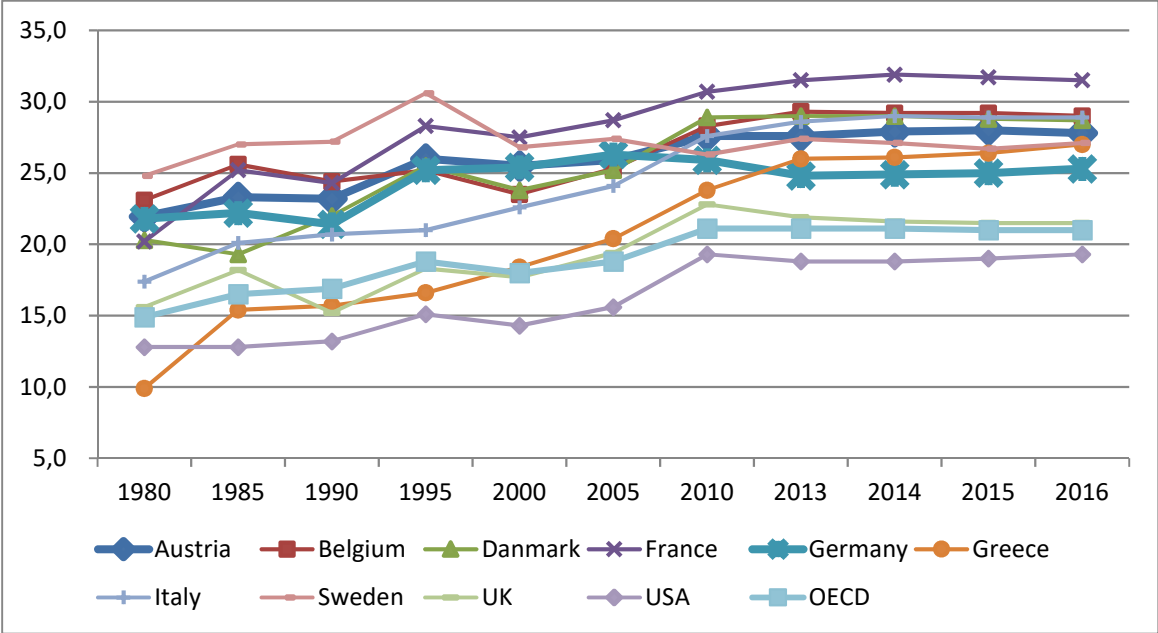
### 2.3. The Welfare State in Modern Times—From Golden to Silver Age

As we know, the “golden age” did not last: after the oil-related crisis of the 1970s, mass unemployment in highly developed nations became a lasting problem, growth rates declined, the societies started to age (i.e., the ratio of the retired population to the working age population

began to increase) and the process of growing global market integration put national economic and social governance under stress.

Despite these undisputed developments, there are questions regarding how the welfare state evolved in the intervening decades: are we witnessing the “silver age” of the welfare state as it responds with remarkable resilience to the above-mentioned challenges by transformation and adaptation (see e.g., Taylor-Gooby 2002)? Or are we in a process of welfare state retrenchment in the neoliberal age (see e.g., Palley 2018)?

Figure 2. Social Expenditure in Percent of GDP, 1980–2016



Source: Social Expenditure Database (SOCX).

Figure 2 appears to support the “silver age” narrative of the welfare state: although there are some countries—those with better endowed welfare programmes such as Sweden and Germany—which have actually seen a moderate decline in overall social spending (as % of GDP), the OECD average is still rising. This macro-quantitative view, however, may be challenged when we look qualitatively at particular social policy programmes. Nevertheless, this may still fit well with the restructuring-resilience argument.

But this argument is put in doubt once it is realised that during the past three decades much greater use has been made of the welfare state than before: unemployment has risen considerably, health costs have increased dramatically, and with the ageing of populations, pension and retirement costs also have increased significantly. This casts a skeptical shadow over the explanatory power of macro-quantitative data with respect to the endowment of welfare states (see e.g., Allan and Scruggs 2004; Korpi and Palme 2003). When Palley (2018) claims a neoliberal assault on the welfare state, he highlights, therefore, not only absolute spending levels, but refers to the generosity level and, implicitly, the re-distributive effect of the welfare programmes as much as structural characteristics, such as a shift from comprehensive (“universal rights”) to restricted (“means-tested”) coverage.

Upon closer inspection, what looks superficially like surprising resilience may turn out to be a severe roll-back of the welfare state.

### 3. The Political Economy of the Welfare State



People are related by economic, social, and political relations. Economic relations are seen as being basically characterised as intertemporal exchange relations, power relations, or relations based on nominal obligations with respect to the underlying ontological vision (neoclassical, Marxist, or post Keynesian). Individuals decide individually according to their preferences (or interests) and their material endowments. “Equality” and “justice” are not sensible criteria for economic relations. But “optimality” is. And optimal configurations of economic relations cannot be expected to govern (if at all) unless the place of their interaction—the market—shows very peculiar, heroic characteristics: perfect competition, perfect information, and perfect foresight. In the social and political realm, however, individuals decide collectively. In other words, they decide on issues which impact not only on their personal utility but on the welfare of all—the “common good.” Political and social relations can be hierarchical or symmetric, depending on the decision mechanism in use. Democratic societies, as opposed to dictatorships or autocratic societies, have opted for the “logic of equality,” that is, the idea that every member of the society is equally well qualified to decide on collective issues irrespective of his material endowments or position in the society: one citizen, one vote. Moreover, “qualification” in this respect does not imply certain capabilities but merely the collectively shared idea of equal rights. Thus, economic and social or political relations in democracies differ in two important ways: economic relations are notoriously unequal and need to be tamed by market regulations, while political and social relations are intrinsically symmetric. On the other hand, following one’s own vested interest in economic relations does not (necessarily) conflict with the idea of maximising the welfare of society and may even be a requirement for this objective (Adam Smith’s famous “invisible hand”). However, in political and social relations, diverging vested interests of individuals, groups or classes may pose serious problems because they may render impossible the formation of a “common will,” which is necessary in order to decide on the desired provision of collective or public goods to serve the “common good.” This phenomenon is known as Arrow’s “impossibility theorem,” implying that any collectively established welfare function entails the high likelihood of preference orderings representing merely relative majorities, in other words, absolute minorities. In order to legitimise such an outcome, the decision-making process must be acceptable to all.

