“Economic Openness, Social Insurance and Development in the other 85 Percent of the World”

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Reading the OECD welfare state literature as an outsider produces a profound sense of drama and mystery (at least by academic standards). Twenty years ago it was fashionable to forecast the death of the welfare state in the face of “globalization”, vaguely construed. Ten years ago, the diversity of welfare states were safe again thanks to a powerful coalition of beneficiaries and some modest, market-friendly tax reforms. Today, new threats have arisen in the guise of immigrants and bond markets; the former ostensibly reduce support for generous tax-transfer systems from inside the nation-state, while the latter insist on austerity from the outside. It is not obvious how much actual empirical change OECD welfare states have undergone, but the academic coverage has had an almost breathless excitement to it. From a death foretold to peace and prosperity and back again in nary two decades!

For once, it seems events in the developing world are more stable than in the OECD. In this paper, I provide an argument that links the historical origins of welfare states in the developing world to contemporary policies and developmental outcomes. In it, I argue and show that there are affinities between decisions about economic policy in the aftermath of World War II and the emergence of social insurance and labor market regulations across the developing world. In my account, social insurance results from distributive struggles among social groups and is a critical tool for the construction of labor markets conducive to capitalist economic development. I show that the insurance and labor market policies developed with an eye toward protectionism and internally-oriented industrialization have had a powerful legacy for contemporary social policy and important implications for the social and economic performance of countries during the ongoing era of globalizing markets. It is a story of continuity within countries and tremendous diversity across them. I argue that this variation helps explain why some economies in the developing world have generated a huge number of good jobs and produced more equitable societies, while others have not.

Though the underlying logic underpinning the supply and demand of social insurance is similar across societies, the implications for economic efficiency and distributive outcomes are quite different when one compares the OECD and the developing world. Research on the OECD suggests that social
insurance can be efficient when it encourages entrepreneurs to take risks they otherwise wouldn’t and
workers to gather productivity-enhancing skills that will only pay off in the long term. Insurance can also
contribute to a fairer society by taking care of citizens who suffer everything from job loss to a workplace
injury. Such arguments underpin claims like those made by Lindert in his history of social policy:

“It is well known that higher taxes and transfers reduce productivity. Well known—but
unsupported by statistics and history…Social spending often has a positive effect on GDP, even
after weighing the effects of the taxes that financed the spending. Not only public education
spending, but even many social transfer programs raise GDP per person.”¹

This is the very heart of the “free lunch paradox”, whereby northern European societies have balanced
large public sectors, equity, and strong economic growth. So hegemonic have these ideas become that
they have made their way to the opinion pages of magazines and newspapers. Jeffrey Sachs, for instance,
writes in the pages of *Scientific American* that “In strong vibrant democracies, a generous social welfare
state is not a road to serfdom but rather to fairness, economic equality and international
competitiveness.”² The overarching message is that extensive welfare states can be perfectly consistent
with high productivity, strong growth and “constructed” comparative advantage.

According to a prominent line of argument, well-designed public insurance programs and labor
market regulations also sustain democracy in the face of capitalism’s vicissitudes. Social insurance, we
are told, provides the linchpin between democratic politics and liberal markets. Indeed, the affinity
between democracy, open markets and social insurance is at the very heart of an explanation for why
countries vary so much in their social effort, an explanation that emphasizes the importance of
international economic competition. As laid out by Cameron (1978), Katzenstein (1985), Garrett (1998),
Rodrik (1998) and Adserá and Boix (2002), the account suggests that actors in the economy seek
protection from volatile international markets through social insurance. 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

¹ 2004: 227-8.
declining tradable industries.” The larger the tradables sector and the greater the international economic competition, the greater the social effort. Government-provided insurance thereby provides the political underpinnings for open markets and fosters the kinds of investments that produce growth.

There is just one problem with this account—it does not work for the 85 percent of the world’s nations outside of the founding members of the OECD. Social insurance did not develop in the smallest, most open economies of the developing world as it did in Europe; its chief constituents were not in the most trade-exposed or competitive sectors of the economy; and it has not facilitated productive investments by entrepreneurs and workers in today’s globalized economy. Quite the contrary, social insurance reached its apex in the largest, most closed economies, and its chief supporters were in the most internally-oriented portions of the economy. In a world of liberalizing markets, social insurance and related labor market regulations are a source of social exclusion, segmented labor markets and low productivity. In short, social insurance is far from the linchpin between democratic politics and liberal markets. If anything, it erodes democratic legitimacy and obstructs the development of competitive economies.

The goal of this paper is to explain the emergence of these systems of social insurance and track their effect on political economies across the developing world over the last several decades of globalizing markets. I pay particularly close careful attention to how public policies have insured workers and producers against economic risk. My focus is on a broad understanding of social insurance—the set of policies including old-age and disability pensions, worker’s compensation, unemployment insurance, health insurance, and regulations on the hiring and firing of workers—whereby the state uses its fiscal and regulatory powers to distribute and redistribute risks across the economy. Because risks are allocated unequally in market economies, social insurance is intimately connected to the regulation and performance of labor markets. Labor laws that detail hiring, firing and severance pay have the same basic aim as insurance spending, namely to protect some workers. In doing so, they raise or lower the costs of hiring and firing some workers but not others and thereby affect the distribution of labor market risks and

3 Adsera and Boix 2002: p.246.
the demand for protection. Understanding the causes and consequences of different national systems of risk sharing, therefore, helps explain the viability of different approaches to development over the last 60 years.

The following section outlines the empirical puzzle, namely the diversity of effort on social insurance spending, huge variation in the extent of labor market regulation, and divergent economic and distributive outcomes during the era of globalizing markets. The second section presents a brief argument on the origins of development strategies and social insurance in the post-World War II era and provides some suggestive evidence linking closed economies to extensive systems of social insurance. Section three outlines an argument and evidence on continuity in those social insurance policies, this despite widespread economic reform and a fundamental reorientation of domestic economies towards international markets over recent decades. I argue that this continuity results from democratically-elected politicians having strong electoral incentives to respond to small but well-organized labor market insiders at the expense of a large, heterogeneous and poorly-organized pool of labor market outsiders. Section four shows that despite being a political equilibrium, social insurance policies have had profoundly negative consequences, including increased inequality, poor job creation, low labor productivity, and weak economic growth. I pay particular attention to how social insurance impacts the microeconomic incentives of capital and labor. Section five briefly explores the implications of social insurance for public opinion on the functioning of democracy and markets and forecasts the implications of those opinions for the future of social policy in the developing world.

1. The Empirical Puzzle: Social Insurance and Development

Though spending data only tells part of the story, Figure 1a shows that social insurance represents a large share of budgets across the developing world. Indeed, it is, on average, the single largest budget category—larger than education, national defense, or any other critical responsibility of modern states. Yet the figure also shows that social insurance evinces huge variation across countries. Indeed, it is the single spending category with the most variation across countries. Likewise Figure 1b shows that industrial relations, a combination of labor organization and wage bargaining institutions, varies hugely
across the developing world. For comparison’s sake, the figure includes the same data for the OECD, where researchers have spent inordinate energy studying industrial relations and welfare policies. These figures present a real puzzle—they show a huge, important budget category that varies a lot across societies and a regulatory environment that matches it for diversity. Despite the huge cross-national variation, little research has focused on either the causes or consequences of social insurance in the developing world, particularly when compared with the OECD. For a global perspective, Map 1 shows social insurance expenditures as a share of government spending around the world.

