Chapter 3

The Origins Of Dualism

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From Spain and Greece to Brazil and South Africa, dualized labor markets are a worldwide phenomenon. In many countries, workers are divided between those with permanent contracts that come with valuable benefits and extensive labor market protections and those who work under contingent contracts or no contracts at all. This latter group receives few or no labor market protections and lower levels of social benefits. They are the world's labor market outsiders. Recent research has suggested that this pool of outsiders has important implications for the nature of democratic politics in the 21st century[1], an argument that is perfectly in line with the core idea of this book, namely that coalitional alignments between different labor market groups are at the heart of post-industrial reform strategies.

Yet the extent of dualization varies hugely across countries. Data on the size of the informal sector around the world (from Schneider et al. 2010) shows that while there is clearly a negative association between the wealth of societies and the extent of dualization, there is also huge variation both within and across rich and developing nations. In the OECD context, the process of dualization has been linked to a number of political and economic processes: increasing competition in manufacturing, the rise of the service sector, the decline of unionization, political choices by Left governments, etc. Echoes of these arguments are present in work on developing countries, where dualization is closely linked to the informal sector and

[1] See, for example, Mares (2006), Martin and Thelen (2007), Rueda (2007), Iversen and Stephens (2008), Palier and Thelen (2010), and the contributions to Emmenegger *et al* (2012).

has received a lot of attention from economists and sociologists (if not political scientists). Indeed, a long tradition of models in development economics emphasize the stark income and productivity gaps inherent in "dual economies" and the uneven growth that characterizes broad swaths of the developing world (Rosenstein-Rodan 1943; Ray 2010). Yet while all of these arguments emphasize important features of dualization, they often focus on the consequences rather than the causes of labor market dualism. Most existing analyses understand dualization as an exogenous factor (some countries have more of it, some countries have less of it) and explore its political and economic implications. They therefore provide little leverage for explaining why dualization varies so much among rich and middle-income countries.

We seek to explain the political origins of dualization. We argue and show that there are affinities between the nature of industrialization in the aftermath of World War II, the emergence of labor market regulations, and the extent of labor market dualism across the world today. Industrialization produces a demand for protection and insurance (called "consumption policies" in the introductory chapter of this book). As recognized by authors like Katzenstein (1985), industrialization in an open economy is consistent with either very modest protection/compensation, as in the US, or very significant compensation, as in the small states of Northern Europe. While this last benign combination of openness and social compensation (and its resulting flexibility and competitiveness) has received a lot of attention in the literature, we argue that both in the OECD and in developing countries the combination of internally-oriented industrialization, stark risk differentiation in favor of insiders and dualized labor markets has been more common. It is this set of outcomes that interests us most. Indeed, the inflexible economies of southern Europe represent a much more general model than the rather unique flexicurity arrangements of northern Europe.

More specifically, we argue below that policies developed with an eye toward internally-oriented industrialization left a powerful imprint on labor market regulations aimed at protecting labor market insiders. Those labor market policies have survived the last several decades of economic liberalization thanks to a series of advantages that insiders have in electoral and interest group politics. Yet by increasing employment protection legislation and protecting workers in some of the least productive sectors, those labor market policies then become a significant determinant of labor market dualization today. Ours is a story of continuity within countries and tremendous diversity across them. We argue that this variation helps explain why some economies have generated good jobs and produced more equitable societies, while others have produced large pools of labor market outsiders.

By focusing on the origins of dualization and its temporal stability, this chapter substantiates the analytical framework of this book as developed in the introductory chapter. Our chapter explains how institutional legacies in the area of labor market regulation have emerged, developed and solidified over time. These institutional legacies have become important supply side constraints on partisan politics and government choices today, as they structure an allocation of resources in favor of the consumptive needs and demands of labor market insiders. More specifically, our argument helps explain why the feasible set of reforms in contemporary southern European countries is so restricted both institutionally and in terms of coalitional realignments. These countries indeed seem "captured" in a logic of dualization and risk differentiation.

The organization of the chapter is as follows: In the following section we provide a more detailed explanation of our main argument and explore the implications for alternative and complementary views in the existing literature. We present two claims: one connecting the process of industrialization to employment protection and the second connecting employment protection to labor market dualization. In the second section, we provide some suggestive evidence showing the link between autarkic industrialization and insider employment protection around the world. We show how resilient insider protection levels have been even in a context of general financial and economic liberalization and we explore the relationship between insider employment protection and labor market dualization. We show that high levels of insider protection are an impressive predictor of subsequent dualization; once insiderness emerges, outsiderness follows. The final section includes our conclusion and a discussion of the implications of our argument for insider-outsider politics around the world.

3.1. Protectionism, Insiders and Dualism

There are several ways of thinking about dualization. They represent different emphases on factors like employment status, access to benefits and protection, political representation, citizenship, etc.[2] For the purpose of this chapter, we follow Rueda (2005, 2006 and 2007) in understanding the division between insiders and outsiders to be essentially related to the unemployment vulnerability of different actors in the labor market. We understand insiders to be workers with highly protected jobs. They are sufficiently protected by the level of security in their jobs not to feel significantly threatened by unemployment. Outsiders, on the other hand, are unemployed, working in the informal sector, or hold formal jobs characterized by low levels of protection and employment rights, lower salaries, and precarious levels of benefits.[3]

[2] For a more detailed analysis of these distinctions in industrialized democracies, see Davidsson and Naczyk (2009).
[3] To be clear, this definition distinguishes dualism that emerges from government regulation of the labor market (as in Spain, Portugal, Brazil, and the like) from segmented labor markets that result primarily from the distribution of skills and labor market demand (as in the U.S. and U.K.). While the latter cases have seen considerable growth in low-wage, high-turnover work, it is not the result of unequal legal treatment of different classes of workers.

Because low vulnerability to unemployment is the key distinction between insiders and outsiders, the emergence of insider employment protection is the first outcome we need to explain. Below, we argue that labor market regulations have their roots in processes of industrialization and we relate this claim to alternative explanations in the existing literature. We then explain what happens subsequently in countries with highly protected insiders and provide an argument for the relationship between insider employment protection and the emergence of dualized labor markets.

3.1.1. Protectionism and the Origins of Labor Market Regulations Around the World

Industrialization exposes large numbers of market participants to a dizzying array of risks: physical injury, unemployment and business failure as a result of downturns in the business cycle or technological innovation, aging in a social context marked by the decline of traditional family networks, etc. Some of these are the direct result of industrial production while others are the result of the economic specialization that is the hallmark of industrialization. In the face of these dislocations, citizens often demand social solutions, and history shows that the widespread demand for social policy is closely associated with labor market specialization, wage labor markets, and urbanization that are inherent to the process of industrialization. Those solutions involve the use of the fiscal and regulatory power of the state to reallocate risks and the costs of mischance. Whether through spending programs for the displaced, diseased or otherwise debilitated or regulations that make displacement less likely, social policy serves to ease the risk of participating in an industrial economy.

Key to our argument is a recognition that policy can *compensate* workers after they have suffered mischance or it can *protect* them from mischance in the first place. While compensatory measures protect workers from ill health, aging, and unemployment *ex post*, labor market regulations are designed to protect them *ex ante*. The former set of policies can facilitate adjustments to market forces, while the latter are aimed at resisting them. This distinction is essential to the rest of this chapter because different experiences with industrialization have resulted in quite different weights on compensatory and protective social approaches to risk, and as we discuss in the next section, the two have starkly different implications for the extent of dualization in today's globalized markets.

History shows that there is more than one path to industrialization. While some countries developed industry in the context of open markets, others pursued import substitution industrialization (ISI). In the open economy cases, policies seek to promote international competitiveness and generate foreign exchange by exporting manufactures. Complementary policies typically included export incentives, low trade barriers (with some exceptions for imports), and weak exchange rates. Import substitution industrialization, with its emphasis on heavy industry to service domestic demand, reflects a very different policy mix: trade protection, the creation and subsidization of infant industries, overvalued exchange rates to promote the importation of capital goods, and the extraction of surplus from commodity exports in order to finance the industrialization project.