### **3.1. Different Forms of Democracy**

The legitimacy of democratic social and political relations, hence, stems from its decision-making process (input legitimacy), not some kind of functional outcome in terms of economic growth, income distribution, or other criteria (output legitimacy). The “common good” needs to be derived from the preferences of the individuals forming a society; it cannot be superimposed by some organic (functional) description; yet functional outcome may impact on the actual choice being made under a given decision-making framework.

Classical theories of democracy argue that majority voting is the best possible way to secure Abraham Lincoln’s dictum of “government of the people, by the people, and for the people” because it best fulfils the criteria of maximising self-determination, utility, and the likelihood of producing correct decisions (see Dahl 1989, 138ff.).<sup>3</sup> Alternatives such as supermajorities or quasi-guardianships score worse on these criteria, and limited notions of democracy such as Riker’s “liberal democracy,” which restricts the objective of democratic majority voting to “removing elected officials from office when the citizens become dissatisfied with their performance” (Dahl 1989, 154; paraphrasing Riker 1982, 181ff.), may be accepted as interpretations of real-world representative democracies linking output and input legitimacy, but they do not challenge the supremacy claim of democratic majority voting.

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<sup>3</sup> “I assume that a key characteristic of a democracy is the continued responsiveness of the government to the preferences of its citizens, considered as political equals” (Dahl 1971, 1).

### **3.2. Democracy in an Agenda-Theoretical Perspective—Minority Rule of the Elite**

Although in terms of “input legitimacy” there may be no better decision-making process than majority voting, neither Lincoln’s idea of “classical democracies” where no one has the power over someone else nor “liberal democracies” as mechanisms to put governments under popular scrutiny may be seen as adequately portraying modern representative democracies. This may be the case, as claimed by democratic elitism (see e.g., Best and Higley 2009), because the representation needed in mass societies creates principal-agent-problems: politicians and legislators are not simply the ambassadors of their voters; they moreover follow their own interests. But due to the professionalisation inherent in any division of labour, they come to form an elite which is supposed to know the common will better than the ordinary voter—or, as Schumpeter put it, the common will is manufactured in much the same way as consumption patterns are created by advertisement and applied psychology, rather than being the objective representations of free and self-determined consumers.<sup>4</sup>

As true as this may be, there is another point to be made: as the impossibility theorem suggests, the common will in heterogeneous societies cannot consistently be formed by way of simple aggregation. Notwithstanding this impossibility, majority voting has become the most tolerated form by which to arrive at a common will. Yet this comes with two major drawbacks: the majority outcome in truly heterogeneous societies in fact mirrors the preferences of a minority. As we know from the “voting paradox,” those minority preferences which can make best use of the agenda-setting and agenda-building process in the political arena will prevail: whoever is able to influence the voting process in a way that his preferences (interests) get particular attention will increase the likelihood of making his preference ordering a matter of general welfare. This has been addressed in the literature as “cyclical majorities,” pointing to the fact that majority voting may not result in stable outcomes with regard to shaping the “common will.” What from a functional perspective may be seen as problematic (ever changing policy orientations) may be regarded as a democratic virtue because it may give everyone the chance to determine the common will eventually. Yet, this is exactly what agenda theory casts into doubt: under the assumption of serious information problems within the electorate, the framing process of political issues becomes an important tool for effectively asserting one’s own preferences. And as the framing process in modern democracies is basically controlled by the media (see e.g., McCombs and Shaw 1972), there is a strong bias in the framing of political issues as the “common will” towards such interests that are either aligned with the interests of the media as capitalist corporations<sup>5</sup> or with the media elites running the communication business. To summarize the argument put forward on the basis of elite and agenda theory, “liberal or competitive democracy” in Riker’s and Schumpeter’s sense has a strong tendency to

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<sup>4</sup> Schumpeter (1976, 263) puts it,

The only point that matters here is that, human nature in politics being what it is, they are able to fashion and, within wide limits, even to create the will of the people. What we are confronted with in the analysis of political processes is largely not a genuine but a manufactured will. . . . The ways in which issues and the popular will on any issue are being manufactured is exactly analogous to the way of commercial advertising.

<sup>5</sup> There were times when, at least, part of the media were not simply capitalist enterprises but influential voices of religious or ideological groups (parties). The more diverse the underlying motivations of producing media products, the more dissonant the framing process may be.

favour minority preferences which are shaped by the media or capitalist elite.<sup>6,7</sup> In a Machiavellian manner, it is the task of this elite to use its power in such a way that the majority will not lose its confidence in the democratic makeup and goals of the elite’s government; in other words, they must keep faith in the “common good” assumption of this kind of “liberal or competitive democracy.” This faith may be undermined simply if the elite makes no attempt to camouflage its interests as “common good” or if the outcome is so appalling that the process which creates such an outcome is contested.

### 3.3. The Elite’s Interest and the Welfare State

The underlying assumption is the following: a “liberal democracy” safeguards the meritocratic interests of the elite by allowing them to set the political agenda and the agenda-building process. In doing so, the meritocracy is able to install a “minority rules” state as opposed to the “majority rule” which may “soak the rich” via a strongly re-distributive welfare state.<sup>8</sup> The interests of the meritocracy can be narrowed to the maximisation of absolute and relative net-income.<sup>9</sup> In order to realise this objective, market income (gross) needs to be determined as much as possible by deregulated markets, while net income needs to be distorted as little as possible by taxes and social contributions, based on fiscal equivalence and re-distribution only as much is needed in order to guarantee social stability (the Macciavelli standard). However, in order to reach its highest possible market income, some regulations (e.g., unfair dismissal regulations, co-determination rights, collective bargaining agreements, or, more generally, collective employee relations) may help to maximise productive efficiency—in other words, a trade-off (conflict) between productive and allocative efficiency may develop.