Figure 1a & 1b Here

Map 1 Here

Yet the mystery only deepens from there. Figure 3 shows that the commitment of countries to social insurance varies incredibly little through time. Judging on the basis of the admittedly scant time-series data from the 1970s through the 2000s, social insurance spending is very stable. In light of research on the OECD showing tremendous continuity in social commitments, it might seem obvious that such policies display a long half-life. Yet it is worth remembering how much has changed over the last three decades across broad swaths of the developing world. From trade liberalization to capital account liberalization to privatization, many countries have pursued policies of profound economic liberalization. Just as the tenets of protectionism have been tossed away, many researchers expected a withering of social policies. Indeed, the expectation of social policy retrenchment has contributed to a wave of research investigating the link between changing exposure to the global economy and social spending in the developing world (Rudra 2008; Avelino, Brown, and Hunter 2005; Kaufman and Segura-Ubiergo 2001).

Figure 2 Here

Finally, Figure 3 displays the huge variation in economic and distributive outcomes over recent decades, including economic growth, job growth and changes in inequality. For the sake of comparison, the figure includes data for advanced, industrial democracies. While those countries cluster together on each measure, developing countries have diverged over recent decades. While some countries have grown
at unprecedented rates, created vast number of new jobs and become more equitable societies, others are poorer, have fewer jobs, and have become more unequal. From the Korean economic miracle to decades of stagnation in Venezuela to the economic disaster of Zimbabwe, it is this huge variation that has motivated scholars of development for decades.

Figure 3 Here

These data raise a number of important questions: Why does government effort on social insurance vary so much across countries? And why have these efforts been so consistent across decades even as the global political economy and many domestic political economies have gone through seismic shifts? Why have economic growth and distributive outcomes diverged so starkly over recent decades in the developing world? It is my contention that the answers to these questions are related and that the search for answers must go back to political bargains struck over economic policies and labor market regulations in the middle of the 20th century.

2. The Origins of Development Strategies and Social Insurance in the Developing World

As in Europe, social insurance and related labor market regulations have their roots in processes of industrialization. From the point of view of 2011, when the decades-long intellectual swing in favor of free markets has barely stalled in the face of a global financial crisis, it is hard to remember how deeply embedded state-led industrialization was to post-war conceptions of development. A number of considerations drove this consensus, including the collapse of commodity markets during the Great Depression, the prevalence of Keynesian state-led intervention in the economic “core”, the decades-long closure of international markets that showed no sign of letting up, and the association of industrialization with economic growth. Of course there were many means to achieve industrialization. There is a voluminous literature on the export-led successes in East Asia (Wade 1990; Amsden 1989; Rodrik 1995) and a parallel literature on import-substitution in Latin America, Africa and Asia (Hirschman 1968; Waterbury 1993). There is even a prominent literature that compares export-oriented and internally-oriented economies with an eye toward understanding divergent developmental experiences over recent decades (Haggard 1990; Gereffi and Wyman 1990; Evans 1995; Kohli 2004; Mahon 1992). These latter
works emphasize a host of differences including state capacity, patterns of state authority, bureaucratic autonomy, colonial legacies, the organization of business, the nature of financial markets, technological adoption, and the like. In most such work, the “state” plays a central role, but it is an abstraction that operates in a political context free of actors with interests, and its power is not derived from anything in society—this despite the fact that modern states depend on the “quasi-voluntary compliance” of their citizens, who inevitably provide the revenues that underpin state action (Levi 1989). The fundamental causal questions are: What are the conditions under which export-led development or import-substitution are equilibrium choices of state leaders? And what is the relationship between development strategies, social insurance, and labor markets regulations?

My answers begin with the interaction between the openness of the global economy and countries’ underlying economic endowments. These factors shape the size and nature of the coalitions that bargain over systems of risk hedging. Consistent with a simple factoral model of the economy, a country’s abundant factors (land, labor, or capital—these also being the key social actors) benefit from a liberal external environment and are hurt by a closed one. When international conditions are beneficial and domestic coalitions favor economic openness, they push for economies that are externally-oriented and rely on trade. When the international economy is closed and domestic coalitions favor protectionism, they push for economies that are internally-oriented and rely on domestic demand. As a result, labor market risks are concentrated in the industrial sector, and systems of social insurance develop to cover the protected, manufacturing sectors of the economy. Even if both of these scenarios can produce extensive systems of insurance, they protect different actors. As explained in greater detail in Wibbels and Ahlquist (2011), the extent to which winning coalitions are able to implement their preferred economic and insurance policies depends on the size of a countries domestic market (closed economy policies are easier to pull off in large markets) and their capacity to offload the costs of those policies on the agricultural sector.

Thus, the size and nature of the coalitions that benefit from social insurance emerge from countries’ underlying economic endowments. Because the returns to different factors of production are
conditioned by the openness of the international economy, many of the findings derived from the European experience are dependent on those countries’ very particular positions in the global economy. In many of those cases, a rapidly liberalizing post-war economy set the stage for pro-trade coalitions to build systems of social insurance that protected and encouraged productivity-enhancing investments. In contrast, most developing nations faced a relatively closed global economy after the great depression and well into the post-war period (only decades later would the allies’ post-war, Bretton-Woods liberalization project expand to include them), which empowered protectionist interests. Indeed, it is telling that the countries that developed the largest industrial workforces in the developing world did so in the context of import substitution industrialization rather than export-competitive, trade-reliant industry as in Europe. These dynamics are consistent with my claim that countries’ relative economic endowments and their resulting position in the international distribution of labor shape the distributive coalitions for and against different development strategies.

Import-substituting development strategies allocated economic risks in a very particular that produced a shared interest among protectionist capital and labor in social insurance and labor market protections. Certainly the most significant risk that scarce labor and capital faced was external competition. Absent external competitiveness, these actors had a long history of lobbying for trade protection (Haber 2007). It is telling that throughout the 20th century almost none of the manufactures in ISI cases were exported, even to proximate regional markets. From this point of view, trade protection and other import-substituting policies had a similar effect as social insurance—they served to reallocate risks away from externally uncompetitive factors. Highly institutionalized social insurance programs served as insulation against any change in government that might result in reduced protectionism (Mallet 1970). Beyond the threat of external competition, other risks presented themselves. Labor’s primary risk was losing a manufacturing job and being displaced into either the urban informal sector or the rural sector, where wages were substantially lower. This wage gap was produced by protectionist trade policies that reduced rural incomes and repressive rural labor practices that limited labor mobility. The quest for insurance against job loss resulted in demands for some combination of unemployment insurance, steep
seniority pay, and/or high severance pay. 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.

Capital in ISI cases faced risks associated with the threat of labor conflict and the limited and volatile buying power in the domestic market. As a result, they had two interests bearing on social policy: First, labor peace in a context of rapid growth in the industrial workforce; and second, the creation of a consumer base large and stable enough to warrant production. Thanks to the extensive protection and subsidies to internally-oriented industry, these countries developed the largest manufacturing workforces (as a share of the working population) in the developing world, and while systematic data is sparse, case-based historical work suggests that they evinced by far the highest levels of unionization. Labor, therefore, was organized and capable of engaging in workplace stoppages and other forms of collective action that threatened capital. Social expenditures and protective labor regulations served to ameliorate labor and reduce the risk of industrial conflict. Second, because social insurance programs increased worker wages and ensured their incomes during times of hardship, the guaranteed capitalists an automatic countercyclical demand boost and stabilized domestic demand (Mesa-Lago 1978:6). To the extent displaced or older workers were covered by insurance, they were free to increase consumption (rather than save for a rainy day) while they were employed and maintained substantial purchasing power when they were not thanks to insurance payouts. To the extent such policies increased worker incomes and enabled them to buy more industrial production, they also expanded the size of the domestic market. Because capital could pass on the costs to these policies to the rest of society through higher prices and the fiscal costs were often subsidized through general revenues, the increase in market size was purchased at the expense of non-beneficiaries in the rural sector. Given the shared interests of protectionist capital and labor, I expect the most extensive systems of social insurance in the largest, most protectionist economies.