While the focus of this chapter is the consequences of internally-oriented industrialization, a prominent literature in political economy has emphasized the relationship between openness and compensation. In economies dependent on international markets, the costs of industrialization can be met with social compensation. As a long line of work suggests, this compensatory approach to market risks plays a prominent role in work on the development of the welfare state in Northern Europe. Whether the welfare state is seen as an efficient compromise in the face of open markets (Cameron 1978; Katzenstein 1985; Garrett 1998; Rodrik 1998; Adserá and Boix 2002) or a reflection of varieties of capitalism (Iversen 2005), social policy compensation supposedly provides the linchpin between democratic politics and open markets. In the former set of arguments, there is an affinity between democracy, open markets and insurance from labor market risks. Adserá and Boix summarize the dynamic well: "In closed economies, politicians have few incentives to engage in substantial public spending. In open economies, a large public sector emerges as the price that the tradable part of the economy has to pay to ensure the acquiescence and cooperation of both the sheltered economy and declining tradable industries."[4] The larger the tradable sector and the greater the international economic competition, the greater the compensation. In the VoC version, high minimum wages and social insurance transfers compress the income distribution.[5] By constraining wages in those sectors where the marginal product of labor is highest, labor market insurance serves as a subsidy to investment in the most competitive sectors of the economy (even as it increases wages in non-tradable sectors). These are benign accounts that emphasize how compensation, competition and democracy can go together.

Yet, as recognized by Katzenstein (1985), *ex post* compensation is only one means of insuring against the risks of an industrial economy. By comparative standards, *ex ante* protective measures are much more common, and as we show below it is the most internally-oriented economies that generated the most extensive *ex ante* protections for labor market insiders. Consistent with the need to respond to dynamic market signals, the most externally-oriented economies promoted low levels of employment protection. They combined these with high

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[4] Adsera and Boix 2002: p.246.

[5] One might reasonably ask why some workers are willing to forego higher wages for social insurance. The answer, as discussed in Moene and Wallerstein (2001) and Iversen and Soskice (2001), is that given some level of risk aversion, workers are willing to forego higher income now for greater income security in the future.

levels of social compensation in the Scandinavian cases and low levels of compensation in the non-OECD export-led industrializers.[6] The most extensive *ex ante* labor market protections did not develop in the smallest, most open economies; its chief constituents were not in the most trade-exposed or competitive sectors of the economy; and it has not facilitated productive dynamic labor markets in today's globalized economy. Quite the contrary, labor markets were most protective in the most closed economies, and its chief supporters were in the most internally-oriented portions of the economy. In these countries, employment protections were explicitly designed to benefit industrial workers who benefited from trade restrictions (and public sector workers who faced no external competition). Why?

While industrialization in an open economy made market actors sensitive to the need for competiveness, adaptability and the costs of insuring against the risks of industrialization, protectionism provided an easy means for actors in the insulated industrial sector to pass them on. Import-substituting economies allocated risks in a very particular way that produced a shared interest among capital and labor in trade and labor market protections.[7] In ISI countries, capital and labor shared a preference for limiting competition, and they coordinated to capture the rents associated with protection.[8] Capital benefited from these economic rents directly through subsidies, trade protection, and anti-competitive regulations on the domestic market; labor

[6] Katzenstein (1985) makes a distinction between social and liberal variants of corporatism (unlike the Scandinavian one emphasized above, the liberal one is characterized by strong outward-oriented employers but weak labor). We address the role of labor in inward-oriented industrializers below.

[7] The argument does not necessarily imply that development strategy choices preceded social policy implementation. They can be chosen jointly, e.g., Perón's promise of substantial benefits to workers while also promoting ISI policies, or they can be chosen sequentially, as what appears to have happened in Mexico and Korea.

[8] Economic rents occur in uncompetitive product markets, and arise due to the market power of producers vis-à-vis consumers. Such power allows producers to charge a price for their products in excess of the price that would pertain in competitive market conditions.

benefited through high wages and employment protection, which were the cost of labor peace in the protected industrial sectors.[9]

The greatest threat to labor in an industrializing economy is unemployment, and its interest vis-à-vis any prospective social policy is to protect jobs and increase wages. One can imagine workers as maximizing their expected wage income, i.e., the probability of finding an industrial sector job times the industrial wage plus one minus that probability times the reservation wage (e.g., farm labor income). Risk is the *ex ante* probability that the worker will not be employed in the industrial labor force. This *ex ante* preferred level of insurance holds for *all* workers, not just those who end up holding well-paying industrial jobs. A worker's preferred level of insurance will be increasing not just in the risk of not holding an industrial job, but also in the difference between industrial and non-industrial wages and the worker's aversion to risk (Moene and Wallerstein 2001). *Ex post*, well-paid industrial workers will still want insurance to the extent that the probability they continue in that job is uncertain, and their demand for insurance will *increase* with income (Moene and Wallerstein 2001).

The severity of labor's *ex ante* and *ex post* risks were shaped by the nature of industrialization. Particularly at early stages of Fordist industrialization, manufacturing utilizes unskilled workers whose counterfactual wage in agriculture is very low. This was particularly true in import-substituting countries, which typically industrialized faster and later than their open-economy counterparts. In such settings the wage gap between industrial and traditional employment tended to be very high. The high levels of inequality between manufacturing wages and farm incomes, in combination with government policies that limited the arbitrage of urban

[9] A link between the competitiveness of product markets and the employment conditions of employees is strongly supported by the labor economics literature. For example, a well-established empirical finding in the OECD is that employees in economies or sectors with relatively low levels of competition enjoy higher wages than those employed in companies operating in more competitive markets (Jean and Nicoletti 2002: 4). There also exists a strong cross-country association between levels of product market competition and levels of employment protection (Conway et al 2005: 31).

and rural wages, implied that the actuarial value of a good industrial job was higher in inward-looking industrializers; in the event of job loss, injury, sickness, etc., workers in such settings had further to fall.[10]

If labor's primary interest is job stability, the interests of capital in industrializing societies center on labor peace. Since Marx, work on the sociology of industrialization has noted that urbanization and the industrial workplace serve to harmonize the interests of workers, facilitate collective action and promote unionization (Silver 2003). In this regard, Collier and Collier's account of labor mobilization in Latin America characterizes industrialization processes more generally. They write that labor stability was most important and most threatened in the dynamic sectors of the urban industrial economy:

> "the paralysis of this latter sector through strikes is therefore an important economic and political event, and the use of repression to control strikes may be especially problematic because of its effect on the skilled labor force in this sector and the greater difficulty of replacing skilled workers" (1991: 41).

Generous labor market protections, steep seniority pay and severance payments are potential means to appease the working class and reduce the risk of labor unrest.[11] These labor market regulations had the obvious effect of insulating workers from being laid off, increasing barriers to entry into the formal industrial labor market, and increasing industrial wages.

The problem, of course, is that such policies increase costs for business. They do so by increasing the barriers to firing urban blue- and white-collar workers while reducing the incentives to hire additional workers from the traditional sectors. Once in place, they increase

[10] One can imagine labor as maximizing its expected return from current wages and its alternatives in the labor market. Where the alternatives are sufficiently poor (conditions of high inequality), it prefers spending on insurance at the expense of human capital. When the alternatives are sufficiently good (conditions of low inequality), it prefers spending on human capital that will permit increased wages in a context of an open development strategy.

[11] Indemnities are a more common policy tool than unemployment insurance in the developing world.

labor turnover costs and provide substantial obstacles for rural workers seeking to break into the modern sector, thereby constraining the supply of skilled workers and limiting the arbitrage between urban and rural incomes. These costs are easier to address in a closed economy than an open one. In ISI countries, product markets were both highly protected and concentrated. Protectionism ensured that producers did not have to compete with foreign companies, and concentrated markets (a typical byproduct of protection, monopolistic state-owned enterprises, and economies of scale) ensured that capital did not face domestic price competition. With captured product markets, capital was free to raise prices, which served to externalize the costs of labor market regulations onto all of society. No such option was available to firms in open economy industrializers as they faced prices set on global markets.