Table 2. Varieties of Capitalism and Varieties of State Conceptions

	<b>Liberal Market Economy</b>	<b>Coordinated Market Economy</b>
<b>Keynesian National Welfare State (KNWS)</b> <b>(1950s—1970s)</b>	- Social security system based on Beveridge orientation (means tested) - Strong trade union rights - decentralised collective bargaining system with strong “local pushfulness”	- Social security system based on Bismarck orientation (comprehensive) - Strong labour market regulation + participation rights

<sup>6</sup> The concept of the “elite” is difficult to define precisely. In the research on elites, they are taken as that circle of people who are in a position to have a definitive influence on political and economic decisions or, as Lopez (2013, 3; italics in the original) puts it:

... the state-of-the-art concept of *elites* is more closely related to the Weberian notion of *power*, understood as the capability of implementing one’s will, even against the will of others (...). Power can be achieved through material and/or symbolic resources. Consequently, elites can be defined as those in possession of those resources (...).

<sup>7</sup> It is often claimed that there is no such thing as “the” elite, but the elite are functionally differentiated (e.g., economic, political, cultural elite, etc.) and very heterogeneous in their interests. However, it is also often claimed that the elites are not so different in their socio-economic pedigree and, at least with respect to their meritocratic orientation, show very similar interests. It is the case, therefore, that the capitalist and media elite which have been focused on so far can be broadened towards the meritocratic interests of the elite without further specification.

<sup>8</sup> Larry M. Bartels (2008, 285) concludes his study “unequal democracy” with this passage: “. . . affluent people have considerable clout, while the preferences of the people in the bottom third of the income distribution have no apparent impact on the behavior of their elected officials.” That description of the situation in the USA can be seen as an ordinary characteristic of a “liberal democracy.”

<sup>9</sup> Although it is unclear whether the prime interest of the elite is “power” or “wealth,” the relation of these two objectives appears to be complementary rather than substitutional. In any case, it is the common procedure in political economics to take income as the predominant factor determining the utility of groups or classes; see e.g., Persson and Tabellini (1999).

	<ul style="list-style-type: none"> <li>- Keynesian demand management</li> <li>- strong capital controls</li> </ul>	<ul style="list-style-type: none"> <li>- centralised collective bargaining system</li> <li>- Keynesian demand management</li> <li>- strong capital controls</li> </ul>
<b>Schumpeterian Competition State (SCS)</b>  <b>(1980s—2000s)</b>	<ul style="list-style-type: none"> <li>- Social system retrenchment</li> <li>- anti-trade union regulations</li> <li>- marginalised collective bargaining system</li> <li>- rhetorically: supply-oriented policies (but, if needed: demand management)</li> <li>- deregulated financial markets</li> </ul>	<ul style="list-style-type: none"> <li>- moderate social retrenchment</li> <li>- moderate decentralisation of collective bargaining system</li> <li>- rhetorically: industrial-relations overhaul (but effectively: basically continuation of Employee Relation (ER) system)</li> <li>- supply-oriented policies</li> <li>- deregulated financial markets</li> </ul>

Source: Own account.

In this setting, liberal democracy is compatible only with a minimal state in the sense that re-distributive state action comprising interventions into not only the process of income generation and distribution but also the (re-)distribution of power (at the individual level as decommodification or the collective level as participation) will be accepted only in an output-oriented perspective as long as it pleases the meritocracy.<sup>10</sup> Such minimal states may look very different over time, taking differing historical settings into account, and also very different across nations, taking differing cultural norms and backgrounds and institutional settings into account (see Table 2). Therefore, we may end up with a “variety of liberal capitalisms” showing quite different levels of re-distribution, decommodification, and participation—i.e., welfare state organisations—over time (i.e., Keynesian national welfare states of the “golden age of capitalism” to Schumpeterian competition states of the “silver age of capitalism”) and across nations (i.e., liberal economies, coordinated economies).

KNWS and SCS are variations of liberal (i.e., meritocratic) capitalism. While the postwar years experienced a phase of system competition and a strong popular belief in technocratic governability (socio-cybernetics), the meritocracy was forced to prove that capitalism can handle the potential trade-off between productive efficiency and allocative efficiency better than its counterpart in the socialist world. Although productive superiority was seemingly easy to prove, it was not supposed to come at the cost of a clearly inferior distributional result, showing much more absolute and relative poverty among the non-meritocracy.

<sup>10</sup> The exact process of how the elite manage to make their interests the subject of the “common good” pursued by democratically elected governments of different partisanship must be the subject-matter of further research of the kind found in Heise (2005). It may be worth mentioning that the convergence of party programmes explained by public choice theories to be the result of the “median voter theorem” can also be interpreted as the result of the agenda-setting and framing power of the elite creating “policy constraints” which parties of any partisanship have to accept (see e.g., Merkel 2001).

