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A Post-Kaleckian, Post-Olsonian Approach to Unemployment and Income Inequality in Modern Varieties of Capitalism

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The 'big trade-off', described by Arthur Okun some thirty years ago, is back again. Equality or efficiency, or to put it differently again: modern highly developed economies and societies must choose between the Scylla of income inequality or the Charybdis of unemployment. Furthermore, it seems that the continental European economies — foremost Germany and France — have sided with more egalitarian ends accepting higher unemployment. This has occurred whilst the liberal economies such as the United States and the United Kingdom choose higher inequality for lower unemployment. In this paper it is argued that the trade-off is not a supply-side necessity to maintain work effort in a situation of incomplete contracts, but is a politico-economic issue between particular interest groups to seek rents. However, unlike in Mancur Olson's seminal approach, it is not the trade unions which are forming distributional coalitions on the labour market. Rather, it is the meritocracy who are happy to use Keynesian-type demand management in order to advance their material interests by pursuing a 'Meritocratically Optimal Rate of Unemployment' (MORU). © 2006 Peking University Press

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1. INTRODUCTION: THE AGE OF INEQUALITY

The quest for equality — as a means to bolster against poverty and as the expression of social justice — has been strongly attacked as 'egalitar-

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ianism' that destroys market incentives[1] and as being incompatible with full employment in the age of the service economy. Indeed, the issue was addressed as early as the 1970s by Arthur M. Okun[2] under historical circumstances completely different from today's: In the 1970s US income dispersion was decreasing, while unemployment was higher than in most European countries. Furthermore, the world was divided into two different, hostile ideological camps of capitalism and communism. At least from an ideological point of view in the battle of systems during the Cold War, the alleged higher efficiency of the capitalist market economy was not to be paid for by lower equality as this would leave the question of superiority open to different preferences. Captialism could be proven as superior over communism only if it could combine a sufficiently high degree of equality (social justice) with superior economic efficiency (in terms of growth and employment). This would highlight the notorious failure of communism to support (intensive) growth. Moreover, the economies of the European countries — being extremely close to the ideological divide — seemed to be able to fulfil these promises during the 1960s and 1970s particularly well.

Only after the downfall of the Berlin Wall in 1989 and the end of the systems confrontation, the need to combine equality and efficiency has finally disappeared. Interestingly, the renewed (alleged) trade-off between equality and efficiency (in terms of providing high levels of employment) unites the liberal-conservative political and academic camp with most of the parts of the progressive, social democratic political and academic camps. However, whilst the former welcomes the implicit demand for higher inequality[3], the latter somewhat hastily demands for a (albeit hard) choice.[4] It is in this sense that we can speak of the age of inequality: an undisputable trend with undisputable negative consequences (the correlation between raising inequality and growing poverty). It is an ideological issue ('social justice') that centres prominently in political discussions and electoral campaigns, and is an academic discourse that focuses completely on the microeconomic logic of market incentives. Very few dissenting economists have tried to keep a macroeconomic eye on the issue[5] and — to my knowledge — there has not yet been a consistent political economy approach focusing on the obvious material interests involved.

[1] This incentive problem has been put as: 'The poor reduce their labour supply because they earn too much and the rich withdraw their labour supply because they earn too little'. John Kenneth Galbraith's reaction was said to be: 'Who believes this, will believe anything'.

[2] See Okun (1970), Okun (1975).

[3] See e.g. Machan (2002), Davis/Meyer (2000), Henry (1995), Kekes (2003), Giersch/Paqu/Schmieding (1992) and, most infamously, Gilder (1982).

[4] See e.g. Iversen (1999), Scharpf (2001) and Schettkat/Appelbaum (1996).

[5] Most prominently Galbraith (1998) and Harrison/Bluestone (1990).

This is where this paper comes in: I will try to explain a different understanding about the evolution of unemployment and income inequality over the past two decades. I will do this by taking a political economy approach, i.e. which will centre upon the different distributional interests among societal groups in different capitalist economic settings. In part two, I will extend Mancur Olson's seminal approach to the political economy of economic development by focusing on the labour market and by giving Olson's approach a Keynesian twist. In part three, I will refer to Michal Kalecki's famous proposition that unemployment can be used as a strong mechanism to shift power relations in the distributional conflict of capitalism. However I will transform Kaleckis's proposition into a determinant of personal rather than functional income distribution. In part four, I will then join the different proposition strings together and derive an unemployment situation which may be called optimal as it best serves the interests of those largely capitalising from pure market outcome — the meritocrats. Furthermore, it will become apparent that such a 'Meritocratically Optimal Rate of Unemployment' (MORU) may be very diverse over the range of varieties of capitalistic models. In part five, the predictions of the MORU theory will be empirically tested. As we are dealing with vested interests often transmitted into political action through ideological infiltration, the carrier of the message himself is sometimes accused of an ideological bias[6] — that is, why any empirical test of political economy issues is so important.

2. MANCUR OLSON, DISTRIBUTIONAL COALITIONS AND ITS KEYNESIAN TWIST

To apply a Keynesian approach to political economy seems both necessary and fruitful in order to provide the 'missing link' in Keynesian economics: "Keynesian economists had failed to develop a general explanation of governments' unwillingness to supply the aggregate demand policies required to achieve full employment", as John and Wendy Cornwall (2005: 6) claim.

Mancur Olson provides the starting point as he has established one of the most powerful political economy approaches in his 'Rise and Decline of Nations'[7] that directly links income inequality and unemployment. He claims that societies produce ever more interest groups that seek to advance their particular well-being at the expense of the well-being of the society as a whole. Such interest groups are only able to pursue this kind of 'rent-seeking' behaviour — which comes as a public good to all individuals who

[6]Obviously, 'ideology' as an object of scientific investigation is here confused with 'ideology' as a subject guiding (un)scientific investigation.