Thus, labor colludes with capital to share the rents of protection in inward-looking industrializers. As in the open economies, unions grow in strength in ISI countries because they act as a buffer against the increasing uncertainties brought about by industrialization. Although referring to an earlier process of industrialization, Agell's (2002) explanation of organized labor's role resonates with the late industrialization of inward-looking countries. In these cases, union strength develops as a response to the specialization-related insecurities inherent to industrialization. Unions provide employment provision services, unemployment benefits, and union member protection (through pressure on employers for bans on overtime work, 'short time' work arrangements as a substitute for lay-offs, etc).[12] Unlike in open economies, however, the consequence of this increased labor power is *ex ante* protection in inward-looking industrializers. It could be argued that *ex ante* protection should be equivalent to *ex post* compensation for insiders if they are indifferent between severance pay and unemployment

[12] In the OECD countries, in this period inward-looking industrialization coincides with other factors magnifying the influence of organized labor (full employment, labor unrest, Keynesian macro-economic management, etc).

benefits for the same value.[13] Nevertheless, immediate *ex ante* protection is more attractive than the more conditional possibility of *ex post* compensation, particularly if the latter is subject to the give-and-take of budgetary and partisan politics. These protections, in turn, have important implications for competitiveness and the development of labor markets. While *ex post* compensation is associated with the positive developments mentioned above—it can subsidize investments in the most competitive sectors of the economy, allows workers to invest in specialized skills, etc–*ex ante* protection promotes labor market segmentation.

Our argument implies a specific historical development of employment protection as a consequence of post-World War II economic development. Empirically, this is clearer in OECD countries (where the data are more easily available). First, starting in the late 1960s, firms accepted highly restrictive tenure and severance pay arrangements—see Blanchard *et al* (1986) and Bentolila and Bertola (1990). In many respects, the creation of a significant degree of "insiderness" (defined as protection for those in standard employment) starts at this point in most OECD countries. This explanation of the development of employment protection in the OECD is consistent with that emerging from the work of Allard (2005). Allard has created a historical series based on the OECD's employment protection legislation indicator (OECD 1999, chapter 2). Her indicator provides a picture of "fairly unregulated labor markets in the OECD overall during the 1950s and early 1960s, with sharp increases in regulation clustered in the 1964-1978 period" (p. 8). We will show below that these highly diverse cross-national levels of employment protection are, in fact, strongly correlated with the nature of industrialization.[14]

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[13] See Fernandez-Albertos and Manzano (2008).

[14] Our argument is not that the nature of industrialization is the only factor that matters. Blanchard *et al* (1986) argue that this process was influenced by a pattern of stability and growth which allowed firms to consider employment protection as relatively costless. Esping-Andersen (1999) argues that Catholic political culture is one of the sources of strict job security regulations (but Emmeneger 2011 finds no evidence for this) Bentolila and Bertola point out that the post-Oil Shock crises contributed to a further reinforcement of legislation in France and the UK, among other countries, around 1975 (1990: 394). And many analysts agree that these later developments were influenced

3.1.2. Employment Protection and Labor Market Dualization

By the end of the 1970s a substantial share of labor in many countries around the world had become significantly insulated from unemployment by restrictive legislation. Our second claim is that, where the advantages of insiders dominate, labor market policies built for an era of protectionism have persisted and served to block the labor market adjustments needed in a world of increasingly open markets. In these cases, pro-insider labor market policies have become a source of social exclusion and segmented labor markets even as they prove to be a robust political equilibrium.

In our account, just as insiderness established itself in those countries that had experienced protectionistic industrialization, a new set of challenges was developing. A large body of work has described the economic shocks associated with the liberalization of the global economy beginning in the 1980s. A common result across all of these cases—developed and developing, open market and import-substituting industrializers alike—was a pronounced process of deindustrialization. A fairly extensive literature in economics has examined the extent of deindustrialization across the world (Pieper 2000; Rowthorn and Coutts 2004). Explanations range from the technological bias of contemporary manufacturing to the diminishing marginal returns to the consumption of manufactured goods as incomes increase. More important for the focus of this chapter is the challenge that deindustrialization represents for insider protection.

Since many of the factors emphasized by standard explanations of deindustrialization are common across countries, they provide limited leverage to explain cross-country variation in the extent of labor market dualization. The fact that industry had shrunk and production changes

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by social unrest and union activism. We are unable to arbitrate among these competing arguments in our analysis below.

demanding flexibility were more common did not imply that outsiderness had to grow. Indeed, the proponents of market reforms argued that while the reallocation of labor and capital inherent in liberalizing policy would certainly destroy some jobs, they would produce new ones in more efficient sectors. Yet, while the transition from an industrial to a post-industrial economy went relatively smoothly in some countries, it did not in others. In the former cases, relatively flexible labor markets facilitated the transition; in the latter cases, labor market protections complicated the transition by protecting insiders and promoting the growth of a large pool of labor market outsiders.

We argue that even where they are large in number, labor market outsiders face stark disadvantages in the democratic process when compared with their insider counterparts. While labor market insiders benefit from concentrated interests and impressive powers of collective action, outsiders have heterogeneous preferences and face severe limitations on collective mobilization. Thus, outsiders tend not to share a programmatic orientation that would them to serve as a key constituency for political parties. Unlike traditional classes or even coherent interest groups, the pool of outsiders is composed of a large number of individuals with few shared interests and even fewer incentives and capabilities to organize around them.

In economies where insiders are well-protected, therefore, the logic of policy change becomes a profoundly dualizing one. When insiders are sufficiently powerful, the need for flexibility to achieve international competitiveness will not result in lower employment protection. The relationship between insider-outsider differences and employment protection can therefore be best understood as a reinforcing loop playing itself out since the late 1970s. Once insider employment protection is high, it allows insiders to direct adjustment strategies by facilitating the emergence of an outsider sector, which allows for the continuation of high levels of insider protection. Thus, where the advantages of insiders dominate, labor market policies built for an era of protectionism have persisted as institutional legacies (cf. chapter 1 of this volume), constrained reform strategies and slowed economic adjustments to a world of open markets.

In developing countries, instead of a boom in new employment opportunities afforded by liberalized markets, millions of workers and small businessmen had to fend for themselves in a burgeoning informal sector. Though there are important debates about what exactly constitutes the informal sector, the crucial characteristic for our purpose is that it is defined by work that occurs outside of the legal system of taxing, spending, and regulation. Informal work spans a broad range of activity ranging from small manufacturing firms, pirates of intellectual property, house cleaners, and everything in between. Informal sectors have become a permanent feature of many developing economies, and a huge body of work has emerged in response (Turnham et al. 1990; Centeno and Portes 2006; de Soto 1989; Gerxhani 2004; Tokman 1992; Maloney 1999; Levy 2008). Generally speaking, informal sectors grow as a result of coping strategies on the part of workers without alternative employment opportunities and the desire of firms to avoid regulations.[15]

In a similar way, the need for flexibility did not result in lower employment protection in many OECD countries. Instead, the flexibilization of labor market legislation that took place in the 1980s affected entry into (not exit from) the labor market (see, for example, Bentolila and Bertola 1990). One of the consequences of this process was a dramatic increase in part-time work and temporary contracts (Maier 1994). The great majority of part-time work and temporary

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[15] The World Bank defines coping strategies in terms of casual jobs, temporary jobs, unpaid jobs, subsistence agriculture, multiple job holding. It defines illegal business activity in terms of tax evasion, avoidance of labor regulation and other government regulations, and failure to register companies. See: http://lnweb90.worldbank.org/eca/eca.nsf/0/2e4ede543787a0c085256a940073f4e4?OpenDocument

contracts, however, pay poorly, are concentrated in low-skilled activities, and offer a precarious level of benefits and employment rights.[16] Moreover, the precariously employed and the unemployed are the main, if not only, group to suffer the consequences of economic fluctuations (being hired in good times and fired in downturns).[17]

3.2. Evidence on the Link between Industrialization, Labor Market Protections and Dualization

Unfortunately, all of the key concepts discussed above—internally orientated industrialization, labor market protections, and dualization—are difficult to measure across a broad cross-section of countries, and there is almost no means of measuring them in a common way as one goes farther back in history. That being the case, we present three waves of highly preliminary evidence bearing on our argument. With each wave, we present evidence for as large a sample of countries as possible, albeit using data that only partially captures the key concepts, and then present results for the OECD sample for which we have better data. First, we show the cross-country association between trade distortions in the 1960s-1970s and subsequent labor market regulations; we have to rely on more modern labor market regulatory data because there is very little data for the developing world that dates to even the 1980s. Second, we show that labor market regulations are extremely stable through time. In light of the data constraints discussed above, we provide results only for Latin America and the OECD, the two regions where we have a reasonably long time-series that is comparable. Third, we show labor market regulations are associated with larger pools of outsiders. We do so with a measure of the size of

[16] See, for example, Maier (1994) for an analysis of part-time legislation and Mosley (1994) for a description of temporary employment in Europe. See also the contributions in Gregory *et al* (2000).

