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Capitalist Varieties Under One Roof: Coping With Diversity in the European Union

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The 2010s were a rough decade for Europe and the current one – ushered in by the Covid-19 pandemic – promises to be just as challenging. The global financial crisis of 2008/9 had shaken economies around the world, but only in the European Union did it lead to sovereign debt crises that seriously slowed down the recovery. The sputtering economy led to bitter fights over economic policies and fed the flames of nationalism and populism around the continent. All of this threatened to undermine the EU's ability to tackle in a unified way the burning questions of the new century: the energy transition, economic relations with China, and the recovery from Covid-19.

What made the management of this 'polycrisis' (Zeitlin et al. 2019) especially difficult was that its effects varied across EU Member States. In many countries of the European north-west the crisis weakened the banks, but their governments managed to shore up the financial sector without increasing the costs of public borrowing. Meanwhile, in southern Europe, attempts to protect the banks led to skyrocketing yields on government bonds, bringing some of these states to the brink of insolvency.

Why did we see such divergence? Whether they blamed profligate governments unable to control their spending (see Dooley 2014; Khan and McClean 2017) or labour market institutions failing to contain inflation and maintain competitiveness (Hancké 2013; Johnston and Reagan 2016), most analysts found explanation in the underlying differences in national economic governance. The subsequent years have therefore seen a flurry of measures to align economic policies and institutions of all EU member states towards an ideal roughly modelled on Germany: export-oriented, fiscally prudent and equipped with a skilled and flexible labour force as well as mechanisms to keep wages pinned to productivity (Johnston and Reagan 2018; Perez and Matsaganis 2018; Jones 2021). These measures include tightening the limits on fiscal deficits, introduction of constitutional ‘debt breaks’ and ‘watchdog councils’ to monitor spending, and in-depth scrutiny by the European Commission of a wide range of economic indicators – wages, employment, education, housing prices – accompanied by recommendations for institutional reform (Verdun and Zeitlin 2018). The same monitoring mechanisms and reform conditionality have also been built into the post-Covid-19 recovery funds.

While the EU’s efforts to foster institutional convergence among its members may seem like a logical response to the unevenness of crisis, this chapter argues that they have been – and are – unlikely to work. The reason is that capitalist diversity in the European Union is not merely a quirk of history or a failure of national governance in certain countries that can be ‘fixed’ though a bout of institutional engineering but is itself largely a product of past integration. Decades of harmonization of European markets and institutions have not only failed to produce convergence but have in fact actively encouraged the development of different production and growth models. This point is frequently under-emphasized even in the scholarly theories of capitalist varieties, but its implications for the efforts to address the EU’s polycrisis are serious.

If diversity is a product of integration, as will be argued here, then more pressure for convergence is unlikely to eliminate it, or its potential costs. But also, if the economic impact of integration is going to be uneven, the EU needs to take more responsibility for managing its costs.

The chapter makes this argument in several steps. The first section reviews two dominant strands of literature on capitalist diversity – the ‘production models’ and ‘growth models’ – to highlight the mechanisms through which international integration contributes to the persistence of capitalist variety in Europe. Section two then draws on the experience of the East European members to highlight the challenges to top-down institutional convergence. The concluding section revisits the debate about the need for convergence in the EU and argues for an alternative policy approach.

Why so different?

The policy push for institutional convergence decades after the launch of the Single Market and the European Monetary Union may appear surprising. One reason clearly is that it took an existential crisis to give the EU the authority to demand such reforms from its member states. Another is that in the heydays of integration optimism many believed that convergence would result more or less automatically. Bringing diverse economies under a set of common market rules was supposed to push them into regulatory competition that should have weeded out inefficient institutions, and the loss of control over monetary policy should have forced labour market adjustments in order to prevent inflation (Verdun and Wylie 2002). And yet, more than three decades later, diversity of economic institutions as well as outcomes continues.

