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Economic Ideas and the Labor Market:

Origins of the Anglo-American Model and Prospects for Global Diffusion*

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Published in 1861, Sir Henry Sumner Maine's Ancient Law is today mostly forgotten with the exception of its "law of progress": that "the movement of the progressive societies has hitherto been a movement from *Status to Contract*."¹ For Maine, "status" was the legal identity associated with continuing social relationships, such as those between master and slave or servant and between family members. These relationships carried definite rights and responsibilities that were, however, dissolving during the nineteenth century, giving rise to Maine's Whiggish "law." Yet Maine's observations would come as little surprise to Morton J. Horwitz, whose prize-winning book, The Transformation of American Law, 1780-1860,² showed how the common law was transformed during Maine's lifetime from a relatively egalitarian set of norms and equitable conceptions of contract to a formalistic approach that eschewed responsibilities in favor of limited contractual commitments. The new approach hastened the economic development of the United States by facilitating economic relationships and by bestowing benefits on merchants and industrialists. The transformation of employment law was less rapid; master-and-servant doctrines favoring employers held sway until late in the nineteenth century, even as the at-will dismissal rule was taking hold.³

Contractualism fit well with utilitarian and voluntarist social philosophies such as those of Jeremy Bentham and, later on, of Herbert Spencer. In economics, it corresponded to the laissez-faire doctrines espoused in the late nineteenth century by economists such as William Graham Sumner and John Bates Clark, the latter a progenitor of the new "neoclassical" approach. Yet despite the economists' enthusiasm for laissez-faire, the real world was one in which efforts constantly were being made to remedy the shortcomings of free markets and free trade. This was Karl Polanyi's "double movement," wherein the extension of an ostensibly self-regulating system of markets brought a spontaneous countermovement of efforts to repair the dislocations and defects caused by market expansion. According to Polanyi, one organizing principle of society was economic liberalism and market expansion; the other was "the principle of social protection aiming at the conservation of man and nature . . . using protective legislation,

¹ Sir Henry Sumner Maine, *Ancient Law* (London, 1931), 141.

² Morton J. Horwitz, *The Transformation of American Law, 1780-1860* (New York, 1977).

³ Sanford M. Jacoby, "The Duration of Indefinite Employment Contracts in the U.S. and England: An Historical Analysis," 5 *Comparative Labor Law* 85 (1982); Karen Orren, *Belated Feudalism: Labor, the Law, and Liberal Development in the United States* (Cambridge, 1994).

restrictive associations, and other instruments of intervention as its methods.”⁴ In England and especially the United States, these efforts ran up against a hostile judiciary that could draw from their quivers a formidable array of economic, social, and legal doctrines with which to slay regulatory attempts. The story is well known in employment and labor law, where the courts--whether in *Lochner* or *Adkins*--held back an array of protectionist legislation.

Polanyi wrote during the Second World War. With the benefit of hindsight, he could see what Henry Maine could not: that the double movement was the dominant strain in Anglo-American history rather than the unidirectional transition from status to contract. Horwitz’s second volume, focusing on the United States during the period from 1870 to 1960, tells a very different story than his first.⁵ Here he discusses the wide-ranging effect of Progressivism on the law: in the critique of contractual formalism, the decisions of Justice Oliver Wendell Holmes, Jr., and in the Legal Realist approach of the 1920s. The shift in legal norms contributed to the establishment of the American regulatory state. So too did the writings of a slew of Progressive intellectuals, from philosophers like John Dewey to institutional economists like John R. Commons and the macroeconomists who followed in John Maynard Keynes’s footsteps. In the labor and employment sphere, the litany of legislative achievement is well known: Norris-LaGuardia, the Wagner Act, the Social Security Act, the Fair Labor Standards Act, and, after the war, the Employment Act, the Civil Rights Act, and the Occupational Safety and Health Act, to name but a few. When combined with the expansion of the labor movement and, later, the civil rights movement, these changes had an enormous impact on American society--an accretion of worker and citizenship rights.

At the workplace level, where seniority rules and dismissal restraints now held sway, the effect of public and private forms of regulation was to create new obligations and more enduring relations between worker and employer. For historian Frank Tannenbaum, who published *A Philosophy of Labor* in 1951, these events--especially mass unionism--constituted a dramatic turn from contract to “status” for American

⁴ Karl Polanyi, *The Great Transformation: The Political and Economic Origins of Our Time* (Boston, 1957), 132. Polanyi also claimed that there was no such thing as pure laissez-faire because the expansion of markets was facilitated by continuous government efforts to establish regulatory frameworks to insure that markets could work.

⁵ Morton J. Horwitz, *The Transformation of American Law, 1870-1960* (New York, 1992).

workers, a development that he welcomed because it gave meaning to an otherwise anomalous industrial society. For others, such as labor economist Arthur M. Ross, the reduction of labor mobility associated with seniority and pensions was also a return to status, but he dubbed it more darkly “a new industrial feudalism.”⁶ Writing at the same time as Tannenbaum, sociologist T.H. Marshall (in lectures delivered at Cambridge in 1949) interpreted the rise of welfare-state legislation and the expansion of higher education in Britain as the completion of a process started in the eighteenth century, when individuals had acquired civil rights, followed by the attainment of political rights in the nineteenth century. Finally had come the “right to a modicum of economic welfare and security,” which was based on the status of citizenship. Whereas status in feudal society had been a hallmark of inequality, citizenship in modern industrial society was egalitarian both in its rights and duties (to work and pay taxes).⁷

Since the 1970s, however, Maine’s screw has turned again, this time in reverse. We are now witnessing a shift from status to contract, particularly in Britain and the United States. A wave of deregulation and privatization has swept government, eroding the social rights Marshall wrote about fifty years ago. In the workplace there has been a noticeable move to more market-oriented, contractual, employment relationships. The courts have moved away from legal realism to more libertarian modes of analysis, spurred, in part, by the law and economics movement. Government policymakers too, have fallen under the sway of a new *laissez-faire* strain in economic analysis.

This essay surveys economic thought in Britain and the United States to assess the influence that economists have had on developments in the marketplace and in government (and also to show reverse causation; economic thinking is less free of historical circumstances than economists appreciate). Next it examines whether recent Anglo-American developments are reproducing themselves in other parts of the world, that is, whether we see synchronous swings from status to contract in continental Europe and Japan. Finally, the essay asks what the future holds in store for labor and

⁶ Tannenbaum, *A Philosophy of Labor* (New York, 1951). Although one might think that Tannenbaum was overly optimistic about the shortcomings of status, it should be kept in mind that his specialty was the history of slavery, with a focus on Latin America.

⁷ T. H. Marshall, *Citizenship and Social Class and Other Essays* (Cambridge, 1950), 11-12. A valuable discussion of these ideas is Wolfgang Streeck, “Revisiting Status and Contract: Pluralism, Corporatism, and Flexibility” in Streeck (ed.), *Social Institutions and Economic Performance* (London, 1992), 41-75.

employment policy: will see a continued pulsing of Polanyi's double movement or a triumph of the liberal Anglo-American model?

Cycles of Economic Thought

The founding of the American Economic Association in 1885 occurred at a moment in American history when farmers, workers, and small businessmen had become increasingly restive about the power of large corporations in American life. The labor movement, single-taxers, and agrarian populists were stirring. Intellectuals were starting to engage and critique laissez-faire doctrines espoused by the courts and by ultra-conservative academics in economics and other disciplines. Several of the AEA's founders, such as Richard T. Ely, had done graduate work in Germany. There they had fallen under the sway of the German historical school and of the Verein für Sozialpolitik. The German economists rejected the free-market doctrines of Adam Smith and his followers in England and America, preferring instead a more statist approach to economic thinking and policy. Like the AEA's founders, they hoped to reshape economics into a problem-solving discipline for dealing with the "labor question" as well as other issues such as trade protection, industrial regulation, municipal ownership and public administration. Here lay the roots of Progressivism: the idea that economic prosperity and social harmony could be achieved through rational administration of markets and organizations. Said Ely, "We regard the state as an agency whose positive assistance is one of the indispensable conditions of human progress."⁸

Ely and his band of reformers were immediately challenged by more conservative economists such as Simon Newcomb and Arthur Hadley. Newcomb, at Johns Hopkins, was an outspoken critic of the labor movement and of socialism, as was Hadley. Both were laissez-faire in their orientation and wanted the AEA to eschew advocacy and be an avowedly neutral professional association. Hadley, who would later write *The Conflict Between Liberty and Equality*, asserted that the danger of believing that economic laws

⁸ Richard T. Ely, "Report of the Organization of the American Economic Association,": 1 *Publications of the AEA* (March 1886), 35. More generally, see the magisterial work by Robert Dorfman, *The Economic Mind in American Civilization* (New York, 1949-1959). Also see Michael Bernstein, *A Perilous Progress: Economists and Public Purpose in Twentieth-Century America* (Princeton, 2001).

can be interfered with by human effort is ten times greater than the danger of an extreme belief in *laissez-faire*.”⁹

Thus were the battle lines drawn between what were to become the “Institutionalists” and the “Neoclassicals”, a dispute that would simmer at least until the 1950s.¹⁰ Both were actually eclectic groups although they had identifiable central tendencies: on the one hand, factual empiricism and an emphasis on historical specificity intended to guide policy reforms, and on the other, theories intended to prove the superiority of *laissez-faire* doctrine (although this had its policy side, chiefly to justify the absence of regulation by unions or government). The institutionalists included well-known activist-intellectuals like John R. Commons as well as more reticent empirical researchers like Wesley Mitchell, who founded the National Bureau of Economic Research in 1920. Britain, too, had its institutionalists, many of them German-influenced, including academic historicists like William Cunningham as well as more empirical and policy-oriented scholars like Beatrice and Sidney Webb, who helped to found the London School of Economics.¹¹

On the neoclassical side arguably the best known economist was John Bates Clark, who developed the marginal productivity concept. Clark had studied in Germany but became an ardent foe of the institutionalists (and a target of Thorstein Veblen’s barbs) as well as a determined critic of Henry George’s land-tax proposals. There were also neoclassicals of a more mathematical bent, like Irving Fisher, considered the father of monetarism. Some of these mathematical modelers were apolitical or, as in Fisher’s case, drawn to peculiar ideas like eugenics and vegetarianism. What held the neoclassicals together was a preference for a *laissez-faire* approach and a desire to build a body of general theory on the lines of Newtonian physics. In England, there was already a group of free-trade economists at Manchester who were joined by marginalist theoreticians like W.S. Jevons and, later, Alfred Marshall. Marshall was the towering figure in English economics in the early twentieth century and more eclectic than most other neoclassicals.