[17] Immigration also plays an important role in buffering insiders. In fact, it could easily be argued that immigrants are the ultimate outsiders. Immigrant labor is not emphasized in this chapter, but see King and Rueda (2008) for a more detailed analysis of this issue taking the insider-outsider model as its starting point.

the informal workforce for a large cross-section of countries and then show more refined results for the OECD. The results are only suggestive, but they are broadly consistent with our argument.

3.2.1. Industrialization and Labor Market Protections

To test our argument on the link between internally-oriented industrialization and labor market protections, we would like to have measure of internal-orientation circa the 1960s and for the initial decades when labor market reforms are passed. It is not obvious how to measure internal orientation during industrialization (Gibson and Ward 1992; Nomi 1997; Balassa 1981; Aitken 1992). In this section, we understand industrialization to take place during the 1960s and 1970s and we measure outward-looking orientations as trade openness. As a proxy that covers as many cases as possible, we rely on Hiscox and Kastner's (2004) data on trade distortions. They use fixed country-year effects in a gravity model to produce an index of trade distortions. This measure has the important advantage over traditional trade ratios of internalizing the impact of country size and distance from markets on trade patterns. To maximize country coverage, we take the average for all countries over the course of the 1970s.

Cross-national data on labor market regulations is very hard to come by, particularly for the years before 2000. That being the case, we rely on more recent data that come reasonably close to approximating our desire to measure obstacles to hiring and firing workers on fixed contracts. The first is a summary measure of "labor freedom" produced by the Heritage Foundation on the basis of the World Bank's *Doing Business* report. The measure equally weights data on six dimensions: Hindrance to hiring additional workers, rigidity of regulations on working hours, the ratio of minimum wage to the average value added per worker, difficulty of firing redundant employees, the legally mandated notice period for firing an employee, and mandatory severance pay. The measure is scaled from zero to 100, with labor regulations falling across the scale. The second, more focused measure is on the cost of firing a worker. Botero et al (2004) collect data on the cost of firing a worker by calculating the sum of the notice period, severance pay, and any mandatory penalties established by law or mandatory collective agreements for a worker with three years of tenure with the firm. Figure 3.1a plots each of these measures against the trade distortions measure discussed above. Though there is obviously considerable noise, there is clearly a negative relationship between labor "freedom" and a history of import substitution (as proxied by trade distortions). Likewise, the costs of firing workers increase with such a history. Obviously, one would like to see if these relationships hold in the face of multivariate analysis and alternative measures of labor protections, but the initial picture is broadly consistent with our hypothesis, even if the picture with regard to the cases in the developing world is less clear. As discussed in Wibbels (2014), deviations from gravity-model trade predictions as per Hiscox and Kastner (2004) mask important variations in trade policy. While export-led industrializers (like Korea) and import-competing industrializers (like Brazil) look very similar on the trade distortions data, they do so for different reasons. While the export-led cases subsidized exports and limited imports (of consumer manufactured, if not capital, goods), import-substituters subsidized the importation of capital goods and taxed exports. Wibbels (2014) shows that the link between import substitution and labor market policies are clearer in the developing world when using a measure of the share of manufactures *not* exported, even if such a measure is hard to make comparable across years and a sample that includes the OECD.

"insert Figures 3.1a and 3.1b about here"

We can complement the analysis in Figure 3.1a with data produced by the IMF on employment protection legislation in low-, middle- and high-income countries. To ensure comparability across different groups of countries (as well as over time), the IMF extends the OECD methodology for collecting and coding the information to the non-OECD countries in the sample. The data in Figure 3.1b reflect the maximum legally mandated severance payments and advanced notice period in months (see Aleksynska and Schindler 2011 for details). Severance pay is measured as monthly salary equivalents and coded according to the OECD methodology. The picture emerging from Figure 3.1b is quite similar to that in Figure 3.1a. The left panel contains all the countries in the sample while in the right panel there are only OECD countries. In the OECD, countries where trade distortions were high in the 1970s (like Greece, Portugal, Spain, Israel and Austria) have high levels of insider employment protection in the 1980s. Countries where trade distortions were low in the 1970s (like the USA, Japan or Switzerland) have low levels of insider employment protection in the 1980s. While the relationship is not perfect, both panels in Figure 3.1b are broadly supportive of our claims.

3.2.2. The Stability of Labor Market Regulations through Time

We argue that ISI is linked to contemporary rates of dualization via labor market regulations, which we hypothesize have proven highly resilient in the face of the political power of labor market insiders. As noted above, beginning in the late 1970s and running through the following decades, politicians and the private sector in many countries, including many former import-substituters, fundamentally re-orientated their economies, and the era of "state-led development" came to a halt. Trade liberalization, macroeconomic discipline, capital account liberalization, privatization of state-owned enterprises and the like swept across the globe. Given that labor markets in import-substituters had been built around a dated vision of economic policy, one might have expected labor market policies to follow the common, liberalizing trend. As explained above, we expect otherwise—the power of insiders should produce tremendous persistence in labor market policies, despite the sea change in other policy spheres.

Keeping in mind how difficult it is to find comparable time-series data Figure 3.2 provides some initial, suggestive evidence. The figure displays Heritage Foundation data on trade, fiscal, monetary, and labor market policies from 1995 to 2011 for both the OECD and developing worlds. Though the data on labor markets is available for only half of this period, it evinces a very different trend than those bearing on trade, fiscal and monetary policies. While the macroeconomic policy tools have undergone a steady process of liberalization, labor market policies have barely moved at all.

"insert Figure 3.2 about here"

We can further explore the stability of labor market regulations by looking back at the IMF data described in Figure 3.1b. Figure 3.3a captures the maximum of both the legally mandated severance payments and notice periods for workers with 9 months, 4 years, or 20 years of experience (see IMF 2011 for details). The figure compares these levels of employment protection (measured as monthly salary equivalents) in two periods: the 1980s and the 2000s. The 45-degree line in the figure denotes no change at all and, remarkably, most cases fall quite close to (if not on) the line.

"insert Figures 3.3a, 3.3b and 3.3c about here"

Moving beyond comparable measures for OECD and non-OECD countries, the two exceptions to the paucity of cross-sectional, time-series data on labor market regulations come from Lora et al. (2001), who report annual data on various reform indices for 19 Latin American countries from 1985 through 1999 and an OECD measure on regular employment protection available from the early 1980s. Latin America is interesting because many of its countries pursued a particularly aggressive version of market liberalization; it is also a region with a high concentration of countries that have a history of import substitution. The OECD data is interesting because it is the region where there has been the most research on insider-outsider labor markets and politics. For the OECD cases, we can use a better measure of insider employment protection. We analyze an indicator summarizing the main aspects of dismissal protection for workers with regular contracts. The OECD indicator incorporates three aspects of dismissal protection: "*(i)* procedural inconveniences that employers face when starting the dismissal process, such as notification and consultation requirements; *(ii)* notice periods and severance pay, which typically vary by tenure of the employee; and *(iii)* difficulty of dismissal, as determined by the circumstances in which it is possible to dismiss workers, as well as the repercussions for the employer if a dismissal is found to be unfair (such as compensation and reinstatement)" (Venn 2007: 6).