4 Indemnities are a more common policy tool than unemployment insurance in the developing world.
Figure 4 shows the graphic results of a regression of social insurance spending for the earliest years possible on a measure of the internal orientation of each country in the post-war period (labeled ISI for “import substitution industrialization”) and a set of controls. These results are robust to instrumenting for the closure of national economies using countries’ economic endowments, using trade openness as the key independent variable, etc. The finding is robust to different demand variables, the inclusion of regime type, and whether I use fitted or actual ISI values. Contrary to the “compensation hypothesis” in which insurance spending is more prevalent the more exposed a country is to volatile international markets (Katzenstein 1985), I find that insurance spending in post-war developing countries is increasing in a country’s internal orientation.

Figure 4 Here

Unfortunately, the data becomes very sparse when one looks beyond spending. I rely on the efforts of Rama and Artecom (2002), who have put together data on employment taxes (as a share of labor costs and a share of GDP). I also rely on the Fraser Institute’s very spartan data on collective bargaining. They produce 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). Finally, I also rely on Rama and Artecom for data that may help assess the effect of social insurance policies. Two of the chief aims of social insurance was to increase manufacturing incomes and promote labor peace. That the case, I estimate simple models of strike activity and manufacturing labor costs. The exact year for which these data are available varies and limit my capacity to capture regulations as designed in the post-war period, though as discussed in the following section, labor market regulations have shown a great deal of persistence in

5 The dependent variable is the average level of spending in the years before the third world debt crisis (1982). The control variables are per capita income, the share of the population over 65, and regime type over the same, early era. The results are robust to additional controls. See Wibbels and Ahlquist (2011) for details.
6 As per the argument in Wibbels and Ahlquist (2011), the instruments for economic openness are market size, the labor endowment and land distribution circa 1960.
7 Similarly, Rudra (2002) finds little support for the compensation hypothesis in the developing world.
8 Labor costs are per worker in manufacturing in current U.S. dollars. Strike activity is measured as the number of strikes divided by the labor force.
recent decades; this increases confidence in the ability to draw inferences from this data. Nevertheless, and given the small sample sizes, the results should be read with great caution.

Figure 5 presents the simulated effect of the key ISI on each indicator of labor regulations when it is toggled across its interquartile range, though note that several of the variables have been rescaled for presentational purposes. As expected, ISI has a significant, positive relationship with employment taxes and collective bargaining. Turning to employment taxes, the figure shows that an eight percent increase in ISI is associated with a nearly one percent increase in labor taxes as a share of GDP and a 3.2 percent increase in those taxes as a share of salaries. Likewise, the figure shows that countries that pursued ISI show evidence of more extensive collective bargaining. The bargaining indicator is a scale designed to range from 1 (wages set by the firm) to 7 (economy-wide bargaining), but it varies from 4 to 7 in this sample. An 8 percent increase in ISI is associated with an increase of about .7 (or nearly a standard deviation) in the extent of collective bargaining. Finally, turning to the effects of these policies, the bottom two rope-and-ladder plots show the simulated effect of an interquartile increase in ISI on wages and strikes. Though it has the predicted positive coefficient in the wage model, it is not statistically significant. The evidence on strikes is less equivocal. An eight percent increase in ISI is associated with a substantial reduction in the number of strikes. Despite having larger industrial working classes than other countries, countries that pursued ISI evinced less labor conflict. An eight percent increase in ISI is estimated to reduce labor conflict by half a standard deviation (or about 2 strikes per thousand workers). The cross-country data is (very) sparse, but the overall picture is consistent with the argument that countries that pursued ISI also developed extensive social insurance systems, including social transfers and labor market regulations. Consistent with the goals of these policies, they seem to have reduced labor conflict and may have increased wages.

Figure 5 Here

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9 Labor costs are available for 1984, as are strikes, although in the latter case, there is also some earlier data for a set of 33 countries; collective bargaining is available for 1985; employment taxes as a share of GDP is available for 1982; and employment taxes as a share of total compensation are only available for 1989.

10 Yes, this sentence makes clear that the figure is useless.

11 Note that I have inverted the original scale.
The underlying politics that made import-substitution industrialization an equilibrium outcome in some countries also produced extensive systems of labor market regulation and fiscal policies aimed at insulating key coalition members from economic risks. The historical record is replete with examples of capital-labor coalitions sustaining protectionist approaches to industrial development. Though less work has noted that those economic policies had important implications for the creation, regulation and sustenance of labor markets, labor histories and work on contemporary social policy consistently show that in countries with a history of ISI, social benefits are inextricably tied to labor status, and labor status is profoundly shaped by labor market regulations. Although industrial labor never came to represent as large a share of the workforce as it did in the small, open economies of northern Europe, it was able to extract additional benefits as part of the core ISI coalition. Above and beyond social spending, it was often able to achieve requirements for collective bargaining thanks to monopolies of representation and compulsory membership laws (Collier and Collier 1991; XX). This account of protectionist interests using their political power to develop extensive systems of social insurance does not fit with the conventional wisdom. Borne of the European experience, research provides a number of reasons to expect a positive association between trade and social effort, but in the developing world, social insurance emerged as the output of protectionist interests.

3. Insiders, Outsiders and the Persistence of Social Insurance

With this spartan account into the historical origins of economic policies and systems of social insurance in hand, I turn to their implications for contemporary policy and developmental outcomes in a world of open markets. The starting point is to recognize that the liberalization of the global economy has had significant implications for the developing world, both in generating trade opportunities and raising the costs of closing off economies from the rest of the world. These changes have coincided with some huge changes in the domestic political economies of many countries as they have pursued a broad swath of reforms, including trade and financial sector liberalization, privatization, and other forms of deregulation. For the many countries that historically pursued closed-economy models of development,
the process of transitioning to free market economies has been particularly marked and was accompanied by a fracturing of ISI coalitions.

While these changes have had an enormous impact on the contours of economic opportunities, they have not changed the fact that labor market insiders—those who benefit from systems of social insurance—have powerful interests in maintaining those systems. Labor market outsiders, on the other hand, are typically a heterogeneous collection of self-employed, informally-employed and unemployed whose difficulty in coordinating collective action is reflected in the persistence of costly policies that provide no benefits to them and even hurt their economic prospects. As a result, labor market regulations and spending on social insurance have persisted. This account of continuity is common in research on social policy in advanced industrial democracies, but it is even more striking in the developing world where social insurance has typically stayed the same despite widespread economic reform. Thus, labor market insiders have been very successful at protecting their social insurance prerogatives even in countries where the closed economies on which social insurance was originally built have dissolved in the face of global integration.

This insider-outsider dynamic is not distinctive to the developing world. It is clear that the combination of deindustrialization and social policies can create a division between labor market insiders and outsiders (Esping-Andersen 1999; Rueda 2007). While the former have access to extensive employment protections, the latter do not. If insiders benefit from high wages and job security, outsiders “…are either unemployed or hold jobs characterized by low levels of protection and employment rights, lower salaries, and precarious levels of benefits and social security regulations.”12 As a result, insiders and outsiders have different interests over labor market regulations and other features of social insurance. Rueda (2007) suggests this has produced a dilemma for parties of the left in the OECD. They can either defend the social preferences of their historic insider constituency or pursue the interests of outsiders; the former implies defending status quo policies and expanding the ranks of outsiders, while the latter implies reducing labor market protections for insiders that have negative effects on outsiders. Nevertheless, given

the large share of jobs covered by insider contracts, the organizational strength of insiders, and the strong productivity of insider sectors, the underlying political alliance between insiders and the left has been quite persistent in European societies with large welfare states.