⁹ Quoted in Daniel T. Rodgers, *Atlantic Crossings: Social Politics in a Progressive Age* (Cambridge, MA, 1998), 103.

¹⁰ Tension between neoclassicals and institutionalists over the labor movement led a group of institutionalist labor economists to leave the AEA and form the Industrial Relations Research Association in 1948.

¹¹ Geoffrey M. Hodgson, *How Economics Forgot History* (London 2001); Sanford M. Jacoby, “The New Institutionalism: What Can It Learn from the Old?”, 29 *Industrial Relations* 316 (1990).

He evinced sympathy for historicism and for the market interventionism of the Fabian socialists, while at the same time adhering to marginalism and stressing the limits of state intervention.¹²

In Britain and America, institutionalism lost out to neoclassicism during the 1940s and 1950s. This was partly due to the growing mathematization of economics and the difficulty of converting institutionalist concepts into formal models. Relatedly, institutionalism lacked a unifying theory that could compete in rigor and simplicity with the neoclassical corpus. Other disciplines took up concerns that had previously had been the domain of institutionalism, as in the economic sociology of Talcott Parsons and Neil Smelser; the historical institutionalism of political scientists like Barrington Moore and Seymour Lipset; and in specialties such as economic history, economic anthropology and economic psychology (e.g., Melville Herskovits, Herbert Simon, George Katona). Finally, elements of the institutional approach were incorporated into mainstream economics, as with the data-oriented National Bureau of Economic Research.¹³

The institutionalists' skepticism about laissez-faire received a boost from the debacle of the Great Depression and the ideas of John Maynard Keynes. Keynes emphasized that active fiscal and monetary policies could reduce business-cycle fluctuations and that similar activism could stabilize international exchange systems. His theories lent support to the underconsumptionist notion that boosting wages -- whether through minimum wages or collective bargaining -- would mitigate deflationary tendencies associated with depression. A new generation of economists merged neoclassical marginalism at the microeconomic level with activist policies at the macroeconomic level. This was the Keynesian synthesis developed by John Hicks and Alvin Hansen (and others) with additional microfoundations provided by numerous postwar economists. Although opposition to Keynes's ideas simmered at the University of Chicago--the center of neoclassical conservatism-- many leading American and British economists of the 1940s and 1950s became followers of Keynes. They were sympathetic

¹² Philip Mirowski, *More Heat than Light: Economics as Social Physics, Physics as Nature's Economics* (Cambridge, 1989).

¹³ Sanford Jacoby, "The Intellectual Foundations of Industrial Relations," working paper, 1990; Charles Camic, "The Making of a Method: A Historical Reinterpretation of the Early Parsons," *52 American Sociological Review* 421 (1987).

to Progressive ideas of market regulation, especially at the macroeconomic level, but in particular sub-markets, too.

Paul Samuelson was an exemplar of the new generation. His textbook, first published in 1948, criticized Adam Smith (his ideas “have done almost as much harm as good”) and promoted the idea of a “mixed system of government and private enterprise.” The ruin of the Depression and the success of the New Deal had left Americans--including economists--“unwilling to turn the hour hand back toward laissez-faire.” Indeed, Keynesians were responsible for the creation of the Council of Economic Advisers, which epitomized the growing tendency to hire economists throughout government as policy analysts. Historian Michael Bernstein terms this “the new economics of statecraft,” a development well suited to the waxing of the double movement between the 1940s and the 1960s.¹⁴

In Britain, too, economists came to play a larger role in policymaking, in part because of the postwar infatuation with economic planning. That movement, which included nationalization of industries, never took hold in the United States, leaving England in the postwar decades as it had been before the Depression: slightly less infatuated with markets and more committed to social intervention than the United States. Perhaps for this reason, the postwar Keynesian synthesis in Britain was generally weaker on the microeconomic side, as reflected in the Cambridge (U.K. versus U.S.) capital controversy of the 1960s and 1970s. However, at the LSE under Lionel Robbins, there were anti-Keynesian and laissez-faire tendencies, as in the work of scholars such as Harry G. Johnson and Ronald Coase, both of whom ended up at Chicago.¹⁵

The Keynesian synthesis was an unstable marriage of disparate ideas. The macroeconomic side was interventionist, concerned not only with theory but with practical methods for achieving full employment and other outcomes. There was also an implicit distributional aspect of Keynesianism that acknowledged unions as a way to maintain purchasing power or, as in the pluralism of John K. Galbraith, as a countervailing economic and political force to the power wielded by large, oligopolistic

¹⁴ Quoted in Robert H. Nelson, *Economics As Religion: from Samuelson to Chicago and Beyond* (University Park, 2001), 89; Bernstein, *Perilous Progress*, chapter 5.

¹⁵ Martin Chick, *Industrial Policy in Britain, 1945-1951* (Cambridge 1997); Mark Blaug, *Economic Theory in Retrospect*, 5th ed. (Cambridge, 1997).

corporations.¹⁶ The microeconomic side, despite its seeming “value free” theories of choice and production, came with an implicit laissez-faire and utilitarian orientation. This was most apparent in price theory (with the exception of concepts like monopolistic competition), which emphasized the superiority of markets for resource allocation. It was less visible in the most interesting microeconomic achievements of the 1950s and 1960s: rational choice theory and game theory. After all, these were highly mathematical innovations and their progenitors included scholars well known for their liberal proclivities, such as Kenneth Arrow and Jacob Marschak.

But it is well to remember that the development of rational choice and game theory was intimately related to the prosecution of the Cold War, as shown by historian S.N. Amadae.¹⁷ The scholars who developed these theories--and mathematical techniques like linear programming and other optimization methods--were heavily funded by the Defense Department, the Navy, and the Air Force (through its RAND research center). Rather than being a classical economic concept dating from Adam Smith, the notion of the rational actor emerged in the postwar years in part as a way of solving strategic military problems as well as ideological challenges confronting the United States. Arrow’s impossibility theorem (written while Arrow was at RAND in the late 1940s) targeted idealist concepts in welfare economics such as “the general social good” and offered in their place a kind of second best, muddling through: all public choices, whether for equity or efficiency, would always involve tradeoffs. No society could ever be perfect.

Yet in lesser hands than Arrow’s, rational choice involved a methodological individualism which asserted that self-interest--not altruism or interdependence--lay at the core of human behavior. Although intended as a critique of totalitarianism, rational choice theory was congenial to libertarianism, surely an unintended but not unforeseeable consequence. Thus James Buchanan and Gordon Tullock in the 1950s and 1960s developed the concept of “public choice” to slay another idealist dragon by showing that there was no such thing as a state that transcends the individuals comprising it. Buchanan and Tullock preferred potent critiques of Keynesianism and the welfare state as instances

¹⁶ John K. Galbraith, *American Capitalism: The Concept of Countervailing Power* (Boston, 1952).

¹⁷ S.N. Amadae, *Rationalizing Capitalist Democracy: The Cold War Origins of Rational Choice Liberalism* (Chicago, 2003).

of totalitarian statism, albeit disguised by the imagery of neutral policymakers serving the public interest.¹⁸

The affiliation of a wide range of economists with the rational choice project caused postwar economics to become a place where ideological differences--between Cold War liberals and libertarian radicals--were muted in favor of a shared disciplinary fascination with theorization and modeling. Or, to update an old saying from the IWW, “feet which meet under the (seminar) table don’t kick.” Like game theory, rational choice theory emphasized that social science was universal and therefore equally applicable in capitalist and communist contexts--it transcended history--a point that harked back to the *Methodenstreit* of the late nineteenth century between Austrian marginalists and German historicists, including Max Weber.¹⁹

The emphasis on universalist theory propelled postwar economics into an increasingly non-empirical direction, again an unintended but not unforeseeable consequence. Combined with Milton Friedman’s brilliant methodological attack on realism and descriptive accuracy, published in 1953, the result--twenty years later--was an economic scholasticism that derogated empirical research in favor of model-building based on “stylized” facts (or sometimes no facts at all). As tabulated by Wassily Leontieff, two-thirds of the articles published in the prestigious *American Economic Review* between 1977 and 1981 contained no data whatsoever. This did not keep economists from deducing policy recommendations from theory, even when the empirical data suggested that those recommendations were wrong (as in the case of the ostensible employment-reducing effect of minimum wage laws). The lack of attention to empirical confirmation--especially of core assumptions in rational choice theory itself--may eventually prove to be its Achilles Heel.²⁰

¹⁸ James Buchanan and Gordon Tullock, *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (Ann Arbor, 1962); Amadae, chaps. 3-5.

¹⁹ Although Weber had been a methodological individualist, he also had emphasized the social foundations of individual action, including economic action. Thus he recognized an affinity between economics and natural science, but asserted that economics could not transcend interpretative and normative issues that were irrelevant to the natural sciences. Reinhard Bendix, *Max Weber: An Intellectual Portrait* (Garden City, 1962); Wolfgang Schluchter, *Rationalism, Religion, and Domination: A Weberian Perspective* (Berkeley, 1989).

²⁰ Milton Friedman, “The Methodology of Positive Economics” in *Essays on Positive Economics* (Chicago, 1953); Wassily Leontieff, “Academic Economics,” *Science* 217 (9 July 1982), 104-107;

Thus at the same time that T.H. Marshall was celebrating the rise of the welfare state, seeds were being sown for a shift of Anglo-American economics in a decidedly opposite direction. During the postwar years, this more conservative undertow was masked by the rhetoric of an interventionist Keynesianism. Lawrence Klein, an econometrician at the University of Pennsylvania, said in 1947 that the Keynesian economic system was “essentially a machine which grinds out results according to where the several dials controlling the system are set. The functional relations are the building blocks of the machine, and the dials are the parameters (levels and shapes) of these functions.”²¹ Keynesianism fell apart in the 1970s as a result of a changing economic environment; it also was undone by the conservative challenge emanating from Chicago.