[7]Olson (1982)

comprise as a group — if the groups are small and homogenous enough to overcome the 'cooperation trap'.[8] Although such interest groups may evolve in every market[9], according to Olson, unemployment is best explained if interest groups on both sides of the labour market are taken into focus. These are trade unions and employer's organisations. For two reasons, in a variety of microeconomic approaches (insider-outsider theories, NAIRU theories, efficiency bargain and right-to-manage models) the supply side has been set at centre stage of the investigations: Firstly, unemployment is usually associated with the notion of 'too high wages' which can better be explained if labour supply (by forming unions) is able to collude an effective distributive coalition. Secondly, once we assume commodity markets as competitive, there would always be pressure to raise real wages by reducing prices — which ought to happen if Walras' Law of markets applies. Therefore, if unemployment becomes a long-term problem of advanced economies, according to Olson, it must stem from the willingness and ability of trade unions to effectively seek rent for their members. These members are mostly low skilled, blue collar workers in manufacturing industries. Hence, the variance in national labour market performances obviously depends on the incubation process of interest groups in general and trade unions in particular throughout the time period without significant institutional, legal or other alterations in a particular society[10]. The longer this time period, the more distributional coalitions, the lower growth and higher unemployment will be. Olson's approach can therefore be described as a theory of 'societal sclerosis'.

Olson's central idea that the pursuit of vested distributional interests may impinge on the general welfare of society, is a challenging one. However his focus on the supply side of the labour market is too narrow. On the one hand, he underestimates what has been called 'the radius of trust' in the literature on social capital, i.e. the possibility and willingness of groups (trade unions in this case) to internalise the external effects of their actions in order to reduce the negative repercussions of rent-seeking behaviour.[11] Secondly, the reasoning rests entirely on the microeconomics of general equilibrium theory. However, if Keynesian macroeconomics are

[8]This has been established and elaborated in his famous 'Logic of Collective Action'; see Olson (1965).

[9]"Such action occurs through professional associations, labour unions, farm organizations, trade associations, and oligopolistic collusions of firms in concentrated industries" (Olson 1996: 74).

[10]Olson (1996: 76) mentions 'revolutionary upheavals', 'totalitarian repression' or 'foreign occupations'. However, drastic institutional change (e.g. under the Thatcher era) may also be counted.

[11]Of course, Olson mentions 'encompassing organisations', which seem to fit the requirements of a wide radius of trust. However, Olson firmly believes that these encompassing organisations are unstable and necessarily dissolves eventually.

to be discussed, unemployment (at its core) may no longer be the result of misguided wage policy but of macroeconomic policy failures. Furthermore, here, income inequality (in an equilibrium position) would no longer be technically determined by the marginal productivity of different jobs requiring different skills. Alternatively it would depend on what society rates as 'fair' and 'tolerable'. This is something James K. Galbraith (1997; 1998) calls 'job or wage structure'.[12] Here, of course, unemployment can be used in order to change established views about 'fair' and 'tolerable' levels of income dispersion, if Keynesian-type macroeconomic policy potentials are not sufficiently used to cure unemployment when it occurs or, even worse, are redirected to create or maintain unemployment. Now, in this post-Olsonian perspective, it would be the demand-side of the labour market, i.e. employers and their organisations, that pursues its vested distributional interests by wasting capacities and reducing general welfare for the society as a whole.

3. MICHAL KALECKI, UNEMPLOYMENT AND INCOME DISTRIBUTION, OR: THE MERITOCRATICALLY OPTIMAL RATE OF UNEMPLOYMENT (MORU)

As John and Wendy Cornwall (2005) claims, most Keynesians[13] failed in posing the question of political limits[14] to the practice of Keynesian-type interventionist employment policies. Yet, this may be at least partly due to the fact, that Keynes himself was not very thoughtful (if not downright naïve) about the possible impact of vested interests on economic policy. Joan Robinson (1976) noted:

> "Keynes liked to believe in the power of ideas to influence the course of history. He sometimes maintained that when the principles of employment policy were understood, economic affairs would be conducted rationally, and he even went so far as to predict a happy future in which our grandchildren could devote themselves entirely to the arts and graces of life."

Robinson also singled out whom she believed to be closer to the real world:

> "Kalecki's vision of the future was more realistic. In a remarkable article published in 1943 on the 'Political Aspects of Full Employment' he foresaw

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[12] "It is a historically, socially, and politically specific set of values and pay relationships in the economy, within and between firms, within and across industries" (Galbraith 1997: 15); see also Galbraith (1998:50ff.).

[13] Particularly Philip Arestis and Malcolm Sawyer (1998) must be explicitly excluded from this charge.

[14] In a mini-symposium on 'Is Keynesian demand management policy still viable?' published in Vol. 17 (1994-95) of the Journal of Post Keynesian Economics, not even one of the papers mentions political limits. There may also be economic limitations due to the lack of cooperation of different policy actors; see Heise (2001), Heise (2005a).

> that when governments understood how to control the commercial trade cycle we should find ourselves in a political trade cycle."

Actually, Michal Kalecki (1943/1990) had not — as is often claimed — described a 'political business cycle'[15] but pointed out that 'the industrial leaders' may not be interested in full employment altogether. As Kalecki was not engaged in the investigation of the connections between the economy, economic policy and the political and electoral system, there is no hint of a political business cycle theory[16] but rather of a 'political equilibrium theory of unemployment' and an indication of how this will be achieved. This is through mystifying an active (i.e. deficit-financed) budgetary policy as 'unsound' and 'perilous' (see Kalecki 1943/1990: 350). A situation of lasting full employment would be, from the perspective of the 'captains of industry'[17], unwarranted on three accounts: 1) In general, they do not want the government to interfere with market processes; 2) they do not want the government to spend money in areas — such as public investment — where there is a potential competition with or crowding out of private investment; 3) they feel that lasting full employment changes the power relations towards the working classes and takes away an effective disciplinary device. These rather cloudy expositions have been re-framed in modern, orthodox labour market theory: In efficiency wage theories, unemployment guarantees to maintain productivity growth. In NAIRU theories, unemployment is needed to prevent the acceleration of inflation. Finally in heterodox, Kaleckian macroeconomics, full employment destroys the social structure of accumulation by squeezing profits[18]. In equilibrium, in order to appropriate profits, capitalists need unemployment or workers will be able to claim any surplus for themselves (in any combination of goods and leisure).[19]

[15]Politico-economic models and cycles have been introduced in the literature by William Nordhaus (1975) and R. Boddy and J. Crotty (1974) who refer to Michal Kalecki's work.