The divide between labor market insiders and outsider in the developing world is even more stark. Beginning in the early 1980s and running through the next two decades, politicians and the private sector in many former import-substituters fundamentally reorientated their economies, and the era of “state-led development” came to a halt. Although most market reforms focused on macro- rather than microeconomic policies, the combination of the initial crisis and the subsequent reforms had a number of common effects on labor markets. Privatization and the restructuring of firms in the face of external competition produced widespread unemployment. Likewise, price competition in tradeables and reduced labor demand contributed to a sharp reduction in real wages. The reduction was exacerbated by the large numbers of women entering the labor force for the first time in an attempt to cope with the crisis. In this context, it is not surprising that levels of unionization, which had been relatively high, fell considerably.

In the absence of jobs in the formal economy, millions of workers entered the informal economy. Devoid of regulations and taxes, 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; Portes 2003; de Soto 1989; Garxhani 2004; Tokman 1992; Maloney 1999; Levy 2008). Generally speaking, informal sectors emerge as a result of coping strategies on the part of workers and the desire of firms to avoid regulations. Individuals in the informal sector do everything from wash car windows to cleaning houses to work in illegal, small-scale factories. The diversity of the activities limits the extent of shared interests, and the small size of firms exacerbates collective action problems. It should not be surprising then that the developing world’s outsiders, the millions of entrepreneurs and workers in the informal sector, have neither sustained interest groups nor served as a coherent constituency that might attract partisan attention. Thus, outsiders in both the developing world and Europe have had little political sway.

13 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.
The heterogeneity and weak collective capacity of outsiders stands in contrast to insiders. Economically, insiders tend to be located in non-tradeable sectors dominated either by the state or oligopolies. These portions of the economy have two characteristics that provide insiders with leverage. First, while unions collapsed in manufacturing tradeables, they retained considerable strength in the public sector and some non-tradeable services, such as utilities. In many cases, privatization of state-owned enterprises was managed in a way that produced private monopolies and oligopolies in large, non-tradeable sectors such as telecommunications, transportation and utilities. Murillo (2000; 2009) describes how some of these privatization were only achieved politically because labor insiders were provided with job security, handsome wage increases, and guarantees that protective labor regulations would remain in place. Second, insiders in these sectors have extensive holdup power in labor and wage negotiations. This holdup power emerges from both the protective ISI-era labor market regulations and the oligopolistic or monopolistic product markets in which they operate. Absent economic competition, employers in these sectors are able to pass on cost increases and have few incentives to push for more efficient labor market arrangements. These characteristics strengthen the economic hand of insiders and preserve their status as key constituencies of some parties (Murillo 2000; Roberts 2010).

An obvious implication of this account is that social insurance and labor market policies should show evidence of tremendous persistence, despite the sea changes in other policy spheres. Figure 6 presents results of a cross-sectional time-series model estimated on annual spending data for every country-year for which data is available. The modeling approach and control variables are similar to those in several recent large-n papers on social policy in the developing world (Kaufman and Segura-Ubiergo 2001; Wibbels 2006; Rudra 2008). Again, the results are robust to additional independent variables and estimation procedures. The (unreported) findings suggest that richer countries with larger elderly populations are associated with more spending on social insurance, and an increase in trade dependence is

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14 The control variables include indicators for key arguments in the recent literature, including trade openness, capital account openness, regime type, per capita income, and the demographic strength of the old-age population.

15 These results with panel corrected standard errors are replicated when estimating panel regressions with vector decomposition following the procedure developed by Pluemper and Troeger (2007) for data with unobserved unit effects in the presence of slow-moving covariates.
associated with a reduction in spending. Regime type and the electoral strength of the left, both in level and difference, have no relationship with spending, either in levels or annual changes. The finding on trade is particularly noteworthy, because it fuels claims of a race-to-the-bottom and is consistent with arguments emphasizing the importance of dynamics over recent decades in shaping policy change. The figure uses the results to simulate the predicted effect of permanent increases in trade exposure on two prototypical cases—Brazil and Korea based on data for each country on the eve of the modern era of globalization. The figure shows that as reliance on trade increases, the predicted level of social insurance spending falls quite modestly. A twenty percent, permanent increase in trade dependence is predicted to reduce social insurance spending in Brazil by a little more than 2 percent of total spending and a little bit less in Korea. More striking than the changes associated with increased trade, however, is the very large cross-national differences. As the previous section makes clear those cross-national differences are associated with historical choices made about economic policy and labor markets in the decades after World War II. Put differently, the cross-national differences rooted in historical bargains explain a great deal more about contemporary spending patterns than any changes associated with the era of market reforms and globalization.

Figure 6 Here

3.2: Insiders and the Benefits of Social Transfers: Evidence from Income Surveys

While the evidence above shows that social insurance spending has survived the market reform era largely intact, it says nothing about the distribution of beneficiaries. The insider-outsider account I develop above implies that the beneficiaries from these social transfers are concentrated among high-earning, formal sector workers. The kind of individual-level income data necessary to truly test this claim is not available. Ideally, I would like to have time-series income surveys for a large number of countries. In lieu of such data, I turn to the Luxembourg Incomes Studies (LIS) for evidence on the distribution of social insurance transfers by income group. Though the LIS is widely recognized as the highest quality, cross-national income survey, it has only recently begun to slowly spread beyond the narrow confines of
the OECD. As a result, it has very weak coverage across the developing world. The data presented below is from income surveys conducted in the mid-2000s.\footnote{The data was extracted using the LIS web tabulator and thus reflects the household weights recommended by the LIS. See the file construction documents here: \url{http://www.lisproject.org/techdoc.htm}.}

Though the country-coverage is weak, Figure 7 presents data on how social insurance spending is distributed across the income distribution for a set of quintessential ISI cases and their export-led counterparts in East Asia. I also include data for Sweden, the social democratic ideal, as a point of comparison. Figure 3a shows the share of total insurance spending by income decile. When reading this figure it is important to keep in mind that Korea and Taiwan spend much less on social insurance, both as a share of their total budgets and as a share of GDP, than the formerly-ISI cases. That in mind, the figure shows that Sweden spends about 60 percent of its social insurance on the poorest half of the population, and spending falls as the population gets richer. Taiwan and Korea evince less progressive spending patterns. While the share spent on each decile climbs slowly in Korea, Taiwan’s spending is “U” shaped, showing that it is concentrated at the low and very high end of the income distribution. In the Taiwanese case, the richest decile receives about 60 percent more of total social transfers than the poorest decile, which is directly connected to generous pensions for high-earning positions in a very competitive public sector. Yet the four former ISI cases in Latin America display far more regressive profiles. In Brazil, Colombia, Mexico and Uruguay, the poor receive very little social insurance. The shares slowly climb across the income distribution until they spike in the top decile. In Brazil, for instance, the top 10 percent receives \textbf{38 times} the share of transfer income as the poorest ten percent.

Figure 7a does not reflect the fact that some countries have much larger social insurance budgets than others. Figure 7b tries to address this by reporting social transfer income as a share of market income by decile for the same set of cases. Again, the Swedish case stands out. For individuals in the poorest decile, social transfers are nearly three times their market income; for individuals in the top decile, social transfers are a tiny share of their market income. Put differently, social transfers in Sweden have a progressive effect on income. The Korean and Taiwanese cases evince the same downward sloping curve,
but because they spend so much less on transfers, they make up a much smaller share of the poor’s income. Among those in the poorest decile, social transfers represent 65 percent of market income in Taiwan and 41 percent in Korea. Again, the formerly ISI cases share a distinctive distribution of social effort. In all four cases, the curves are basically flat, which indicates that social transfers make up about the same share of income for the rich as they do for the poor. Given that the rich have considerably higher market incomes than the poor, this implies that most transfer spending is actually being targeted at the rich, which is exactly what we saw above in Figure 7a.