Figure 3. Determination of Re-distribution in Varieties of Liberal Democracies

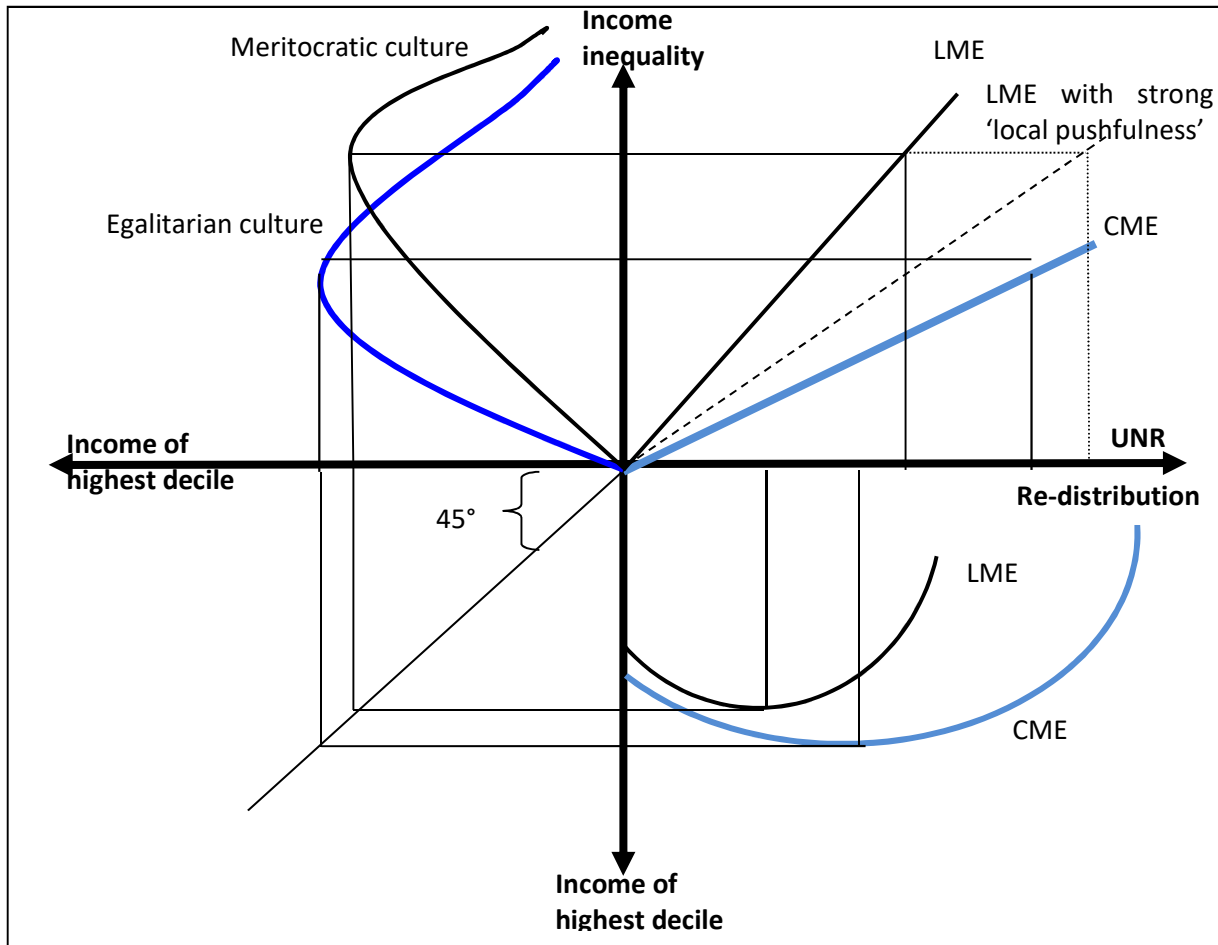


Figure 3 attempts to capture these ideas. From a meritocratic perspective, the optimal size of re-distribution through welfare state programmes is determined in two different varieties of capitalism: the LME and the CME. The LME is characterised by a more uncritical belief in the virtues of free markets,<sup>11</sup> less regulation of labour markets, and weaker labour market institutions, fostering a capital market-based short-term profit-maximisation strategy (“shareholder-value”). Yet it entertains a stronger belief that income inequality is a necessary and tolerated sign of success (“meritocratic culture”). The CME relies more on bank-based long-term profit maximisation (“stakeholder value”), fostering incentives to enhance productive efficiency to the detriment of market flexibility (allocative efficiency). This includes both labour market regulations to increase human capital investments and worker participation schemes. This goes along with the idea that the cohesion of society allows for only a certain income inequality (“egalitarian culture”). The upper left quadrant of Figure 3 depicts the idea that a growing income inequality will increase the income of the meritocratic elite only to a certain point. Once this point is surpassed, absolute income of the meritocracy will fall although relative income (income inequality) will continue to rise. This may be so because aggregate

<sup>11</sup> Such a belief may be culturally enshrined in a way that actors fail to realise the options available to them, which have been brought to light by the research on “varieties of capitalism.” For instance, when confronted with research results indicating that German style employee relations based on participation rights and labour market regulations give German companies a competitive advantage based on higher labour productivity even within the confines of a “liberal market economy” (see Tüselmann, McDonald, and Heise 2003), British managers declared that they simply cannot handle any kind of cooperative labour relations.

demand may suffer from ever increasing income inequality as much as the cost of protecting income-generating wealth will rise. Due to differences in cultures, the point of maximum income of the elite will be at higher income inequality in the LMEs as compared to the CMEs. And because LMEs favour allocative efficiency over productive efficiency, absolute income determined by total factor productivity may be lower in LMEs than in CMEs.

The lower right quadrant illustrates that some re-distribution from the successful to the less successful market participants will be necessary in order to maximise the income for the meritocracy. Feelings of insecurity associated with the opening of an economy to the global market or the introduction of new technologies (enhancing allocative as well as productive efficiency) may well cause costly opposition to such developments and result in demands for social compensation; in other words, part of the overall gain will have to be re-distributed to the potential losers of such developments. And as the CMEs favour productive over allocative efficiency, they may generate higher per-capita income but might be compelled to pay higher compensation to the non-meritocracy.