[16]Although he claims to have presented 'a regime of the political business cycle'; see Kalecki (1943/1990: 355). However, he uses the term 'political business cycle' in a completely different way than it has become customary since Nordhaus; see e.g. Henley (1988).

[17]Kalecki uses different descriptions for those, who pursue their special interests through lasting unemployment: 'captains of industry', 'industrial leaders', 'bosses', 'business leaders', 'businessmen', 'big business'. This leaves us without a clear idea of whom he really envisages: capitalists as the class of capital owners and representatives of profit-earners in functional income distribution or executive and high-ranked white collar employees (and also profit-earners) as representatives of the higher income percentiles in personal income distribution. From this context and later work, one can infer that Kalecki is referring to capital owner and, therefore, functional income distribution.

[18]See e.g. Kotz/Donough/Reich 1994; Marglin/Schor 1990; Bowles/Edwards/Roosevelt 2005.

[19]Henley (1988: 439) points to the parallels to Marx's 'reserve army'.

Without engaging in fundamental discussions about functional income distribution, this Kaleckian version of a political economy of unemployment cannot be made easily compatible with two decades of post-war economic history. The co-existence of full employment and a positive profit share in most OECD countries in the 1950s and 1960s would either require the assumption of a disequilibrium situation for the entire period or some degree of monopolistic competition in almost very commodity market. Or, as in Post Keynesian macroeconomics, functional income distribution (and the existence of profits) does not depend on unemployment but rather on a positive rate of interest (which closes the only degree of freedom of the distributional system; see e.g. Sraffa 1960) which is determined by liquidity preference considerations (see e.g. Riese 1981). However, these qualifications do not necessarily eradicate the Kaleckian idea altogether, but might shift the focus of intention from functional to personal income distribution, and from class conflict to meritocratic deliberations. As the expression 'meritocracy' is far from being clearly defined, let us refer to the Fontana Dictionary of Modern Thought (1977: 384):

> "A word coined by Michael Young (The Rise of Meritocracy, 1958) for government by those regarded as possessing merit; merit is equated with intelligence-plus-effort,... Egalitarians often apply the word to any elitist system of education and government,..."

Moreover, according to Benabou (2000: 321), there is "no single, value-free definition of meritocracy, but only preference orderings about equality of opportunities and equality of outcomes". Meritocracy, therefore, must be placed between the one extreme of aristocracy, where opportunities and outcomes are structured only by decent, and the other extreme of egalitarianism, where opportunities and outcomes are entirely equally distributed among the members of a society. Obviously, modern societies have abandoned aristocratic structures and float somewhere between meritocracy and egalitarianism. Despite the degree varying considerably through redistributive welfare arrangements and institutions directly impinging on market outcomes, in every highly developed country some measure of egalitarian redistribution of opportunities and outcomes are employed.[20] Therefore the concept of meritocratic deliberations used for our purpose puts the quest for income inequality at centre stage: in line with economic merits — defined by 'pure' market outcomes accepting an initial endowment of real, financial and human capital — any increase in net income dispersion is welcomed as improving economic efficiency. Obviously, someone who is better endowed with real, financial or human capital would profit materially from any meritocratic policy shift — yet, I do not purport that the better-

[20]Although welfare arrangements have not been historically invented for egalitarian purposes, they do have this effect; see e.g. Baldwin (1990).

offs — or as I will call them in line with the above given description: the elite[21] — necessarily pursue meritocratic aims, as I am not claiming that the non-elite necessarily favours egalitarian ends. This may, for instance, vary considerably with the individual preference structure (materialistic, post-materialistic) or individual perception of income mobility. However, elite studies reveal a strong meritocratic orientation of the elite which has become more pronounced over the past two decades.[22]

To summarise, the above outlined post-Kaleckian version of the political economy of unemployment does not focus on the class struggle over functional income shares but puts forward the idea that unemployment may be (mis-)used by the elite in order to champion meritocratic ideas of personal income distribution. For reasons having been advanced by Lester Thurow (1971) and which we will discuss below, the elite may not want to end redistribution and a compression of the income (and particularly the wage) structure entirely, but seek an 'optimal degree of income inequality'. Or to put it differently: the elite are tempted to address a policy pursuing a 'Meritocratically Optimal Rate of Unemployment', abbreviated as MORU.

4. MORU IN THE VARIETIES OF CAPITALISM

Many studies have shown that unemployment is a strong and significant factor in determining income inequality in general and wage dispersion in particular as measured by a gini-coefficient or by the ratio of highest to lowest income decile (P90/P10).[23] Here, nominal wage increases in relation to labour productivity growth and (expected) inflation — i.e. the 'distributional margin' — will come under pressure if wages are to play

[21]'Elite' is another ill-defined notion. Primarily, it is used for those groups of individuals that are able to take or influence collective rather than merely individual decisions: political, economic, organisational or media elites for instance. I presuppose that there is a strong correlation between being materially better-off and being part of the elite - and that is why I use 'elite', 'better-offs' and 'meritocrats' interchangeably.

[22]This is definitely true for the media, economic and liberal-conservative political elites in Germany. It is also true for the social-democratic political elite that have become markedly more meritocratic over the past two decades. Therefore, it is basically the trade union elite that still takes a non-meritocratic, egalitarian perspective; see e.g. Brklin (1997).

[23]See e.g. Förster (2000) or Volscho (2004) for a comprehensive overview. Jäntti/Jenkins (2001) take a more sceptical view — yet they do not deny the relationship but point to a more complex interaction between unemployment, inflation and inequality. Below, I will discuss in more detail which income variable to be taken in order to capture the inequality visions of the meritocracy. Suffice to say here, that wage dispersion will serve as proxy as wage income is still by far the most important source of income for the vast majority of the people and the link between wage income and unemployment (both being determined on the labour market) is the closest. Furthermore, it has been shown that recent trend in income inequality largely stem from the underlying trends in wage dispersion; see Förster (2000: 8).