Figure 7a & b Here

Though the LIS data is not available for very many cases and does not speak to the distributional effects of labor market regulations (as distinct from insurance spending), it does show that in formerly ISI cases, social insurance spending is profoundly mal-distributed in favor of insiders. That these countries are spending many multiples more on social insurance as a share of GDP than their East Asian counterparts only underscores the negative distributional implications.

3.2: Beyond Spending: Labor Market Regulations in an Era of Market Reforms

It is woefully difficult to find comparable time-series data on labor market regulations across countries. In the regression analysis below, I rely on cross-sectional data from the mid-1990s through the middle 2000s. The one exception to the paucity of cross-sectional, time-series data comes from Lora (2002), who reports annual data on various reform indices for 19 Latin American countries from 1984 through 2000. The region 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.

Figure 8a & b Here

Figure 8a shows the evolution of market reforms across several policy spheres through time—labor markets, financial markets, trade policy, tax policy, privatization, and an overall index of market reform—relative to policy in 1985, the first year data is available. The data is striking. While

17 Need some detailed information here on the construction of the indices.
governments pursued some privatization of state-owned enterprises, they made enormous changes to financial, trade, and tax policies. In contrast, the region as a whole has seen almost no change in labor market policies. Figure 8b shows that this is not the result of averaging over the 19 countries; it shows that most of the countries of the region pursued basically the same labor market policies in 1999 as they did in 1985. Though the changes are tiny, it is worth noting that the former import substituters, including Uruguay, Mexico, Argentina, and Brazil that 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.

Moving beyond region-specific data, Figure 9 graphically presents the results of models of contemporary labor market policies. Because time-series data on labor market indicators is generally unavailable, I estimate cross-sectional models with each country’s pre-debt crisis ISI score as the key independent variable. I include measures of per capita income, regime type and the political power of the left as control variables. The data comes from three sources: the Fraser Institute’s (2009) various indices of “labor freedom”, Botero et al.’s (2005) extensive data collection efforts associated with their work on the regulation of labor, and Rama and Artecona (2002) who aggregate and harmonize data collected mostly by the ILO. The dependent variables are measured at various points in time, but most are from the period between 2000 and 2006. Consistent with the spending results above, I expect the legacy of ISI to be alive and well in the regulation of labor markets; if so, the ISI variable, measured on the eve of market liberalization, ought to have a positive, significant correlation with labor regulations.

The ISI indicator achieves statistical significance in the expected direction in all but one of the models. Rather than report the results in exhausting tabular form and to give a sense of the scale of the effects, Figure 9 presents the simulated effect of increasing the ISI score across its interquartile range in

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18 Per capita income data from Penn World Tables; regime type is from Polity and is lagged a year; the political power of the left is measured as the number of years between 1980 and 2000 that the left governed each society. The latter controls for the common argument that the electoral strength of the left is a key determinant of social policy outcomes (Bradley, Huber, Moller, Nielsen, and Stephens 2003; Huber, Mustillo and Stephens 2008).

19 I have inverted the scale of the Fraser indices such that positive scores reflect more heavily regulated labor markets.
each of the models. Turning first to the Fraser data and working down the figure, such an increase in early ISI increases the cost of social insurance by about 1/3 of a standard deviation and the extent of collective bargaining by the same amount. Likewise, early ISI is associated with higher costs of hiring and firing—an interquartile increase in ISI raising hiring and firing costs by half a standard deviation, dismissal costs by 1/3 a standard deviation, and minimum wages by a mere 10 percent of a standard deviation. Finally, the Fraser Institute’s overall indices of labor market regulations and “labor freedom” are simulated to become 15 and 20 percent of a standard deviation more restrictive as ISI increases by about 8 points.

Figure 9 Here

The Botero and ILO data suggest a similar picture, thought they use different sources to produce measures of similar concepts. Social insurance costs to workers and their employers are simulated to increase by 1/3 of a standard deviation using the Botero data and 2/3 of a standard deviation using ILO data. Unemployment insurance generosity increases by 1/3 of a standard deviation using Botero data (no such data is available in the Rama and Artecona [2002] dataset). The influence of unions in industrial relations increases by 1/3 and 1/5 of a standard deviation using the respective sources, and the extent of collective bargaining increases by nearly half a standard deviation using the Botero data and more than 2/3 of a standard deviation using the ILO data. Though there is important variation, the general picture is one of early ISI experiences being associated with pretty substantial increases in the scale and scope of labor market regulations in the 2000s.

Given the close historical link between ISI and social insurance, it seems reasonable to expect that social insurance 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, social insurance has persisted. It is the case that the shift from ISI to free market economies fragmented previously dominant factor-based coalitions, but they were replaced by a sectoral, insider-outsider dynamic that privileged the constituents of social insurance. The power of insiders has been borne of their continued organizational strength in the nontradable service and state sectors, where for various reasons, employers can pass on high costs to the entire domestic market of
consumers. These are the groups that 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—the large number of businesses and workers in the informal sector that grew out of the crisis of ISI and has persisted thanks, in part, to high costs in the protected, insider labor market. 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 insurance reforms. Given the centrality of labor market regulations and social insurance systems for the very survival of insiders, they have spent considerable resources blocking microeconomic reforms, even as they passed on various macroeconomic ones that, while painful, did not strike at their very survival (Murillo and Schrank 2009).

4. Consequences for Equity, Productivity and Growth

Finally, I emphasize that these systems of social insurance have had important implications for the evolution of inequality, the capacity of economies to create good jobs, and ultimately, economic growth. 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 most of the developing world. Built as they were for the demands of autarkic economic policies, systems of social insurance 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), encourage capital to invest in the low-productivity informal sector, and discourage capital from making human capital-intensive investments. As a result, social insurance has contributed to the growth of informal sectors, weak labor productivity, income inequality, and slow economic growth.

My emphasis on the composition of the insured and protected helps explain the differential effect of social insurance and labor market regulations on economic growth in Europe and elsewhere. In Europe, the winning insurance coalitions were oriented toward market competition. The countries that developed the most extensive systems of social insurance were export-oriented economies in which risks were
widely shared, and the coalitions supporting the expansion of social insurance included pro-trade working and middle classes. The resulting systems of social protection insured productive sectors and facilitate market competition. Outside Europe, the winning insurance coalitions emerged in large, closed economies, and the coalitions supporting social insurance were protectionist. The resulting systems of social insurance benefited those actors and were ill designed for competitive markets. While the former systems of insurance and labor market regulation might increase the productivity of capital and labor, the latter decrease it.

The extent to which specifically social policy matters for the performance of labor markets and the economy writ large is a matter of real disagreement. One line of thinking builds on the notion that anytime governments redistribute resources, they distort incentives, a sin compounded by the deadweight loss inevitably associated with any government activity. More specifically, Lazear (1990), Saint-Paul (1996), Siebert (1997) and others suggest that under very general conditions, job security provisions, including severance pay and unemployment insurance decrease the level of employment by raising the costs of hiring and firing. The empirical evidence on these points is mixed (Botero et al 2005; Agell 1999; Blanchard and Wolfers 2000), however, and that has inspired the emergence of a prominent alternative account (Agell 1999, 2001; Iversen 2005; Iversen and Soskice 2010).

