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Globalization as a problem, as a solution, and as a part of the landscape

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There are basically three stories about the globalization–welfare state nexus. The first story argues that globalization is the cause of the chronic crisis of the welfare state. The second maintains that whatever the cause of the welfare state crisis, globalization is not part of it. The third story holds that globalization, far from causing the welfare state's troubles, is a consequence of these troubles and part of their solution. The paper reviews each of these stories and traces their intellectual origins.

Globalization in politics and political science

Every era experiences itself as in crisis. There is always some event or structural change that appears to threaten the very foundations of society. Whether this threat truly exists is less important than the fact that its existence is generally assumed in public discourse. Crises are collective perceptions of reality that structure the political agenda and lend an epoch its identity. Looking back on crises, of course, it is often difficult to understand why they were considered such. What was once considered critical often appears *Biedermeier* in retrospect.

Globalization was the Western European crisis of the 1990s. The red menace had disappeared with the implosion of the Eastern Bloc and public attention turned to the dangers connected to capitalism's final triumph. The increasing internationalization of the economy was a particular cause for concern. It was feared that the integration of formerly separate national markets would upset the balance of power between economy and polity. The state is, after all, a local hero; its powers are limited to the national territory. Wouldn't its ability to control the market decline as the market grew beyond its territorial

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boundaries? Of course, the government could continue to intervene in the economy. It could levy taxes as before, redistribute income, and regulate production and consumption. But wouldn't it thereby only bring about the flight of mobile market forces, and capital financial, real, and human in particular? This was the worst case scenario. For only one thing is worse than being exploited by capital, and that is not being exploited by it!

The globalization of markets seemed to leave governments with no choice but to pursue neo-liberal policies. In the conventional wisdom, 'good government' became synonymous with 'market-friendly government'.[1] Competitive party democracy was running idle because global competition left no room for leftist economic policy alternatives. The corporatist foundation of the welfare state was at risk because (mobile) capital, thanks to its new international exit options, no longer needed state support to move (immobile) labour toward wage restraint and discipline. The welfare state appeared to be doomed, despite the undiminished support it still enjoyed among the population. Only a 'residual state'[2] would survive, with no power to counter 'The Economic Horror'[3] of the global market. The large majority of the world's population would be left exposed, unprotected, and in misery.

Of course, globalization was not only an issue in public discourse, but also for political science. The political science work on globalization falls roughly into three camps. One camp, the 'globalists', is occupied with rationalizing the diffuse public fear of globalization into a coherent and empirically founded grand narrative of global competition and secular welfare state decline. As a scientific articulation of a commonly shared perception, this position was highly popular during the early 1990s. But it also drew intra-scientific criticism from the second camp, the globalization sceptics. The members of this camp maintain that public apprehensions are ill-founded and overblown: whatever the cause of the crisis of the welfare state, globalization plays no part in it. According to this camp, there is neither theoretical reason nor empirical evidence to believe that national policy autonomy has decreased as a consequence of increasing economic interdependency. The problem with this line of argument is that the pressure on the welfare state is obvious and undeniable. If globalization is not to blame, what then? According to the third, revisionist camp, the welfare state itself is the culprit. Turning the globalist argument upside down, this camp argues that globalization, far from causing the welfare state's troubles, is a consequence of these troubles and part of their solution. The 'ostensible "terror of economics" poses no problem whatsoever', but, rather, points 'to the way out of a self-made cul-de-sac'.[4] The debate between the three camps has focused on two questions. How much globalization is there? And what consequences does it have for the national welfare state?

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How much globalization?

Globalization is a multifaceted phenomenon. However, in its most basic, economic meaning it refers to the process of international economic integration. As the volume of international trade and capital movements increases, and as the significance of multinational corporations grows, the distinction between the domestic and the global economy becomes increasingly blurred. Enthusiastic globalists maintain that this distinction has already lost its meaning. According to them, market participants no longer distinguish between domestic and international transactions. Production and consumption are organized and coordinated globally and prices have equalized. '[N]ational borders have effectively disappeared and, along with them, the economic logic that made them useful lines of demarcation in the first place'.[5] Less visionary globalists doubt that the world has reached this 'hyperglobalist' stage yet.[6] National borders are still important barriers to economic exchange. However, globalists also believe that the permeability of these borders is rapidly increasing, exposing national economies to growing competitive pressures. Economic interdependencies are intensifying while cross-national differences fade.