Attempts to explain this persistence have led to a flourishing of comparative political economy as a discipline and produced many different typologies and labels: the 'Anglo-Saxon' vs. the 'Rhenish', 'Nordic' and 'Mediterranean' capitalisms (Albert 1993; Amable 2003); the 'coordinated', 'liberal' and 'mixed' market economies (Hall and Soskice 2001; Hancke et al. 2007); as well as 'export-oriented' and 'debt-oriented' growth models. Yet more varieties have been identified among the post-socialist economies in Europe: 'dependent market economies' (Nölke and Vliegenhart 2009), 'neoliberal', 'embedded neoliberal' and 'neocorporatist' economies (Bohle and Greskovits 2012), as well as 'oligarchic', 'patrimonial' and various state-authoritarian types (Myant and Drahokoupil 2010).

These typologies emphasize different aspects of the economy and highlight different elements of the institutional subsystems – welfare institutions, the role of the state more than others. Most can, however, be grouped into roughly two camps which I will call *production models* and *growth models*.

Production models

The literature that relates the institutional structure of an economy to its production specialization has a long pedigree, including attempts to explain different pathways towards industrialization, or the link between dependence on commodity exports and authoritarianism (e.g. Gerschenkron 1962; Karl 1997).

More recently, the research into production models in industrialized economies has focused on uncovering the ways in which domestic institutions shape divergent responses of countries to globalization (Streeck 1991; Holingsworth and Boyer 1997; Hall and Soskice 2001). The main argument, broadly speaking, is that domestic institutions supply individual companies with inputs they need to compete in the international markets – finance, skills, technology – but do so in very different ways.

This argument is formulated most strongly by the Varieties of Capitalism (VoC) approach which sees these cumulative differences as amounting to a country's *comparative institutional advantage* (Hall and Soskice 2001). Thus, a company in say Germany can count on highly trained and cooperative industrial workforce, patient, long-term funding from banks and close relations to both competitors and suppliers that facilitate diffusion of new technologies. This is an environment well suited to production of goods that rely on quality and gradual innovation, such as engineering products and complex consumer goods like automobiles. It also allows German companies to retain a competitive age in the face of increased competition, but in exchange binds them to institutions that ensure that the necessary inputs continue to be produced: dual vocational training in which firms take an active part, largely at their own expense; higher levels of employment protection to compensate workers for the risks involved in acquiring industry-specific skills; collective bargaining, which prevents companies from 'poaching' workers from one another and gives employee organizations a say in how companies are run; and participation in industry and employer organizations that facilitate coordination between companies (Hall and Soskice 2001; Iversen and Soskice 2001).

A very different set of constraints faces a firm in the UK or Ireland. Here companies more frequently raise capital on the stock market, which are more likely to finance original, high-risk ventures than are banks. But the stock markets also make company financing less stable. To remain flexible, firms therefore need to be able to hire and fire workers more easily too. This leads to a more adversarial relationship with the unions and practically rules out the kind of long-term cooperative employment relations that facilitates investment in industry-specific skills. At the same time, individuals have an incentive to invest in their own education – as evidenced also by the private costs of higher education in UK and Ireland compared to the continent – because the absence of collective bargaining means less wage compression and greater returns to those whose skills are in high demand.

These stylized accounts represent what the VoC literature calls 'coordinated' and 'liberal' market economies – the first represented by a cluster of countries in Northwestern Europe (Germany, Austria, Belgium, Netherlands, Sweden, Finland, Denmark), and the latter by UK and Ireland in Europe, as well as other Anglo-Saxon economies (US, Canada, Australia, New Zealand) (Hall and Soskice 2001). The VoC does not argue that these different types were created through mutual competition – various authors have explored at length the role of history, path dependence and politics in the formation of Europe's capitalist varieties (Thelen 2004; Iversen and Soskice 2009). Yet the core claim remains that the persistence of diversity has been reinforced by global, and especially European market integration. As integration eliminates economic barriers and sharpens competition, some features of the system might change, but the domestic producer groups will rally to protect those institutions that allow them to remain competitive (Hall and Soskice 2001; Hassel 2014).

