

# Globalisation and economic issues

Giuliano Bonoli

Globalisation is often considered to be one of the key challenges facing advanced welfare states, although there is disagreement as to the extent to which it actually matters. Some authors have argued that the impact of globalisation on the sustainability of welfare states is rather marginal, and the financial problems welfare states are currently facing, would exist also in the absence of globalisation. They are mostly due to endogenous challenges like ageing, welfare state maturation and changes in the nature of employment (Pierson 1998). Others, take a different view and although they accept the importance of endogenous challenges, believe that economic internationalisation is having an important impact on welfare states.

Among those who believe that globalisation matters, there is a further disagreement as to the direction of the pressures induced by it on welfare state transformation. A review of some of the most recent literature on the subject suggests that one can identify three different perspectives on the relationship between globalisation and the welfare state. First, some authors believe that globalisation is bad news for welfare states, that it will limit or is limiting their expansion, and may even force a more or less radical dismantling, and that in any case economic internationalisation means a reduction in the extent to which governments can control what goes on in their domestic economy (for example Scharpf 2000; Cerny 1990; Strange 1993; or for a more sanguine view, Omaha 1995).

A second set of authors, in contrast, believe that globalisation is leading / will lead to an expansion of western European welfare states. As workers and citizens in democratic societies become more exposed to risks associated with international trade and capital movements, they will demand more social protection. Hence we can expect the current trend towards more economic integration at the international level to result in more welfare spending (Katzenstein 1985; Garret 1998; Rodrik 1996; Rieger and Leibfried 1998).

A third strand of literature has focused on the impact of globalisation on the welfare state as it is mediated by politics. Here instead of an economic deterministic approach to social policy making, it is assumed that the global discourse on economic internationalisation and the participation in debates of international institutions (like the World Bank, or the OECD), constitutes an asset in the hands of political actors wishing to alter existing distributional equilibria, which essentially means retrench welfare provision (Deacon 2001, Palier and Sykes 2001).

In sum, the debate on the links between globalisation and social policy is an immensely vast one, and in my understanding there is neither a commonly accepted position, nor one that seems to be clearly confirmed by empirical developments, this, in spite of the fact that academic from various disciplines have been dealing with this issue for at least a decade.

In this paper, I start by presenting the theoretical underpinnings of each of the above theses on globalisation and the welfare state. We then move on to review some quantitative data on the exposure to international economic forces of our seven countries and their responses, and

conclude by putting forward a set of somewhat tentative conclusions, which try to reconcile the different theoretical positions with what can be observed empirically.

### ***Globalisation as an obstacle / limit to welfare state development***

Among the first theses on globalisation and the welfare state, the first to have been put forward (and up to now the only one to have made it into public and political debates) is the view that because of the increased degree of competition among advanced market economy, and between them and emerging economies, the welfare states of the “trente glorieuses” will not be affordable any longer. Being in competition with countries that have low social protection standards, low taxation, low labour costs, means that the expensive social programmes that inflate labour costs and reduce business profitability will have to be disposed of (see eg. Omaha 1990).

As the debate developed, and probably as welfare states increasingly showed their resilience, more sophisticated versions of the “globalisation and the welfare state” thesis emerged. Susan Strange, for example, does not go as far as predicting the outright dismantling of western welfare states, but argues that globalisation means above all a major loss of economic (and social) sovereignty for nation states. Increasingly, she believes, governments are forced to negotiate policies with the biggest transnational corporations (TNCs), both national and foreign ones. Market punishment for fiscal and social policies that are seen as detrimental to business profitability does not need to take the form of relocation of production in other, more co-operative countries. Thanks to a web of intra-company financial and product flows, TNCs can transfer profits away from high tax economies to more business friendly ones (Strange 1993)

Among the proponents of the “globalisation matters” thesis, Fritz Scharpf (2000: 68-85) stands out as one of those who makes the case most forcefully. In his view, the process of economic internationalisation started in the 1970s, has increased international competition in three areas that are of particular importance to the welfare state:

- the products market
- the capital market
- tax competition among states

The combined effect of increased competition in these fields is a downward pressure on social expenditure, and a reduction in the room for manoeuvre that countries have in designing their welfare states. The policy repertoire from which countries can pick policy instruments has got shorter as a result of international constraints.