It is impossible in a brief essay to summarize Chicago’s ascendance to its dominant place in Anglo-American economics. It started with Frank Knight, a creative theorist who established a Chicago tradition that challenged institutionalism as well as the Progressive and Keynesian approaches to regulation. In the 1930s, Knight was joined by Jacob Viner, a fierce opponent of Keynesianism, and by Knight’s student, Henry C. Simons, a monetarist who hated the New Deal but most especially labor unions. Later appointed to the law school, Simons is also viewed as the father of the law and economics movement.²²

A second Chicago generation was comprised of luminaries such as Milton Friedman and George Stigler, who published in a variety of fields, as well as those with a particular focus on labor issues, such as Gary Becker and H. Gregg Lewis. Friedman wrote widely on methodology, monetarism, price theory, and risk. His 1968 paper on the natural rate of unemployment was a critical nail in the coffin of Keynesianism. Stigler also was a polymath and the epitome of a neoclassical style that combined theorizing with policy pronouncements devoid of empirical content. During the course of his career

Deirdre McCloskey, *The Rhetoric of Economics*, 2nd ed. (Madison, 1998); Simon Deakin and Frank Wilkinson, “Minimum Wage Legislation” in Boudewijn Bouckaert and Gerrit De Geest, Gerrit (eds.), *Encyclopedia of Law and Economics*, vol. 1 (Cheltenham, U.K., 2000), 561-571.

²¹ Quoted in Nelson, *Economics as Religion*, p. 57.

²² Melvin Reder, “Chicago Economics: Permanence and Change,” 20 *Journal of Economic Literature* (March 1982); Edmund W. Kitch, ed., “The Fire of Truth: A Remembrance of Law and Economics at Chicago,” 26 *Journal of Law and Economics* 163 (1983); J. Bradford DeLong, “In Defense of Henry Simons’ Standing as a Classical Liberal,” 9 *Cato Journal* 601 (1990).

Stigler wrote about antitrust law, unions, minimum wage laws, public utility regulation. It was Stigler who helped promote the writings of an LSE-trained colleague, Ronald Coase, who, through his seminal 1961 article, "The Problem of Social Cost," and through his editorship of the *Journal of Law and Economics*, was the person who made law and economics an influential movement.

Coase was widely known for his papers that encouraged smaller government through the use of markets, auctions, cost-benefit analysis, and incentives -- what we today would call privatization and deregulation. (Back in 1950 he wrote a monograph blasting the BBC for being a state-sanctioned monopoly.) But he is most famous for the "Coase theorem," which brought an efficiency-oriented approach to legal analysis. As developed by Guido Calabresi, Richard Posner, Richard Epstein and others, the Coase theorem asks judges to make decisions that foster a Pareto-optimal use of resources by minimizing costs and maximizing net gains, even if the gains are unfair or contravene non-economic rights. Indeed, the irrelevance of any norm other than efficiency is the gist of the law and economics effort to re-establish market individualism and contractual formalism in the law. Like rational choice theory, with which it shares core assumptions, law and economics is open to empirical, factual criticism but those criticisms tend to bounce off the band of idealistic assumptions that lie at its core.²³ There are other substantive problems -- the difficulty of internalizing negative externalities; the biases that result from using wealth rather than utility as a guide to efficient resource allocation; information scarcity that limit solutions to local rather than global maxima (and thus prone to second-best defects)--but these criticisms also have not penetrated.²⁴

The law and economics movement has cut a wide swath through legal scholarship and decision-making, partly due to the "Pareto in the Pines" (later palms) seminars started in the late 1960s to educate legal scholars and judges in the fundamentals of Chicago-style law and economics (with funding from conservative groups like the Olin Foundation). Although law and economics initially was viewed as having greatest

²³ See, for example, Stewart J. Schwab, "A Coasean Experiment on Contract Presuppositions," 17 *Journal of Legal Studies* 237 (1988).

²⁴ Kenneth J. Arrow, "The Organization of Economic Activity: Issues Pertinent to the Choice of Market versus Non-Market Allocation," in *The Analysis and Evaluation of Public Expenditures: The PBB-System*, Joint Economic Committee, 91st Congress, 1st session, vol. 1 (Washington DC: 1969); Herbert Hovenkamp, "Marginal Utility and the Coase Theorem," 75 *Cornell Law Review* 783 (1990); Gary T. Schwartz, "Economics, Wealth Distribution, and Justice," 1979 *Wisconsin Law Review* 799 (1979).

relevance to torts, it has steadily expanded to include other issues, such as labor and employment law. In Britain, law and economics is not as strong nor as Posnerian as in the United States, though it is more widely accepted in Britain than Western Europe.²⁵

The Triumph of Neoclassicism

The collapse of Keynesianism in the early 1970s was partly a result of the intellectual assault from Chicago: the natural rate hypothesis, the rational expectations theory of Robert Lucas, and -- an evocative phrase -- the concept of “policy impotence.” These criticisms were well-timed, coming at precisely the moment that the economic environment had changed in ways that undercut traditional Keynesianism. The simultaneous rise of unemployment and inflation (“stagflation”) was not easily accommodated by the Keynesian framework, nor was the increase in world trade and capital flows that marked a new wave of globalization. Open-economy Keynesianism existed in theory but in practice was difficult to pursue.

With the demise of Keynesianism, what was left of the neoclassical synthesis were its microfoundations, which were, by and large, ill-suited to support regulatory innovation. Without Keynes to connect economics to a progressive tradition that tried to fix market failures, the discipline increasingly embraced laissez-faire ideas. Whereas Chicago in the 1950s had been a respected academic center but hardly the central tendency among English-speaking economists, it now dominated disciplinary discourse. Undergraduate students routinely were assigned Friedman’s *Capitalism and Freedom*, in which Friedman (along with his wife, Rose) called government “a threat to freedom.”²⁶ During the period 1988-1998, the most heavily cited articles in English-language economics journals were by Gary Becker, Robert Lucas, Robert Barro, and James Heckman, who, with the exception of Barro, all taught at Chicago.²⁷

²⁵ Nicholas Mercurio and Steven G. Medema, *Economics and the Law: From Posner to Post-Modernism* (Princeton, 1997); Stephen Medema, “Chicago Law and Economics,” working paper, Department of Economics, University of Denver, June 2003; Richard Posner and Jeffrey Paul, eds., *Labor Law and the Employment Market* (New Brunswick, 1985); Seth D. Harris, “Coase’s Paradox and the Inefficiency of Permanent Strike Replacements,” 80 *Washington University Law Quarterly* 1185 (2002); Ian R. Macneil, “Other Sociological Approaches” in Bouckaert and De Geest (eds.), *Encyclopedia of Law and Economics*, vol. 1, 694-718.

²⁶ Milton Friedman, assisted by Rose Friedman, *Capitalism and Freedom* (Chicago, 1962).

²⁷ Barro had taught at Chicago and at Rochester, a Chicago satellite, before moving to Harvard. Citation data are from Nelson, *Economics as Religion*, 116.

It is an open question whether Chicago-style neoclassicism would have claimed the field so decisively had the political climate in Britain and the United States not taken a right turn in the late 1970s and 1980s. The enormous popularity of Ronald Reagan in the United States, and to a lesser extent, of Margaret Thatcher in Britain, conferred intellectual legitimacy to libertarian economic ideas and an opportunity to implement them. There is an interaction here: ideas propelled the conservative movement at the same time as that movement gave those ideas recognition (as well as publicity from a variety of conservative foundations and think tanks: the American Enterprise Institute, the Cato Institute, the Federalist Society, and the Heritage, Olin, and Scaife foundations, to name but a few in the United States, as well as similar groups in Britain, such as the Adam Smith Institute, the Bow Group, and the Institute of Economic Affairs). Sometimes the economists took the lead in the policy arena, as was the case with sectoral deregulation. Other times--as with social security, labor law reform, and occupational safety--the impulse to privatize or deregulate initiated with industry but was blessed by economists.

Movement towards the market also occurred in less expected places. Major deregulation--of transportation, energy, and finance--started during the Carter administration, after a step in this direction under President Ford. The Carter approach--a slow rather than radical retreat from activist government--eventually found a permanent home in the Democratic Leadership Foundation (established in 1985). The Brookings Institution, which had once been a bastion of Keynesianism and an advocate of progressive interventionism, tilted right as the Keynesian synthesis fell apart. By the mid-1980s, Brookings had become an ardent supporter of deregulation and a foe of Japanese-style targeted support for particular (usually manufacturing) industries, so-called "industrial policy." A 1984 Brookings report advocated a cash-flow tax, a first step towards a long-desired conservative goal of a consumption tax in lieu of progressive taxation. The chief economist for the U.S. Chamber of Commerce said the report "shows that we have won the philosophical revolution." These changes were partly the result of the new political climate in Washington and partly due to generational change, as more traditional liberals like Joseph Pechman were replaced by younger centrists such as Robert Crandall and Robert Lawrence. Although it would be crass to say that Brookings

swung from left-center to center-right in order to obtain corporate donations, the fact is that business support for Brookings rose from \$95,000 in 1978 to \$1.6 million in 1984. Brookings' fund-raiser at the time, a conservative Republican named Roger Semerad, said that these gifts demonstrated that Brookings was "no longer tied to decades of ideology."²⁸

One study of deregulation during this period makes the point that, when deregulation was pro-competitive, it engaged Democrats who saw it as a way of reducing consumer prices (and inflation) and of restricting government protection of business. But when deregulation was seen as hurting groups with little or no pricing power, like labor and the environment (as with Davis-Bacon repeal or OSHA and EPA deregulation), Democrats were usually opposed. Most consistent in their enthusiasm were economists, who produced deregulation proposals for a variety of industries and areas such as the environment and workplace safety. With the possible exception of telecommunications, economists were usually unanimous in urging policymakers to proceed.²⁹

The political influence of economists also was due to changes in government. Policy analysis and initiation increasingly were executive functions. The White House, cabinet-level departments, and other federal agencies established in the 1970s new policy analysis units that were staffed by economists. Together with counterparts in the thinktanks and in academia, the economists constituted "an informal, professionally based network of deregulation advocates." Reliance on these analysts was viewed as a way around career specialists with more parochial views (i.e., less enamored of markets, which was taken as evidence of regulatory capture). Criticism of the new deregulatory orthodoxy was muted, as early success with the airlines cleared the way for additional reforms.

