GLOBALIZATION AND THE WELFARE STATE:

FOUR HYPOTHESES AND SOME EMPIRICAL EVIDENCE

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INTRODUCTION

The 'new globalism' of the late 1980s and 1990s has widely been viewed as having profound implications for national economic policy autonomy and domestic policy choices. Policy discussions in many countries have become increasingly internationalized in the sense that the impacts of foreign actors and forces—foreign investors, international financial markets and the global economy—are invoked as justifications for particular policy positions.

In this paper, we examine the implications of this 'new globalism' for one of the most important areas of national economic policy, the welfare state. While much has been written on "globalization" and on the "crisis of the welfare state", the relationship between these two contemporary phenomenon has not been well articulated. Part of the reason for this is undoubtedly because the term "globalization" is itself nebulous. In this paper, we restrict ourselves to analyzing only those facets of globalization which have direct bearing on the welfare state. This means primarily considering the globalization of short term capital, of long term capital and of trade.

Even this leaves with us significant room for debate. Here, we provide a guide to this debate by analyzing four competing hypotheses on the relationship between globalization and levels of spending on the welfare state. For the purposes of this paper, we define welfare state spending as government spending on education, health, and social security and welfare. The hypotheses that we analyse we call: the "downward harmonization hypothesis"; the "upward convergence hypothesis"; the "convergence clubs hypothesis"; and the "globalization irrelevance hypothesis".

In the next section, we provide a detailed discussion of each of these four hypotheses. We then provide some preliminary evidence on these hypotheses by examining levels of welfare state spending. We restrict our attention (in both of these Sections) to OECD countries since the impact of globalization on the welfare state may differ by level of economic and institutional development.[1] Given the limitations of available

data, we restrict our empirical investigation to a subset of OECD countries for which reliable time-series data can be constructed. We find some evidence for convergence of welfare spending, not universally, but among countries with similar political institutions.[2]

GLOBALIZATION AND THE WELFARE STATE: FOUR HYPOTHESES

The process of globalization is a complex one and there are considerable differences of opinion about its extent and its impact. Researchers differ about the causes of globalization, its importance, and the mechanisms through which it affects other variables. As a guide through this tangled web of competing views, we divide the literature into four main groups, each defined by a prediction about the observed pattern of welfare state spending. It should immediately be noted, however, that although we divide the literature into these four categories, there are differences within these groups and, as will become evident, our categorization on the basis of predicted outcomes still permits different explanations within each category as to why these outcomes might be observed.

We start by considering one of the most popular hypotheses, namely, that globalization has led to a reduction in the ability of nation states to conduct independent economic policy and that this has inevitably put downward pressures on welfare state expenditure levels.

The Downward Harmonization Hypothesis

The downward harmonization hypothesis (also sometimes referred to as the "race to the bottom" hypothesis) is perhaps best summarized by the following quotation from Dharam Ghai, Director of UNRISD:

> Global economic integration, within a free market context, now poses new challenges for the welfare state. The virtually instantaneous mobility of capital in unregulated markets seriously affects the capacity of governments to regulate national economies; competition for capital and markets increases pressure to adopt a low wage strategy, including a reduction in the cost of social benefits and weakening labor standards; and the twin goals of maintaining acceptable levels of employment and defending the principles of equity and solidarity seem increasingly incompatible. [1994, i]

The argument identifies increasing capital mobility and competition, both to attract capital and to maintain export markets, as key elements of globalization which are undermining national economic policy autonomy and adversely affecting the welfare state.

Evidence of increased capital mobility and increased internationalization of capital markets during the 1980s has been documented by Cosh et al. They argue [1992; 19] that "the financial markets of the advanced industrial countries have undergone

Table 1
The Role of FDI in World Economic Activity 1960-91

Item	1960	1975	1980	1985	1991
World FDI Stock as a Share of World Output	4.4	4.5	4.8	6.4	8.5
World FDI Inflows as a Share of World Output	0.3	0.3	0.5	0.5	0.7
World FDI Inflows as a Share of World Gross Fixed Capital Formation	1.1	1.4	2.0	1.8	3.5

Source Crotty et al. [1995, 52]

far-reaching changes since the mid-1970s. These changes essentially stem from the following interrelated factors: the progressive deregulation of financial markets both internally and externally in the leading countries; the internationalization of these markets; the introduction of an array of new financial investments; and the emergence and the increasing role of new players, particularly institutional investors, in the markets." Cosh et al, following Levich [1987] and Feldman [1986] argue that capital markets have become more integrated during this period.

The reasons for this internalization of capital markets are identified closely with the policies followed by the major industrial nations in Cosh et al's analysis, a point also made forcefully by Helleiner [1994]. This is not, however, the only reason; others place more emphasis on the reductions in transactions costs and the information revolution as central explanations of the trend to capital market internationalization.