Central to these alternative models is the notion that social insurance can improve on a pure market outcome. This occurs through two chief mechanisms. First, social insurance in the form of minimum wages, social insurance transfers, and increased firing costs compress the income distribution. If insurance coverage is broad, it serves to constrain wages in those sectors where the marginal product of labor is highest; these are typically sectors where workers have the highest skills and output tends to be exported. By constraining the wages of the most productive workers, social insurance serves as a subsidy to investment in the most competitive sectors of the economy (even as it increases wages in non-tradeable sectors). If, as in endogenous growth models, those sectors are subject to increasing returns, social

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20 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.
insurance improves upon deregulated labor markets. While there may well be efficiency losses in the less productive sectors of the economy, they will be more than made up for by increased investment in increasing returns sectors. Second, social insurance increases incentives for the accumulation of human capital and specific skills (Iversen 2005; Agell 1999). On one hand, as social insurance increases the wages of the low-skilled, firms will hire fewer of them, and workers will increase human capital investments to avoid unemployment. On the other hand, some forms of production require investments in specific skills as a complement to specialized technologies. Those investments represent sunk costs and will only be realized if prospective workers and investors are insured against losses. Together, these factors—improved capacity to make specific investments, higher levels of human capital, and implicit subsidies to high productivity sectors—underscore the role of social insurance in improving the productivity of the economy.

This alternative account of social insurance reverberates little with the systems of social insurance in most of the developing world. As the previous pages make clear, the countries that developed the most extensive systems of social insurance in the developing world were those that pursued import-substitution industrialization. The labor market effects of the debt crisis and resulting trade and macroeconomic reforms were severe. Social insurance coverage fell due to high unemployment and a marked increase in informal (and therefore uncovered) employment. This did not significantly reduce the fiscal costs of these programs, but it did exacerbate the already regressive nature of them. At the same time, labor regulations that favored a smaller and smaller cohort of workers, many of them concentrated in non-tradables, proved highly resistant to reform.

Figure 10 provides a graphic presentation of how systems of social insurance can have divergent effects. The figure presents hypothetical wage distributions in a country with universal social insurance coverage and another where only insiders benefit from social insurance. In the first country, social insurance serves to compress the wage distribution via a combination of minimum wage laws, restrictions on hiring and firing, and direct fiscal transfers. The blue shaded area represents the reduced wages of high-end workers and the increased wages of low-end workers. The reduced wages at the top of the
distribution generate a de facto subsidy to investments in high productivity sectors. The increased wages at the bottom may reduce demand for low-wage workers, but that might be overcome by increased demand for education and skills on the part of such workers. At the aggregate level, if the high-end investments are subject to some increasing returns, they will more than make up for any losses in productivity at the bottom of the wage distribution. The second figure shows what happens to wages when only a small group of insiders benefit from social insurance. When social transfers and labor market protections affect only those workers, the initial, unimodal distribution is replaced by a bifurcated wage market. Thanks to regulations and union representation, insiders will have hold-up power and their wages will increase; the green shaded area represents these rents. With high costs in the insider labor market, firms and employees will flood the unregulated, low productivity, low wage outsider one (see discussion of the informal sector below); the reduced income among outsiders is reflected in the red shaded area.

Figure 10 Here

This change in the wage distribution is likely to have important economic costs since the large outsider market is relatively unproductive while production in the insider market faces limited competition. informal sectors have several characteristics that are likely to serve as a drag on the distributive and productive performance of economies. Four characteristics stand out. Perhaps most obviously, firms in the formal sector tend to be small, a natural result of the need to avoid the regulatory eye of the state. Small firms are associated with weak vertical integration, dated technologies, and general failure to take advantage of economies of scale. Moreover, since most contracting relations are necessarily informal, there are real constraints on the capacity of informal firms to outsource elements of the production process that would obviate the need for vertical integration. Second, because informal firms lack formal property rights to their assets, they have a difficult time accessing credit markets. Being credit constrained, they are unable to make the kinds of investments that would increase productivity and induce scale economies. Third, given their small size and weak capacity to borrow, it is no surprise that informal firms have a hard time making capital investments and tend to use dated technology. As a result, they tend to be labor intensive, and in the absence of technological complements, there is limited demand
for workers with high levels of human capital.\textsuperscript{21} Thus, weak technology and low incentives for human
capital accumulation go hand in hand. Fourth and finally, survival in the informal sector oftentimes
requires paying off public inspectors and officials, hiring informal security, investments in informal
adjudication procedures, and the like. All of these factors contribute to the finding that the informal sector
is associated with corruption high levels of corruption.

Certainly there is now substantial evidence that informal sector workers are less productive,
poorer, lower-skilled and paid less than their formal sector counterparts (Kaufmann and Kaliberda 1996;
Heckman and Pages 2004). Similarly, a growing body of evidence suggests that informal firms are very
inefficient. La Porta and Shleifer summarize evidence from firm surveys by suggesting, “There is very
little support for the romantic view [that informal firms are efficient alternatives to formal ones], and
indeed the differences in productivity between the formal and informal firms are so big that it is very hard
to believe that the registration of unregistered firms will lead to large productivity gains.”\textsuperscript{22} Indeed,
Garxhani (2004) concludes in her survey of the literature that “this sector gives little opportunity to
economic growth and accumulation.”\textsuperscript{23} While participation in the informal sector might be rational for
individual entrepreneurs or workers (as emphasized by Maloney 2004), it is likely to be socially
suboptimal.

These arguments lead to three empirical expectations. First, countries with extensive systems of
social insurance will produce larger informal sectors, all else equal. This can result either from the high
fiscal costs or high regulatory costs of formal sector employment. Second, social insurance systems
should be associated with increased inequality over recent decades. This increased inequality should
result from: a) the direct maldistributed nature of social insurance transfers; and b) how labor market
regulations decrease the supply of labor to insider labor markets while increasing it to the outsider labor
market. Third and finally, reduced labor productivity, the inefficient allocation of capital and labor to
small, informal firms, and related dysfunctions associated with bifurcated labor markets should slow

\textsuperscript{21} This is the spirit of the early and influential model of the informal sector provided by (Rauch 1991).
\textsuperscript{22} 2008: p.6.
\textsuperscript{23} 2004: p.17.
overall economic growth.

4.1 Size of the Informal Sector

Measuring the size of the pool of labor market outsiders in the developing world 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. That the case, I report results from the two measures of informality with the best cross-country coverage. The first is provided by the World Competitiveness Report (2007), which reports the results of a survey of business leaders in which they were asked to estimate the amount of business activity that is unregulated. I take the second measure from Schneider (2007), who models the informal sector as a latent variable inferred from several observable regulatory and economic indicators. Each measure has its problems. In the former case, the opinions of business leaders may or may not be accurate and the construction of the variable artificially caps the informal sector at 50 percent of the economy. The latter measure is much more complicated and utilizes a host of indicators that might not be related to informality. That the case, the two indicators cover many more cases than alternative measures and are correlated at .70

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. As such, each model controls for logged per capita income. Beyond social insurance and labor market policies, the main other factor hypothesized to impact informality is the difficulty of a firm registering with the authorities. As the time and cost of registering increases, informal firms are expected to proliferate; as they do so, employment in the informal sector also should grow. As such, I also include a control for the cost of registering a business. Consistent with (and courtesy of) La Porta and Shleifer (2008), I use the (log) number of procedures required to legally start a business from Djankov et al. (2002) and the 2008 Doing

24 The observables are taxation/GDP, the Heritage Foundation’s index of regulation, the unemployment rate, GDP per capita, the annual rate of economic growth, and the “annual rate of local currency per capita”. I have no idea what this last set of words refers to.
Business Report as a proxy for the cost of formality. The key dependent variable in each model is an indicator of the extent of social insurance. The measures include initial social insurance spending, average insurance spending for the entire period, and several of the indicators of labor market regulations discussed in the previous section.