Globalization sceptics deny that there has been any major change. To be sure, the volume of international transactions has increased. But the domestic market is still the primary economic unit. National differences are disappearing very slowly, if at all. A convergence of economic structures is barely apparent. Economic interdependence is no more pronounced than in earlier epochs of world history. In fact, at the end of the 19th century, the world may well have been more deeply integrated economically than at the end of the 20th century, without any apparent negative effect on the strength of the nation state.[7]

More globalization than a hundred years ago?

The globalists see their thesis of the revolutionary character of globalization vindicated by the high growth rates of cross-border transactions. All curves slope upward (see Figure 1).

World trade is growing faster than world production. In the OECD-world, for example, the share of exports in gross domestic product more than doubled from about 10% on average in 1960 to over 20% in the 1990s. At the same time, the quality of world trade has also changed.

- International trade is increasingly conducted inside multinational companies. Intra-firm trade supposedly already accounts for one third of total international trade. The increasing ease of cross-border trade allows companies to locate functionally related production units in

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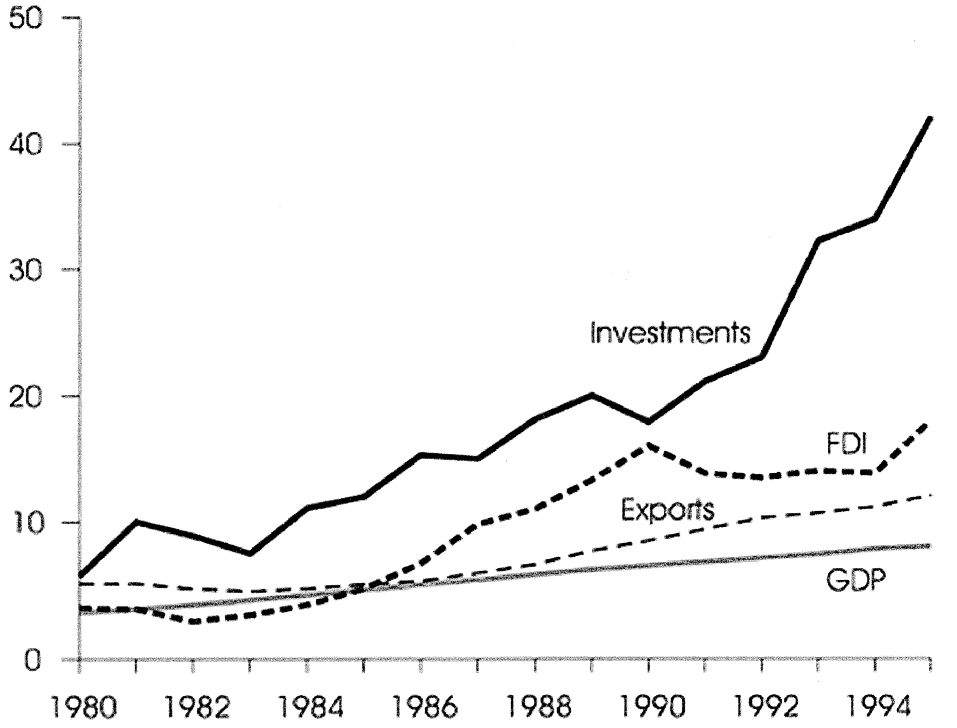


Figure 1. The growth of cross border transaction flow (source: T. Plümper (2001) Weltwirtschaft und Wohlfahrt. Die Politischen Determinanten des Wachstumsbeitrags der aussenwirtschaftlichen Offenheit (Konstanz, unpublished, p. 135)).

spatially distant locations, and this, in turn, further increases the demand for, and volume of, international trade.

- International trade is expanding into formerly closed sectors of the economy. Again, the main agents of change are multinational corporations. They increasingly trade in products that used to be non-tradable, such as retail, personal services – education, health, beauty, food and fun – or public utilities, and thus carry international competition into even more sectors of the national economy.