Yet tools like cost-benefit analysis--and associated "scorecards" that purported to show how the costs of government regulation exceeded its benefits--were not as scientific or normatively transparent as their proponents claimed. Costs were easier to quantify and monetize than benefits, resulting in biased assessments. Distributive effects were usually judged irrelevant to efficiency considerations. Even some insiders occasionally expressed

²⁸ Peter Bernstein, "Brookings Tilts Right," 110 *Fortune* (23 July 1984), 96.

²⁹ Martha Derthick and Paul Quirk, *The Politics of Deregulation* (Washington, D.C., 1985), 237-257.

doubts about the policy-analysis approach. George Eads, a respected policy economist who had served on the Council of Economic Advisers, said that economists “should devote less attention to policies’ consequences for allocative efficiency and more to their distributive effects that bear on equity.”³⁰

Much the same story can be told for Britain, where government economists during the Thatcher years were among the most eager to liberalize markets and shrink government’s role. In fact, according to one comparative study, British and U.S. outcomes were “broadly similar” because “British reform was modeled after economic and legal notions already popular in the United States.”³¹

Parallel developments occurred on the privatization front, although here Britain took the lead, partly because it had more in the way of state-owned industries to sell off (steel, gas, petroleum, telecom, energy). Just six months after taking office, Prime Minister Thatcher initiated a public offering of shares in British Petroleum. In the United States, privatization had more of an effect on state and local governments, chiefly in the form of “contracting out” of services to private providers of everything from prison administration to waste disposal. Vouchers, whether for housing or schools, were part of this movement, as were tuition tax credits. More recently, a combination of ideology and fiscal problems have led some states to seek privatization of core governmental functions such as policy making and program design (as in the recently proposed privatization of Texas’s public-assistance system). Again, the strongest and most consistent advocates of privatization have been economists (as well as the companies seeking government contracts), an enthusiasm springing from the economists’ folk wisdom that government, unlike the private sector, is “bureaucratic” and “represses innovation,” and that the best criterion for judging program effectiveness is efficiency, that is to say, cost.³²

What was extraordinary in all of this was the near-total absence of economic discourse critical of the new faith in markets, whether labor markets, financial markets, or international markets. (Among economists, to question the net benefits of free trade is to

³⁰ Ibid., 251. Also see Richard W. Parker, “Grading the Government,” *70 University of Chicago Law Review* 1345 (2003).

³¹ Steve Vogel, *Freer Markets, More Rules* (Ithaca, 1998), 257.

³² William Gormley (ed.), *Privatization and Its Alternatives* (Madison, 1991); Jonathan Walters, “Going Outside,” *Governing* (May 2004); Daniel Yergin and Joseph Stanislaw, *The Commanding Heights: The Battle Between Government and the Marketplace that is Remaking the Modern World* (New York, 1998).

risk being branded an apostate.)³³ Even in Britain, where public opinion was sometimes hostile to the idea of privatization, economists were mostly favorable. Thus unlike the previous era of pro-market ebullience--when there were critical, influential economic voices like Commons and Keynes--this time around there were (and are) few dissenters within Anglo-American economics. Pluralism--which includes the notion of a marketplace of ideas as well as countervailing power--has been replaced by an uncritical adulation of markets, entrepreneurs, and business. Inside Anglo-American economics, either there is no recognition of intellectual conformity, or it is defended as professional consensus.³⁴

Admittedly, acceptance of progressive economic ideas in the early twentieth century was a drawn-out process that may never have happened but for the disaster that was the Great Depression. Prior to the depression, citizens had been assured that their own efforts, combined with those of paternalistic employers (so-called welfare capitalism) would be sufficient to protect them against economic risk. This turned out not to be the case and was the principal reason for the rise of the New Deal welfare state. Moreover, the depression (like the Second World War) fostered a communitarian ethos based on the realization that all social strata were vulnerable to the same economic and military risks.³⁵

Both politicians and economists held to the idea that slaying the twin dragons of underconsumption and business monopoly was the way to prevent future depressions. As noted, this belief invested the labor movement with a societal mission. Not only were unions viewed as a boost to consumption, they were also seen as a check on business's influence in the media and government. The public thought of unions as an embodiment of the communitarian ethos that had come out of the depression and war, despite McCarthyism and anti-labor campaigns by business. During the 1950s and 1960s, the Cold War caused more than a few Republicans to give support, albeit grudging, to the labor movement because the latter demonstrated that Western workers did not need

³³ But see Steve Lohr, "An Elder Challenges Outsourcing's Orthodoxy", *New York Times*, 9 September 2004.

³⁴ See Peter Monaghan, "Taking on 'Rational Man'," 49 *Chronicle of Higher Education* (24 January 2003) on efforts to reshape Notre Dame's heterodox economics department.

³⁵ Sanford M. Jacoby, *Modern Manors: Welfare Capitalism since the New Deal* (Princeton, 1997).

Communism to be prosperous and free. In short, support for pluralism was a way of signaling that labor and democracy needed each other.³⁶

By the 1980s, this had all changed. The depression had little relevance to most baby boomers and to the new “Gen X.” Communism was on the ropes. And inflation and globalization made purchasing power less vital to economic health. Now the public--and economists--saw unions differently--as selfish “special interest groups.” Although Freeman and Medoff’s *What Do Unions Do?* took a contrarian view, emphasizing the economic benefits of employee participation, their ideas had less of an impact than those of Mancur Olson, who wrote about unions (and other interest groups) from a Buchanan-influenced public choice perspective. In *The Logic of Collective Action* and in *The Rise and Fall of Nations*, Olson made short shrift of pluralism, arguing that it led not to democratic health but to gridlock and societal sclerosis. Libertarian economists like Friederich Hayek (a favorite of Margaret Thatcher’s) were back in vogue in the 1980s, making similarly bold arguments that unions were “the biggest obstacle to raising the living standards of the working class as a whole . . . [and] the main reason for the decline of the British economy in general.” In the United States, conservative economists, with support from private foundations, established new publications, like the *Journal of Labor Research*, to tout the economic virtues of a union-free society. None of this is to say that economists caused Margaret Thatcher to press for a half-dozen trade union and employment acts or Ronald Reagan to fire the air-traffic controllers, close labor out of the White House, and slash the budget of the Department of Labor. But it is to assert that economists offered intellectual legitimacy--higher ground--to those taking a hard line against unions, whether in government or the private sector. Ironically, the same criteria had legitimated unions in the postwar decades--prosperity and democracy--now were offered as justification for bashing them.³⁷

As unions lost power in Washington and London, so too did workers lose power in the workplace. Employment relationships became increasingly market-oriented as

³⁶ Derek C. Bok and John T. Dunlop, *Labor and the American Community* (New York, 1970).

³⁷ Richard Freeman and James Medoff, *What Do Unions Do?* (New York, 1984); Mancur Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (Cambridge, 1965) and *The Rise and Fall of Nations: Economic Growth, Stagflation, and Social Rigidities* (New Haven, 1982); F.A. Hayek, *Economic Freedom* (1991) cited in Ray Richardson, “Hayek on Trade Unions: Social Philosopher or Propagandist?”, Centre for Economic Performance, Discussion Paper no. 178 (1993), 4.

employers reneged on security commitments to employees. This took a variety of forms: downsizing, cutbacks in health benefits, termination of defined-benefit pension plans, and greater use of temporary and contingent employees. The reduction in employer spending on pension and health benefits was particularly critical in light of the fact that the United States has spent more on employer-provided benefits than other nations.³⁸

Indeed, a key element in the new individualist ethos was to shift risk from government and employers to individual employees. While those with education and “hot skills” welcomed the opportunity to be masters of their own fate--as in Silicon Valley, The City, and Wall Street--for others the 1980s and 1990s were a time of trauma.³⁹ Welfare state cuts--both commission and omission of benefit adjustments--hit hardest at the poor and the working poor in the United States, affecting programs like AFDC, unemployment insurance, and the minimum wage. In Britain, much the same was true: sharp cuts for programs like public housing and a decline in unemployment-insurance replacement rates, but shelving of a proposal to privatize the National Health Service, the “third rail” of British politics.⁴⁰ The events of the past twenty years have rolled back, to varying extent, the status rights established during the 1930s and 1940s, rights that had kept markets from strictly determining one’s economic fate by creating communities of shared risk--at the workplace and in the nation as a whole. The reallocation of risk, from business to individuals, and with government playing a smaller role, has been the central dynamic of Anglo-American labor markets during the past thirty years.

As during previous periods when market individualism was held up as an ideal--the Gilded Age and the 1920s, for example--income and wealth inequality have risen during the past twenty years. While growth of market inequality is occurring in most rich countries (but not Japan or Switzerland), the United Kingdom and the United States lead the pack in the share of pre-tax income going to the top 1% bracket (whose share

³⁸ Sanford M. Jacoby, “Are Career Jobs Headed for Extinction?” 42 *California Management Review* 123 (1999);

³⁹ Jacoby, “Are Career Jobs Headed for Extinction?” 135; Jacoby, “Risk and the Labor Market: Societal Past as Economic Prologue” in Ivar Berg and Arne Kalleberg, eds., *Sourcebook of Labor Markets: Structures and Processes*, (New York, 2001), 31–60; Jacob Hacker, *The Divided Welfare State: The Battle Over Public and Private Social Benefits in the United States* (New York, 2002).