The mechanisms that explain why increased international economic competition generates downward pressures on welfare state development has to do with the fact that it is today considerably easier for producers and investors to shift production and capital to the countries in which they can obtain the highest post-tax profits. In practical terms, producers are likely to choose for their production facilities countries where total labour costs are low (and as a result social security contributions are also low), countries where employment protection is limited, so that production can easily adapt to shifts in demand and countries where taxation is low. This latter point concerns both corporate taxation, which has a direct impact on post-tax

profits, but also personal income tax: low rates of personal income tax mean that employers can more easily (and cheaply) recruit managers and as a result keep the wage bill under control.

Investors are likely to take advantage of the increased mobility of capital and will have a tendency to prefer countries in which post-tax profits, and as a result returns to capital, are greater. As a result, producers based in high taxation countries, or in countries that because of labour market regulations or social protection costs limit companies ability to generate high profits, may experience difficulties in obtaining the funds needed to finance expansion. Both international and domestic investors, in fact, can be expected to shun the national economy and go to countries where post tax profits are higher.

Of course, post tax profit depends also on the amount of value added generated by workers. This means that two countries, one of them with high taxes, high social security contributions and the other one, with low taxes and low social protection may be equally able to attract foreign investment (and to retain domestic investment) and producers, if workers there produce the same amount of value added. This entails that workers in the high tax, high labour cost country must be more productive than those in the low tax, low social protection economy. This final consideration, in contrast to the previous ones, is not inimical to the welfare state. If anything, it puts pressure on countries with high labour costs to invest more in education and training and research and development. Scharpf's approach emphasises above all the differences among advanced market economies in the way they are affected by globalisation. Depending on the economic structure and on the institutional set up of the welfare state, countries will be more or less under pressure from globalisation and will be inclined to adopt different solutions. Having said that, in his view economic internationalisation still constitutes a limitation on the expansion of welfare states.

### ***Globalisation will cause an expansion of welfare states***

In the early 1980s, Peter J. Katzenstein (1985), writing on small European countries, argued that the size of their economy was responsible for the development some of the most generous welfare states that exist on our planet. In his view, because of the small size of their internal market, the prosperity of these countries has traditionally been based on their openness to international trade. Unlike larger countries, the option of protectionism has never been a viable one for them. Non-participation in international exchanges meant the inability for national firms to reach markets sufficiently large to achieve the necessary critical mass and economies of scale needed to be profitable and to generate wealth.

The strong internationalisation of these small economies meant that they have been traditionally more exposed to international competition than their larger counterparts, which meant need for comprehensive systems of social protection. Because of the strong pressure to be competitive, these countries could not afford industrial conflict, and as a result saw the emergence of corporatist systems of interest intermediation which resulted, with some variations, in generous social protection systems.

When first outlined, this thesis applied to a handful of smaller countries until the 1970s. Since then, however, the exposure of large countries to international trade and competition has increased so much that they are now in the same situation in which smaller countries have found themselves throughout the 20<sup>th</sup> century. An adapted version of Katzenstein's thesis

would argue that the increase in economic internationalisation of the last two decades is likely to lead to more demands for social protection and to pressure to avoid conflict, and hence to the development of more generous welfare states (Rodrik 1996; Rieger and Leibfried 1998) The validity of this thesis has been confirmed by quantitative analyses of a large number of countries which have shown a connection between the degree of economic openness and public expenditure (see e.g. Rodrik 1996).

### ***The political impact of globalisation***

This third perspective abandons the economic determinism the we find in the previous two and argues that a good proportion of the current discourse on globalisation is socially and politically constructed. Here globalisation is understood as an ideological construct, that can serve political ends. For example, the globalisation argument can be used to justify retrenchment oriented welfare reforms that are in fact supported for essentially distributional reasons, but that cannot be presented as such. International organisations like the World Bank and the OECD play an important role in this respect, by providing government with policy repertoires from which they can pick and chose policy solutions that generally emphasis their compatibility with today's highly internationalised economy (Palier and Sykes 2001).

Globalisation, as a discourse or as an actual development has certainly altered political equilibria in western countries. If anything it as made the threat of the exit option for capital more credible, and this enhanced its position in national political decision-making. This may of course lead to a redefinition of distributional equilibria that were agreed upon in a context, the *trente glorieuses*, characterised by a different pattern of power relationship between capital and labour.