The argument refers not only to short-term financial assets (such as bonds and equities) but also extends to foreign exchange markets. Data on the volume of foreign exchange transactions would also support the general argument that international financial transactions have increased substantially during the past 20 years.[3] The French macroeconomic policy reversal in 1983 served as an early example of the rising power of international financial markets but the currency crises which the British, Italian and Swedish governments encountered in 1992 as a result of their participation in the European exchange rate mechanism fully illustrated the impotence of national governments in the face of currency flight. The Mexican *peso* crisis of 1995 offered further evidence of this.

The importance of long-term capital (i.e. foreign direct investment) flows has also risen sharply in the 1980s and 1990s as indicated in Table 1. As well as increased (especially short-term) capital mobility, globalization also has a trade dimension. Certainly, national economies have become more open as the ratio of trade to GNP has generally risen in OECD countries over the past few decades although it is important to note that, in contrast to the increases in capital flows which occurred primarily in the 1980s, increasing trade volumes were primarily a phenomenon of the 1970s.[4]

This summary of the trends in selected dimensions of globalization gives some indication of the sorts of the changes underway in the international economy to which supporters of the downward harmonization hypothesis might appeal. These changes, it is argued, represent a 'new globalism' qualitatively different from previous periods.[5]

The implication of this process of globalization, as suggested by Ghai above, is that there is downward pressure on the levels of spending on the welfare state. Such an outcome might be expected especially since, as Helleiner [1994, 165] has argued, the original architects of the Bretton Woods agreement, John Maynard Keynes and Harry Dexter White, originally regarded capital controls as necessary to preserve the "political autonomy of the welfare state." Agreement with this outcome is not, however, limited to those with Keynesian sympathies. In fact, it is possible to find arguments from across a wide ideological spectrum that globalization is constraining national policy choices and that this has important implications for the welfare state; what differs is an assessment of the desirability of these implications.

As indicated above, the effects of globalization on the welfare state may come through two channels, namely, the greater mobility of capital and the greater openness of international trade. We discuss each channel in turn. As a point of entry into this discussion consider the view of two influential European economists, Drèze and Malinvaud, who argue that the welfare state may have adverse economic consequences because:

> (i) measures of income protection or social insurance introduce undesired rigidities in the functioning of labor markets;
> (ii) welfare programmes increase the size of government at a risk of inefficiency; their funding enhances the amount of revenue to be raised, and so the magnitude of tax distortions;
> (iii) ... welfare programmes may lead to cumulative deficits and mounting public debts. [1994, 95]

Part of the argument made by Drèze and Malinvaud refers to the alleged microeconomic efficiency and incentive problems with the welfare state, but their arguments are also relevant to the globalization debate. With respect to their first point, concerning the functioning of labor markets, it has been argued that the welfare state, by increasing rigidities in labor markets, has slowed down the adjustment of the economy to the changes required by globalization and a more extensive international division of labor. Furthermore, such 'adjustment gradualism' has been harmful as it has led to higher adjustment costs and induced hysteresis in labor markets.

For an example of this type of reasoning consider the arguments made by Canadian economists Courchene and Lipsey. Brown [1994, 116-17] summarizes their position thus: "in their view, the social contract must change to complement the nature of the economy on which it rests. In other words, the welfare state should complement the underlying structure of the economy, and should not—and probably cannot—be used in the long run merely to offset fundamental changes happening there ... [they] believe that the old social contract has been rendered obsolete by global events beyond the control of any national government. Canada's current dilemmas result partly from the social contract's sluggishness in adapting to the new globalized economy." The welfare state therefore needs to be reconstituted on a more 'flexible', less universal, and less expensive, basis.

With regard to the second and third points made by Drèze and Malinvaud, namely those concerning the level of taxes needed to support the welfare state and the potential for deficits arising from commitments to meet welfare spending, these too have clear relevance for the role that globalization might play in constraining national policy choices.

With respect to taxation, Drèze and Malinvaud argue that taxes are distortionary and that they should therefore be kept to 'reasonable' levels, which implies similarly 'reasonable' levels of government spending on the welfare state. This argument also has resonance with the globalization literature in that low taxes are required not only to minimize "distortions" but also to prevent capital, in this case foreign direct investment, from relocating (or to remain attractive to new investment) in a world of few restrictions on capital mobility.

As an example of this type of argument consider, for example, Connolly and Kroger [1993, 45]. They argue that "the liberalization of capital markets adds ... a further dimension [to policy making]. As investment decisions depend upon expectations (i.e. what really matters is the expected rate of real return), it is important to establish a high degree of micro-economic credibility. A lack of supply-side credibility would result in micro-economic risk premium, which would require a real rate of return which is superior to that of other countries. The credibility of any micro-economic regime depends upon various factors among which the operation of the labor market, the taxation system and infrastructure conditions are the most important. In addition, public interference in the market process could become an important obstacle to attracting private capital."