⁴⁰ Paul Pierson, “The Politics of the Welfare State,” 48 *World Politics* 143 (1996); James Allan and Lyle Scruggs, “Political Partisanship and Welfare State Reform in Advanced Industrial Societies,” 48 *American Journal of Political Science* 496 (2004).

doubled in the UK and the US since the late 1970s). They also lead in total inequality after income is adjusted for taxes and transfers. That is, in contrast to Western Europe, policy changes in Britain and the United States have accentuated rather than counteracted market effects.⁴¹

One serious effect of unrectified inequality is to weaken the political influence of those in the lower half of the income distribution. A feedback is created, whereby those already falling behind are unable to prevent regulatory changes that cause them to slip even further. In the period from the 1930s through the 1970s, a different kind of feedback existed: a communitarian ethos led to public policies and wage-setting norms that reduced inequality; in turn, the reduction of inequality spurred changes that fostered egalitarian public policies. The position of the middle class relative to the poor is one of the strongest predictors of how much its GDP a nation commits to social spending.⁴² Now the dynamic is running in reverse, as rising inequality pulls the middle class further away from the poor. Money-driven politics reinforce this trend. As Gary Burtless and Christopher Jencks observe, “if the rich can buy more political influence than other Americans [or Britons], and if the political process then yields policies that allow the rich to further increase their share of total income, it is hard to reconcile this result with traditional norms of how a democracy should operate.”⁴³

Western Europe and Japan

Western Europe and Japan have hardly been immune to the ascendance of markets in the Anglo-Saxon world. Even in egalitarian social democracies, the pre-tax distribution of income has become more unequal. State-owned enterprises have been privatized, such as Renault, Deutsche Telekom, and NTT. Germany’s Hartz reforms are aimed at restructuring German labor markets, including a tightening of unemployment insurance provisions and a loosening of restrictions on temporary employment, an emulation of the Dutch approach. In Germany as in other countries with strong welfare

⁴¹ Emmanuel Saez, “Income and Wealth Concentration in a Historical and International Perspective,” working paper, Economics Department, U.C. Berkeley, February 2004; A. B. Atkinson, “Measuring Top Incomes: Methodological Issues,” working paper, Nuffield College, Oxford University, 2003.

⁴² Peter Lindert, “What Limits Social Spending?” 33 *Explorations in Economic History* 1 (1996).

⁴³ Kevin Phillips, *Wealth and Democracy: A Political History of the American Rich* (New York, 2002), 123; Gary Burtless and Christopher Jencks, “American Inequality and its Consequences,” Luxembourg Income Study, working paper no. 339 (March 2003), 22, 42.

states, there is growing reliance on market incentives in the design of programs such as managed competition to pare healthcare costs.⁴⁴

The receptiveness to Anglo-American neoliberalism is a sign that the coalitions which produced postwar social democracy are cracking. Postwar reconstruction is long since over, unions and churches are less influential, and immigration has changed the willingness to extend Marshall's citizenship rights to people perceived as "different." Moreover, the strong economic performance of Britain and the United States in the 1990s as compared to France, Germany, and Japan has made credible the inference that market-oriented reforms in the former were responsible for strong growth; ergo, laggard European and Japanese economies would perform better if they adopted the Anglo-American model. That theme is played out over and over in pronouncements from the OECD, the Office of the U.S. Trade Representative, *The Economist*, and other bastions of neoliberal sensibilities.

Yet the evidence suggests that Japan and Europe have thus far preferred to steer a different course. Steve Vogel's comparative study finds that European and Japanese deregulation has had the paradoxical effect of creating stronger markets but not weaker governments, giving rise to what he terms "reregulation": the formulation of more rules and government controls to manage new forms of competition (something that would not surprise Polanyi). Vogel finds this to be the case in Japan, France, and Germany with respect to deregulation of the telecom, finance, and broadcasting industries, and, to a lesser degree, of transport and utilities. Whereas the Anglo-American approach was based on the presumption that changes in competition compelled governmental disengagement, elsewhere governments held to the idea that competitive changes could best be accommodated by revamping regulation rather than eliminating it.

As for privatization of government services--whether by contracting out, vouchers, or other mechanisms--the evidence again suggests that the U.S. and, especially, the U.K., went further in this direction than other rich OECD countries. This is hardly surprising in light of the fact that privatization was less a response to changing

⁴⁴ Lane Kenworthy, "Welfare States, Real Incomes, and Poverty," working paper, Department of Sociology, Emory University, February 2004; Michael Fertig and Jochen Kluge, "A Conceptual Framework for the Evaluation of Comprehensive Labor Market Reforms in Germany," Institute for the Study of Labor (IZA) discussion paper 1099, Bonn, 2004; Lawrence Brown, "Exceptionalism as the Rule? U.S. Health Policy Innovation and Cross-National Learning," 23 *Journal of Health Politics, Policy, and Law* 35 (Feb. 1998).

competitive conditions than a “fiscally ambitious, ideologically charged phenomenon [that began when] English academics and Conservative party officials prepared a sweeping privatization agenda as Margaret Thatcher took office ... Conservative intellectuals in the United States set out to emulate the British example.” Privatization that took the form of selling state assets was more prevalent outside the United States, but this was simply a reflection of the fact that there was little in the way of state-run U.S. industry to sell off.⁴⁵

Key to labor-market regulation is the administration of industrial relations through law and adjudicative bodies. Nothing on the scale of Margaret Thatcher’s deregulatory reforms has taken place in any of the other OECD countries, including the United States. Changes in the United States have occurred in more subtle fashion through judicial and NLRB interpretations of the legal framework for union organizing and bargaining. Elsewhere in the advanced world, however, not only have industrial relations systems remained relatively benign with respect to unions but they have in some instances expanded the statutory responsibilities of trade unions (e.g., the EU’s various directives on works councils, consultation, and participation). Hence it should come as little surprise that of the five advanced economies with declining union density and coverage from 1980 to 1997, four were in the Anglo-American realm: the U.K., the U.S., New Zealand, and Australia (the exception is Japan). Of the remaining 14 countries whose union density and/or coverage was stable or rising, 13 were located in Europe (the exception here was Canada). Three of those countries -- Finland, Spain, and Sweden -- had rising density and stable/rising coverage.⁴⁶

The main public expenditure that still differentiates Europe from the United States (and Japan) is “the welfare state” -- insurance plans for unemployment, health, and old age, as well as poverty-mitigation programs. In Scandinavia and rest of continental Europe, welfare state retrenchment has occurred--there have been cuts in unemployment and health insurance and growing use of means-tested pensions--yet cuts have been smaller than those occurring in Britain and the United States, thus leaving sizeable gaps

⁴⁵ Vogel, *Freer Markets, More Rules*, passim.; Andrew Massey, ed., *Globalization and Marketization of Government Services* (New York, 1997); John Donahue, *The Privatization Decision* (New York, 1989), 4.

⁴⁶ Richard B. Freeman, “The U.S. Economic Model at Y2K: Lodestar for Advanced Capitalism?”, 26 *Canadian Public Policy/Analyse de Politiques* S187, S 194 (2000).

and still-sizeable European welfare states. Although retrenchment is producing more privatized systems for pension and health care delivery around the world, again it is Britain and the United States (the latter already a relatively privatized system) that have taken the largest steps in this direction, thereby boosting inequality.⁴⁷

State, Law, and Society

Why do Europe and Japan continue to move along different trajectories than the Anglo-Saxon countries? Why is the risk burden in those societies still shared more equally by government, business, and individuals? For decades these questions have occupied the center of comparative research in the social sciences, so an essay like this can do little more than hint at explanations. The fact that national trajectories begin at different points is crucial to the concept of “path dependence,” which asserts that historical starting points, however random, have long-term ramifications for the development of economic and social institutions. Europe and Japan both went through a sequence in which big government -- the legacy of monarchy -- emerged before big business. As a result, the state had both the power and legitimacy necessary to direct national economic development. Not only did the state promote industrialization, it wielded regulatory powers to mobilize resources and promote industrial harmony. German business may not have liked Bismarck’s ideas about social insurance or, later on, worker committee laws (the first in 1891) but business had long experience operating in an environment where it had to defer to the state to protect its interests. This was quite different from the situation in, say, the United States, where the federal government remained relatively small and weak prior to the First World War and where business had no serious challengers to its political power and influence.⁴⁸

The fly in the ointment here, of course, is Great Britain, whose institutional sequencing was similar to the continent’s, yet whose liberalism took hold at an early date. What made Britain different was simply the fact that, when it came to industrialization,

⁴⁷ Burtless and Jencks, “American Inequality”, op. cit; Alberto Alesina, Edward Glaeser, and Bruce Sacerdote, “Why Doesn’t the U.S. Have a European-style Welfare State?”, Harvard Institute of Economic Research, working paper 1933, 2001; Evelyn Huber and John D. Stephens, *Development and Crisis of the Welfare State* (Chicago, 2001); Geoffrey Garrett, *Partisan Politics in the Global Economy* (Cambridge, 1998); Bo Rothstein, “The Universal Welfare State as a Social Dilemma,” 13 *Rationality and Society* 213 (2001).

⁴⁸ Sanford M. Jacoby, “Corporate Governance in Comparative Perspective: Prospects for Convergence,” 22 *Comparative Labor Law and Policy Journal* 5 (2000).

Britain was first. One of its first-mover advantages was superiority in manufacturing prowess, which caused it to press for liberalization of trade (not unlike the United States today with respect to trade in high-technology products). Compared to Britain, the continent and Japan were late developers whose governments were deeply involved in creating institutions that would promote industrialization: from state-owned industry to industrial cartels to universities to social insurance.⁴⁹

Accompanying the rise of a developmental state was the proliferation of theories to justify its existence. In countries like Germany, France, and Japan, the academic study of economics was antipathetic to libertarian neoclassicism. Economists were more skeptical of markets and more focused on institutional design, an orientation that led to strong links between economics on the one hand and law, engineering, and public administration on the other. Also, because this pragmatic approach to economics eschewed neoclassicism's totalizing corpus of theory, it tended to be more eclectic, with multiple schools and movements.

In Germany, for example, the association of economics with government can be traced back to the cameralists of the eighteenth century. The cameralists were princely advisors who wrote about applied principles of economic policy and administration. When Germany began to industrialize, their successors -- the historical economists -- continued the tradition of applied economics in the service of government. The historical economists were ardent nationalists, intent on using the state to devise programs that would hasten Germany's industrialization with a minimum of social friction. Hence they rejected the English liberalism (which they snidely termed "Smithianism") in favor of protectionist policies to foster Germany's infant industries. Although called "socialists of the chair" for their advocacy of social insurance and employee representation, they nevertheless exerted considerable influence on the conservative Prussian government. Much of their research was "institutional," often consisting of case studies intended to guide business and public policymaking.⁵⁰

⁴⁹ Ronald Dore, *British Factory, Japanese Factory: Origins of National Diversity in Industrial Relations* (Berkeley, 1973); Peter Mathias, *The First Industrial Nation: An Economic History of Britain, 1700-1914* (London, 1969).

⁵⁰ C. Gide and C. Rist, *A History of Economic Doctrines*, 2nd ed. (Boston, 1948).