Figures 3.3b and 3.3c show that the picture that emerges in the Heritage data in Figure 3.2 and in the IMF data in Figure 3.3a is not the result of averaging across countries. Figure 3.3b shows that most of the countries in Latin America pursued basically the same labor market policies in 1999 as they did in 1985. Again, most cases fall quite close to the line 45-degree line denoting no change at all. Though deviations from the line are very limited, it is worth noting that the former import substituters, including Mexico, Argentina, and Brazil have, if anything, made policy more restrictive rather than more liberal over the 15-year period. At least in the Latin American sample, it seems that labor markets have seen much less reform than other areas of public policy. Figure 3.3c presents a very similar picture for the countries in the OECD. Cases are again concentrated along the 45-degree line. Only in Spain and Portugal have extremely high levels of insider employment protection in the 1980s become less high ones in the 2000s (but these two countries still remain within the group characterized by the highest levels of insider employment protection).[18]

Given the historical link between ISI and pro-insider labor market regulations, it seems reasonable to expect that restrictive labor market policies would have gone the way of other policies that characterized the internally-oriented development model. Yet while differential exchange rates, high tariffs, state-owned enterprises, industrial subsidies, and the like have disappeared, pro-insider labor market policies have persisted. The power of insiders has been borne of their continued organizational strength in the non-tradable service and state sectors, where for various reasons, employers can pass on high costs to the entire domestic market of consumers. These groups are the political legacy of the era of import substitution. Their privileged economic and organizational position stands in stark contrast to the heterogeneous interests and weak capacity for action among the outsiders. In many cases, the economic and organizational strength of insiders makes them privileged constituents for political parties and provides them influence when governments considered social policy reforms. Given the centrality of labor market regulations for the very survival of insiders, they have spent considerable resources blocking microeconomic reforms, even as they passed on various

[18] In the case of Spain, the attack on the employment protection of insiders (even if marginal) was one of the consequences of conservative governments starting in 1996. This chapter does not emphasize the connection between insider protection and Left government, but see Rueda (2007) for an analysis of this topic.

macroeconomic ones that, while painful, did not strike at their very survival (Murillo and Schrank 2009).

3.2.3. Labor Market Regulations and Dualization

Finally, we turn to our last explanandum: labor market dualization. An ideal measure of dualization would include the unemployed, the involuntarily under-employed, those on contingent contracts, and those in the shadow economy. But, again, there is no such data for a large cross-section of countries (indeed, there is not even comparable unemployment data). As a first cut we rely on an indicator of the size of the informal labor market. Measuring the size of this pool of labor market outsiders is a daunting task complicated by the fact that much of the work and production takes place outside of the purview of tax authorities, regulators and many survey firms (La Porta and Shleifer 2008). Neither workers nor firms declare earnings to the government, and both firm and income surveys have a hard time reaching individuals in the informal sector. We therefore use a measure provided by the World Competitiveness Report (2007), based on a survey of business leaders in which they were asked to estimate the amount of business activity that is unregulated.

For the OECD and non-OECD sample, our key independent variables are assorted measures of labor market regulations that proxy for pro-insiderness. We rely on the measure of labor market freedom from the Heritage foundation and the measure of severance costs from the IMF described above. We then add three measures provided by the Frasier Institute. The first is a product of the World Competitiveness surveys, which ask respondents whether the hiring and firing of workers is impeded by regulations or flexibly determined by employers; it is scaled from 1-8, with regulations declining across the scale. The second measure is the cost of dismissing workers and is calculated by the Frasier Institute on the basis of the World Bank's *Doing Business* data. The measure includes information on the advance notice, cost and penalties for firing a worker, with regulations again falling across the scale. Finally, we also rely on the Fraser Institute's data on collective bargaining, with the expectation that peak level bargaining will produce pro-insider policies. The Frasier Institute produces an index scaled from 1-7 designed to capture the extent to which wages are set at the firm-level (=7) or by a collective bargaining process (=1).

Probably the only standard finding in the small cross-national quantitative literature on informality is that there is an inverse relationship between societal wealth and informality. Because of this, we run a series of simple models that control for logged per capita income. The key independent variable in each model is one of the indicators of labor market regulations discussed above. We limit the sample to countries that have had some history of industrialization and have populations that exceed two million people.[19] Table 3.1 reports the results of the five models described above. The findings suggest that protective labor regulations are associated with a larger informal sector (different signs reflect different codings of the labor market regulations variables). While the relationship is less clear for some indicators, the overall results show that informal employment is climbing in the restrictiveness of labor regulations.

"insert Table 3.1 about here"

Our OECD sample allows us once more to use a measure for the dualization of labor markets that better addresses our theoretical claims. In Figure 3.4 we use once again the OECD

[19] We operationalize a history of industrialization as an industry to GDP ration in excess of 20 percent at some point since 1980.

index of insider protection as country averages for the 1980s used in Figure 3.3c. We then use a measure of labor market dualization in the 2000s that includes individuals who are unemployed, in fixed-term employment and in involuntary part-time employment as a percentage of the civilian labor force.

Given the importance of secure employment to the definition of insiders, including the unemployed within the category of outsiders is not controversial. The classification of fixed-term and part-time employment is perhaps not as straightforward. There are two aspects to employed "outsiderness." The first has to do with the precarious nature of employment. Fixed-term and part-time jobs are not simply insider contracts with added flexibility; they are, in fact, characterized by low wages, protection and rights (see, for example, OECD 1998). The second has to do with the involuntary nature of outsider employment. Most outsiders would like to have insider jobs. This is particularly the case when looking at fixed-term employment (most workers holding fixed-term contracts in the OECD do so involuntarily) but it is also the reason why we focus on involuntary part-timers.[20]

"insert Figure 3.4 about here"

Figure 3.4 again presents some evidence in support of this chapter's arguments. In the OECD, countries with high levels of insider employment protection in the 1980s developed high levels of labor market dualization in the 2000s. It is, in fact, the case that this relationship would be also present if we used labor market dualization data from the 1990s. Notoriously dualized countries like Spain and Portugal are an example of this combination of high insider employment

[20] Because of missing data, labor market dualization is measured only as unemployment and involuntary part-time employment in Australia and New Zealand and only as unemployment in the USA.

protection and high labor market dualization, but so are Finland, Sweden, or the Netherlands. Countries like the US, the UK, Australia, Switzerland, Ireland and Denmark are examples or very limited insider employment protection in the 1980s which then promoted low levels of labor market dualization in the 2000s.

3.3. Conclusions

While protections from labor market risks might have facilitated skill investments, helped overcome labor market failures, and increased overall productivity in a small handful of European countries, they have led to bifurcated, unproductive labor markets across many other OECD countries and most of the developing world. Built as they were for the demands of autarkic economic policies, systems of social protection built upon *ex ante* protections have proven poorly adapted for a world of open economies. Such systems limit the capacity of workers to enter the formal economy, reduce their incentives to gather human capital (the returns of which are low in the informal sector), and encourage investments in low-productivity sectors. As a result, labor regulations that date to protectionist processes of industrialization have contributed to the growth of informal sectors, weak labor productivity and income inequality.[21]

Above and beyond the economic costs associated with bifurcated labor markets, our account of their origins and effects speaks to the overall framework of this volume and has implications for further, related, literatures in at least three ways. First, although not one of the goals of a volume that mostly focuses on advanced capitalism, it provides a framework for unifying the study of the welfare state and labor markets in developed and developing countries.

[21] The claim that insider-oriented labor market protections are inefficient does not necessarily conflict with Boix's finding in this volume. In his chapter, Boix shows that Kenworthy's index of wage coordination and Blanchard and Wolfers' index of employment protection are uncorrelated with economic growth. It is the nature of economic growth that is of interest to our argument. We contend that *ex ante* labor market protections tend to encourage low-productivity growth with limited human capital investment.