The "taxation system", presumably meaning low taxes on capital, is identified therefore as one factor determining the location of increasingly mobile capital. This obviously has direct implications for the level of government expenditure. Indirectly, some of the other factors identified as important by Connolly and Kroger also have implications for the welfare state. For example, they suggest that labor market operations and perceptions of "public interference in the market process" are all important for corporate investment decisions; it is unlikely that an extensive welfare state will be viewed as contributing to "microeconomic credibility". We would thus expect welfare state spending to fall to competitors' levels, converging at the level of the lowest spender.

With respect to budget deficits, it has been argued that governments' ability to finance such deficits on more integrated international capital markets has been increasingly constrained. In this scenario, international capital markets are seen as making judgments as to the fiscal responsibility of governments, and credit ratings depend upon such judgments. For some, such a development is not unwelcome since global financial markets are now seen as providing the disciplining device that national governments failed to develop. Thus, we might expect that as the power of global financial markets increases, the ability of states to borrow to finance their spending would come under increasing scrutiny and the necessity of reducing the size of the welfare state to the level of more frugal and 'financially responsible' countries would become more evident.

All of these arguments point to downward pressure on welfare state spending. This prediction is also supported by 'political resource' models of the determinants of relative welfare state spending, which suggest that welfare state spending depends on the strength of interest groups which support the welfare state.[6] It can be argued that all countries are experiencing downward pressures on their levels of welfare state spending because capital, as a class, has become more powerful with the process of globalization and that it is not in capital's interests to have an extensive and expensive welfare state. Thus, globalization has been accompanied by a fundamental shift of political power towards capital and away from other groups who might support an extensive welfare state; the result is that the welfare state, whose existence and level depends upon the political resources it can rely upon to support it, is under attack.

These arguments, stemming from Drèze and Malinvaud's analysis, have primarily been concerned with greater capital mobility but there is a second channel of the possible influence of globalization on the welfare state through the globalization of trade. At first, this may seem implausible since the welfare state provides primarily non-tradeable goods and any trade effects should be felt primarily by the tradeable goods sector. However, Alesina and Perotti [1994] develop a model in which the income transfers necessary to finance the welfare state reduce the competitiveness of the tradeable goods sector.[7] As a result, pressures to reduce the size of the welfare state arise in order to maintain the competitiveness of the tradeable goods sector.

In addition to the general hypothesis that we would expect globalization to lead to downward pressure on average levels of welfare state expenditure, we might also expect to observe changes in the composition of welfare state spending. In particular, it has been argued that the welfare state has been transformed by the pressures of globalization into the 'competitor state'. The process of globalization, it is argued, has dramatically changed the relation of states to the international economy; whereas states could previously be seen as "gatekeepers" insulating domestic economies from the ravages of the international economy, their policy autonomy has now been reduced to the point where they have in fact become agents transmitting the requirements of the globalizing economy to the domestic economy.[8] We would expect to see, therefore, not only a reduction in the size of the welfare state but also to see education expenditures and labor market retraining programs expand relative to health and social security and welfare spending over time as states seek, not only to reduce the level of welfare state spending, but to redirect it to those activities which are believed to enhance competitiveness in the global economy.

The Upward Convergence Hypothesis

While the arguments above view the 'new globalism' as a predominantly post mid-1980s phenomenon, others view the integration of the international economy as being a phenomenon characteristic of the past century, particularly the post-1945 period. During this period, according to some, there has been an international diffusion of technology so that levels of total factor productivity, and therefore per capita income, have converged over time [Abramowitz, 1986; Baumol, 1986]. The benefits of an open trading system have accrued, therefore, to follower countries that have been able to take advantage of the possibilities of technological catch-up.[9]

Thus, many neoclassical economists have been concerned about exploring the extent to which national economies have converged to higher per capita income levels in the post-World War II period.[10] The implications of this convergence, if it occurs, for the welfare state are not explicitly made. However, it is argued that consumer preferences tend to become more homogenous as income levels converge and hence we might expect similar patterns of welfare state spending to emerge. As Abramowitz notes, "as followers' levels of per capita income converge on the leader's, so do their structures of consumption and prices" [1986, 389]. Furthermore, the income elasticities of demand for public spending in general, and health and education spending in particular, are relatively high and hence we would expect rising expenditures on these items.[11]

This latter prediction can also be found in structuralist theories, popular with welfare state theorists in the 1960s and 1970s, which viewed the rise of the welfare state as a "modern" phenomenon accompanying industrialization and rising levels of per capita GNP. As Esping-Andersen argues:

> One variant begins with a theory of industrial society, and argues that industrialization makes social policy both necessary and possible—necessary because pre-industrial modes of social reproduction, such as the family, the church, *noblesse oblige*, and guild solidarity are destroyed by the forces attached to modernization, such as social mobility, urbanization, individualism, and market dependence. The crux of the matter is that the market is no adequate substitute because it caters only to those who are able to perform in it. Hence, the 'welfare function' is appropriated by the nation-state. [1990, 13]

The view that the welfare state grows up with industrial society also finds support in the structuralist Marxist literature. Here it is argued that capitalist industrial society requires both a well-educated and relatively healthy workforce and a legitimacy which can only be achieved by social spending. The result is that the state acts to provide these needs of the capitalist system as a whole through welfare spending [O'Connor, 1973].