any role in signalling relative scarcity. This is one of the best established empirical relations in economics that lies behind the (original) 'Phillips curve'. Here, on the one hand it will, at least temporarily (as long as disequilibrium lasts), shift functional income distribution in favour of capital owners — who may be supposed to belong to the higher income deciles. On the other hand, unemployment always has a strong bias towards the less skilled — i.e. the wages of the less skilled, which can be supposed to belong to the lower income deciles, come under the most pressure. Combining both trends, high income earners relative to low income earners will profit from unemployment — which plainly means that wage dispersion and overall income inequality will rise with growing unemployment. However, the 'inequality elasticity' of unemployment depends on several factors: the overall strength of the social partners at the negotiating table (in terms of union density and coverage rate; see Volscho [2004]) and particularly, the collective bargaining system, the state's involvement in collective bargaining and also labour market and welfare state regulations (EU Commission 2004: 109ff.). There is a clear and very strong relation between the degree of corporatism[24] of a collective bargaining system, the strictness of labour market regulations and the generosity of the welfare state and a solidaristic wage policy stance in terms of the compression of the qualificational wage structure.[25]

These different characteristics can be sensibly clustered to form two 'models': 'corporatist' and 'liberal' (see tab. 1). Since Esping-Andersen's (1990) famous distinction between different 'worlds of welfare capitalism', many attempts have been made to group different countries. While Amable (2003) proposes as much as five different ideal types of capitalism (market-based, social democratic, Asian, continental European and South European models), Michel Albert (1991) differentiates between an Anglo-Saxon and a Rhenish model of capitalism and Hall/Soskice (2001) identifies the liberal

[24]By corporatism, I not only mean the de jure centralisation of the wage bargaining system (i.e. at company or regional or nation-wide level) but also its de facto cooperation between regional and sectoral levels, union density and coverage rates and state involvement. Germany, for example, is often taken at face value — i.e. wage bargaining struck at regional-sectoral levels, — yet the high efforts of cooperation of the trade unions under the roof of the Deutscher Gewerkschaftsbund is not praised accordingly. Moreover France, for instance, shows low union density and de jure decentralised wage bargaining, but a very high coverage rate, a decent degree of cooperation of unions and a high state involvement in labour market regulations which would not be correctly mirrored if France would be rated at low corporatism level.

[25]See e.g. Barth/Zweimüller (1995), Zweimüller/Barth (1994), Moene/Wallerstein (1996) and, particularily OECD (1997) where the combinations here termed 'corporatism' are tested. There are but two exceptions from this very close link: Austria and the Netherlands which both manage to provide a rather wide qualificational wage dispersion under a very centralised wage bargaining system - both countries will acquire a special status in this study.

market economies (LME) and the coordinated market economies (CME). Without spending too much time on comparing the different categorisations, I will — for the sake of simplicity and measurability and sufficient for my limited scope — side with Albert and Hall/Soskice in broadly distinguishing, at this point, a 'corporatist bargaining model' which is very much in line with Albert's 'Rhenish capitalism', Hall/Soskice's CME and a 'liberal bargaining model' aligned with Albert's 'Anglo-Saxon Model' and Hall/Soskice's LME. Renowned from several studies (see e.g. Alesina/Di Tella/MacCullock 2001; Delhey 1999), we may also distinguish between different cultures of inequality which may form a second dimension to be added to the institutional distinction: the 'liberal culture' allows for the acceptance of high income inequality, while a 'Scandinavian culture' is much more averse to inequality and, in between, a 'Continental culture' of intermediate inequality acceptance can be singled out. In tab. 1, the two dimensions are combined and those countries classified that will be empirically tested later.

TABLE 1.

Varieties of Capitalism in selected OECD countries

	LME	CME
Liberal inequality culture	USA, CAN, UK, NZL, AUS	
Continental inequality culture		F, GER, NL, B, A, I
Scandinavian inequality culture		SWE, DK, N

Source: Amable (2003); Wallerstein/Golden (2000); OECD Employment Outlook 1999; Golden/Lange/Wallerstein (2002); Delhey (1999)

The next step will be to determine a rate of unemployment, which — taking the different cultural backgrounds and institutional settings seriously — will best serve the interests of the meritocracy: a Meritocratically Optimal Rate of Unemployment (MORU). In order to do so, we assume a positive relation between unemployment and income inequality, and for the sake of simplicity, we take the 'income dispersion function' (ID) to be linear:

$$ID : \Pi = aU; \tag{1}$$

Π =Income dispersion as measured by D90/D10, a = institutional parameter covering LME and CME; U = unemployment rate

The institutional parameter will be standardised as 1 in order to cover CME's and as 2 in order to cover LME's.

Moreover a link between the level of income inequality and the interests of the meritocracy is established. For reasons exposed above, the highest income decile[26] here is taken as proxi for those comprising as the elite which I have chosen to call 'meritocracy' — and the utility derived from their (absolute as well as relative[27]) income measures the interests of the meritocracy. Furthermore there are several reasons why the utility (and even underlying income) may eventually reach a maximum with growing income inequality, i.e. with growing relative income: a) increasing inequality is accompanied by growing political instability which may harm economic growth and (gross) income generation in general, but may also impinge on crime prevention and property protection cost in particular. Thus inequality may be detrimental to the (net) income of the meritocracy (see e.g. Persson/Tabellini 1991 and Thurow 1971); b) increasing income inequality, simply by reducing the overall marginal propensity to consume, may reduce aggregate demand expectations and therefore reduce private investment outlays and, subsequently, private consumption spending (see e.g. Heise 1999); c) research into social capital has established a clear (negative) link between income inequality and social capital in a society and also created a clear (positive) link between the stock of social capital and economic growth (see e.g. Halpern 2005); or d) it may, as Lester Thurow (1971: 327) puts it, depend on the "aesthetic taste for equality or inequality similar in nature to a taste for paintings".

The meritocracy's utility function u_M takes the following form:

$$u_M = b\Pi - \Pi^2; \tag{2}$$

$b =$ cultural factor measuring inequality acceptance

However, the 'optimal degree of inequality' (i.e. where the utility function of the meritocracy reaches its maximum) will vary according to the established cultural embedding of individual tastes and values: again we standardise b as 3 in order to cover the Scandinavian culture, 4 to cover the Continental culture and 5 to cover the liberal culture. The more egalitarian values and attitudes a society professes (i.e. the lower b), the higher will be the cost (in terms of growth detriment and crime prevention) of growing income inequality and, therefore, the lower the 'optimal degree of inequality'. Important to notice is that this inference has been made from the perspective of a meritocracy embedded in a specific cultural setting.