### ***Developments in the international economy***

Over the last three decades, western economies have become considerably more internationalised. The data presented in table 1 shows that this is true in a number of different respects. First, in relation to capital movements, between the 1970s and the end of the 1990s, most countries have abandoned the instruments they used to have at their disposal for controlling financial flows out of the country. Table 1 shows that countries that used to impose restrictions on capital mobility have all reduced them (Finland, Spain and the UK). In contrast, those that in the 1970s already allowed total mobility of capital (Switzerland and Germany) have not changed their position.

Table 1: Selected indicators of economic openness

	Restrictions on capital mobility (0= no restrictions, 4 = substantial restrictions)		Imports as a proportion of GDP		Exports as a proportion of GDP	
	1970 ca.	1999 ca.	1970 ca.	1999 ca.	1970 ca.	1999 ca.
Finland	3	0	21	29	23	38
France	1	0	13	24	13	26
Germany	0	0	20	29	17	29
Spain	2	1	14	29	15	27
Sweden	1	0	21	38	21	44
Switzerland	0	0	35	37	33	42
UK	2	0	23	28	24	26

Source: Armingeon et al. 2002

In relation to development in products exchanges, all the countries covered by our sample have seen an increase in the proportion of GDP spent on imports and generated by exports. Both in the 1970s and at the end of the 1990s, however, there is a clear distinction between the larger countries (France, Germany, UK and Spain), whose economies are less exposed to international trade, and the smaller countries (Finland, Sweden and Switzerland). In the late 1990s, however, the level of exposure to international trade of the larger countries is similar to that of the smaller countries in the 1970s.

Table 2: Exports as a percentage of world exports

	1980 ca.	1999 ca.
Finland	0.7	0.7
France	5.5	5.7
Germany	9.4	10.4
Spain	-	-
Sweden	1.5	1.5
Switzerland	1.5	1.7
UK	6.1	5.2

Source: Armingeon et al. 2002

Increased exposure to international trade does not seem to have meant loss of competitiveness for the countries covered by our project. Between 1980 and 1999 the share of world exports represented by each of the seven countries has remained roughly constant. Germany and Britain have witnessed minor changes upwards and downwards respectively.

Globalisation means larger movements of capital across countries. One important indicator reflecting the extent to which capital is invested across borders is the flow of foreign direct investment into and out of individual countries. The size of FDIs, both entering and exiting the countries of the sample has soared over the last 15 years. It provides a fair indication of the increased internationalisation process to which they have been exposed. While in all countries both inward and outward investment have increased dramatically, most of them were in 1984 and remained in 2000 net exporters of capital. Spain has moved to be one of the major recipients of FDIs flows to a net exporter of capital, while the contrary happened to Germany, a country which for several years remained of difficult access to international investors. In the German case, 2000 may be exceptional, as up to 1999 the country remained a

net exporter of capital. Estimates for 2001 suggest that total FDI flows are going to be substantially lower than in the previous year, due to the loss of value of company stocks (OECD 2002). This notwithstanding, the last two decades of the 20<sup>th</sup> century have seen a dramatic increase of foreign direct investment.

Table 3: Foreign direct investment (million US dollars)

	Inflows		Outflows	
	1984	2000	1984	2000
Finland	138	8,800	493	24,000
France	2,198	42,900	2,126	175,500
Germany	534	195,200	4,736	49,800
Spain	1,773	37,500	249	54,700
Sweden	290	23,400	1,506	40,600
Switzerland	520	16,300	1,139	42,700
UK	-241	119,700	8'039	255,100

Source: OECD 1996; 2002

Globalisation is expected to put welfare states under pressure by limiting the tax raising powers of government. As capital is more mobile, it can be expected to move to the more fiscally advantageous locations, so that countries have an incentive to lower tax rates so as to attract productive activities onto their territory. On this basis, one would expect the proportion of GDP consumed by taxation to decline during years of increasing economic internationalisation. Table 4 shows clearly that this has not been the case. Total taxation, during the period of increasing economic internationalisation has increased in all countries covered except Germany, where it has slightly declined (which is surprising, considering reunification), and in the UK, where it stayed constant.