The importance of multinational companies is also corroborated by the rapid growth of foreign direct investments. Foreign direct investment occurs when an investor acquires a controlling share in a business in some other nation. Since the 1960s, such investments have grown three times faster than world trade and four times as fast as world production. The stock of foreign investments accounts for over 10% of world GDP. The sales effected by multinational companies through their network of foreign affiliates have risen to as much as 25% of world GDP.

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The growth in foreign direct investments was dwarfed, however, by the growth in cross-border portfolio investments, i.e. purchases of non-controlling positions in equity, debt or cash securities issued by private citizens, banks, corporations, or governments of other countries. International bank lending in the western industrial nations and offshore locations rose from US$120 million in 1970 to about US$8 billion in 1995. International trade in stocks and bonds grew from a share of barely 10% of GDP in 1980 to far more than 100% in the mid 1990s. At the same time, the volume of the international currency market exploded from US$17.5 billion to US$297.5 billion. '[T]he extensity, intensity, velocity and impact of contemporary global financial flows and networks are largely unprecedented' and fundamentally transform 'the conditions under which the immediate and long-term prosperity of states and peoples across the globe is determined'.[8]

Globalization sceptics concede that the volume of world trade, foreign direct investment and financial transactions has increased. They note, however, that the absolute level of international transactions is still low. About 80% of all goods and services are still produced and consumed domestically. The vast majority of all production facilities are still domestically owned, and even in the capital market national borders still play a role. It is true that the gross volume of international financial transactions has increased dramatically. However, net capital flows have hardly grown at all. There is much cross-intermediation and cross-ownership but very little net-transfer of capital across borders.[9] 'While all the zeros in statistics about the size of the international capital markets make great reading, they may not be very informative about real changes in the structure of the global economy, or about the pressures they exert on governments'.[10]

Globalization sceptics also note that the current state of economic integration is not without precedent. At the high point of the gold standard, the world economy was probably at least as integrated as it is today. International trade grew at similar rates and reached similar levels in terms of share of exports in total production. Capital controls were almost as low as they are today, and net capital movements were considerably higher. Argentina, for example, imported capital between 1870 and 1890 amounting to 18.7% of its total national income; the 2.2% it imported in the 1990s appears rather modest in comparison.[11] The sceptics conclude that 'the level of autonomy … in the period up to the First World War was much lower for the advanced economies than it is today'.[12]

The welfare state makes the difference

Even if it were true that globalization was more constraining 100 years ago, it would not necessarily follow that the globalists' concern for the sustainability of the welfare state is unfounded. The state at the turn to the 20th century had fewer

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policy responsibilities, needed less autonomy, and, therefore, was probably less vulnerable to the dangers of economic globalization.

Until the First World War, the role of the state in the economy was essentially limited to providing the institutional and technical foundations for the national market. The state guaranteed freedom of trade, legal certainty and a stable currency, and it provided for roads, railways, harbours, and postal services.[13] The first forays into social policy, for example in the field of occupational health and safety, did occur during the 19th century. However, they were rather ad hoc and haphazard and not embedded into any larger conception of state duties. In light of the reigning liberal orthodoxy, they appeared rather problematic and anomalous. This only changed when the Great Depression of the 1930s broke the ideological hegemony of laissez-faire thought. Right across the political spectrum, the experience of mass unemployment, falling wages, dramatic downward social mobility, and currency mayhem undermined confidence in the ability of the market to regulate itself. The economy, so it seemed, could not be left to itself. The state could no longer content itself with providing the institutional and technical preconditions of the market. It also had to guarantee the market's smooth operation and the social acceptability of its outcomes. State and market were no longer thought of as opposites, but as complements. More market seemed to require more state rather than less.

Following the Second World War, all advanced industrial states greatly expanded their capacity for market intervention. Of course, there were national variations reflecting differences in government institutions, political philosophies, and historical exigencies. However, the general thrust was always the same. The government needed to control economic developments at the macro-level and to mitigate economic hardship at the micro-level. It had to prevent economic slumps and guarantee high levels of growth and employment, and it had to provide citizens with universal insurance against individual risks such as old age, sickness, unemployment and poverty. These twin goals were epitomized by the concept of the 'Keynesian welfare state'. Keynesian macroeconomic policy, i.e. the active, 'counter-cyclical' use of monetary and fiscal policy instruments, was to stabilize the business cycle and ensure full employment. The welfare state, in turn, was to use progressive taxes, social transfers and public services to redistribute market allocations of wealth and risk from those doing well in the market to those in danger of falling by the wayside. The hope was that both policies would reinforce each other in a virtuous cycle: The welfare state apparatus would provide the government with the financial clout to pursue counter-cyclical economic policies aimed at maintaining full employment, and full employment, in turn, would provide the welfare state with a sound revenue basis.[14]