Finally, it is only a small step to determine the 'Meritocratically Optimal Rates of Unemployment' (MORU). If there is anything like an optimal position in personal income distribution and unemployment is a strong ex-

[26]It would be very reasonable to choose the highest income quartile (P75) as proxi for the meritocracy in order to widen the scope of investigation. However, if at all (see below) comparable data is available for only the lowest, the middle and the highest income deciles.

[27]"Individuals are not just interested in their own incomes. The incomes of other individuals may appear in their own utility functions" (Thurow 1971: 327).

planatory variable in income inequality, there must certainly be a magnitude of unemployment which can be associated with the establishment and maintenance of those model-specific distributions. This can be formally proved by solving (2) under the condition of (1):

$$u_M = b(aU) - (aU)^2 \tag{3}$$
$$= baU - a^2U^2 \tag{4}$$

The utility maximum will be determined by setting the first derivative $\triangle u_M / \triangle U = 0$:

$$0 = ba - 2a^2U \tag{5}$$
$$U = ba/2a^2 \tag{6}$$

In order to get the model specific Meritocratically Optimal Rates of Unemployment, we would have to insert the respective (standardised) institutional and cultural parameters a and b into equation (6) as in tab. 2:

TABLE 2.

Varietes of MORUs

	Bargaining model (institutional parameter a)	**Value system** (cultural parameter b)	**Incentives**
High MORU			
$MORU_{concor}$ ($U = 2$)	Corporatist (centralised) ($a = 1$)	Continental ($b = 4$)	Low inequality elasticity + intermediate inequality tolerance
Medium MORU			
$MORU_{scancor}$ ($U = 3/2$)	Corporatist ($a = 1$)	Scandinavian -egalitarian ($b = 3$)	Low inequality elasticity + low inequality tolerance
$MORU_{liberal}$ ($U = 5/4$)	Liberal ($a = 2$)	Liberal ($b = 5$)	High inequality elasticity + high inequality tolerance
Low MORU			
$MORU_{condec}$ ($U = 1$)	Corporatist (decentralised) ($a = 2$)	Continental ($b = 4$)	High inequality elasticity + intermediate inequality tolerance

It is the highest, if a corporatist bargaining model is coupled with a continental value system showing an intermediary egalitarian stance (MORU-concor). The MORU is lowest, if a corporatist bargaining system that al-

TABLE 3.
Hypothetical equilibrium levels of unemployment and income inequality in varieties of capitalism

		MORU		
		Low	Medium	High
Income inequality Culture	Low		Scandinavian, corporatist CME	
	Medium	Continental, decentralised CME		Continental, centralised CME
	High		Liberal LME	

lows for high(er) wage dispersion meets a continental value system (MORUcondec).[28] Furthermore there are two intermediary MORUs if a liberal bargaining system is mixed with a liberal, non-egalitarian value system (MORUliberal) or if a corporatist bargaining system meets a Scandinavian-egalitarian value system (MORUscancor).

Before we will take a closer look at the empirical backing of the exposed political economy of meritocracy, let us first formulate a hypothesis that can be derived from what has unfolded above (tab. 3). It can be seen that the Continental CMEs are sub-divided into a group of countries that are labelled as 'centralised' and another group of countries — the Netherlands and Austria — which are labelled 'decentralised'. This distinction is made in order to take the specificity of those two countries into account which is a-typical to CME's: a distinctly higher dispersion elasticity of unemployment (i.e. a higher parameter a). In a meritocratically optimal equilibrium, we would expect these continental economies to have the lowest unemployment rate which organises a high level of wage dispersion within a corporatist bargaining setting, i.e. this would be illustrated by a rather high income inequality. In liberal economies, we would expect a simultaneity of high income inequality and an intermediate position with respect to unemployment. Although the Scandinavian corporatist economies also would be expected to hold an intermediate position with respect to unemployment, income inequality must be much lower here. Moreover, the corporatist-continental economies would be expected to show an intermediate position with respect to income inequality, yet the highest unemployment rate of all country clusters.

[28] I am not describing all possible MORUs but only those which will be tested empirically. If there were economies that would couple a liberal bargaining system with an egalitarian value system, we would expect them to have the lowest MORU.

TABLE 4.

Hypothetical trends in unemployment and inequality in varieties of capitalism

		△UNR		
		Low	Medium	High
△ ID	Low		Scandinavian, corporatist CME	Continental, centralised CME
	Medium	Continental, decentralised CME		
	High		Liberal LME	

For at least three reasons, we should also examine trends (i.e. changes in time) rather than exclusively levels: 1) no economy will ever be in a position of stable equilibrium and, 2) we cannot expect the meritocracy to be able to completely achieve its goals in terms of pushing the economy towards a position which would best serve their interests; 3) comparable data on unemployment rates as well as income inequality still demonstrates a high degree of imponderability with respect to levels (see e.g. Moran 2005), but should be more reliable with respect to developments. Therefore, we would have to work out what development we would expect the different country clusters to take (see tab. 4) if they were to all begin from the same position, which would be a position of (near) full employment coupled with a rather egalitarian wage and income structure - i.e. a description which fits the situation very well at the end of the 'golden age' in the 1970s. Both, in the Scandinavian-coordinated economies as well as in the Continental-centralised economies we would expect a rather low increase in income dispersion due to the 'sheltering' institutions (low a). However, the latter will have to pay a higher price — i.e. higher increase in unemployment — because the higher inequality aversion in the Scandinavian-coordinated economies may render high and lasting unemployment that would be dangerous with respect to the interests of the Meritocracy (lower b). In the LMEs with liberal culture, unemployment would have increased quite similarly to the development in the Scandinavian-coordinated economies — as they both show intermediary MORUs — yet at much higher income inequality dynamics. Finally, there are CMEs featuring a Continental culture that allows for distinctly higher income dispersion (i.e. the decentralised CME).