Table 4: Total Taxation as a proportion of GDP

	1980	1997
Finland	36.9	47.3
France	41.7	46.1
Germany	38.2	37.5
Spain	-	-
Sweden	48.8	53.3
Switzerland	29.1	34.6
UK	35.2	35.3

OECD *Statistical Compendium*.

A more sophisticated version of the thesis linking globalisation to tax competition would not necessarily link increased economic internationalisation to lower rates of taxation. After all, levels of taxation depend on a whole range of factors, including the fiscal needs of governments. If all competing governments face similar needs, then a downward competition in overall levels of taxation is unlikely. What can be expected, in contrast is a shift from fiscal instruments that tax mobile sources of income, to those that are imposed upon less mobile ones. In practical terms, one would expect the proportion of tax revenues that comes from highly mobile sources like corporate taxation and personal income tax to decline, and that that comes from less mobile sources, like VAT and social security contribution to increase.

Table 5: Proportion of different fiscal instrument in total tax receipts

	Personal income tax		Corporate income tax		Taxes on goods and services		Social security contributions	
	1980	1996	1980	1996	1996	1996	1980	1996
Finland	38.8	35.0	3.9	6.7	35.7	30.1	19.6	25.8
France	12.9	14.1	5.1	3.8	30.4	27.3	44.9	45.4
Germany	29.6	24.2	5.5	3.8	27.1	27.9	34.5	40.6
Spain	20.4	23.0	5.1	5.9	20.7	29.2	48.5	35.9
Sweden	41.0	35.3	2.5	5.6	24.0	22.8	31.4	32.3
Switzerland	35.6	32.0	5.8	5.6	20.4	17.9	30.9	37.4
UK	29.8	25.9	8.3	10.5	29.2	35.2	16.6	17.3

Source: OECD *Revenue Statistics*, various issues.

In this respect, the picture revealed by table 5 is inconclusive. In none of the countries there seems to be a clear trend away from the fiscal instruments that are more exposed to tax competition, and there is as a result no clear general trend in this direction. This findings contrast with the series of tax reforms adopted in several OECD countries over the last decades, which, among other things, have generally reduced rates of corporate and personal taxation. Corporate taxation, for example, has been cut in a majority of advanced democracies in the 1980s and 1990s. The average cut was of 7 percentage points (Swank 1998). According to Swank, this apparent inconsistency is due to the fact that if on the one hand tax reforms have reduced rates of taxation, they have also eliminated or reduced investment relief. The revenue of corporate tax remains as a result constant.

### **Conclusions**

As anticipated above, these should be seen a tentative conclusion and as a basis for discussion. They result from both the literature survey presented in the first part of the paper on from the empirical evidence presented thereafter.

1. Globalisation is not resulting in a radical dismantling of welfare states. After a couple of decades spent in an increasingly globalised economy and without seeing a radical dismantling of welfare states, the early propositions on the incompatibility between an internationalised economy and the welfare state seem increasingly inaccurate. To the extent that there is retrenchment going on in advanced welfare states, this can be explained with reference to other independent variables such as the transformation of employment, ageing and pension scheme maturation (Pierson 1998)
2. Globalisation may be preventing countries to adopt some policy solutions, that would be extremely difficult to adopt also in the absence of globalisation, because of political reasons. The thesis that globalisation limits the policy repertoire within which government can pick their social policy option seems convincing. However, it may be the case that the sort of policies that are now impossible because of globalisation would be extremely difficult to implement even in its absence. High rates of taxation for business may lead to investment strikes even in the absence of the exit option.
3. Globalisation is not causing an expansion of welfare states. The only areas of expansion (services for working mothers, older people) are the least related to globalisation. An exception may be active labour market policies. The last few years have seen some

expansion in some specific areas of social policy, but these are among the least related to globalisation. Expansion has concerned family services and policies that help women reconcile work and family life. The only exception may be active labour market policies which can be understood as a globalisation induced effort at making national economies more competitive.

4. A plausible effect of globalisation on the welfare state is through the political system, by altering political equilibria (makes the exit threat more credible). However this effect is difficult to prove.
5. It is possible that globalisation has yet to come... The apparent inconsistency between the magnitude of the predictions on the impact of globalisation on social policies and the insignificance of observable empirical development may simply be due to a longer than expected time lag between cause and effect...

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