A host of recent contributions have provided rich insight into the link between global markets and changes in social priorities, innovations in targeted poverty relief, and social policy reform in the developing world. In the OECD, an equally significant literature has emphasized the changing nature of the welfare state (and the role of conditionality and workfare).[22] But most of these literatures are focused on *changes* in social policy, even if researchers draw on different theoretical traditions, develop distinct causal claims, and use diverse empirical methods. Clearly, by emphasizing insider employment protection and uniting OECD and non-OECD cases, we tend to see continuity where others see considerable change. More generally, we believe there is considerable room for unifying the study of welfare states and social protection across the developing and developed world around a set of simple factors—labor market risks, the competitiveness of markets, interest organization and representation, and partisan politics—that characterize democratic capitalism the world over.

Second, we place a specific set of actors, policies and institutions—those relating to labor markets—at the center of the analysis and link them to the emergence and extent of bifurcated labor markets. This approach is not entirely new but our findings do call into question the generality of an influential claim in research on advanced industrial democracies. In some European countries, extensive systems of social insurance that broadly share risks coexist with highly productive economies. In some accounts, social policy, labor market regulations, educational systems, etc. are an equilibrium political outcome that promotes economic competitiveness; this is a virtuous story in which many good things go together. We diverge from such accounts by describing an equilibrium in which social insurance persists despite huge negative effects on economic efficiency. Efficient *ex post* compensation is much less common than inefficient *ex ante* protection in most developing countries, but also in some OECD

[22] See, for example, Rueda (forthcoming).

countries. In the introductory chapter of this book, the political economy of countries with such an institutional legacy have been referred to as a model of "capture", because weak state capacity is combined with strongly consumption-oriented institutional legacies. Structuralist or functionalist accounts cannot explain the persistence of such an institutional arrangement, which is clearly economically inefficient and limits occupational change and adaptation. Such regulations also severely constrain the range of politically reform strategies. A reorientation of consumptive towards investive state expenditures and regulations is politically difficult because institutional constraints and the configuration of preferences and power relations all but preclude the emergence of an investment-oriented reform coalition.

Third and finally, our account speaks to the sustainability of markets and democracy in a globalized world. An enormous body of work on the OECD suggests that social policies have served a key role in mediating the relationship between capitalism and democracy. Absent the security provided by social insurance, citizens would reject the creative destruction inherent in the market and fail to make productivity enhancing investments that generate returns over the long run. Fueled by the democratic power to vote and organize, citizens have demanded insurance as compensation for the costs of open economies. If *ex post* social compensation has played a key role in smoothing citizen participation in markets in a handful of OECD countries, *ex ante* employment protection across much of the rest of the world would seem ill-equipped to fulfill such a role. It benefits too few citizens located in the least propitious portions of the economy and does so while generating distortionary economic incentives and limiting opportunities for many entrepreneurs and workers. The political consequences for the failure of social insurance to be the glue binding democratic politics and market participation can be quite damaging.

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Figures 3.1: Early Trade Distortions and Labor Market Policies

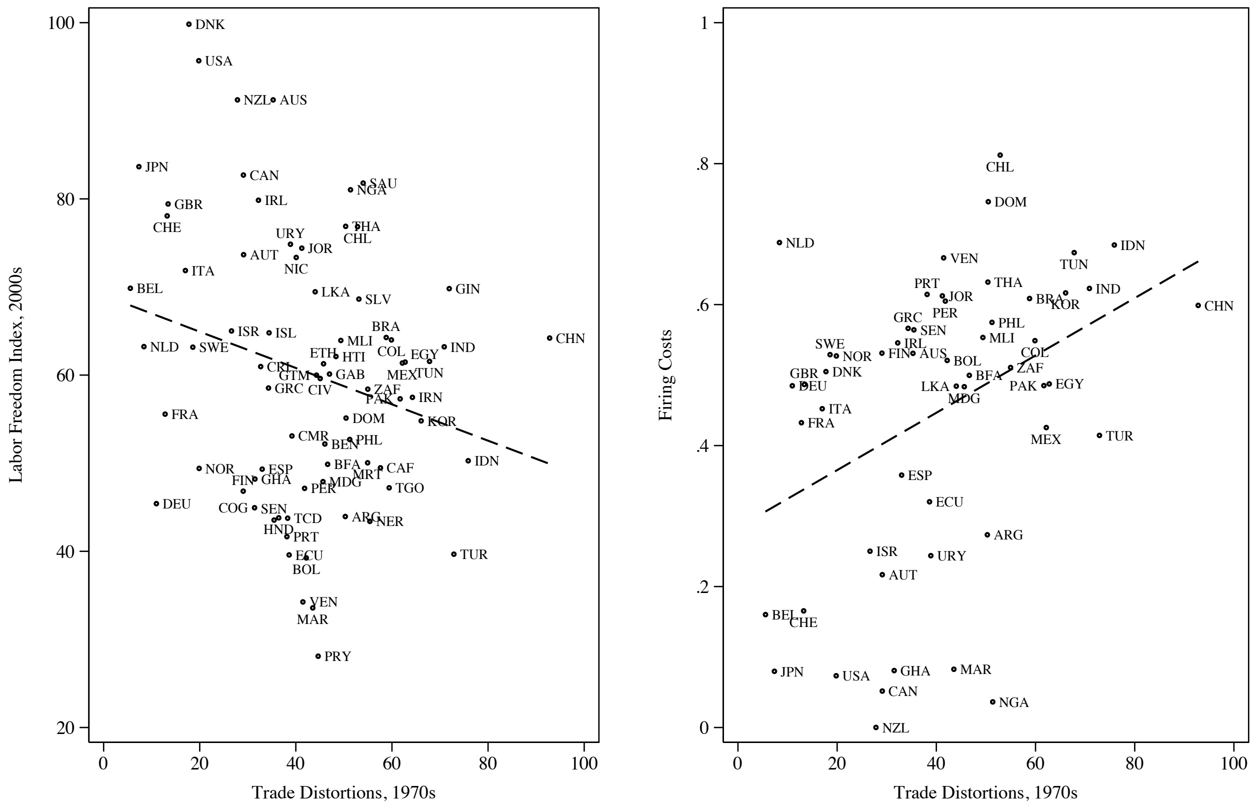

Figure 3.1a: *Trade Distortions and General Labor Market Regulations*

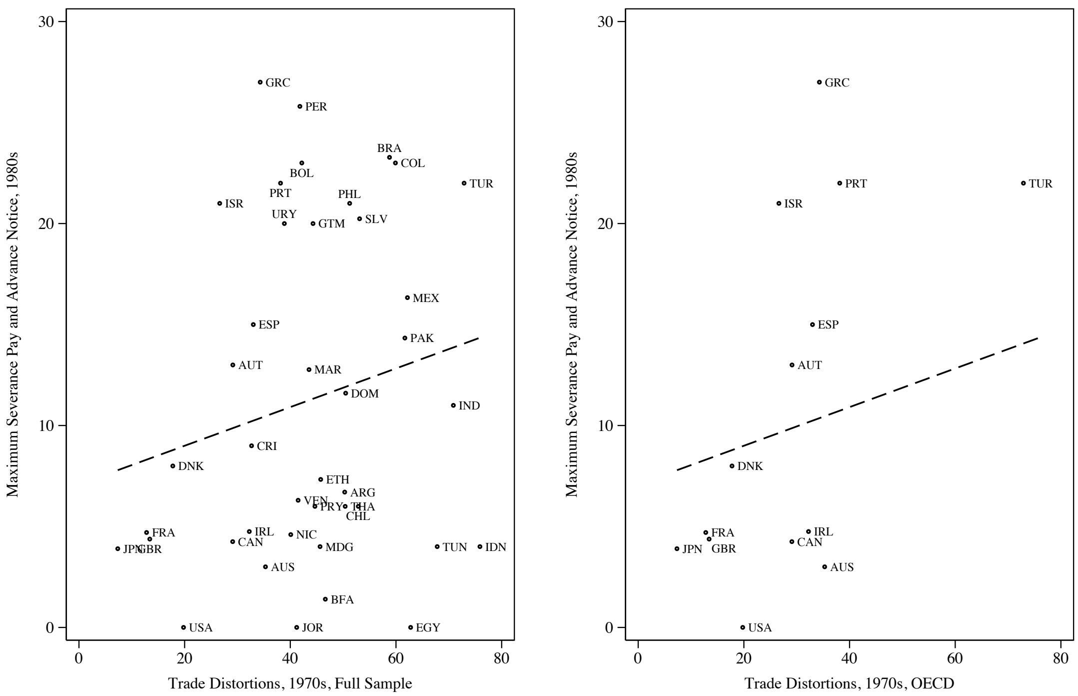

Figure 3.1b: *Trade Distortions and Severance Costs, Full Sample (left panel) and OECD*