5. EMPIRICS OF MORU

Before we go into the empirics, let us discuss which variable we would ideally like to look at and, under the constraints of only limited comparable data availability, which proxy to take. First of all, it must be remembered that we are going to take the perspective of the meritocracy. 'Meritocracy' has been proxied by the 'highest income percentiles' which is usually taken as the highest income decile (for methodological reasons, the 9th decile). However, the question arises as to which income category ought to be taken: gross or net income, individual or household income, wage or overall (including capital) income? As a meritocratic perspective is taken — i.e. earnings according to merits depending on the endowment with human, financial and real capital and its implementation within different markets — individual, overall, net income seems to be most appropriate. However, although differences in absolute levels of income dispersion between different concepts may be quite substantial and some reordering of country rankings may be possible (which is probably most pronounced in the case of Austria; see e.g. Pontussen 2000: 297ff. and Guger/Marterbauer 2004), the differences in gross and net income varying across the different countries and country clusters and non-wage income seems to be more important for the meritocracy than for any other income-group in society. Furthermore, the results are not very sensitive with respect to the income concept chosen (particularly if trends rather than levels are measured) for the following reasons: 1) trends in disposable income distribution and individuals gross earnings are very similar (see e.g. Smeeding (2002: 195) and compare with inequality trends as displayed in tab. 5); 2) redistributing welfare systems narrow inequality levels but follow the exact trend of market inequality, i.e. more egalitarian economies (with respect to market (gross) income) show higher levels of redistribution (with respect to outcome in net incomes) than less egalitarian economies[29], and the trends in rising market income inequality are mirrored by the trends in lowered redistribution (see e.g. Kenworthy/Pontussen 2005; Burniaux 1998); 3) the most important factor in determining levels and trends of income inequality is by far the underlying levels and trends of wage dispersion — and this result is robust to changes in the method of decomposing earnings into different income categories (see e.g. Burniaux 1998; Förster 2000).

There are basically two sources that would be able to provide internationally comparable data on levels and trends of income inequality: the Luxembourg Income Study (LIS) and the OECD Labour Market Statistics. As the LIS provides disposable income data based on household income rather than individual income, this study relies on the OECD Labour Market Statistics. Although the national definitions and sources are not

[29] Which has been called 'paradox of redistribution' by Iversen/Soskice (2004).

entirely similar and the data does not cover the same time period for all countries, this seems to be as close as we can get to standardised and comparative data and, for the reasons outlined above, it will surely suffice with respect not only to income trends but may also be taken as moderately reliable with respect to a comparison of levels.

In order to test the exposed theory of MORU, we need enough variance in unemployment and income inequality over time and among the different countries. As can be seen from tab. 5, at the end of the 1990s — after three major economic crisis — the picture of almost full employment in the early 1970s in all countries under investigation has changed: unemployment has not only more than doubled to an average of 5.6%, the variance has also more than doubled — i.e. some countries must have coped much better than others. The same is true for income inequality (and underlying wage dispersion): over the past two decades it has not only considerably increased but the texture of inequality has also become pronouncedly different (with a much higher variance). Again, some countries have suffered (or allowed for) much more dispersion than others — and it will be our task to discover if there are distinguishable patterns.

In tab. 6, the results are exposed with respect to levels of unemployment and income inequality: as expected Denmark, Sweden and Norway forming the Scandinavian, corporatist model show only a moderate increase in unemployment and income inequality as they produce a medium MORU and are very reluctant to inequality. Canada, the United States, the United Kingdom, Australia and New Zealand make up the liberal model. However these countries show a moderate increase in unemployment and rather high change in income dispersion, while Germany, France, Italy and Belgium comprising the centralised continental model had to pay its only small increase in income inequality with a marked increase in unemployment — something which the Netherlands and Austria (taken separately to form the decentralised continental model) were able to prevent (low unemployment). This was due to an allowance for higher inequality — exactly as predicted. The country clusters not only happen to follow exactly the hypothetical patterns put forward above (compare tab. 6 to tab. 3) but also show only small variances — which is to say that differences among the countries forming a cluster are low (which one would expect, if the cluster makes sense).

The picture does not change at all if we examine the trends in unemployment and income inequality (see tab. 7): Again, reflecting the hypothesis, we see a very distinct pattern of changes across the varieties of capitalism with, in part, extremely high degrees of coherence amongst the

TABLE 5.

Unemployment and income inequality in the early 1970s and late 1990s

	UNR (mid-70)	UNR (end-90)	Change UNR	Income dispersion (end-70)	Income dispersion (end-90)	Change ID
NL	2.9	2.5	−0.4	2.56	2.91	+0.35
DK	2.8	4.4	+1.6	2.15	2.15	+0.0
Ger	1.8	7.8	+6.0	2.88	3.04	+0.16
SWE	2.0	4.9	+2.9	2.03	2.22	+0.19
NOR	1.5	3.3	+1.8	2.05	2.08	+0.03
F	2.8	8.5	+5.7	3.25	3.05	−0.20
B	2.3	6.7	+4.4	2.30	2.20	−0.10
I	5.0	10.4	+5.4	2.32	2.40	+0.08
A	1.3	3.6	+2.3	3.45	3.66	+0.21
USA	5.6	4.0	−1.6	3.78	4.57	+0.79
CAN	5.0	6.8	+1.8	4.02	4.17	+0.15
UK	2.0	5.0	+3.0	2.91	3.45	+0.54
NZL	0.5	3.9	+3.4	2.89	3.41	+0.52
AUS	2.7	6.3	+3.6	2.73	2.87	+0.14
(unweighted) Average	2.7	5.6	+2.8	2.81	3.01	+0.20
Variance	2.2	5.08	+4.79	0.399	0.603	+0.204

Note: 'mid-70' refers to the respective year with lowest unemployment in the first half of the 1970s; 'end-70' refers to the last year before inequality started to rise — never later than 1979; 'end-90' refers to the end of the business cycle in the late 1990s/early first decade of the 21st century (unemployment rates) and respective year for income dispersion (if available; otherwise the latest available year is taken).

Source: UNR = internationally standardised unemployment rates: OECD (2005); Income dispersion = 9th decile/ 1st decile; daily, weekly or monthly gross earnings: OECD-Labour Market Statistics DATA and OECD (1996) for Austria and Norway. For Norway, data is only available for 1991. See appendix: earnings documentation.