Seen in this light, globalization can be seen as a new stage during which we might expect to see increased levels of welfare state spending. This arises because, given the arguments above that the welfare state arose in large part out of a desire to provide income security for individuals in the face of structural changes in the economy, then globalization might be expected to increase the need for the welfare state. A more extensive welfare state would be required to meet the increasing social strains caused by an increased international division of labor or, in the structuralist Marxist analysis, to provide continued legitimacy for capitalist accumulation on a global scale.

A recent argument which bears resemblance to some of these points has been made by Rodrik [1996]. Rodrik finds that there is a strong positive statistical relationship between size of government and degree of trade openness in a sample of over 100 countries. He further concludes that "the estimated coefficient on initial government spending is strongly negative, implying a (conditional) convergence effect on government spending ... Not only is openness an important determinant of govern-

ment consumption levels across countries, openness in the early 1960s turns out to be a significant predictor of the *expansion* of government consumption in the subsequent three decades" [1996, 8].[12] Rodrik suggests that the explanation for this statistical finding can be found in the role that government spending plays in reducing the role of external risk to which economies are exposed; since more open economies have higher degrees of such risk they compensate by having larger public sectors. Or, to use Rodrik's words, "societies seem to demand (and receive) a larger government sector as the price for accepting larger doses of external risk" [1996, 1] with the result that "globalization may well require big, not small, government" [*ibid.*, 26]. Rodrik's results indicate that the relationship between trade openness and higher government spending holds for both education and health expenditures although there is some ambiguity about the spending on social security and welfare.[13] Certainly, we would expect the argument to hold for social security and welfare spending in OECD countries.

The theories outlined above, although derived from a variety of theoretical frameworks, all share a common prediction about the relationship between globalization and welfare state spending levels, namely, that the relationship is expected to be positive and that this relationship would also hold for the three categories of welfare state spending considered here: education, health and social security and welfare. All theories point to a rising average level of welfare state expenditure and some suggest, more strongly, a convergence towards the higher level.

The Convergence Clubs Hypothesis

The two hypotheses considered above both predict that the responses to globalization will be similar for all OECD countries. However, given the significant institutional differences between these countries it may be argued that we would expect a variety of responses. Consider the following argument by Esping-Andersen:

> We should ... not exaggerate the degree to which global forces overdetermine the fate of national welfare states. One of the most powerful conclusions in comparative research is that political and institutional mechanisms of interest representation and political consensus building matter tremendously in terms of managing welfare, employment and growth objectives. ... Countries ... vary in their capacity to manage conflicting interests. [1994, 4]

In analyzing these institutional differences between OECD countries one oft-made distinction is between those countries whose economies utilize corporatist institutions to manage conflicting interests and those which take a more laissez-faire approach. This division has been argued to be especially important in determining policy responses and policy outcomes to the world economic slowdown after the oil price shocks of the 1970s. Specifically, it has been argued that in countries with high degrees of corporatism the social bargain has enabled economies to adjust more rapidly and efficiently to changes in external conditions.[14] The centralized bargaining structures of corporatist states, with their inclusion of business, labor and government in

national economic policy-making, has enabled them to more efficiently strike social bargains which involve greater degrees of real wage flexibility in return for higher employment levels and a higher social wage (i.e., more extensive welfare state). The globalization of the mid-1980s and 1990s could plausibly be argued to be a similarly important change in external conditions which requires coordinated policy responses. If it is true that globalization puts downward pressure on welfare states then we might expect that corporatist countries would be better able to adapt their policy choices in response. Reducing welfare state expenditures is a politically divisive process and corporatist countries might have the institutional structures more capable of managing such a process. However, corporatist countries' structures depend in considerable degree on the provision of welfare state benefits as part of the social bargain underpinning their structures. We would therefore expect reductions in welfare state spending to have a definite lower bound and we would not expect the size of the welfare state to shrink to that of non-corporatist countries.[15] In the latter countries, we might again expect downward pressure on the welfare state although perhaps with some variation in achieving this objective given the political obstacles to welfare state reductions and the absence of well-developed institutional mechanisms to overcome them. We might expect to find, therefore, that responses to globalization varying with the degree of corporatism, with both high and low corporatist countries facing downward pressure on welfare state spending but with the highly corporatist set of countries still having higher levels of welfare state spending and being capable of pursuing more coordinated responses than the low corporatist countries.