Finally, the upper right quadrant portrays the mechanism by which income inequality is basically brought about: disequilibrium in the labour market—i.e., unemployment—will put pressure on the wage bargaining process—as the main determinant of income distribution (see Förster 2000)—in order to bring about the desired income inequality. And here, the stronger institutions of CMEs need more pressure (i.e., higher unemployment) to produce a certain inequality than LMEs do. However, LMEs may only *de jure* be more flexible and less resistant to labour market pressure but not *de facto*. As Soskice (1990, 50f) reports, the absence of comprehensive labour market regulations, including labour action and collective bargaining legislation, may well result in strong “local pushfulness” from the trade unions at the company-level if unionisation is strong and conflict-oriented.<sup>12</sup> In such a case, as indicated in Figure 3 by the dashed line, the unemployment rate necessary to create the intended income inequality may even be higher in LMEs than in CMEs.

What Figure 3 shows is a “meritocratically optimal rate of unemployment” (MORU) and a “meritocratic minimal state” (MMS) comprising social programmes with re-distributive effect. MORU and MMS will look quite different with respect to the organisation of the economic systems: MORU is likely to be higher in CMEs while MMS will be less re-distributive in LMEs.<sup>13</sup> Of course, MORU and MMS are only optimal states from a meritocratic point of view. The actual state of unemployment and the welfare system depends on many factors such as the degree to which the meritocracy is effectively able to enforce its interest as the “common will” in the political system and to what degree the meritocracy is able to enforce the policies necessary to establish the desired MORU. The latter depends on the ability of the meritocracy to dominate the public discourse in terms of agenda-building and its ability to dominate economic research and economic counselling in terms of agenda-setting and policy framing.

Moreover, MORU and MMS are also time-dependent. As Figure 4 shows, distributive cultures may vary over time as much as the institutional structure of an economy and the orientation of public policy-making. In the years after WW2, the elite in Western capitalist economies were faced with a very intricate situation: during the Great Depression capitalism had proven to be extremely unstable, and in its attempt to better economic and social conditions

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<sup>12</sup> Many of the policy reforms of Margaret Thatcher in the UK and Ronald Reagan in the USA proclaimed as “deregulation” and “flexibilisation” measures (OECD 1994, 105) were, in fact, regulations—yet very one-sided to the detriment of trade unions only (see e.g., Heise 1997).

<sup>13</sup> In this little model, the puzzle known as “paradox of redistribution” or the “Robin Hood paradox” “in which redistribution from rich to poor is least present when and where it seems most needed” (Lindert 2004, 15), is comfortably explained by the pursuit of elite interests in different institutional and cultural settings different from electoral systems such as “proportional” or “majoritarian” as in Iversen and Soskice (2006). However, as there seems to be a strong correlation between the different electoral and economic systems, we might be faced with the statistical problem of multicollinearity here.

for its respective people it became extremely mercantilistic and dangerous to the international order. The liberal idea that the pursuit of individual and national interests can be reconciled with both the common good and a stable and peaceful international order was anything but obvious.<sup>14</sup> At the same time, communism took centre stage in history, challenging capitalism as the “natural” order. Behind the emerging “iron curtain,” a different economic system—“real existing socialism” under Soviet hegemony—had been established, putting pressure on those who wanted to restore capitalist order under democratic conditions: they had to prove that capitalism performs better in the economic realm (measured by levels and growth rates of per-capita income) and in the social realm as well (measured in terms of the distribution of income and poverty rates).<sup>15</sup> Additionally, the experience of warfare over the past decade had not only strengthened the collective feelings and motives for solidarity (at the supply side) on the one hand and a claim for collective support (at the demand side) on the other, but also had brought about a level of state expenditure financed by unprecedented tax rates—providing financial space for democratic governments to divert public expenditure away from military purposes. Finally, in the area of economics a new approach—Keynesianism—began to dominate; it not only was able to explain the occurrence of the Great Depression; it appeared also to provide the economic tools—demand management—in order to cope with capitalist instability in the future. And as social policies and their re-distributive effects could be easily integrated into Keynesian economic governance, as well as the existing constraints on international mobility of commodities and factors of production still in place after the protectionism of WW2, a regime became acceptable and desirable to the meritocracy which has been dubbed “Keynesian national welfare state” (KNWS<sup>16</sup>) by regulation theorists (see Jessop 2004).<sup>17</sup> One of the best

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<sup>14</sup> The critical attitude towards the capitalist order had already emerged after WW1 and became more pronounced after the Great Depression in the late 1920s and after WW2. As early as 1922, Ludwig von Mises, a prominent liberal economist, wrote:

The supporters of Socialism . . . are not confined to the Bolsheviks . . . or to the members of the numerous socialist parties; all are socialists who consider the socialistic order of society economically and ethically superior to that based on private ownership of the means of production. . . . If we define Socialism as broadly as this we see that the great majority of people are with socialism today. Those who confess to the principles of Liberalism and who see the only possible form of economic society in an order based on private ownership of the means of production are few indeed. (von Mises [1922] 1932, 26–27)

<sup>15</sup> Obinger and Lee (2013, 259) point out that,

The rivalry between the West and the communist bloc during the Cold War was not restricted to military tensions but also included fierce economic and social competitions. As its core stood the performance of ideologically conflicting regimes with regard to policy outcomes, sports, cultural achievements, technology, and economic well-being. The resulting ambitions to outcompete the rival bloc/country and to flaunt the achievements of one’s own political and economic regimes were strongly driven by the vested interests of the political elites, notably ambitions to enhance regime legitimacy. During the Cold War, governments of all kinds were reliant on achieving mass compliance among their populations and gaining political legitimacy since mass loyalty and domestic political stability were prerequisites for succeeding in this conflict.

Gilman (2017) also states that,

Although some US conservatives never fully accepted the principle of redistribution, the Cold War context—that is, the threat posed by the alternative of Communism—meant that from the 1930s through the 1970s, even Republican Presidents like Dwight D. Eisenhower and Richard M. Nixon basically accepted the Keynesian, mixed-economy framework and the support of welfare programs. President Nixon even went so far as to promote a Guaranteed Minimum Income—a program very similar to a Universal Basic Income (UBI), the darling idea of today’s Left.

