



# Community Economics

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## Have US Firms Taken the “Low Road”?

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The “Great U-Turn” in income inequality has been widely documented within the academic literature and the popular press. Prior to the mid-1970s, household incomes were converging with strong growth of the middle class. Over the past 30 years, however, there has been a reversal of that trend, or a “Great U-Turn” has occurred with the middle class being hollowed out. While this trend has been observed in nearly all developed economies, the Anglo-Saxon economies of the US and UK have been particularly hard hit, especially when compared to European economies. The marked differences between the US, UK and European economies has resulted in numerous hypotheses and studies aimed at explaining the differences. In this issue of *Community Economics* we focus on one line of reasoning that has drawn the most attention and it centers on the institutional differences and the impact those differences have on business philosophies.

Political scientists and economists who study institutional structures characterize the US and UK economies as “Liberal Market Economies” whereas European, and to some extent Asian, economies can be described as “Coordinated Market Economies.” Liberal Market Economies tend to follow more closely the philosophy of neo-classical economics where firms function in perfectly competitive markets and are driven by short-term profits. Political scientists Peter Hall and David Soskice note that in Liberal Market Economies a firm’s access to financial credit and capital are driven by profitability and the ability of the firm to meet “market expectations.” The latter being defined by Wall Street analysts’ predictions of firm quarterly earnings. In addition, firm CEOs are rewarded by the performance of the firm’s stock values, which in turn are driven by short-term profitability.

In Coordinated Market Economies, firms depend more heavily on non-market relationships defined by trade and business associations, labor organizations and public institutions. In the US and UK strong anti-trust regulations prohibit firms from forging strategic alliances which is often the backbone of growth strategies in Coordinated Market Economies. In Germany, for example, firms are linked more tightly through dense business networks where common business and labor associations are often represented on supervisory boards. As such, access to credit and capital is defined by these networks, and not short-term profitability. Arch-enemies such as DaimlerChrysler and BMW have a surprisingly high level of overlap on their supervisory boards through joint labor organizations and representatives of the major financial institutions.

In Japan, the level of overlap is even more pronounced and is built on *keiretsu*, which are a family of companies with dense interconnections cutting across sectors, the most important of which today is *vertical keiretsu* with one major company at its center. This pattern of *keiretsu*-led cooperation and coordination has significant implications for patterns of skill acquisition, technology transfer and access to credit and capital. Workers are encouraged to acquire firm- or group specific skills and strong relationship skills within and across the family of companies. To encourage workers to make this investment, firms customarily offer them life-time employment. Within the US and UK anti-trust regulations prohibit *keiretsu*-type organizations from developing.

Economists such as Bennett Harrison and David Gordon maintain that these institutional differences defined how firms reacted to the global economic slow down starting in the 1970s. Harrison and Gordon, among others, argue that firms had two broad approaches to the global slow down, which is defined as the business "high-road" or "low-road." Firms located in Coordinated Market Economies responded by taking the high-road by reinvesting in labor training and technology adoptions to enhance productivity and promote revenue growth. In the US and UK firms took the low-road by reducing costs in order to maintain short-term profitability. Harrison argues that businesses in the US pursued a strategy of "flexibility" in terms of their relationships with input providers and labor. The dark side of this movement to flexibility is the central cause of the wage polarization now occurring in the US.

Labor economists have advanced the idea of "dual labor markets" to help explain the pattern developing in the US and UK (or Liberal Market Economies). Dual labor markets are composed of a primary and secondary component. The primary market is made up of highly trained workers and management who are offered full-time, year-round jobs equipped with health insurance, pension plans, paid vacations, organized learning and opportunities for upward mobility. Secondary markets are composed of part-time and flex workers who are not offered benefits such as health insurance and pension plans, job security or opportunities for advancement. In the name of short-term profitability firms in the US and UK have aggressively pursued a greater reliance on the secondary market.

A second complementary phenomenon has been the movement of US and UK firms to outsource elements of production. Larger firms that dominate the primary market are increasingly turning to smaller firms to provide services that were once done in-house. These can range from input suppliers in manufacturing to professional business services. These smaller contracted firms often dominate the secondary labor market. Larger firms are constantly pressuring input suppliers to reduce costs with the threat of contracting with another input firm. The smaller firms that dominate the secondary market often lack the resources or the incentive to invest in worker training or product development.

The Liberal and Coordinated Market Economies can also be separated by views on bankruptcy as a legitimate business strategy. In the US, bankruptcy as an option to restructure was at one time viewed as business failure and an option of last resort. Today, bankruptcy is a viable option and is no longer viewed in such a negative light. Firms use bankruptcy as a strategy to renegotiate labor contracts and further squeeze supplier contracts. The case of United Airlines is a clear example of how a firm can enter bankruptcy, continue to operate, restructure itself with the intent of reducing costs, and then exist bankruptcy with a clean slate. The threat of bankruptcy has become a large stick in the name of becoming lean and mean.

The movement in Liberal Market Economies to become lean and mean in the name of short-term profitability has exacerbated the gap between the primary and secondary labor markets. The result has been a widening of the income gap between the rich and the poor and a hollowing out of the middle class. Unfortunately, because of the ingrained institutional differences, there are no easy solutions to the widening income gap.

Additional Readings:

*The Political Economy of Inequality*. 2000. F. Ackerman, N.R. Goodwin, L. Dougherty and K. Gallagher editors. Washington DC.: Island Press

Bennett Harrison. 1994. "The Dark Side of Flexible Production" in *Lean and Mean*. New York: Guilford. Chapter Nine.

*Varieties of Capitalism: The Institutional Foundations of Comparative Advantage*. 2001. P.A. Hall and D. Soskice editors. Oxford University Press.

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