It is possible that the relevant categorization of countries is not by the degree to which their institutions may be regarded as corporatist but by their regional affiliation. Characterising the current phase of the world economy as one dominated by globalization is not without its critics and one alternative would be to view regionalization as a more dominant force. Hirst and Thompson, for example, argue that "perhaps the most significant post-1970s development, and the most enduring, is the formation of supra-national trading and economic blocs" [1992, 369].[16] If this is the case, then we might plausibly expect to see "convergence clubs" emerging on the basis of regional affiliation. In particular, we might expect to see welfare state spending converging among members of regional trade blocs.

The concern over the possibility of downward harmonization has led to attempts to provide safeguards in regional trading agreements as the environmental and labor side agreements negotiated in NAFTA and the Social Chapter of the EU 1992 project illustrate. In general though, there is a large difference between the policies of the two most powerful economies in the regional blocs of NAFTA and of the EU. Specifically, Germany has a much more extensive welfare state model than the U.S. The outcome of European integration may be more favorable to the welfare state than that of NAFTA as a result although the difficulties of positive integration (as opposed to the negative integration represented by the removal of regulations) remains real in the European case.[17] Nevertheless, we would expect pressures for upward harmonization to be highest in Europe and the pressures for downward harmonization to be greatest in NAFTA. The two regions may therefore exhibit quite different convergence patterns with two distinct convergence clubs emerging.

The Globalization-Irrelevance Hypothesis

The arguments made above all rely on the assumption that globalization (or regionalization) is taking place to a significant degree and that this has implications for the autonomy of national economic policy making. However, other theorists dispute the importance of globalization and it is certainly valid to question the reliability of the theoretical links between globalization, even if it is occurring, and the welfare state.

Consider first the arguments about the existence of globalization. With respect to the global integration through increased trade argument, although economies are more open as a result of tariff reductions there has been a simultaneous rise in non-tariff barriers; the degree of increased trade openness is therefore open to doubt and trade figures alone undoubtedly overstate the case. Furthermore, although production is said to be becoming more global in the sense that increasingly greater amounts of production are occurring in host countries, Lipsey et al. find this increase to be modest and conclude that:

> Given all the attention that 'globalization' has received from scholars, international organizations, and the press, [our data] are a reminder of how large a proportion of economic activity is confined to single geographical locations and home country ownership. Internationalization of production is clearly growing in importance, but the vast majority of production is still carried out by national producers within their own borders.[18] [1995, 60-61]

Perhaps the case for globalization is strongest when considering the growth of short-term financial markets. Even here, however, the argument is not unambiguous and Zevin [1992], for example, argues that international capital mobility in the 1980s is similar to that found in the 1880s. In his view, it is not the 1980s which are new but the immediate post-World War II period which is exceptional in the degree to which international capital mobility was restricted.

The increased mobility of long-term capital, another alleged dimension of globalization, is also open to dispute. Despite its growth during the post-World War II period, there is still evidence that there are considerable barriers to the movement of long-term capital. As Epstein [1994] argues, it does not appear that we have moved to a Walrasian world where we have a pool of world savings with countries freely borrowing from it. Epstein further shows that for U.S. multinationals in the period 1951-86, there was no tendency for profits rates to equalize across countries or for the variance of profit rates to fall over time suggesting that significant barriers to the mobility of long term capital remain.

Whilst these arguments question the degree to which globalization has taken place, others question the hypothesized links between globalization and the welfare state. For example, the argument advanced by Dreze and Malinvaud that welfare states may lead to "cumulative deficits and mounting public debts" is straightforward but controversial. It is controversial in that it implies an analysis of state spending behaviour which may not be accurate and on the specific grounds that although spending on the welfare state may be a large budget item, it is not the only item and deficits could equally be reduced or eliminated by reducing spending in other areas. Furthermore, the integration of global capital markets may enable governments to borrow *more,* not less, by increasing their access to global capital supplies.

The argument that increased capital mobility will constrain the ability of governments to raise taxes to finance the welfare state and constrain the type of interventions that it can make remains a hypothesis. It may turn out to be false because a large body of literature of firm location decisions find little evidence that tax rates are a major factor and, as suggested earlier, it appears that there are still significant barriers to long term capital mobility.[19] Furthermore, evidence from two highly integrated areas shows that even the restrictions placed on countries who have joined the European exchange rate mechanism have not led to significant levels of labor market convergence [Anderton and Barrell, 1995] and that the U.S. states still exhibit substantial differences in social welfare provision despite over a century of free capital movements.

If one accepts these arguments then, we should not expect globalization to have had any significant impact on welfare state spending levels. If we do find any trends, or more strongly convergence, in welfare state spending levels then we should look elsewhere for their explanations. This suggests that countries continue to have policy choices, albeit constrained by their own history and institutional structures, but that such choices are made for non-globalization related reasons, of which the most important might be government ideology. In this case, whilst right wing governments may invoke the forces of globalization to assert that there are no alternatives to their reductions in welfare state spending (or spending growth), they are no more than that: assertions designed to demobilize the opposition rather than statements of fact. Thus, we might expect countries to differ in their patterns of welfare state expenditure but these differences would be explained by political affiliation of the ruling party and there is no necessary reason to believe that a convergence of expenditures would be observed.