<sup>16</sup> Actually, there are different labels in use. Most common is Jessop’s “Keynesian welfare national state.” Simply for linguistic reasons, I prefer to call this state conception “Keynesian national welfare state.”

<sup>17</sup> Although there is a clear co-integration between the institutional and regulatory frame named KNWS and the “golden age” of capitalism, the direction of causality is unclear: regulation theorists argue that the “golden age” of capitalism is based on the KNWS because its institutions temporarily pacified the capital-labour conflict intrinsic in capitalist production and, thereby,

known and most intensively researched examples of such a KNWS is the “*Soziale Marktwirtschaft*” (see e.g., Heise and Görmez Heise 2013) in Germany, which had been established under conservative rather than socialist or social democratic governments.

Figure 4 captures these ideas accordingly: in the upper left quadrant, income inequality, coupled with the income of the meritocracy, favouring a rather egalitarian income distribution even from the perspective of the elite, is termed “post-WW2 collectivism.” In the upper right quadrant, the institutional constraints for putting pressure on the collective bargaining system via unemployment are portrayed and dubbed “coordinated economy during KNWS”; these show rather strong potential to provide resistance, taking CME as an example. Moreover, the lower right quadrant sheds light on the re-distributive content of the KNWS resulting from a cost-benefit analysis (portrayed in lower part of Figure 4): in a situation of pending system competition and a high demand on solidarity related to the war, a growing re-distributional impact of welfare state arrangements provides rising utility to the meritocrats, yet at ever falling margins. On the other hand, rising costs are correlated not only in terms of lower absolute and relative income but also in terms of power sharing with a welfare state expansion which not only re-distributes income but also increases the degree of decommodification of labour. The MMS is given where utility exceeds cost the most or, put differently, where marginal utility of a re-distributive welfare state equals marginal cost.

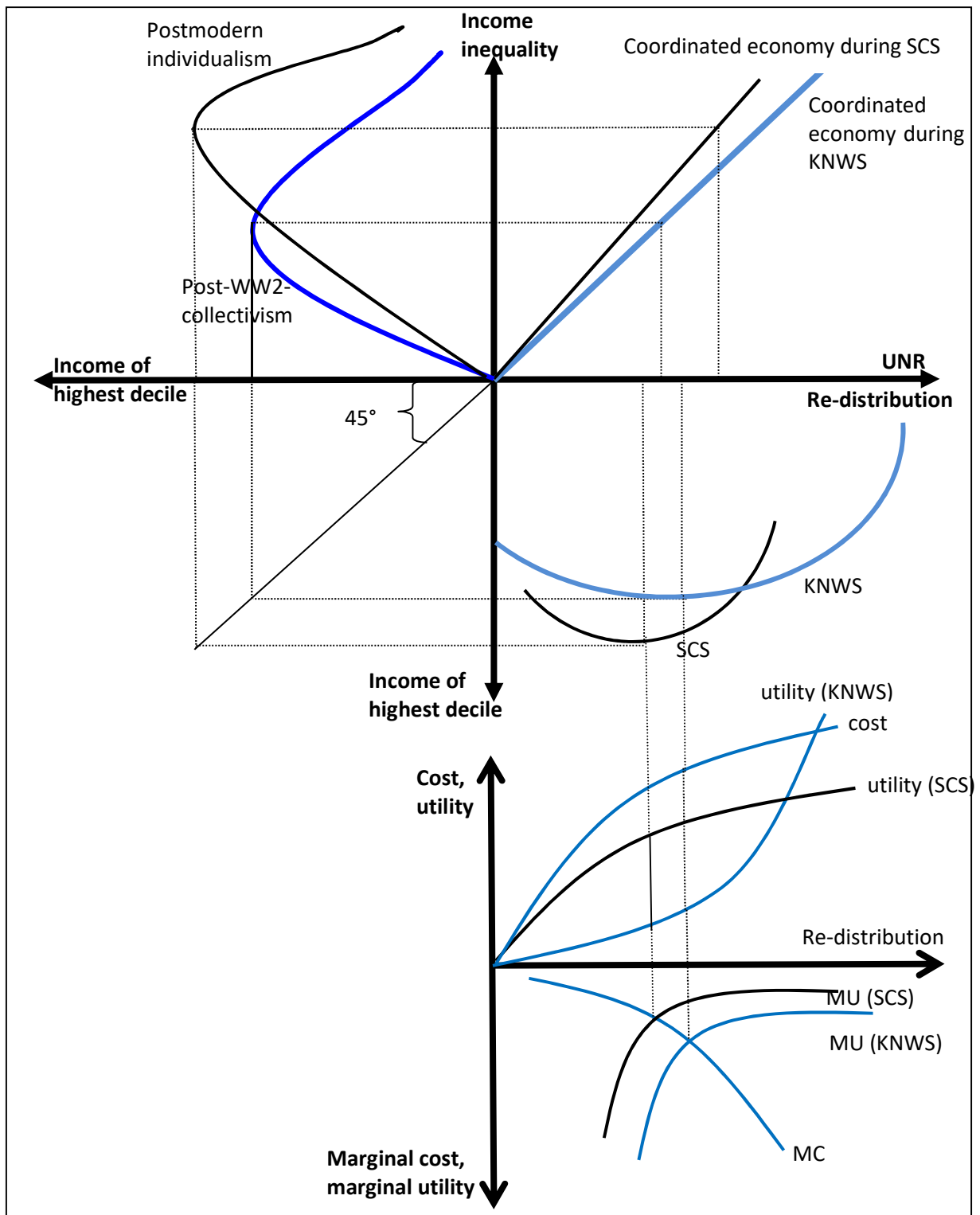
Clearly, with changing conditions, both the cost-benefit situation and the distributional culture can change significantly. While the cost may remain largely unaltered, the benefits of a re-distributional welfare system may diminish when the competition between systems disappears because of the collapse of the alternative system. This development may be strengthened as a result of growing economic globalisation intensifying local competition (“Standortkonkurrenz”). Moreover, a shift in economic policy orientation from Keynesian demand management towards neoliberal supply-side policies triggered by a paradigm shift in the economic discipline from Keynesian to monetarist-neoclassical economics may additionally undermine, from the perspective of the elite, the potential benefits of a welfare state. The regime formation under such altered conditions and the desired MMS of the globalised age has been dubbed “Schumpeterian competition state” (SCS). In conjunction with a change in the distributional culture towards “postmodern individualism” favouring more inequality (as depicted in the upper left quadrant of Figure 4) and institutional change towards deregulation and decentralisation of labour markets and collective bargaining systems (shown in the upper right quadrant of Figure 4), the different characteristics of MORU and MMS can be described under the different state conceptions of KNWS and SCS. During periods of KNWS, income inequality is lower and the re-distributional content of the welfare state greater than in SCS, while MORU will be higher in SCS as long as labour market institutions remain generally stable.