The logic of institutional comparative advantage could thus explain why, for instance, trade liberalization accelerated the decline of manufacturing in the UK, but less so in Germany, and why employers in the Netherlands continue to support collective bargaining even in the face of falling union membership. The implications for the broader question about the desirability, and the likelihood of institutional convergence in Europe are also clear-cut. Institutions are protected by powerful cross-class coalitions and are resistant to change. Moreover, as institutions provide specific advantages to firms, forcing change may undermine their comparative advantages and make an economy less successful.

However, the binary of coordinated and liberal market economies does not do justice to the breadth of capitalist variety in Europe, and in fact leaves out most economies in East and Southern Europe that have been the main subjects of reform pressures in recent years. From the point of view of the VoC, both regions are home to different combinations of 'liberal' and 'coordinated' institutions. The southern economies have indeed been dubbed 'mixed' market economies (Molina and Rhodes 2007) to describe the contrast between high levels of coordination that prevail in the capital markets and some parts of industry, and the more liberal and adversarial relations in the rest of the economy.

Similar fragmentation in the modes of coordination has been observed in East European 'dependent' market economies (Nölke and Vliegenhart 2009), but here the division rather runs along ownership lines. In Eastern Europe, fragmented domestic capital with weak financial and business institutions and contentious relations with the state stands in contrast to a highly organized and coordinated network of foreign firms that rely on external connections and public support to secure their supply chains, finance, and even skills (Nölke and Vliegenhart 2009; Scepanovic and Bohle 2018; Ban 2019).

The implications of the existence of these mixed types for the prospects of institutional reform and convergence in Europe are also less obvious. The early VoC effectively argued that institutions across different sub-systems reinforced one another, and that such 'complementarities' were at the root of institutional comparative advantage. The less coherent, 'hybrid' institutional systems would lose out, and end up adjusting either towards the more liberal or the more coordinated pole (Hall and Gingerich 2009). It would appear that the EU's policy responses in the aftermath of the financial crisis were inspired by similar logic. Liberalization of labour markets, decentralization of collective bargaining and breaking up of the links between state, industry and banks all signalled adjustment towards the more liberal model (Hall 2018).

As argued in the introduction, this policy approach has been far from successful. Moreover, the subsequent fierce debates over the relative merits and demerits of different institutional systems in Europe helped to reveal just how much the 'coordinated' economies of the core have themselves been changing. The notion of institutional complementarities increasingly came under fire, and the field of comparative political economy saw the emergence of an entirely different paradigm, that of growth models.

Growth models

The focus on production models proved a useful tool to explore different pathways to competitiveness within one integrated market. However, by highlighting the institutional systems that support the production models of the lead export sectors, this approach overlooked the trends that were under way in the rest of these economies and which, unfortunately for the approach, ended up in the eye of the storm.

The most important of these trends was an explosion in private household borrowing that affected economies across Europe. The overexposure of Irish, Spanish and Greek banks made headlines in the crisis, but the expansion of private credit affected just as much some of the coordinated 'core'. Denmark, Sweden and the Netherlands have in fact some of the highest levels of per capita household debt in Europe. Nor were the changes limited to finance. Most of these economies have been experiencing rapid growth in service sector employment, away from their traditional specializations in high value-added manufacturing. This was accompanied by changes in the educational systems, employment relations and social policy (Hassel and Palier 2021). In other words, even as some countries fought to preserve the core features of their comparative institutional advantage, others showed signs of looking for alternative sources of growth.

The 'growth models' perspective departs from the microeconomic supply-side view of institutions as providers of essential assets to competing firms, and looks at the institutional structures from a macroeconomic perspective, as ways of supporting different sources of demand (Baccaro and Pontusson 2016). Reliance on exports, or external demand, is only one option. Another one is to build up domestic demand, either through rising wages, public expenditure or loans.

What does this have to do with European integration and the prospects of convergence? In the postwar period most of Europe relied on domestic consumption. Trade and capital restrictions meant that capital owners had to get majority of their profits from the domestic market, so wage growth had a positive effect on investment as long as the cuts in profits due to higher labour costs could be offset by expanding production. Welfare systems, expansion of education and coordinated wage bargaining all served to support this growth in demand. However, market opening since the 1970s, and in Europe radical liberalization of product and capital markets since the mid-1980s, meant that capital was free to seek lower production costs and higher investment returns elsewhere, and wage growth increasingly came to be seen as an obstacle to investment (Lavoie and Stockhammer 2013).