Because the various indices of labor market regulations are coded in different ways and there are a large number of models, discussion of each coefficient would be space consuming (and boring!). In lieu of such a discussion, Figure 11 provides a graphic presentation of the relationship between the size of the informal sector, the two social insurance indicators, and the four indicators of labor market regulations using component-plus-residual plots. Note that the “Dismissal”, “Hire/Fire”, and “Collective Bargaining II” variables are coded such that labor markets regulations are less protective across the x-axis. The overall picture is noisy but quite consistent—informal sectors are larger in countries with more extensive systems of social insurance. The coefficients in the models with social insurance spending as the key independent variable suggest particularly large effects, with a 10 percent increase in spending predicting a 25-30 percent increase in the size of the informal sector as a share of the workforce.

Figure 11 Here

4.2 Inequality

Research on income inequality emphasizes two dynamics—trade liberalization and factor price equalization (Leamer 1998; Hanson and Harrison 1999) and skill-biased technological change (Krugman 2000; Goldberg and Pavcnik 2007). Though research has paid less attention to the role of social insurance on inequality, particularly in the developing world, evidence from the OECD provides a mixed picture. On one hand, extensive systems of unemployment insurance and labor market regulations are associated with relatively regressive welfare states in Christian Democratic countries such as Germany; at the same time, those countries have more equal wage distributions than countries that have less generous systems of social insurance, such as the U.S. To examine the impact of social insurance on changes in the wage distribution during the era of globalized markets, I estimate several multivariate models to assess the impact of social insurance on changes in inequality over recent decades.
Table 1 reports the results of several panel regressions of inequality on early social spending measures and a series of controls. The dependent variable is derived from the GINI coefficients reported in the most recent version of the UN/World Bank WIID project and supplemented with the Standardized Income Distribution Database (SIDD-3) (Babones 2008). I rely primarily on the WIID as it provides better through time coverage and variance. In cases where the SIID-3 data provides times series variation and the WIID does not, I rely on the former (approximately a dozen cases). I measure the dependent variable in three ways: as the average log difference in inequality between 1980 and the most recently available data, typically from about 2000; the percentage change in the gini over the period; and the level of inequality circa 2000. I choose 1980 as the starting point as this (and the surrounding five years on each side) is before the widespread movement toward liberalizing markets that was jumpstarted by the debt crisis of 1982. Going further back in time is impossible in light of data constraints. Given the complications inherent in cross-country comparisons of inequality measures derived using different methods (Atkinson and Brandolini 2001), I prefer this measure of within-country change to several plausible alternatives.

I control for initial income inequality (about 1980), the initial level of per capita income and the extent of democratic governance over the two decades. The results, reported in Table 1 suggest that the extent of social insurance is associated with increased inequality over the last two decades. Focusing on the results for Model 2, which are the easiest to interpret, they suggest a one standard deviation increase in social insurance spending (about 14 percent) is associated with an increase in the gini coefficient by about 2.25. The effect is not huge, but the results are quite robust in the face of additional controls. The introduction of various indicators of trade dependence and change in trade dependence over recent decades does little to the key results on social insurance, nor does the inclusion of an indicator of the

25 To be precise, the measure is: ((Gini_{2000}/Gini_{1980})^{.05})-1. This is the standard way of measuring growth in the economic growth literature.
26 Given how sparse the data on inequality is, I calculate the beginning point as the average of inequality levels between 1975 and 1986. Calculating the beginning point between 1975 and 1982 does not change the results but removes 17 cases from the sample. The endpoint of each country’s data series on inequality varies between 1998 and 2003; I take the average of inequality levels between 1998 and 2003 as the endpoint.
27 The democracy indicator is the average polity score over the two decades.
strength of the electoral left.\textsuperscript{28} While increases in trade dependence are consistently and positively associated with increased inequality, the strength of the left has no effect at all.

\textbf{Table 1 Here}

\textit{4.4 Economic Growth}

Finally I turn to the impact of social insurance on economic growth in the developing world during the era of open markets.\textsuperscript{29} I estimate panel regressions of economic growth measured in two ways: as the percentage growth of per capita income from 1980 until 2000 and the log difference in GDP per capita over the same period. The key independent variable is the measure of social insurance spending as a share of total spending. I include a fairly standard body of controls, including initial logged per capita income to test for convergence, the fertility rate (Przeworski et al. 2000), natural resource dependence (Sachs and Warner 1995), and trade openness. Unless otherwise noted, independent variables are panel averages for the years from 1980-2000. Note that there is reasonable evidence that the relationship among some of these variables might be non-linear (Banerjee and Duflo 2003) and/or that there is reason to expect indirect effects among variables (Barro 2000). These results should be taken as very preliminary.

The results of Model 1 in Table 4 suggest that the greater the share of the budget devoted to social insurance, the lower per capita income growth over the subsequent two decades. The results are nearly significant in Model 1 and are significant in Model 2. Looking at the results from Model 2, each 10 percent increase in social insurance (the standard deviation is about 14), decreases annual growth by .6 percent. Thus, a country with a per capita income of $2000 in 1980 that spends an additional 10 percent of its budget on social insurance is estimated to sacrifice $900 per capita 20 years later.

\textbf{NOTE TO READERS:} clearly much work to be done here.

\textbf{Table 4 Here}

These results are far from conclusive, but they are suggestive. If decades of growth regressions tell us anything, it is that results are unstable in the face of many potential regressors and the tenuous link

\textsuperscript{28} I use the number of years the left governs up to 2000. The left variable on which this is based comes from the Database of Political Institutions (2009).

\textsuperscript{29} The empirical growth literature is fabulously extensive. See Barro 2000; Perotti 1996; Banerjee and Duflo 2003.
between parameters of theoretical interest and the data I have to work with (Sala-i-Martin 1997). If anything, the cross-national inequality data makes analyses even more problematic (Atkinson and Brandolini 2001). That the case, the challenge of harmonizing micro-level data across countries that might provide more convincing tests of the arguments I have forwarded here are most daunting. Keeping the data limitations in mind, the results above suggest one overarching conclusion. The legacy of social insurance programs established in an earlier era of developmental capitalism cast a very long shadow. Thanks to political configurations in the post-World War II era, these cases developed social policies aimed at the creation of labor markets poorly suited for today’s global economy. Those systems protect a narrow group of insiders and produce a large unproductive group of outsiders. The results, though rational for individual entrepreneurs and workers, are socially inefficient. In light of data constraints, the results are only suggestive, but they do indicate that social insurance policies have important negative implications for development.

5. Conclusion: Legacies, Trends and Forecasting the Future

My account of the origins and evolution of capitalist development and social insurance in the developing world has implications for three literatures. First, it addresses an ongoing boom in research on social policy in the developing world and does so in a way that seeks to integrate insights derived from the rich body of work on the OECD. 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. Nearly all of this literature is focused on changes in social policy, even if researchers draw on different literatures, develop distinct causal claims, use diverse empirical methods, etc. Clearly, I tend to see continuity where others see considerable change. But it is worth emphasizing that research preoccupied with year-on-year policy changes has a hard time explaining why nations began the current era of liberal international markets with wildly different social priorities. While it might be true that Brazil spends slightly less on social insurance in today’s globalized world than it would have in a counterfactual, closed-economy world, such an analysis offers less insight into Brazil’s current high level of social insurance spending. Likewise, it certainly cannot explain why it spent thirty
times more than a country like Korea at the beginning of today’s globalizing era. In providing an analytical foundation for explaining those cross-national differences, I provide a bridge between the historical origins of developmental capitalism and the contemporary emphasis on social policy reform.