After the Second World War, an institutionalist tradition continued to influence German economics. One example was Walter Eucken's Ordnungstheorie, which stressed the regulatory principles necessary to make markets vital yet orderly.⁵¹ Eucken's ideas--and those of his fellow economists in the Freiburg School--formed the basis for the postwar Soziale Marktwirtschaft--the social market economy--in which government relied on law and regulatory policy to establish a framework for markets. These ideas animated the "German model": a blend of corporatist capitalism, active fiscal and regulatory policies, social insurance, and worker participation. Although the Freiburg School continues to have an anti-neoclassical wing, it gravitated towards Buchananesque public choice theory in the 1970s. German institutionalism is becoming more focused on transaction-cost and Coasean concepts spawned in the United States, although it has less of the efficiency-orientation and libertarian bias that accompanies the law and economics movement in the United States.⁵²

France presents a different picture because it had a stronger indigenous marginalist tradition (Jules Dupuit and Leon Walras). Nevertheless, its leading economists were, like Dupuit, associated with the Grandes Ecoles, whose mission was to help the state develop the French economy. After the Second World War, an emphasis on state-owned industry and state planning led to peculiar hybrid tendencies. One had ingenieurs-economistes from Mines and from Ponts et Chaussees enthusiastically advocating marginal cost pricing for nationalized electricity industry and econometric forecasting to aid in the implementation of indicative planning. (e.g. Maurice Allais, Edmond Malinvaud, Pierre Masse).⁵³ There were also plenty of Marxist and radical economists, leading to the emergence in the 1970s of the regulation school, a blend of Marxism and historical institutionalism that arose at places like Cepremap (Centre d'etudes prospectives d'economie mathematique appliquees a la planification) and is

⁵¹ Walter Eucken, *The Foundations of Economics* (London, 1950).

⁵² Rudolf Richter, "Institutional Thought in Germany", working paper, University of Saarland, 2000; Robert Delorme, "Ordnungstheorie and The Theory of Regulation Compared from the Standpoint of Complexity" in A. Labrousse and J.-D. Weisz, eds, *Institutional Economics in France and Germany* (Berlin 2001); Roland Kirstein, "Law and Economics in Germany" in Bouckaert and De Geest (eds.), *Encyclopedia of Law and Economics*, vol. 1, 160-164.

⁵³ John Zysman. *Political Strategies for Industrial Order: State, Market, and Industry in France* (Berkeley, 1977); Martin Chick, "Economists, Economic Ideas, and Energy Policy in Britain, France, and the United States Since 1945," working paper, University of Edinburgh, 2004.

associated with economists such as Robert Boyer, Michel Aglietta and Alain Lipietz. Although neoclassicism recently has made deep inroads, this has not occurred without a fuss. A few years ago graduate students at France's leading universities launched a movement against neoclassicism, whose unrealism they dubbed "autistic." The Post-Autistic Economics (PAE) movement, headquartered at the prestigious Ecole Normale Supérieure (ENS), generated tremendous publicity in France. There have been articles in Le Monde as well as a promise from Jack Lang, Minister of Education, that he would commission a report on the PAE's charges that economics in France has become overly mathematized and doctrinaire--that is to say, orthodox neoclassical--in its approach.⁵⁴

Japanese economics had close ties to the German historical school, hardly surprising given the variety of ideas and organizational forms that Japan borrowed from Germany, another late developer. This imparted an historicist and institutional flavor to Japanese economics, both before and after the war. Postwar economists like Kaname Akamatsu were decidedly anti-liberal in their advocacy of protectionism and export-promotion policies, ideas that found a close fit with the objectives of the Ministry of Trade and Industry.⁵⁵ Japan also had numerous Marxist economists, several of whom developed influential ideas such as Kozo Uno's stage theory and the crisis theories of Shigeto Tsuru and Makoto Itoh.⁵⁶ Today, neoclassical economics is on the ascendant but it is far from being the dominant approach in Japan, where, at least among academic economists, there is less uniformity than in the United States.

Of course, it's difficult to say which came first: particular approaches to economics or the demand for particular ideas, whether from a developmental state (Europe and Japan) or a powerful business community (the United States). In fact, it is probable that there was an interaction here. The vitality of non-neoclassical schools outside the United States has played an independent role in braking the adoption of neoliberal policies, just as the prominence of neoclassicism in the Anglo-Saxon world has had the opposite effect. Anyone who doubts that economists can affect policy outcomes should consider one telling example: the impact on developing countries of a

⁵⁴ Information on PAE can be found at the website, <http://www.paecon.net/>.

⁵⁵ Shiro Sugihara and Toshihiro Tanaka, eds. *Economic Thought and Modernization in Japan* (Cheltenham, U.K., 1998).

⁵⁶ Thomas Sekine, "Uno Riron: A Japanese Contribution to Marxian Political Economy, 13 *Journal of Economic Literature* 847 (1975).

neoclassical perspective at agencies like the International Monetary Fund. In recent years, the IMF has imposed strict privatization conditions on its borrowers and this has had measurable effects on the extent of privatization, especially in the form of asset sales.⁵⁷

Law and Politics: A recent development in comparative scholarship is the statistical analysis of social outcomes based on a country's legal system. The assumption is that a nation's regulatory outcomes are shaped by its legal traditions. Common law countries (the Anglo-Saxon group) are more inclined to rely on juries, judicial discretion, and contractual control of business. Civil law countries (whether French, German, or Scandinavian codes) cede less autonomy to juries and judges, and control of business is more likely to occur via regulation than contract. One area where legal systems seem to matter is corporate governance: common law systems are associated with greater ownership dispersion, ostensibly because the courts early on protected investors against monarchical expropriation and this was extended to include protection from insider dealing. Investors therefore had less incentive to press for block holding as a way of monitoring business, which is the outcome observed in civil law countries that did not enforce shareholder rights as scrupulously.⁵⁸

Another area where legal origin has been shown to matter is labor-market regulation. Botero et al. measure at the national level various labor outcomes such as employment law (e.g., how strong are protections against dismissal), collective bargaining laws (e.g., how strong is the right to strike or mandated employee participation), and social security laws (including various measures of the generosity of health and pension benefits).⁵⁹ When these outcomes are regressed against a country's legal system, there is a significant relationship: civil law countries have more extensive labor regulations than common law countries. The result holds even if one takes into account "political" variables such as the strength of the left and union power. Although these political variables matter, they have

⁵⁷ Nancy Brune, Geoffrey Garrett, and Bruce Kogut, "The International Monetary Fund and the Global Spread of Privatization," 51 *IMF Staff Papers* 195 (2004).

⁵⁸ Rafael LaPorta et al. , "Investment Protection and Corporate Governance," 58 *Journal of Financial Economics* 3 (Oct-Nov 2000). Note that Japan is coded as a Germanic law nation.

⁵⁹ Juan Botero, Simeon Djankov, Rafael LaPorta, Florencio Lopez-de-Silanes, and Andrei Shliefer, "The Regulation of Labor," NBER working paper 9756, 2003. The author's bête noire for the "political" approach to national variation in labor regulation is Mark Roe, although, of course, there is a vast and nuanced literature on this topic. Mark J. Roe, *Political Determinants of Corporate Governance* (Oxford, 2002).

less explanatory power than a nation's type of legal system. This is a powerful demonstration that there is something exceptional about the Anglo-Saxon nations and it has to do with the common law.

Or does it? The problem is that many factors affect labor outcomes and only a few of them are included in the analysis. Social norms such as individualism versus collectivism (are the poor in poverty because they are lazy or because they are up against tough circumstances?) likely are relevant yet are omitted. Then there is the matter of sequencing: is it really the common law that matters or is it relative power of business and the state at key moments in a nation's economic history? The two, unfortunately, are correlated and difficult to disentangle.

The Botero et al. approach privileges one starting point (legal origins) and ignores others (to do with political economic history). Consider the following counterfactual: Imagine if in 1900 the U.S. had been a laggard in world economic development. To kick-start the economy, the federal government invests in heavy industry, promotes oligopolies, counsels employer restraint, and hires John R. Commons and his associates to write national labor legislation. One rather doubts that the common law would have prevented this development. (It did not prevent it in early twentieth-century Australia or Canada. Even today, Canada's employment-law index ranks higher--that is, is more protective, than Sweden's, and its social-security index is higher than Germany's.)⁶⁰ There is an ahistorical quality to the Botero et al. analysis. We are never told the mechanisms through which legal origins actually determine outcomes such as social-insurance spending. Nor is the possibility considered that a country's development is not entirely fixed at the birth of its legal system (so-called strong path dependence) but instead can be shifted during extraordinary periods -- punctuated equilibria -- that break the path established earlier on, as in the United States in the 1930s.

Finally, because Botero et al. ignore an important political factor differentiating the

⁶⁰ Two other points: first, a labor scholar would immediately notice that there might be some problem in the construction of these indices because industrial relations regime in Canada is coded as less "pro-worker" than that of the United States. Second, another issue Botero et al. fail to consider is the point first made by the Webbs: that employment law and trade unions are not complements but substitutes: a country with a strong labor movement may be less inclined to regulate employment or possibly even to seek social insurance. This would call for a different--more recursive--statistical approach. See Peter Swenson, *Capitalists Against Market: The Making of Labor Markets and Welfare States in the United States and Sweden* (New York, 2002).

United States from other countries: its use of majority voting instead of proportional representation. As others have shown,⁶¹ majoritarian systems are associated with less inclusive, non-universalistic forms of social insurance. S.M. Lipset, in his studies of American exceptionalism (why there are no viable socialist or social-democratic parties in America) emphasizes voting systems as well as social norms and cultural values. Equalitarianism and individualism, whose strength in the United States Lipset traces to the absence of a feudal and aristocratic past, are not strong foundations on which to build new status rights, whether at the workplace or associated with citizenship.⁶²

Society: One thing we have learned about social insurance is that cross-class alliances are politically necessary to support redistributive schemes like public pensions and health insurance. Societies in which there is a high degree of trust and social cohesion tend to form common “risk communities” that result in higher social welfare expenditures. We also know that shared ethnic and racial identities are a powerful basis for creating these communities.⁶³ In the United States, among the earliest and most long-lived cross-class insurance schemes were the private burial, sickness, and pension societies that existed within ethnic communities, both for immigrants from Europe as well as in African-American and Mexican-American communities. Conversely, race played a deeply divisive role in early debates over the Social Security Act and, later on, in efforts to enact the Great Society programs of the 1960s.⁶⁴

In Europe and Japan, there were fewer immigrants and few racial minorities. Ethnic uniformity sustained a sense of social solidarity across regional and economic lines. In the early days of the British welfare state, “people believed they were paying the social

⁶¹ Torsten Persson and Guido Tabellini, “Comparative Politics and Public Finance,” 108 *Journal of Political Economy* 1121 (2000).