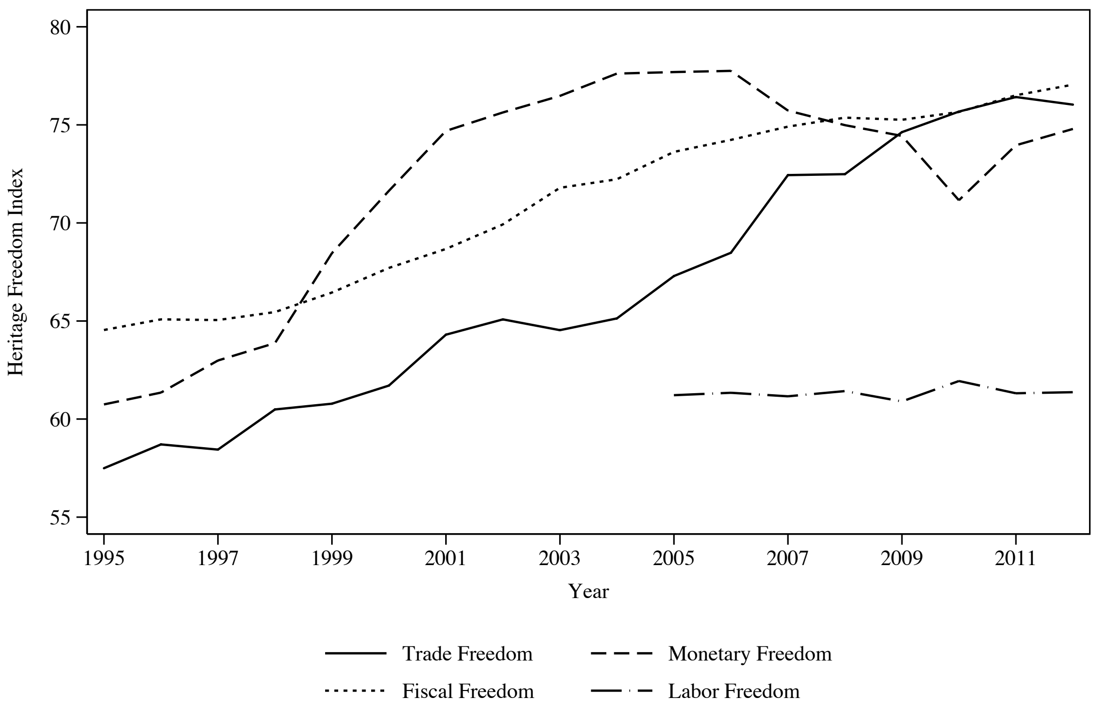

Figure 3.2: *Economic Policy Through Time in Developing and OECD Countries*

Figures 3.3: Labor Market Policies Across the Decades around the World, Latin America and the OECD

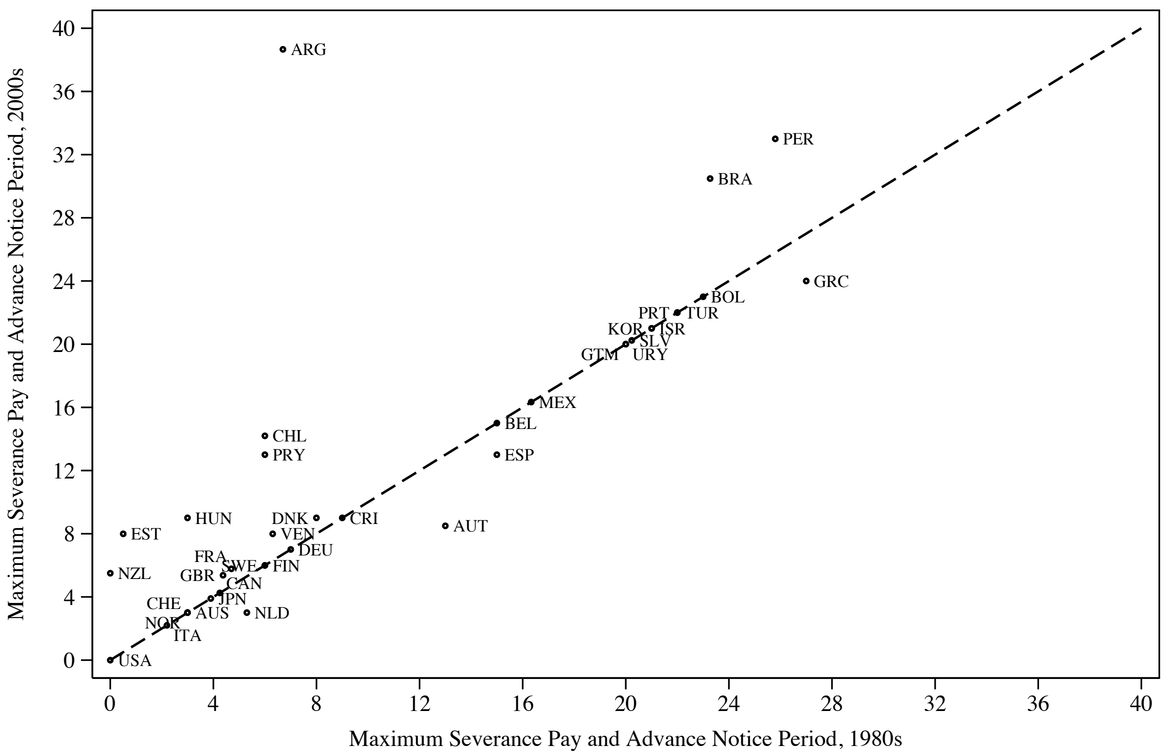

Figure 3.3a*: Severance Pay around the World in the 1980s and 2000s*

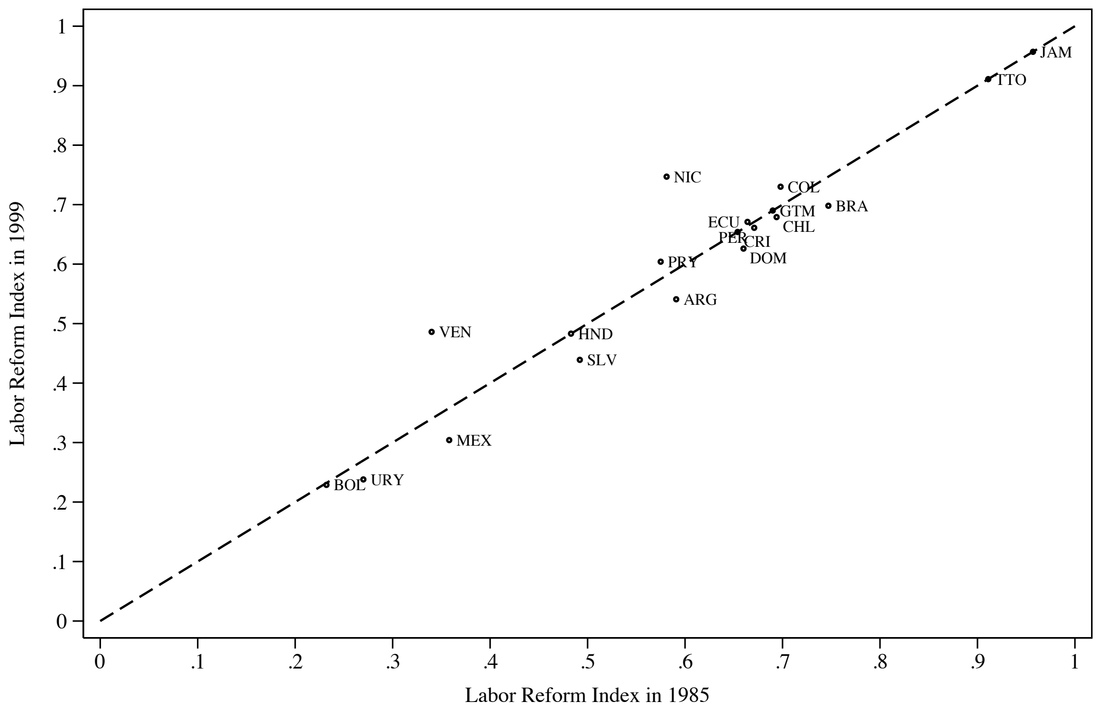

Figure 3.3b: *Labor market reform index in 1985 and 1999 in 19 Latin American countries*