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slowed down the falling trend in the profit rate. However, from a non-Marxist perspective, the “golden age” of capitalism, considered as the result of a major catching-up process after the massive destruction of productive capital during WW2, could well be interpreted as the economic basis of a KNWS.



Figure 4. Determination of Re-distribution in Different Historical Settings



### 3.4. Some Empirics of MORU and MMS

If the political economic interpretation of the development of the welfare state given above as an expression of the minimal state from a meritocratic perspective in different historical and institutional settings is valid, we need to find empirical traces with respect to the development

of the MORU as the trigger as well as the re-distributional content of the MMS and the relative income of the elite as the objectives.

Table 3. Changing Patterns of Welfare State Characteristics over Time and across Nations; 17 OECD Nations, 1960–2010

	KNWS*		SCS**	
	Liberal+	Coordinated++	Liberal+	Coordinated++
<b>Unemployment rate<sup>°</sup></b>	4.5	4.2	6.2	7.6
<b>Income inequality<sup>°°</sup></b>	0.31	0.25	0.33	0.27
<b>Re-distribution(1)#</b>	-0.12	-0.19	-0.13	-0.2
<b>Re-distribution (2)###</b>	1.61	2.39 (2.45)	1.55	2.28 (2.28)

Notes: \* 1960–1990; \*\* 1991–2010; + Australia, Canada, Ireland, Japan, New Zealand, Switzerland, USA, UK; ++ Austria, Belgium, France, Germany, Italy, Denmark, Finland, Netherlands, Norway, Sweden; ° average over the respective period; °° Gini-coefficient at the end of the respective period, no comparable data available for Japan, New Zealand and Belgium; # difference between Gini-coefficient of market and disposable income at the end of the respective period, no comparable data available for Japan, New Zealand and Belgium; ### expected benefit index at the end of the respective period (KNWS, 1987; SCS, 2002) according to Scruggs with 0 as minimum and 3 as maximum, data in brackets: without Italy as Italian data appear questionable.

Source: Scruggs (2006); Ameco databank; Caminada et. al (2017); Wang and Caminada (2017).

The picture is clear and as predicted (see Table 3): LMEs show a markedly more unequal income distribution than CMEs, independent of the historical circumstances. Yet the re-distributive effect of the welfare state is more pronounced in CMEs. Moreover, the re-distributive effect has declined over time independently of the institutional setting. Due to an ageing population, the immense increase in health costs and an increase in unemployment, i.e., an exposure of a larger part of the population to welfare programmes, the welfare state has neither consistently declined in size—in terms of social expenditures in relation to GDP (see Figure 2 and part 2.2.)<sup>18</sup>—nor in its re-distributive effect, if measured by a change in income inequality before and after taxation and social transfers by Gini-coefficients (see row 3 in Table 3). However, if the “generosity” of the welfare state is measured by coverage ratio and financial alimentation per individual case (see row 4 in Table 3), it appears hard to deny that the re-distributional content of welfare state systems has declined—and this is even more pronounced if instead of the average of pre- and post-welfare-Gini-coefficients, the quintiles are compared on the income scale. While re-distribution towards the lowest income quintile decreased by about 1% during the SCS period compared with the KNWS period, we see re-distribution

<sup>18</sup> If one takes a more differentiated picture by focusing on different social policy areas and taking into account that the number of recipients (i.e., unemployed) may have changed, the result changes even with respect to overall social expenditure levels:

“ . . . our results strongly suggest that welfare states are less resilient than envisioned in the literature on “new politics” (. . .). In fact, the 1990s— . . . seem to mark a turning point. Until then, only the speed of expansion decelerated but since then an actual trend reversal has taken place. Welfare states are no longer simply growing at a slower pace but shrinking. At the same time, social spending is directed less at curbing inequality and more oriented towards the elderly and services. As a consequence, the welfare state becomes less decommodifying and more supportive of markets” (Elsässer, Rademacher, and Schäfer 2015, 9).

towards the highest income quintile (or, rather, the reduction in contributing to re-distribution) increased by about 0.6% before the time of the world financial crisis (see Causa and Hermansen 2018, 42; after the world financial crisis, due to rising unemployment, the re-distributional contents increased slightly, only to start to decrease again when the economies started to recover and austerity programmes started to show an impact).