The modern welfare state plays a far greater role in the economy and, in turn, is far more dependent on the economy than its liberal precursor at the end of the

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19th century. The public sector now often consumes up to 40 or 50% of the gross domestic product, and the government is held to account for economic developments. Economic crises – low growth, high inflation, high unemployment – are no longer blamed on the market, but on the State. The fate of governments has come to depend on macroeconomic indicators. The question of whether the economy was more or less strongly integrated 100 years ago is, therefore, at most of historical interest. The politically decisive issue is whether the welfare state as it exists today is sustainable under current conditions of economic globalization.

What are the consequences for the welfare state?

Globalization as a problem

Globalists believe that globalization will ruin the welfare state. They maintain that the welfare state can control the market only if it is not itself subject to market forces. Since globalization exposes the welfare state to international market pressures, it inevitably undermines the welfare state's viability.

In the eyes of the globalist, it is no coincidence that the turn away from laissez-faire policies during the 1930s went hand in hand with a turn towards economic nationalism. Governments raised trade barriers and capital controls and revoked fixed exchange rate commitments, because they understood that, in order to bring the domestic market under political control, they needed to shield it from international economic pressures. Economic closure was part of the new interventionist agenda. After the war, the Bretton Woods monetary regime and the GATT trade regime reintroduced an element of liberalization into international economic relations. However, the commitment to liberalization remained limited. The regime only obliged the member states to fix exchange rates, liberalize capital movements, and lower trade barriers to the extent that this did not interfere with domestic macroeconomic management and social policy programs. Keynesian welfarism remained the top priority. Its requirements determined how far the re-internationalization of the economy could go. International liberalism was 'embedded' in national welfare policy.[15]

The process of globalization, so globalists fear, is disembedding liberalism again. It pushes economic openness beyond levels compatible with welfare state functionality. It is no longer international markets that have to adjust to the needs of national welfare states, but the welfare state that has to adapt to the dictates of international markets. The globalists believe it cannot do this without abandoning its macroeconomic and social policy mission.

Why should globalization force the welfare state to give up on active macroeconomic management? Because it robs national monetary policy of

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'its sovereignty over interest rates'.[16] Interest rates are a central element of macroeconomic control. According to Keynes, 'the whole management of the domestic economy depends upon being free to have the appropriate rate of interest without reference to the rates prevailing elsewhere in the world'.[17] Capital control is a corollary to this. Governments can stabilize international interest rate differentials only if they are able to restrict cross-border capital flows. Globalization, by lowering capital controls, undermines this ability. As a consequence, variations in national monetary policy no longer result in corresponding variations in national interest rates, but in offsetting international capital movements: capital outflows in the case of loose monetary policy, capital inflows in the case of tight monetary policy. In a borderless world, the interest rate ceases to be a strategic variable of national policy. Rather it is a global given.

France's economic policy about-turn in the early 1980s is generally considered to be a textbook example of how globalization disempowers national macroeconomic policy. Assuming office with a Keynesian expansionary strategy in 1981, the new socialist government was already 'forced by the realities of the international capital market to capitulate by the summer of 1982'.[16] Loosening the money supply while all of France's major trading partners were restricting it, the government was quickly saddled with a massive surge in trade and budget deficits. Unable to defend national reflation against the international trend, it switched course to a policy of tight money and austerity budgets. Apparently even recalcitrant socialists are too weak to resist global market forces for any considerable time.

In addition to undermining macroeconomic control, globalization also weakens the ability of the welfare state to provide social insurance against inequitable market outcomes at the micro-level – at least so the globalists think. In their view, globalization makes it easier to move goods, services, capital, and jobs across national borders, and, consequently, more difficult to subject them to national taxes. In a globalized economy, taxpayers can avoid high domestic taxes by shifting a mobile tax base – read capital – to low-tax countries. *Exit* becomes a viable option and a credible implicit threat. National taxing power is reduced. Governments can no longer adjust the domestic tax burden to the revenue needs of the welfare state, but must take foreign tax policy into consideration. If domestic taxes are higher than elsewhere, capital flight results. Relatively low taxes, by contrast, may attract foreign capital.