European countries adapted in different ways. Some, like Germany, shifted to an export-based growth model, which required keeping wages firmly in line with productivity. In the large export-oriented sector this meant using collective bargaining to ensure wage moderation, but also investments into the training of low-skilled workers. It also meant, however, preventing wage inflation in the growing service sector from undermining these competitive gains, and this was partly accomplished through changes in the employment legislation that allowed for increase in precarious and low-paid jobs (Hassel 2014).

In many other countries, including southern ones, such as Spain and Italy, manufacturing sectors fought to keep wages in check but lacked clout to impose the same kind of discipline on others. Wages continued to grow in the public sector, and in sectors that relied on domestic demand – tourism, construction, retail, as well as in the growing 'knowledge economy'. Much of this demand expansion was now fuelled by credit, but a number of countries managed to turn growth in the domestic service sectors into a new source of competitiveness in high value-added finance, ICT and business services (Thelen 2021). For some, like the UK, this also meant rapid erosion of manufacturing exports, but in others, like Sweden, the conflicting logics of consumption-led growth in services and profit-led growth in manufacturing continue to battle, leading to institutional compromises and a more balanced growth model (Baccaro and Pontusson 2016).

Like the production models theories, then, the growth models approach offers a sceptical view on the prospects of institutional convergence in Europe, although for different reasons. In this view, institutions are not functional solutions to the problems of international competitiveness, protected from change by cross-class coalitions of producers and by inter-institutional complementarities. Instead, institutions are seen as products of political struggles, in which certain dominant social blocks can for a time impose their preferences, but where these compromises are in constant dangers of being challenged from inside and outside by actors seeking a larger portion of wealth.

This also implies a more complex view of the impact of European integration on different countries' institutions. Integration is no longer viewed merely as an external structure that exerts competitive pressures on local firms. It is now also perceived as a source of opportunities for various actors to explore new strategies of wealth accumulation and change their bargaining power, which in turn allows them to reshape domestic institutional arrangements. This allows us to explore, for instance, how the expansion of credit that re-directed some southern countries towards consumption-led growth was facilitated by the deep integration of the European financial markets. It also allows to see how the success of German export industries was made possible not only by the efficiency of domestic wage-setting institutions, but also by the Euro area shielding them from currency pressures that such success may have otherwise engendered (Jones 2021).

The emphasis on politics, internal conflict and multiplicity of pathways thus makes the growth models perspective a potentially promising tool for the study of institutional change in transnational context. Much of this work is, however, still in early stages, as the early literature focused on explaining the changing growth models of the 'core'. To see more clearly how the transnational agency shapes institutions of the EU member states, we turn next to the closest the EU has to an experiment in institutional transfer: the experience of East European member states.

Lessons from the East

Both the transition from socialism as well as the accession to the European Union required an overhaul of economic institutions in this region. The EU played an active role in this, with the Commission providing guidance, training and funding for the construction of market-supporting institutions (Bruszt et al. 2020). Similar to the current efforts in the south, these policies did not necessarily reflect a consensus distilled from the existing institutional systems of the 'old' EU members – these, as we saw earlier, remained quite diverse. Rather, they reflected the prevailing ideological preferences for liberal market arrangements at the time of the 'Washington consensus', as well as suspicion towards the old state-connected elites. The result was a spate of reforms that insulated monetary policy, encouraged privatization, liberalized labour markets and weakened union bargaining power, promoted investments in general and higher education to support the transition towards 'knowledge economy' and invested in the development of domestic stock markets, among other by encouraging privatization of pensions (Ther 2016).