In placing the organization of labor markets in the context of broader social conflicts over the organization of the economy, I build on considerable work on the welfare state in Europe. At the same time, the findings call into question the generality of two common claims in research on advanced, industrial democracies. First, in the context of Europe, 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 is fundamental ingredient of economic competitiveness; this is a virtuous story in which many good things go together. I diverge from such accounts by describing an equilibrium in which social insurance persists despite huge negative effects on economic efficiency. Second, one of the dominant accounts suggests that social policy emerges as a means to compensate various labor market participants for the risks they face and that global economic exposure and social insurance reinforce one another. Clearly, the argument and findings here belie the notion that economic openness and social insurance necessarily go together. While the most dynamic portions of OECD economies were export-oriented manufacturers during the postwar period when welfare states boomed, the comparative advantage of most developing countries was in primary products. In the developing world, only countries that pursued import substitution developed industrial working classes large and organized enough to even approximate those in the OECD, and while those workers were able to negotiate substantial insurance programs, they did so in a context of protectionism, not free trade. In short, bringing comparative advantage and the dynamics of global capitalism into the literature on the link between trade and social policies suggests that the bargain of embedded liberalism was a historic anomaly characteristic of a small number of countries.

The second broad literature that my account (briefly!) addresses is that on the political economy of development. Research on development is broadly divided between two camps, one emphasizing the centrality of institutions and the other the importance of contingency. The institutionalist camp has been
ascendant for at least a decade and emphasizes the political and economic rules that regulate exchange. The precise institutions that matter for economic success are often obscure, and when they are clearly specified, their link to the fundamentals of growth economics can be obtuse. It is unclear, for instance, how institutional constraints on the chief executive relate to the supply of capital, labor, or their productivity when combined. The alternative camp includes a diverse array of work on everything from economic geography to the link between aid, policies, and growth. Contingency is central to some of these accounts because economic first-movers take off for largely arbitrary reasons and subsequently develop thanks to economies of agglomeration. A different approach suggests that the underlying ingredients of growth are so context-dependent, so weakly linked to public policies, and so poorly understood that the best we can reasonably suggest is that countries be left to experiment with an open-ended menu of strategies for development. If the institutionalist approach tends to analytical abstraction, the alternative approach leads to the expectation of no (or a very tenuous) relationship between policies, institutions and developmental outcomes. Neither approach clearly identifies the key sets of actors and interests the can promote development.

I place a specific set of actors, policies and institutions—those relating to and governing social insurance and labor markets—at the center of the analysis and link them to the productivity of capital and labor. I provide some preliminary evidence that systems of social insurance have systematic micro-level incentives for workers and capital. In the OECD cases, those incentives might productivity enhancing, but in much of the developing world they are not. Instead, they lead to investments in inefficient, informal modes of production. This approach is not entirely new; there is, for instance, a large and growing literature on how and why informal sector employment is relatively unproductive. Here I provide a historical explanation for why informal sectors vary in their size and how social insurance conditions the investment decisions of capital and labor. Certainly I do not mean to suggest that social insurance is the key for understanding post-war economic development, but social insurance and attendant labor regulations do have a very important impact on the relative price of (and productivity of) labor.
Third and finally, my 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 only generate returns over the long run. Fueled by the democratic power to vote and organize, citizens have demanded insurance as the cost for open economies. If social insurance in the OECD plays a key compensatory role in smoothing citizen participation in markets, the social insurance across much of the developing 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. But if social insurance seems unlikely to be the glue binding democratic politics and market participation, what exactly is its political role? How do publics respond when they are systematically excluded from the benefits of the formal economy? Do they blame democratically-elected politicians, or democracy itself? Or left without social protections do they respond by turning against free markets as a means to provide economic opportunities?

Figure 13 provides some preliminary answers to these questions. The figure reports the predicted effect of an interquartile increase in social insurance effort on a wide array of survey questions on attitudes towards markets and democratic politics taken from the full series of World Values Surveys dating back to 1981.30 In each case, I have scaled the responses so that higher scores represent anti-market opinions. In each and every one of these models, the coefficients on social insurance are significant and their sign indicates that social insurance is associated with stronger anti-market sentiments. This is true whether the question is about whether competition is good, faith in private companies, the desire to limit

30 In each case, I estimate simple OLS models with clustered standard errors (some countries are surveyed multiple times) in which the dependent variable is the country average response to a question bearing on democracy or economic competition. The key independent variable is spending on social insurance as a share of GDP. I control for economic growth in the previous year under the expectation that citizens will have more positive evaluations of regimes and markets when the economy is doing well and for regime type (using Polity) with the expectation that citizens in democracies have more optimistic evaluations of democratic governance and markets.
trade, etc. None of these findings hold in a larger sample that includes the wealthy countries of the OECD (results on the broader sample are unreported). Turning to the right-hand panel of the figure, it shows that while social insurance is associated with negative opinions of markets, it has no impact on general attitudes toward democracy. The picture changes somewhat when we turn to specific democratic institutions; the figure suggests that citizens in countries with more extensive social insurance systems have systematically poorer opinions of their parliaments and political parties. Though one would be ill-advised to take this kind of aggregative-level analysis too seriously, it seems that countries with extensive systems of social insurance engender skepticism of markets and that while these attitudes are not associated with decreased support for democracy as a system of governance, it does for specific democratic institutions.

Figure 13 here

Ultimately, then, my broad historical sweep may provide a lens through which to consider the future prospects for democracy and liberal markets in the developing world. Many early import substituters continue to see powerful anti-market movements twenty years after economic liberalization. Indeed, as social spending on protected sectors has been difficult to retrench and labor markets have proven particularly resistant to reform, these governments have struggled to provide social support to the truly poor and investments in human capital that would increase productivity—budgets are simply too constrained. Conditional cash transfers seem to be a common response in countries with large social insurance systems, and the logic of the programs are firmly embedded in the broader political and economic contexts described above. They offer the potential for politicians to attract the votes of poor workers at very low cost. Of course, there are a large number of poor workers because the formal systems of social insurance have produced massive informal sectors. That conditional cash transfers provide access to those voters cheaply is important because the costs of mature social insurance systems have grown enormously, leaving little fiscal space for large programs. It is worth noting, for instance, that Brazil’s famous, large Bolsa Familia program costs about 1/35th of its exceedingly regressive pension system.
There is now quite solid evidence that many conditional cash transfer programs do serve to improve the economic condition of the very poor, but it is worth noting that the emergence of extensive conditional cash transfer systems may actually exacerbate the dysfunctional labor market dynamics described above. When social benefits are not contingent on formal sector employment, workers have little reason to forego the flexibility of the informal sector for the rigidity of the formal sector. This is exactly the dynamic in Mexico described by Levy (2006), who characterizes that country’s conditional cash transfer program as a subsidy to informal sector employment. It remains to be seen if such programs can serve the crucial role of mediating the ever-present tension between democratic politics and market economics, but I’m doubtful.
Partial List of References

CEPAL. n.d. "Base de Datos de Gasto Social (Actualizada hasta fines de 1999)." CEPAL.


Figure 1a: The Distribution of Social Insurance Spending Across the Developing World

Figure 1b: The distribution of collective labor relations laws across the world (regulations tighter across the x-axis)
(Variation between countries in Collective Relations Laws)
Figure 2: The Distribution of Development Outcomes Around the World—Economic Growth, Job Creation and Inequality