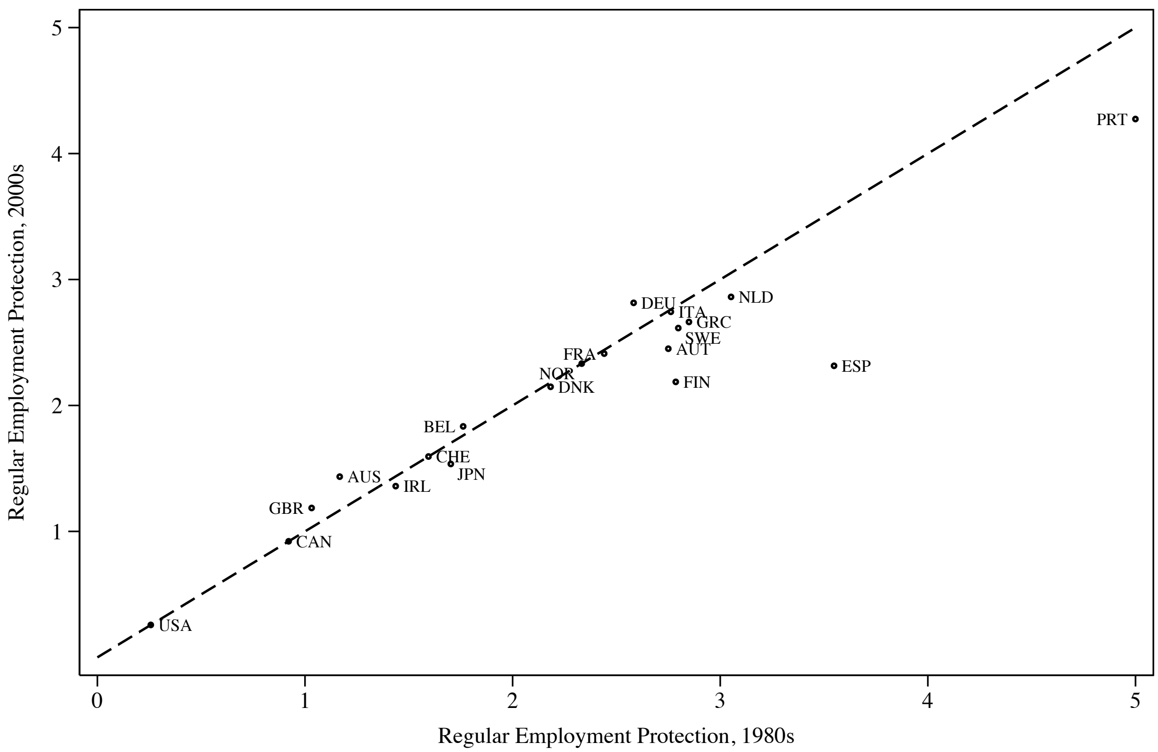

Figure 3.3c: *Labor market policies in 1980s and 2000s in OECD countries*

Table 3.1: Labor Market Regulations and the Size of the Informal Sector

	Model 1	Model 2	Model 3	Model 4	Model 5
Hire/Fire	-0.704				
	(0.446)				
Dismissal		-0.677***			
		(0.227)			
Labor Freedom			-0.103**		
			(0.0435)		
Collective Relations				13.63**	
				(6.177)	
Severance Costs					0.141
					(0.0874)
GDP pc (logged)	-9.108***	-7.887***	-8.396***	-9.626***	-5.969***
	(0.746)	(0.843)	(0.778)	(1.035)	(0.817)
Constant	115.5***	104.3***	111.9***	110.3***	78.75***
	(7.383)	(7.556)	(6.915)	(10.23)	(7.401)
Observations	67	63	68	47	54
Adj. R-squared	0.695	0.720	0.708	0.660	0.513

Standard errors in parentheses.

* p<0.1, ** p<0.05, *** p<0.01

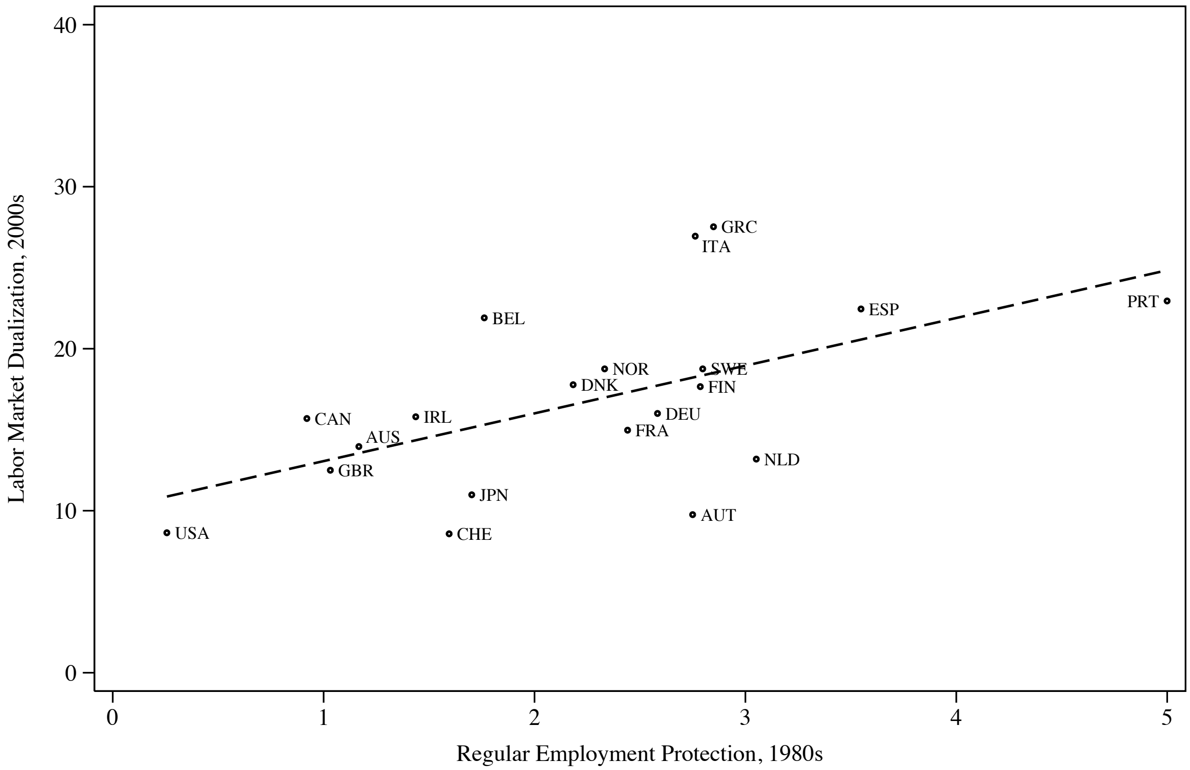

Figure 3.4: *The Relationship between Employment Protection and Labor Market Dualization in the OECD*