Yet none of this turned the East European countries into textbook 'liberal market economies', at least as far as development of comparative institutional advantages was concerned. Even in the Baltic states, which structurally came closest to the liberal model, no burgeoning services sector replaced labour-intensive manufacturing as a source of export earnings (Bohle and Greskovits 2012; Bohle 2018). A complicating factor was that constructing certain domestic institutions could not ensure that they fulfilled their function, especially if European integration offered an alternative mechanism. Investment financing is a good example. Despite all efforts at reform, neither the domestic stock markets nor the overwhelmingly foreign owned banking sectors played a big role in company financing (Scepanovic and Bohle 2018). Instead, the bulk of capital came from direct foreign investment.

The FDI itself offered another potential pathway for institutional transfer. East Central European countries, for instance, had become prime destinations for German capital investing in relatively capital intensive and high value-added industries. These companies brought with not only capital and technology but also entire networks of suppliers. They also established own associations that actively lobbied governments for policy changes, including revival of vocational training (Drahokoupil 2009; Ban 2019). Nevertheless, this propitious combination of export specialization and institutional culture did not lead to the transplantation of the 'coordinated' model to East Central Europe. Investors were eager to secure in-house cooperation with employees but eschewed higher-level collective bargaining. They demanded legal changes that allowed them to employ very young trainees through the systems of dual education but refused to contribute to the training schemes beyond the needs of their own companies. Above all, the institutional systems of these 'dependent market economies' (Nölke and Vliegenhart 2009) remained deeply fragmented between sectors dominated by export-oriented foreign firms and domestic capital mostly focused on the national market.

In sum, neither top-down institutional engineering nor import of entire economic sectors resulted in convergence of the East European institutional systems with those of the older EU members. What we saw instead was evolution of distinct sub-types, each shaped by its specific pattern of integration into the wider European economy: export-oriented manufacturing in East Central Europe, finance-led reorientation towards services in the Baltics (Bohle and Greskovits 2012). While this does to some extent confirm the VoC thesis that different economic specializations are underwritten by different institutional systems, the East European capitalist varieties by no means represent stable, self-reinforcing 'models'. Instead, and more in line with the expectations of the growth models literature, these are based on fragile political compromises, and depend heavily on the stability of various mechanisms that link them to the larger EU market.

The financial crisis made this readily apparent. The Baltic states, which had amassed huge amounts of private household debt, were in fact the first economies in Europe to buckle – Latvia requested a bailout as early as 2008. But while Baltics' ready embrace of harsh austerity was held up as an example to the more recalcitrant bailout recipients, their recovery was due just as much to other, less advertised factors.

For one, the East European economies were saved from the crippling costs of rescuing private banks because the banks were foreign owned to begin with, and because the EU's competition policy, as well as direct negotiations between the EU institutions and private banks, made sure they remained put instead of repatriating capital out of the region. The same was true of the subsidy schemes to West European manufacturing, which also helped along the recovery in East Central Europe. Another factor had to do with massive labour emigration. According to the Eurostat, the number of working-age citizens living abroad nearly doubled for all eastern member states, and in 2018 remittances outpaced both foreign investment and EU funds as a source of external finance in these countries (Bohle 2018).

Finally, even though deep integration into the EU's capital, goods and labour markets provided a lifeline in the immediate aftermath of the crisis, the crisis itself, and the difficult recovery since, had prompted political realignments and a rethinking of the regional growth models. The banking systems may have been saved from collapse through transnational intervention, but lending was severely curtailed, bringing the Baltics debt-led growth model to an abrupt stop. In East Central Europe, too, foreign investment became more volatile, and the wage convergence ground to a halt. International financial institutions began to warn that without serious investment in innovation the region will be heading into a middle-income trap (EBRD 2017).

The slowdown also offered domestic capital an opening to challenge the dominance of the foreign-led export growth model. Loud denouncements of rapacious foreign banks and 'economic colonialism' by western firms have become the staple of populist politics in Poland and Hungary. While it is unclear to what extent there is really a shift to a different growth model (Bohle and Greskovits 2018; Scheiring 2020), a search is definitely under way.