Governments are tempted to undercut each other's taxes.[18] An international tax competition results which drives the effective burden on capital down 'to zero'.[19] For the welfare state, this has two far-reaching consequences. First, the revenue basis shrinks. Governments can no longer turn a fiscal profit on capital, and hence find it more difficult to fund a given level of social transfers and public services. Second, the usefulness of tax policy as an instrument for redistribution

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declines. Because 'the rich' usually gain a higher proportion of their total income in the form of capital income than 'the poor', the progressivity of the tax system automatically decreases when capital income is effectively tax free. Redistribution is then limited to transfers between immobile factors, that is, between high and low labour income. At best, this means 'Socialism in One Class',[20] and at worst the complete 'Erosion of the Welfare State'.[21]

Globalization as a part of the landscape

Globalization sceptics do not believe that globalization poses any serious problem to the welfare state. They see neither theoretical reasons why international markets should undermine national macroeconomic control, nor empirical evidence of any significant reduction of the scale and scope of the welfare state.

These sceptics argue that even if international capital markets were perfectly integrated, which they deny, monetary policy would still remain a useful tool of national macroeconomic management.[22] While the globalists are right that governments cannot have 'sovereignty over interest rates' in a borderless world, they are wrong in concluding that this automatically vitiates national policy autonomy. Monetary policy can still have an effect on the national economy. It just no longer works through the interest rate but through the exchange rate. An increase of the money supply, instead of lowering the interest rate triggers an outflow of capital. This outflow, in turn, puts pressure on the exchange rate and leads to a devaluation of the national currency. This, then, fuels exports, slows imports, and thus improves the utilization of national resources.

There is only one case where market integration clearly undermines national macroeconomic control: the case of monetary policy in a context of open borders *and* fixed exchange rates.[23] As the so-called Mundell–Fleming model – the standard macroeconomic model of the open economy – shows, the three policy goals of monetary policy autonomy, free capital mobility, and stable exchange rates, cannot be had simultaneously. This implies that a government cannot have monetary policy autonomy in the presence of free capital movements and stable exchange rates. It also implies, however, that a government can liberalize capital controls *and* retain monetary policy, autonomy, as long as it is willing to give up stable exchange rate relations. The real problem of the French socialists was that they were not prepared to make this sacrifice. If they had left the European monetary system, they could have continued with a Keynesian expansionary strategy. Their decision, in the end, to remain in the European monetary system and give up on Keynesianism instead can hardly be blamed on globalization.[24]

The sceptics also doubt that globalization does much harm to the revenue basis of the welfare state. Capital taxation has never played a significant role in financing the welfare state. The main burden has always been borne by labour. It

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is quite unlikely, therefore, that declines in capital tax revenues will result in serious financing problems.[25] More importantly, there is no evidence that revenue from taxes on businesses and capital income is declining. On the contrary, the effective tax burden on capital has significantly increased in the OECD since the 1970s, contributing to a rise in total tax revenues. In addition, contrary to globalist fears, the relationship between economic openness and capital taxation seems to be positive rather than negative. Econometric studies suggest that countries that are strongly integrated in the world market systematically tax capital higher than less strongly integrated countries. Apparently, the welfare state continues to have considerable leeway with respect to tax policy, even in a global marketplace. Governments wishing to expand the public economy for political reasons may do so (including increasing taxes on capital to pay for new spending) without adversely affecting their trade competitiveness or prompting multinational producers to exit.[26]

Globalization as a solution

The sceptic account raises some obvious questions. If globalization does not make a difference, why is it happening? And if the internationalization of markets is not the cause of the troubles of the welfare state, then what is? The revisionist camp provides answers to these questions. Its proponents maintain that the problems of the welfare state are first and foremost self-inflicted and that globalization is but a consequence of these problems.