TABLE 6.
Unemployment and income inequality at the end of the 1990s in varieties of capitalism; absolute levels

		MORU		
		Low	Medium	High
Income inequality	Low		(SWE; DK; Nor) UNR:4.2 [0.67] ID: 2.15 [0.01]	
	Medium	(A; NL) UNR: 3.0 [0.605] ID: 3.28 [0.281]		(Ger; F; B; I) UNR: 8.4 [2.4] ID: 2.67 [0.192]
	High		(USA; UK; AUS; NZL, CAN) UNR: 5.2 [1.7] ID: 3.69 [0.453]	

Notes: Italic numbers in square brackets show the variance among country clusters. The overall variance in unemployment rates is 5.08 and in income dispersion 0.603.
Source: See tab. 5

country clusters[30] — i.e. the overall variance is an inter-model variance, not an intra-model variance. The results are clear: Scandinavian, corporatist economies are more successful in terms of unemployment increases as they are, on the one hand, less tolerant to inequality and, on the other hand, have allowed for a slightly stronger increase in inequality than the Continental, centralised countries. The liberal economies experienced a strong rise in inequality which was triggered by a modest increase in unemployment, while the Continental decentralised economies paid for the good labour market performance by an intermediary rise in income dispersion despite its low tolerance for inequality (as compared to the liberal model).

To make the empirical picture complete, let us come back to Okun's 'big trade off' mentioned at the beginning. In tab. 8, equations (2) and (3) show that there is definitely no statistically significant correlation between the level of unemployment and the level of income inequality but only a rather

[30]The rather poor performance of the continental, decentralised cluster with respect to variance in unemployment trends is not really a surprise as we only have a sample of two countries. Furthermore, in the case of the liberal economies, the rather high variance stems only from the exceptionally well development of unemployment in the US as compared to the early 1970s which is due to a number of very distinct factors. Only one of these factors is that unemployment rates in the USA are seriously underestimated as a large part of long-term unemployment is represented through prison inmate figures rather than unemployment figures; see e.g. Katz/Krueger (1999) or Western/Beckett (1999). If the data was corrected for these underestimations, the variance would drop to below 1.0.

TABLE 7.

Changes in unemployment and income inequality in varieties of capitalism (absolute change since 70s)

		$\triangle$ UNR		
		Low	Medium	High
$\triangle$ ID	Low		(SWE; DK; Nor) UNR: +2.1 [0.490] ID: +0.04 [0.018]	(Ger; F; B; I) UNR: +5.4 [0.482] ID: −0.01 [0.028]
	Medium	(A; NL) UNR: +1.0 [3.645] ID: +0.28 [0.008]		
	High		(USA; UK; AUS; NZL, CAN) UNR: +2.0 [4.628] ID: +0.42 [0.086]	

Notes: Ialic numbers in square brackets show the variance among country clusters. The overall variance in changes of unemployment rates is 4.79 and in changes in income dispersion 0.204.
Source: See tab. 5

weak, yet significant correlation between the change in income inequality and the change in unemployment (regressions 5 and 6) — which is usually taken as argument for the quest for higher income differentiation as a prerequisite for higher employment growth.[31] If the inverse causation running from unemployment (changes and levels) to inequality (changes and levels) suggested by the exposed MORU theory was correct, the rather weak and insignificant correlations would depend on the model-specific variations resulting in non-linear relations between dependent and independent variables. Once this is taken into account by introducing a simple variable catching the affiliation of individual countries to specific country clusters, we would expect a clear rise in the strength and significance of the relationships. As we can see from regressions 1 and 4 in tab. 8, this is actually the case — rendering not only the independent variables 'change in unemployment rates' significant (in equation 1 and more significant in equation 4), but also the variable 'Model' and the whole specification (see F test) and it reduces clearly the risk of misspecified functions (as in equations 5 and 6).

[31] As the International Monetary Fund (IMF) and the Organisation for Economic Cooperation and Development (OECD) play leading roles in propagating the 'big trade off', this is sometimes called 'IMF-OECD orthodoxy'; see e.g. Siebert (1997); IMF (2003); OECD (1997).

TABLE 8.

OLS regression results — Inequality and Unemployment

	(1) IDEnd90	(2) IDEnd90	(3) IDEnd90	(4) $\triangle$ ID	(5) $\triangle$ ID	(6) $\triangle$ ID
UNREnd90			$-.041$			$-.055*$
$\triangle$ UNR	$-.173*$	$-.138$		$-.079***$	$-.069**$	
Model	.376 **			.106*		
R-Square	.425	.151	.018	.517	.329	.220
F test	4.063 **	2.142	.219	5.876 **	5.877 **	3.427*
DW test	2.282	1.515	1.390	1.869	1.033	.937
N	14	14	14	14	14	14

Notes: IDEnd90 = $P90/P10-$ratio at the end of the 1990s; $\triangle$ID = absolute change in income distribution between the end of the 1970s and the end of the 1990s; UNREnd90 = internationally standardized unemployment rate at the end of the 1990s; $\triangle$ UNR = absolute change in unemployment rates between early 1970s and late 1990s; Model = variable catching different model affiliation; $***$ =significant at 1% error level; $**$ =significant at the 5% error level, $*$ =significant at the 10% error level; DW test = Durbin−Watson test on autocorrelation; N = number of cases.
Source: See tab. 5.

6. CONCLUSION: MORU AND THE POLICY OF FULL EMPLOYMENT IN THE EU

The empirics are so strong that the proposed political economy of meritocracy cannot easily be ignored. However, this is not the place for a conspiracy theory of unemployment. It would certainly be oversimplifying to argue that the political actor — i.e. governments and central banks — care only for meritocratic interests. Even if the very individuals who are acting on behalf of the political actor were taken as part of the meritocracy, in a democratic electoral environment it would be difficult for them to outspokenly pursue their interests if they cared about being re-elected. Therefore, meritocratic interest can only be pursued if the interests have been successfully put forward and connotated as ‘common good’. Within the confines of this article, it is impossible to show how this common good can be achieved in general, and has been achieved in the particular countries under investigation here. What seems obvious is that the meritocracy as a group is too amorphous to pursue its vested interests by way of organising a pressure group.[32] Therefore, it seems much more promising to follow Gramscian lines of hegemony in order to understand how ideolo-

[32] Which does not rule out the possibility of ideological networks to be formed that may act as pressure group: The Mont Pelerin Society is an organisation which works in secrecy but has a strong world wide influence on agenda building and agenda setting processes; see e.g. Desai 1994, Collard 1968).

gies favouring certain interests may and have become dominant (see e.g. Cockett 1995; Cox 1996; van der Pijl 1995).