Moreover, the unemployment rate increased quite significantly during the SCS era as compared to the KNWS period, in both the LMEs as well as the CMEs (see row 1 in Table 3). However, during the KNWS period, unemployment was slightly lower in CMEs as compared to LMEs. This would be consistent with our proposed model only if we assume “strong local pushfulness” as a characteristic of LMEs. Of course, most economic and labour market reforms in LMEs at the beginning of the 1980s sought to curb the power of trade unions and deregulate labour markets. Once these measures started to have an impact, the unemployment rate in LMEs fell below the unemployment rate in CMEs.<sup>19</sup>

Finally, the ultimate objective of the meritocracy—income maximisation— showed a very peculiar development which appears entirely consistent with the approach presented here (see Table 4): independently of the economic system, the relative income of the top income earners (10th income decile) declined during the KNWS period under the conditions explained above—and more so in CMEs than in LMEs. However, this decline, as compared to the pre-war years, was more than reversed during the SCS period when the collective and system pressure on the meritocracy dwindled—and more so in LMEs than in CMEs.

Table 4. Top Decile Income Share in LME and CME across Time and Nations

	(1) 1950	(2) 1979	(3) 2010	(4) KNWS (2—1)	(5) SCS (3—2)
<b>LME+</b>	0.33	0.31	0.38	-0.02	+0.07
<b>CME++</b>	0.33	0.28	0.33	-0.05	+0.05

Notes: + denotes Australia, Canada, Japan, New Zealand, Switzerland, USA, UK; ++ denotes Denmark, France, Germany, Italy, Sweden, Netherlands.

Source: World Inequality Database (<http://wid.world.data>) and Piketty (2014, Chap.9).

#### 4. Conclusion

In a liberal democracy, the elite has the framing and agenda-setting power to “manufacture a political will” (see Schumpeter 1976, 263) according to its interests.<sup>20</sup> The welfare state, “one of the great social innovations of the 20th century” (Palley 2018, 32), is not the result of a long social struggle on the part of the needy; rather, it results in its general features from the minimal state of meritocratic exigencies. Under the very peculiar circumstances of the post-WW2 era, this even translated into a rise in social welfare spending to more than a third of national income—up from less than a twentieth of GDP at the beginning of the 20th century. The

<sup>19</sup> While the average unemployment rate in LMEs as compared to CMEs during the 1960s was 2.6% to 1.9% and 3.9% to 3.7% in the 1970s, it rose to 7.0% as compared to 7.1% in the 1980s and 6.9% to 8.3% in the 1990s (own calculations; sources: see Table 3).

<sup>20</sup> Thorstein Veblen (1919, 160f) pinpointed this insight already as early as the beginning of the 20th century when he declared in his famous *The Vested Interest and the Common Man*:

So that the population of these civilised countries now falls into two main classes: those who own wealth invested in large holdings and who thereby control the conditions of life for the rest; and those who do not own wealth in sufficiently large holdings, and whose conditions of life are therefore controlled by these others. It is a division, not between those who have something and those who have nothing—as many socialists would be inclined to describe it—but between those who own wealth enough to make it count, and those who do not.

particular design of welfare state organisation was the subject-matter of political conflict, and a clear distinction between liberal and coordinated market economies can be attributed to cultural differences and institutional settings. Yet the core of the welfare state conception serves the interest of the meritocracy as much as those who benefit from social programmes and re-distribution. And the neoliberal attack on the welfare state since the 1980s is not a necessary re-calibration due to changing economic conditions or a growing lack of solidarity among the people but an expression of a modified cost-benefit analysis from the elite's perspective.

Taking into consideration that the recent world financial crisis has been exploited to increase the pressure on the welfare state by introducing austerity measures allegedly in order to sustain public finances, one might argue that the future of the welfare state might look bleak. However, this is not the only possible direction forward: with the digital revolution and the growing importance of social media, the meritocracy's agenda-setting and framing power may be undermined (see e.g., Gillmor 2004; McCombs 2005; Meraz 2009). It may be too early to judge the full consequences of these structural changes in the media landscape, but it might help to relax the "political constraints" of the meritocracy's "TINA" rhetoric.

Moreover, the elite remains constrained by the democratic scrutiny of the majority and the possibility that a high cost on their income can be imposed upon them. Ignoring these constraints by becoming (overly) impudent may also undermine the elite's agenda-setting and framing power: alternative narratives that favour alternative interests will receive more attention and followers, perhaps becoming dominant. This may be good news for leftist parties but, as recent developments suggest, may equally benefit populist parties, bringing them to greater prominence.<sup>21</sup> While leftist parties would point to the growing demand for social security measures, including re-distributional effects in a quickly globalising world (see e.g., Swank and Betz 2003; Houtman, Achterberg, and Derks 2008), populist parties would—in an attempt to turn back the clock and to fight the alleged causes of the incriminated effects—rather than strengthen the national confines by protectionist measures (instead of compensating the potential losers of economic globalisation) possibly mixed with chauvinistic measures to focus any remaining welfare state programmes on national subjects only (see Michel 2014, 171ff).

Obviously, both potential reactions are anti-meritocratic in the sense that they reject the elite's pretention merely to pursue the "common good." Therefore, the elite might be inclined to instrumentalise the anti-meritocratic mood—rather than to regain dominance over the agenda-setting and framing process—by combining populist political conceptions of the "us and them" kind with neoliberal economic and social policies. The Trump administration, one of the richest and most elitist governments in the history of the USA with respect to the socio-economic pedigree of the president and his state secretaries, appears to play this game. However, although there might be conceptual analogies between right-wing populism and neoliberal market fundamentalism (as the basis of meritocratic economic and social policies; see Pühringer and Ötsch 2018), this kind of anti-elitism on the part of the elite resembles a "riding the tiger" strategy—a strategy that Karl Polanyi in *The Great Transformation* saw as responsible for the rise of fascism (Polanyi 1944, 242). Let's hope that history will not repeat itself.

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<sup>21</sup> Populism can be defined "as an ideology that considers society to be ultimately separated into two homogeneous and antagonistic groups, 'the pure people' versus 'the corrupt elite,' and which argues that politics should be an expression of the *volonté générale* (general will) of the people" (Mudde 2004, 543).

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