⁶² Seymour Martin Lipset, “Trade Unions and Social Structure,” 1 *Industrial Relations* 89 (1962); Lipset, *American Exceptionalism: A Double-Edged Sword* (New York, 1996); Sanford M. Jacoby, “American Exceptionalism Revisited: The Importance of Management” in Jacoby, ed., *Masters to Managers: Historical and Comparative Perspectives on American Employers* (New York, 1991).

⁶³ Peter Baldwin, *The Politics of Social Solidarity: Class Bases in the European Welfare State, 1875-1975* (Cambridge, 1990); Theda Skocpol and Richard Leone, *The Missing Middle: Working Families and the Future of American Social Policy* (New York, 2001); Jonathan Scwhabish, Timothy Smeeding, and Lars Osberg, “Income Distribution and Social Expenditures: A Crossnational Perspective,” working paper, LIS, May 2003.

⁶⁴ Jacoby, “Risk and the Labor Market,” op. cit; Theda Skocpol, *Protecting Soldiers and Mothers: The Political Origins of Social Policy in the United States* (Cambridge, MA, 1992).

welfare part of their taxes to people who were like themselves.”⁶⁵ Marshall’s essays on citizenship were written after the Second World War, an experience that reinforced a sense of national unity. But solidarity had a darker side. Some Europeans and Japanese viewed social insurance (and related policies such as immigration law) as a way to strengthen their nation's racial characteristics. Laudable goals of uplifting the poor and building human capital occasionally transmogrified into ugly eugenic experiments to sterilize or even euthanize those with "inferior" characteristics. The European left, even including the Swedish Social Democrats, was prone to these impulses as, of course, were the Nazis.

National solidarity was not entirely a racial phenomenon nor the result of an “in one boat” mentality produced by war. Some of it drew on pre-existing status traditions in countries that were late industrializers, whether Germany, Japan, or Scandinavia. These societies entered modernity with a paradoxical combination of contract and status: working-class protest from below and noblesse oblige from above. Of course, industrializing elites not only built upon existing status traditions but also resuscitated and adapted them to fit modern sensibilities, as with Japanese employers’ “familyism” and the nationalist concept of the *kokutai*.⁶⁶ In Europe, the elite’s sense of responsibility for the lower classes--coupled with encouragement from the Church-- made it possible to enact social-insurance legislation (the Church was especially interested in protecting mothers and families). While many in the “better” classes were put off by militant trade unionism, they had greater sympathy for craft-based or confessional unions whose focus on self-improvement and product quality resonated with guild and status traditions from an earlier era.⁶⁷

When it came to organizing workers, American unions believed that ethnic homogeneity made it easier to establish solidarity. Although American unions, especially those in the AFL, were criticized for their anti-immigrant and anti-Negro attitudes, these sentiments were partly based on organizational strategies, however misguided and racist. U.S. employers well understood the difficulty of creating solidarity in multi-racial and

⁶⁵ Alan Wolfe and Jytte Klausen, "Identity Politics and the Welfare State," 14 *Social Philosophy and Policy* 231 (1997).

⁶⁶ Byron K. Marshall, *Capitalism and Nationalism in Prewar Japan: The Ideology of the Business Elite, 1868-1941* (Stanford, 1967).

⁶⁷ Gosta Esping-Andersen, *The Three Worlds of Welfare Capitalism* (Princeton, 1990).

multi-ethnic workplaces. Companies like International Harvester and Thompson Products intentionally hired diverse employees and also stoked ethnic animosities in ugly ways. Conversely, when American workers were able to overcome these ethnic and racial divisions in the 1930s, their new unions became champions of national programs for social insurance, protective legislation, and other labor-market regulations.⁶⁸

Of course, one must be careful not to exaggerate differences between Europe and United States with respect to ethnicity. Parts of the upper Midwest were as homogeneous as the towns and villages left behind in Europe. On the other hand, modern Europe saw enormous population movements and mixing of ethnic groups, from the Thirty Years War on to the twentieth century. Around 1800, there were seven major migratory labor systems in Europe, and not a few of these migrant workers stayed in the countries where they labored. As Germany began to industrialize in the late nineteenth century, its cities were flooded with immigrants from the East, to the extent that annual in-migration reached 20 to 25 percent in some cities. And of course, Belgium and Switzerland have long been riven by linguistic and cultural divides.⁶⁹

What Lies Ahead?

The key question facing Western Europe and Japan today is whether their strong foundation for citizenship rights and employment rights--modern forms of status--will be able to withstand the drift towards markets and individual risk-bearing. One source of change are the neoliberal ideas developed in the Anglo-American world, which are taking hold in both Europe and Japan. The transmission occurs through the dominance of Anglo-American economic thought, through the globalization of media, and through tighter market integration, especially financial markets, where Anglo-American institutions hold sway. There are enormous consequences to something as innocuous as the requirement that companies seeking to list their shares on the New York Stock Exchange must conform to U.S.-style corporate governance standards. Those standards

⁶⁸ Lizabeth Cohen. *Making a New Deal: Industrial Workers in Chicago, 1919-1939* (Cambridge, 1990); Jacoby, *Modern Manors*.

⁶⁹ Sanford M. Jacoby and Matthew W. Finkin, "Labor Mobility in a Federal System: The United States in Comparative Perspective," SSRN working paper 514482, March 2004.

have the potential for setting in motion that kind of risk-shifting from shareholders to employees that has steadily eroded private employment rights in the United States.⁷⁰

Another source of strain is the growing population heterogeneity of Western European nations. Because of rising immigration and relatively high birth rates among immigrant families, there is nativist resentment over the burden of having to extend welfare-state support to “others.” Right-wing politicians like Jean-Marie Le Pen and the late Pim Fortuyn seek to fan the anti-immigrant flames; others use those sentiments as an opening wedge for paring back the welfare state. The evidence shows that having a right-wing government in power is associated with cuts in unemployment insurance and sickness benefits in European nations since 1980.⁷¹

The rise of lower-wage competition from places near (eastern Europe) and far (China) is putting pressure on European manufacturers to reduce their domestic labor costs or, if unsuccessful, to relocate production to lower-cost regions. One of the easiest ways to reduce costs is to reduce the tax burden on employers, either by cutting welfare expenditures or shifting the tax incidence from business to individuals.

In the past, industrial relations systems were premised on the idea of “taking wages out of competition” in the domestic labor market. Now the competition is transnational, at least in manufacturing, leaving unions searching for a response other than acquiescence.⁷²

One counter-current is the transformation of the European Union from a customs zone to a transnational political entity developing a new model for promoting economic security. The European Union is seeking to bolster Marshallian citizenship rights by decoupling those rights from national territoriality and securing them at the transnational level. The new European constitution includes among its objectives a “social market economy,” “full employment,” and “social protection.” It includes twenty fundamental social rights, such as the right to fair dismissal and the right to receive support during unemployment and old age. Left unsaid is the question of how these rights are to be actualized--especially given job competition between high- and low-wage EU countries--and how the responsibility for risk-sharing will be handled in a transnational framework.

⁷⁰ Sanford M. Jacoby, *The Embedded Corporation: Corporate Governance and Employment Relations in Japan and the United States* (Princeton, 2005).

⁷¹ Allan and Scruggs, “Political Partisanship and Welfare State Reform,” 507.

⁷² Richard Hyman, *Understanding European Trade Unionism: Between Market, Class, and Society* (London 2001).

Words come (relatively) cheap. But one thing is clear: Europe is proposing legal foundations for a vision of the economy and society that is entirely different from the Anglo-American model.⁷³

Now that Japan is emerging from its prolonged recession, the rationale for recasting its institutions in an American mold is harder to sustain. Although values are changing in Japan--towards less egalitarianism and social cohesion--it remains a relatively homogenous and solidaristic society. The share of income going to the top one percent in Japan stands at the same level as in 1950 and is about 40 percent the size of the share going to the top one percent in the United States.⁷⁴ Corporations continue to play a large role in shouldering risk burdens for employees, despite constant claims that Japanese welfare corporatism is on the wane. Despite its flaws, Japan's system of universal health coverage has produced the lowest infant mortality rates and highest life expectancy among the advanced industrial societies.⁷⁵

The argument is sometimes made by economists that there is an efficiency-equity tradeoff that will eventually hurt those who tilt too far in the direction of equity.⁷⁶ The implication is that indulging a taste for equity carries a price: Europe and Japan risk falling further behind in the coming years. In fact, the evidence for the effect of income equality on growth is equivocal, with studies finding both faster *and* slower economic growth resulting from income and wealth inequality.⁷⁷ On the one hand, greater inequality provides incentives (and reduces tax disincentives) for effort and longer working hours. On the other hand, greater equality creates opportunities for information sharing at the corporate level (the community firm approach to sustaining innovation) and at the societal level (the coordinated market economy that internalizes externalities,

⁷³ Jeremy Rifkin, *The European Dream* (New York, 2004); "The Ultra-Liberal Socialist Constitution," *The Economist* (18 September 2004), 59.

⁷⁴ Chiaki Moriguchi and Emmanuel Saez, "The Evolution of Income Concentration in Japan: 1885-2002," working paper for the Economic History Association meeting, August 2004.

⁷⁵ Ronald Dore, *Stock Market Capitalism, Welfare Capitalism: Japan and Germany versus the Anglo-Saxons* (Oxford 2000); Christian Oberlander, "Universal Health Insurance Coverage in Japan," Harvard School of Public Health, working paper, 2001.

⁷⁶ Arthur M. Okun, *Equality and Efficiency: The Big Tradeoff* (Washington, D.C., 1975).