Before considering the data, we conclude this section by providing a summary of the four hypotheses. Figure 1 illustrates differences between the hypotheses in terms of how important they judge globalization to be, what they consider the implications of globalization to be for average welfare state spending over time, and whether they predict, more strongly, a convergence of welfare state spending.

TRENDS IN WELFARE STATE SPENDING

The four globalization hypotheses summarized in Figure 1— 'Downward Harmonization', 'Upward Convergence', 'Convergence Clubs', and 'Globalization Irrelevance' — have differing implications for trends in welfare state spending. In this section, we examine those trends as a means of evaluating these competing views.

We use national expenditures on education, health, and social security and welfare (as percentages of GDP) as measures of welfare state size. The main difficulty in doing so is the paucity of comparable cross-country data for the relevant period, from the early 1970s to the present. Using two data sources, the OECD study *Social Expenditures 1960-1990* [OECD, 1985][20] and the *Government Financial Statistics Year-*

FIGURE 1
Summary
Globalization and the Welfare State: Four Hypotheses

Hypothesis	Globalization Important?	Mean Welfare State Spending	Convergence of Welfare State Spending
I. Downward Harmonization	Yes	Lower	Yes
II. Upward Convergence	Yes	Higher	Yes
III. Convergence Clubs			
a. Corporatist	Yes	Lower: Non-corporatist Lower (?): Corporatist	No: Non-corporatist Yes: Corporatist
b. Regional	Regionalization more important	Lower: North America Higher (?): Europe	Yes: North America Yes: Europe
IV. Globalization-Irrelevance	No	Lower (?): Right-wing Gov'ts Same (?): Left-wing Gov'ts	? ?

(?) indicates an uncertain effect.

book [IMF, 1995], we were able to assemble statistics on education and social security and welfare spending for ten OECD countries, and on government health expenditures for eight countries.[21] These statistics contain spending by all levels of government. The use of such aggregate data as a measure of welfare state size is not beyond criticism, but as Freeman notes, "indicators of the extent of the welfare state like the share of public expenditures or of taxes in GDP are imperfect, but probably give a reasonable picture of differences in the magnitude of social policy activity across countries and over time" [1995, 247].

In addition to examining average levels of welfare state spending, we also wish to test for convergence. However, testing for convergence is problematic because of "the absence of an agreed upon definition of convergence" [Hall et. al, 1992, 99]. Given this, we report two simple statistics as indicators of changes in the variation of social spending as a percentage of GDP — the standard deviation and the coefficient variation of spending by countries in the sample. If both decline over time, we will conclude that convergence has occurred.

Important components of welfare state spending are likely to be counter-cyclical. Obviously, welfare and unemployment payments will increase during recessions, but other welfare state expenditures may vary cyclically as was well. For example, expenditures on post-secondary education may increase during economic downturns as individuals choose schooling instead of competing in a tight labor market. Consequently, cross-sectional comparisons of welfare state spending in any one year may be inappropriate, if countries are at different points in their business cycles.[22]

To mitigate this potential source of bias, we will limit our analysis to welfare state spending in business cycle peak years. For each country in the sample, we identified peak years of the business cycle by linearly detrending real GDP. We then used the business cycle peaks closest to 1970, 1980, and 1990, within the period 1970-1992. Our cross-country analysis is carried out in terms of three periods for which these business cycle peak years are proxies: the early 1970s, the late 1970s to early 1980s, and the late 1980s. (See Appendix Table A1 for the years used for each country.) Of course, since the severity of business cycle volatility is not uniform across countries, this procedure may not fully correct for cyclical variations in welfare state spending. Nevertheless, we believe this to be a reasonable first approximation.

Table 2 shows total welfare state spending for our sample of eight countries. Spending increased between the first two periods and then remained stable—i.e. while welfare state size increased in the 1970s, the 1980s are not characterized by the sharp decline in welfare state size that some hypotheses might suggest. The absence of welfare state growth in the 1980s (after the ubiquitous growth of welfare state spending in the 1970s) could, however, be taken as indicative of a response to pressures from globalization.[23] We do not observe convergence based on either test statistic, which is evidence against both the 'Downward Harmonization' and the 'Upward Convergence' hypotheses.

If globalization fosters the development of 'competitor states', then change may occur in the composition rather than in the overall level of welfare state spending. A strong version of the 'competitor states' hypothesis would predict an upward convergence in spending on education and/or downward convergence in spending on health and social security and welfare.[24] However, disaggregating the data by type of spending did not reveal this pattern.[25] Average national spending on education declined in the 1980s, with no indication of convergence. Social security and welfare spending increased in the 1970s and remained roughly level in the 1980s; we observe a *divergence* of spending levels among our sample countries during this period. In the 1970s, government spending on health increased and converged; the upward trend in spending continued in the 1980s, but convergence did not. Available data allows us to include Japan and Sweden in the sample for spending on education and on social security and welfare but their inclusion does not change the patterns discussed above.