Conclusion: the prospects of managing capitalist diversity in the EU

This chapter argued that the EU economic integration, far from promoting convergence, has in fact been part of the reason that capitalist diversity persists in Europe. Indeed, the review of the two currently dominant perspectives in comparative political economy shows that they both recognize the fundamental role played by international market integration in perpetuating diversity, although they do so in different ways. The Varieties of Capitalism literature grounded in the production models approach views institutional difference as part of developing competitive specialization in an integrated market. The growth models perspective rather sees transnational market integration as altering the structure of opportunities for different actors to earn higher returns on their assets, and thus pushing countries to look for different sources of growth.

Even as they acknowledge the role of integration, however, both perspectives treat it as a starting point, a background structure that too easily fades from focus as the analysis zooms in on the importance of domestic institutions, politics and ideas. This may not be surprising for a discipline that is above all preoccupied with comparisons of national systems, but an excess of methodological nationalism has meant that European comparative political economy has largely ignored the role of the EU and has until very recently had relatively little to say about how the EU could, or indeed should, manage this internal diversity.

Studying the evolution of capitalist institutions in the East European member states can prove instructive in this regard, as this is where the most extensive experiments in institutional engineering have taken place in recent decades. The literature makes it clear that such efforts did not result in replication of the core states' institutional models, but instead lead to different and more unstable patterns of 'dependent' institutional development and economic specialization that have left these economies highly vulnerable to external shocks.

One may argue, a little cynically perhaps, that the success of this experiment depends on one's measure of success. From the point of view of the EU, or at least of its net contributor states, it may not matter very much that Slovakia or Lithuania have not yet found a reliable road to structural and economic convergence with the 'core' EU members. What matters is that these countries' institutional systems allow for achieving price flexibility that renders extensive EU 'bailouts' unnecessary. Yet a closer look at the much-praised crisis responses in the Baltics and East Central Europe shows that this flexibility was due not only to radical austerity, but to significant transfers accomplished through an informal banking union, revenues from structural funds and massive labour emigration: mechanisms that are not readily available for the larger southern economies.

Most of all, therefore, research into Eastern European capitalisms helps to highlight the extensive transnational entanglements of Europe's institutional systems. Understanding those, and their role in continuing capitalist diversity, could help to break new ground not only in the study of comparative political economy, but also in the design of EU-level policy. If we think of EU member states not as discrete economic units that must all live by the same rules, but as one integrated economy that is shaped by the interaction of local institutions and transnational market actors, it becomes clearer that we cannot really expect all its national parts to function in exactly the same way. This also suggests that instead of attempting to 'fix' the periphery, the EU as a whole might need to look for a growth model that accommodates better its different parts.

The struggle over the Covid-19 recovery funds shows both the potential and the difficulties of such an approach. On the one hand, the emphasis on ambitious investment goals and the green economy suggests a willingness to move towards a growth model more focused on internal demand and investment. On the other hand, the fact that funding for individual members' investment plans remains conditional on structural reforms in the public sector and labour markets suggests that the EU is finding it hard to let go of its bias towards export-led growth (Johnston and Reagan 2018). The tension between the two is likely to mark the EU politics for years to come. Which of the two prevails may in the end depend as much on the outcome of internal political battles as on changes in the global economic environment.

Questions for discussion

1. What are the main drivers behind the diversity of capitalist economic models in Europe?
2. What role does the European Union have in managing the internal diversity of economic models? How has this role evolved in the last decades ?
3. What explains the delay of East European member states to become what is generally understood by 'liberal market economies'?
4. How does the Covid-19 crisis affect European economic integration? In what way could the advent of the health crisis influence political realignments and a rethinking of regional growth models?

Recommended for Further Reading

Ban, C. (2016) *Ruling Ideas: How Global Neoliberalism Goes Local*. Oxford: Oxford University Press.

Ban, C. and Bohle, D. (2021) 'Definancialization, financial repression and policy continuity in East-Central Europe', *Review of International Political Economy* 28 (4): 874–97.

Streeck, W. (2017) *Buying Time: The Delayed Crisis of Democratic Capitalism*. New York, NY: Verso.

Tooze, A. (2021) *Shutdown: How COVID Shook the World's Economy*. New York, NY: Penguin.

Vachudova, M. (2019) 'The EU's Eastward Enlargement and the Illiberal Turn', *Current History* 118 (806): 90–5.