⁷⁷ Phillippe Aghion, Eve Caroli and Cecilia Garcia-Penalosa "Inequality and Economic Growth: the Perspective of the New Growth Theories," 37 *Journal of Economic Literature* 1615 (1999); Robert Perotti, "Democracy, Income Distribution and Growth: What the Data Say," 1 *Journal of Economic Growth* 149 (1996).

promotes human capital investments, and reduces instability).⁷⁸ More generally, there is no conclusive evidence that government spending is associated with reduced economic performance, contra Okun's assertion.⁷⁹

Markets and laws interact in unpredictable and complex fashion. For example, the conventional neoclassical wisdom that constraints on employers such as minimum wage laws uniformly reduce employment by raising the cost of labor; this turns out, upon close empirical scrutiny, to be wrong, at least in the United States.⁸⁰ A recent paper on European wage floors -- minimum wages and contractual union rates-- finds that European employers faced with relatively high wage rates for less skilled workers will respond by investing more in employee training and physical capital to raise productivity up to levels that can sustain the higher wage floors. In the long run, this moves companies up the product learning curve and makes them less vulnerable to low-wage competition.⁸¹ The general point is, as Wolfgang Streeck recently put it, that institutions and policies "that were clearly not created for economic reasons and with economic efficiency in mind, may turn out to be sources of superior economic performance and competitiveness." Employers adapt to these social and political constraints as they do to the constraints imposed by market competition: with creative and often beneficial innovations.⁸²

It is true that Britain and the United States turned in better economic performance in the 1990s than either Western Europe or Japan. But if we extend the period of observation to include the 1980s (when the U.S. was in the doldrums) and the early 21st century (when Europe and Japan were in recovery), the picture changes. For the period 1980-2003, comparatively egalitarian countries like Japan and Norway had faster real GDP growth per capita than the United States. If one examines real GDP growth per

⁷⁸ Takeshi Inagami and Hugh Whittaker, *The New Community Firm: Employment, Governance and Management Reform in Japan* (Cambridge, 2005); David Soskice, "Divergent Production Regimes: Coordinated and Uncoordinated Market Economies in the 1980s and 1990s," in H. Kitschelt, P. Lange, G. Marks and J. Stephens, ed., *Continuity and Change in Contemporary Capitalism* (Cambridge, 1998), 101–134..

⁷⁹ Joel Slemrod, "What do Cross-country Studies Teach About Government Involvement, Prosperity and Economic Growth," *Brookings Papers on Economic Activity* 373 (1995).

⁸⁰ David Card and Alan Krueger, *The New Economics of the Minimum Wage* (Princeton, 1997).

⁸¹ Jorn-Steffen Pischke, "Labor Market Institutions, Wages, and Investment," NBER working paper 10735 (2004).

⁸² Wolfgang Streeck, "Educating Capitalists: A Rejoinder to Wright and Tsakalotos," 2 *Socio-Economic Review* 425, 426 (2004).

employed person, the picture turns even less favorable for the United States, with seven of thirteen advanced economies growing more rapidly than the United States. Of course, the latter finding is largely the result of the U.S. economy having generated more jobs, albeit at the bottom of the labor market, while Europe and Japan have endured higher unemployment combined with high productivity and wages for their employed workers. It's a case of working smarter (but with more unemployment) versus working harder (but with more inequality). The point, however, is that nations don't have to tolerate inequality--as a result of individualistic risk-sharing--to achieve economic growth.⁸³

For the Anglo-American countries, the big question hinges on Polanyi's double movement: Are we at the "end of history" or are we likely to see a regulatory response to the expansion of markets, contracts, and individualism of the past thirty years?

When we project the present moment forward, we tend to see the future as being like the present, only more so. It's difficult to imagine the rebirth of the double movement in an era of declining governmental and employer responsibility for mitigating the risks of economic life. The communitarian ethos bred by the Great Depression and the Second World War -- a form of social capital that sustained unions and the welfare state -- is eroding. With unions growing ever weaker in the U. S and the U.K., there seems little possibility of the labor movement helping to solve the collective action problem by pressing for an expansion of economic rights. The ostensible experts on these issues--the economic mandarins--tend to intellectual conformity and lack of imagination (and enthusiasm) regarding the possibilities to be achieved from a less rugged and more egalitarian society.

Yet here and there are signs that Polanyi's double movement is stirring. Polanyi argued that market regulation could not be reduced to class interests or sectional rent-seeking but instead occurred when coalitions formed across different strata and groups. In the United States, the fact that outsourcing is now threatening the jobs of upper middle-class professionals has changed the debate over globalization. Misgivings about free

⁸³ U.S. Bureau of Labor Statistics, "Comparative Real Gross Domestic Product Data for Fourteen Countries. 1960-2003" (Washington, D.C., 2004) at <http://www.bls.gov/fls/flsgdp.pdf>

trade have gone from being seen as the backward-looking anxieties of saurian industrial unions to concerns that have broader legitimacy. The greater volatility of personal incomes over the past twenty years has come at the same time as corporate earnings have become not only higher but more stable. In other words, risk has risen and has been shifted to employees, yet most of them have not shared in the returns associated with greater risk. Combined with the simmering unease over corporate governance and corporate responsibility—in a word, Enron--the United States may be on the cusp of a national debate about the level and distribution of risk and return.⁸⁴

Lest all this sound Pollyannaish, consider the point recently made by Cass Sunstein: that Franklin D. Roosevelt's 1944 proposed Second Bill of Rights--one that would ensure the right to a "useful and remunerative job," to education, medical care, housing, and protection from the fears of unemployment and old age--has had an enduring, if sometimes underground, impact on the law. The notion of economic rights came very close to receiving constitutional status from the Supreme Court in the 1960s until Nixon's court appointees stopped the movement in its tracks. Sunstein contends that, despite the new (or revived) rhetoric of reaction, the idea of economic rights for all -- not just for property owners -- continues to percolate in the consciousness of our legislators, judiciary, and citizens. Several of these rights are enshrined in the new European Constitution. As with modern social insurance, the United States may again find itself importing enlightened ideas from across the Atlantic.⁸⁵

Mainstream Anglo-American economics finds itself increasingly fissured. No less than Paul Samuelson himself recently published a sharp attack on the claim that outsourcing was, despite momentary inconveniences, merely another welfare-improving benefit of free trade.⁸⁶ The work of behavioral economists and psychologists like the recent Noble prizewinner, Daniel Kahneman, has delivered a sharp empirical blow to the rational choice model. Experimental evidence shows that people will cooperate in situations where rational choice theory predicts that they will not, and that they willingly pay their share for public goods when public choice theory predicts that they are

⁸⁴ Peter Gosselin, "If America is Richer, Why Are Its Families Less Secure?", *Los Angeles Times* 10 October 2004), 1.

⁸⁵ Cass Sunstein, *The Second Bill of Rights: FDR's Unfinished Revolution and Why We Need It More Than Ever* (New York, 2004).

⁸⁶ Lohr, "An Elder Challenges Outsourcing's Orthodoxy, op. cit.

indifferent to fairness or are free riders. As economist Thomas Ulen observes, “law and economics has premised much of its scholarship on rational choice theory. Therefore the implications of the literature critical of that theory for law and economics are profound.”⁸⁷ The implications go well beyond law and economics. The fact that people persistently underestimate risk, even with complete information, suggests that there is a rationale for social insurance. At a philosophical level, there is an emerging Habermasian critique of rational choice for failing to take into account the consequences of communication between actors, a finding that relates to empirical observations that actors tend towards cooperation and voters and legislators do not behave as predicted by the theory. If nothing else, these developments show the liabilities of neoclassical theory's rational choice framework. If all of social science, not just economics, had been based on rational choice's version of homo economicus (this was the universalistic aspiration of its proponents), we would have no alternatives to its present problematic edifice.⁸⁸

At a more practical level, the claims made in support of deregulation have turned out to be exaggerated, as has been the case with energy deregulation (California being a case in point) and privatization (whether by vouchers or by Halliburton). In Japan and Europe, as well as in the developing world, there is now greater skepticism about radical deregulatory proposals. Even MIT economist Paul Joskow, long an advocate of deregulation, has recently expressed misgiving about diminishing returns from a narrowly neoclassical approach to regulation. He argues that too much attention has been given to the virtues of markets and not enough to the benefits of reducing transaction costs through organizations and regulation. Joskow urges that economists pursue more interdisciplinary research, and pay closer attention to institutional detail and the long-term dynamics of innovation.⁸⁹

⁸⁷ Thomas Ulen, “Rational Choice Theory in Law and Economics,” in Bouckaert and De Geest (eds.), *Encyclopedia of Law and Economics*, vol. 1, 809; Russell Korobkin and Thomas S. Ulen, “Law and Behavioral Science: Removing the Rationality Assumption from Economics,” 88 *California Law Review* 1051 (2000).

⁸⁸ Joseph Heath, *Communicative Action and Rational Choice Theory* (Cambridge, MA 2001); Donald Green and Ian Shapiro, *Pathologies of Rational Choice Theory: A Critique of Applications in Political Science* (New Haven, 1994).

⁸⁹ Paul L. Joskow, “New Institutional Economics: A Report Card,” working paper based on presidential address to the International Society of New Institutional Economics, Budapest, 2003.

If there is one thing to be wary of, it is the mindset that views the future as an inevitable extension of the present. When we take an historical view, we are more likely to see the possibility of unexpected changes and recurring patterns than is the case for those whose historical sensibility is inert. As Albert O. Hirschman points out, even the arguments we hear today about the futility of controlling markets through human agency are themselves forms of rhetoric that have been repeated in different voices for the past two hundred years. Since the French Revolution, reactionary pundits have claimed that efforts to empower the disenfranchised or make the poor better off either produce negative unintended consequences (the road to hell paved with good intentions) or reproduce the existing structure of power and income (through the rent-seeking behavior of putative reformists, as in public choice theory). What Hirschman calls the “rhetoric of futility” produces a suspicion of anyone and anything seeking to overturn immutable facts about human nature or the economy’s natural laws.⁹⁰ Although the future is notoriously difficult to predict, I place my bets on a renewed effort to balance markets and their deficiencies. The United States may never achieve that balance in quite the same way as Europe and Japan, but neither is it likely to continue ad infinitum on its present trajectory.

⁹⁰ Albert O. Hirschman, *The Rhetoric of Reaction: Perversity, Futility, Jeopardy* (Cambridge, MA, 1991).