The revisionists believe that Keynesian macroeconomic management is inherently prone to failure. The problem is that a monetary or fiscal expansion can stimulate economic activity only if it comes as a surprise. If market participants expect it, they will raise prices and wages in anticipation and thus sap the stimulus. However, a Keynesian government can hardly prevent such an anticipatory reaction. It is committed to an active macroeconomic policy. Everybody knows about this commitment and will, therefore, anticipate government attempts to surprise the market. The government, of course, knows this, and will try to outdo public expectations by spending and printing even more money. However, once the price in terms of inflation and budget deficits becomes unbearable, the government is forced to retreat from the macroeconomic policy stance that has caused this pathology of expectations in the first place.[27]

This vicious cycle is, according to revisionist thinking, the fundamental cause of the French Socialist policy about-turn in the early 1980s. The government realized that the perverse side-effects of its expansionary strategy by far outweighed the benefits. Instead of invigorating the economy, it got French employers and trade unions addicted to ever-higher doses of fiscal and monetary policy. In order to break out of this Keynesian trap, the government voluntarily

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surrendered the monetary policy autonomy that is the precondition for any Keynesian macroeconomic policy.[28] This is why it not only decided to stay in the European monetary system, but, shortly afterwards, also liberalized capital controls. The French government's loss of autonomy was not forced on it by a process of globalization that had spun out of control, rather it was a deliberate choice. The government used the opening-up of the national economy as a commitment device to overcome the problems of its domestic weakness-of-will in macroeconomic policy – as did other European governments.[29]

The revisionists also believe that the welfare state is the main source of its own revenue problems. On the one hand, the welfare state exacerbates these problems by stifling the economy on which it depends for its funding. The taxes and social security contributions it levies withdraw resources from the market that the market could use more productively. The regulations it imposes on producers and consumers block the bouts of creative destruction that are the necessary precondition of capitalism's continued dynamism.[30] On the other hand, the welfare state systematically enhances citizens' dependence on welfare programmes and thus pushes up its own spending requirements. The prime example is unemployment. The welfare state provides unemployment insurance and social assistance programmes that reduce the incentive to take up a job. It also, however, levies taxes and social security contributions to pay for these and other programmes, which increases non-wage labour costs and thus decreases the incentive for employers to offer jobs. In particular, the pay-as-you-go financed continental welfare states are at risk of falling into the 'welfare without work' trap,[31] where a high tax burden on labour leads to high unemployment, which, in turn, pushes up unemployment-related welfare spending, thus increasing the tax burden on labour even further.

To liberal economists, of course, these insights come as little surprise. They have always considered the welfare state the 'prototype of a self-destructive … solution'.[32] The revisionists, however, think that help is under way. The globalization process supports governments that want to make their welfare states more sustainable in two ways. First, it increases the perceived pressure and thus weakens the entrenched opposition to welfare reform. Secondly, it facilitates reform consensus by decreasing interest heterogeneity. Globalization boosts the international division of labour. Countries specialize on sectors in which they have comparative advantage and give up on sectors in which they have a relative disadvantage. As a consequence, economic structures will diverge across countries rather than converge, as predicted by globalist scholars, while the internal homogeneity of national populations will increase. 'Collective identity and interest … become organized around particular sectors and products, whose fortunes in the world economy become largely identical with those of the territorial communities that produce them'.[33]

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This 'externalisation of heterogeneity'[33] facilitates agreement on reforms that tailor the welfare state to the specific needs of national lead sectors. Small countries, of course, find this strategy of national specialization much easier to pursue than large countries. This may explain why the small welfare states of Northern Europe did so much better, during the 1990s, than the large continental welfare states. It may also account for the surprising fact that these states are among the staunchest defenders of national sovereignty when it comes to the political as opposed to the economic integration of Europe.

After globalization

Ten years later, the European welfare state is again, or if you like still, in crisis. Only the theory of the crisis has changed. Globalization no longer arouses strong feelings. The focus of public concern has shifted to the internal contradictions of the welfare state. The current fear is that the welfare state systematically destroys the social and economic conditions on which it depends for its own livelihood. The epitome of this fear is the much-debated phenomenon of demographic ageing. Every proverbial man on the street now seems to know that the welfare state, by subsidizing longevity and penalizing fertility, creates an untenable generational imbalance. The choice is 'between tax hikes on a scale unprecedented in peacetime or drastic government spending cuts'.[34] The demographic threat approaching the welfare state is massive, unstoppable and overwhelming – just like globalization was in the old days of the 1990s.

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