The apparent divergence of spending on social security and welfare in the 1980s suggests the possibility of 'Convergence Clubs'. To explore this possibility, we have divided our sample of countries into 'corporatist' and 'non-corporatist states', based on the corporatism index developed by Crouch [1983].[26]

As one might expect, corporatist and non-corporatist have substantially different average levels of total welfare state spending in all periods (Table 3). In corporatist countries, the absence of welfare state spending growth during the 1980s is consistent with the view that downward pressures resulting from globalization were evident. However, average welfare state spending levels were maintained during the 1980s and convergence is seen during this period suggesting that corporatist states had institutional structures which elicited a common response to those pressures.

Table 2
Total Welfare State Spending as % of GDP

	Period 1 Early 1970s	Period 2 Late 1970s to Early 1980s	Period 3 Late 1980s
Australia	13.1%	18.2%	15.3%
Austria	22.3%	27.1%	28.8%
Canada	19.7%	20.3%	23.4%
Denmark	27.4%	33.3%	32.8%
Germany	26.3%	30.5%	28.3%
Norway	27.1%	27.2%	28.1%
United Kingdom	19.4%	21.3%	20.8%
United States	16.9%	18.6%	16.9%
Mean	21.5%	24.6%	24.3%
Standard deviation	0.049	0.054	0.058
Coefficient of variation	0.226	0.219	0.240

Welfare state spending is defined as expenditures on education, health, and social security and welfare, by all levels of government.
Sources: See Appendix Table A1.

The story is somewhat different for the set of non-corporatist states. Their mean levels of total spending fell slightly in the 1980s and their individual spending levels diverged (after converging in the 1970s). This was particularly true for spending on social security and welfare (Table 4). The fact that two of the non-corporatist states, Japan and Canada, experienced substantial increases in this category of spending, suggests that either they were not experiencing global pressure to reduce social spending or that in the absence of corporatist institutions, restricting welfare state spending may prove difficult.

Although we have controlled for business cycle variations by drawing data from business cycle peak years, it could be argued that secular differences in macroeconomic conditions can influence trends in welfare state spending. It is possible that the convergence of social spending among corporatist states reflects similar long-run economic conditions, particularly since these countries are all European.[27] As a rough check on this possibility, we considered national unemployment rates in business cycle peak years.[28] We observe a secular increase in average unemployment rates for both corporatist *and* non-corporatist states. This suggests that the apparently systematic difference in social spending patterns between corporatist and non-corporatist states does not reflect differing economic conditions, but rather differing responses to the pressures of globalization.

CONCLUSIONS

In the first part of this paper, we identified four hypotheses concerning the relationship between globalization and the welfare state. This relationship is an important one because globalization is the subject of great controversy, and has become an

Table 3
Total Welfare State Spending as % of GDP
Corporatist vs. Non-Corporatist States

	Period 1 Early 1970s	Period 2 Late 1970s to Early 1980s	Period 3 Late 1980s
Corporatist			
Austria	22.3%	27.1%	28.8%
Denmark	27.4%	33.3%	32.8%
Germany	26.3%	30.5%	28.3%
Norway	27.1%	27.2%	28.1%
Mean	25.8%	29.5%	29.5%
Standard deviation	0.020	0.025	0.019
Coefficient of variation	0.079	0.086	0.065
Non-corporatist			
Australia	13.1%	18.2%	15.3%
Canada	19.7%	20.3%	23.4%
United Kingdom	19.4%	21.3%	20.8%
United States	16.9%	18.6%	16.9%
Mean	17.3%	19.6%	19.1%
Standard deviation	0.027	0.013	0.032
Coefficient of variation	0.154	0.065	0.167

Corporatist states are those with Crouch index > 2.
Welfare state spending is defined as expenditures on education, health, and social security and welfare, by all levels of government.
Sources: See Appendix Table A1.

important factor in the ongoing and often acrimonious debate over the reform of the welfare state. The statistics on welfare state spending described in the previous section of this paper lead us to several conclusions:

- The mean levels of welfare state spending decreased slightly in the 1980s, in contrast to the 1970s, when all countries in our sample experienced increased spending as a percentage of GDP. This is consistent with the hypothesis that the process of globalization in the 1980s resulted in downward pressure on welfare state spending.
- There is evidence of neither a downward convergence nor of an upward harmonization of welfare state spending in the full sample of countries.
- We do, however, observe a convergence of welfare state spending in the 1980s among the corporatist states in our sample. The same is *not* true of spending by non-corporatist states; welfare state spending by non-corporatist states diverged in the 1980s.
- Average spending on education and on social security and welfare both declined in the 1980s, while spending on health increased. This is inconsistent

Table 4
Spending on Social Security and Welfare as % of GDP
Corporatist vs. Non-Corporatist States