The instrumental transmission mechanism of meritocratic interests is more obvious: again, Michal Kalecki foresaw already as early as the mid-1940s how meritocratic politics will nevertheless prevail, even if the meritocracy represents only a tiny minority of society and their interests stand against the interests of the general public welfare: By way of de-legitimizing or de-capabilising Keynesian macropolicies[33] in academic and public discourses and enthroning orthodox policies of 'sound money' and 'sound finance'[34], the economic policy maker gets the instruments of coarse-tuning meritocratic unemployment at hand whether he is aware of it or not. By way of 'under-cover, hidden' Keynesian macropolicies Kalecki nevertheless has instruments to fine-tune unemployment if the respective MORU is close at reach[35]. Furthermore, academics fail to address the obvious discrepancies between outspokenly neo-liberal, supply-side advocates ('read my lips') and the very same having pursued a macropolicy which most closely resembles Keynesianism: the Reagan and George W. Bush administrations in the USA and the Thatcher administration in the UK. What seems to be a puzzle and can, therefore, only be addressed as 'ironic', as has been done by Norbert Andel in his presidential speech to the International In-

[33]In a first round, the 'monetarist counter-revolution' made Keynesian policies accountable for the stagflation problems and growing public indebtness of the 1980s and 1990s. In a second round, globalisation has been claimed to undermine the capabilities of Keynesian policy making at national levels. Both blows together were severe enough to turn even progressive, non-economic social scientists and social democratic policy makers away from Keynesian demand management; see e.g. Scharpf (1991); Iversen (1999).

[34]The actual transmission from interests to ideology and then to public policy in modern media democracies, have been presented by this author against the background of German Social Democratic Politics; see Heise (2005b).

[35]Which is a very important part of the story as the political situation may easily become unstable if growing inequality (and poverty) would be paralleled with rising unemployment. This can be seen for example through the infamous 'Toxteth riots' at the beginning of the Thatcher era when unemployment soared and inequality began to rise dramatically. The meritocracy has no interests in surpassing 'its MORU'. Again, the actual making of the policies must not necessarily be downright meritocratic, but may, for instance, come about by a 'pragmatic' monetary policy taking unemployment (or the 'output gap') in a symmetric way into consideration (i.e. the policy reaction function includes output gaps just as much as inflation gaps). This may explain why the monetary policy of the FED is typically regarded as more 'pragmatic' than the monetary policy of the ECD or its forerunner, the Deutsche Bundesbank (see e.g. Fritsche et al. 2005 or Siklos 2004). On the other hand, the anti-inflation bias associated with 'sound monetary policy' plays a crucial role in keeping up pressure on inequality (directly and via unemployment; see e.g. Lippi 1999: 63ff.).

stitute of Public Economics[36], is perfectly understandable in the context of a political economy of meritocracy.

What are the consequences of the political economy of meritocracy exposed above? Firstly, it is important to address the interests and hidden agenda involved. Quite as it was Mancur Olson's approach, in order to let the public welfare prevail, distributional interests must be rejected and 'distributional coalitions' abolished. This, however, is not as easy as it sounds because the meritocracy does not 'seek its rents' through organisations that act as monopolies on markets, but rather through elite pressure that monopolises public opinion ('pensée unique'). In such a state, only educating the public can work, and a less uniform ideology of mass political parties (i.e. veritable 'political competition') would help. Secondly, one may be tempted to think of reducing the inequality tolerance of society by, for instance, a collusion of those suffering most from the policy of meritocracy: the low skilled unemployed. However, this may result in a politically very costly and probably uncontrollable path if it helps radical parties to settle and grow in the political spectrum. Thirdly, one might think of joining the continental, decentralised model by increasing the inequality elasticity of unemployment. However, there are also drawbacks to this solution: On the one hand, there seems to be a trade off between inequality and efficiency in terms of productivity growth. An egalitarian wage policy has, for instance, always served as 'productivity whip' in Sweden and a productivity slowdown is alleged to have accompanied the good employment performance of the Netherlands (see Naastepad/Kleinknecht 2004; Kleinknecht 2003). On the other hand, dispersing the wage scale, particularly at the low skilled end, may reduce employer's incentives to train the workforce and can severely harm production systems that are based on vocational education (e.g. Germany; see Rogers Hollingsworth 2000: 284ff.). However most importantly, this solution is based on the capability of the political actor to use monetary and fiscal policy measures in order to fine tune the economy (although this will not necessarily be the announced policy). If, albeit, governments have 'tied their hands' to principles of 'sound money' and 'sound finance' not only ideologically but also institutionally — as is the case in the European Union with the independence of the European Central Bank and the establishment of the 'Stability and Growth Pact' —, they may find it difficult to pursue the kind of expansionary macropolicy needed to reward growing wage dispersion and income inequality.

We have to face reality: in economic particulars, everything is directed towards the distribution of outcomes. This is the case in direct economic encounters on markets. It is also the case in societal encounters most di-

[36] "It is ironic that in the same country where the counterrevolution against the keynesian revolution originated, the conservative government uses dept finance to an extent without any parallel in the time of peace" (Andel 1986: 11).

rectly through social policies and, of course, through economic policies in general. To believe, as Keynes seemed to, that there are 'objective' economic policies based on the 'correct' understanding of the 'real economic world' and which are 'functionally' addressed to cure economic problems (as the dentist cures tooth aches[37]) does not take into account that economic policy is embedded within a political system that must accommodate diverse interests. Mancur Olson (1996: 92) concluded a summing up of his theory in the following:

> "The most important implication of the analysis, however, is that the only real solution is for societies to acquire a better understanding of economics and of the present argument. ... No historical process that is understood is inevitable."

Despite my disagreement with Olson's particular approach and my alternative way of looking at politico-economic matters, this general statement can certainly and wholeheartedly be embraced.

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[37] "But, chiefly, do not let us overestimate the importance of the economic problem, or sacrifice to its supposed necessities other matters of greater and more permanent significance. It should be a matter for specialists — like dentistry. If economists could manage to get themselves thought of as humble, competent people, on a level with dentists, that would be splendid" (Keynes 1930/1972: 332).

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