	Period 1 Early 1970s	Period 2 Late 1970s to Early 1980s	Period 3 Late 1980s
Corporatist			
Austria	15.6%	18.8%	19.1%
Denmark	14.9%	20.0%	21.0%
Germany	16.2%	19.2%	17.7%
Norway	13.6%	14.4%	15.0%
Sweden	10.4%	16.6%	18.83%
Mean	14.1%	17.8%	18.3%
Standard deviation	0.020	0.020	0.020
Coefficient of variation	0.145	0.113	0.107
Non-corporatist			
Australia	5.0%	7.9%	6.2%
Canada	8.8%	9.1%	12.0%
United Kingdom	9.3%	11.5%	10.5%
United States	8.4%	9.5%	7.3%
Japan	3.6%	6.8%	8.0%
Mean	7.0%	9.0%	8.8%
Standard deviation	0.023	0.016	0.021
Coefficient of variation	0.328	0.174	0.243

Corporatist states are those with Crouch index > 2.
Sources: See Appendix Table A1.

with the strong version of the 'competitor states' hypothesis which predicts an *increase* in spending on education and a decrease in other forms of welfare state spending.

Our results suggest that globalization may indeed have posed a challenge to the welfare state in the 1980s. However, the responses to that challenge were not uniform across the set of countries in our sample. The fact that corporatist states did show a similarity in their response is an indicator of the importance of institutional structures in determining how countries respond to economic conditions that are beyond their direct control.

It should again be noted that our results should be viewed as suggestive rather than definitive. The number of countries in our sample was relatively small and our analysis of welfare state spending trends has been concerned with finding consistency with the four hypotheses outlined in the first part of this paper, rather than with tests of causality. Nevertheless, on the basis of our findings, it has been possible to draw some tentative conclusions.

If, in fact, countries are obliged to respond to global pressures, then a central policy question is: should nations passively accept, and comply with, such pressures, or should they seek ways to limit the destructive tendencies which globalization may hold for the welfare state? The experience of the 1980s suggests that multiple responses to globalization are possible; the fate of the welfare state appears to depend on institutional structures and policy decisions, rather than on an inevitable capitulation to global forces.

NOTES

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1. In particular, the effects of increasing international economic integration on the countries of Eastern Europe, Latin America and East Asia may be quite different given their diverse institutional histories and levels of development. An analysis of the effects of globalization on these countries lies beyond the scope of this paper. See Esping-Andersen [1994] for discussion.
2. However, we caution that in the light of the above mentioned data limitations, our results should be regarded as preliminary rather than definitive.
3. For example, Frankel [1996, 5-6] shows that foreign exchange trading increased rapidly during the 1980s and 1990s and, by April 1995, amounted to approximately U.S. $1,200 billion per day, some 40-50 times larger than world trade flows per day.
4. For example, exports plus imports as a percentage of GDP rose from 30.0 to 43.0 percent between 1970 and 1980 for the G-7 countries. The figure then fell slightly to 41.5 percent in 1990. See World Bank, *World Tables 1992*.
5. It has been argued that the last decades of the nineteenth century can be seen as the period of 'internationalization' when the world economy expanded on the basis of greater links between national economies, the 1960s and 1970s as a period of 'multinationalization' when the world economy became more integrated as the activities of multinational corporations increased, but that the 1990s are characterized by a period of 'globalization' where production, trade and finance become truly global. See Oman [1996] for more details on the differences between the three periods.
6. For a review of this literature see, for example, Amenta [1993].
7. Alesina and Perotti argue that redistributive taxation will cause wage-earners to bargain for higher wages, thereby increasing costs and prices and reducing the competitiveness of the economy. The ability of wage-earners to attain such higher wages depends upon union strength although Alesina and Perotti argue that the effects of union strength on wage outcomes will be non-linear.
8. For more on this hypothesis see Cox [1994].
9. Abramowitz [1986] argues that countries' ability to catch up depends on their social capabilities.
10. The "convergence hypothesis" has proved to be an extremely controversial one even within mainstream economics. The initial studies of Abramowitz and Baumol cited here were criticized for a number of reasons including the fact that they used data only from industrialized countries. Theoretical work from the endogenous growth literature and empirical work using larger data sets have subsequently been used to challenge the convergence hypothesis although the latter still has its share of supporters. For review see, for example, the exchanges introduced by Durlauf [1994].
11. A rising share of government consumption in GDP as per capita income increases, reflecting an income elastic demand for government services, is sometimes referred to as "Wagner's law".
12. Conditional convergence in this context means that countries' levels of government spending converge if we allow for differences in specified demographic and structural conditions. (For the conditions included see Rodrik [1996, 6]).
13. Specifically, higher social security and welfare spending is associated with higher degrees of openness in Rodrik's results for 1990-92 data but not for the 1985-89 data. Rodrik suggests that the inclusion of developing countries in his sample may explain this result since social security and welfare systems are difficult to devise in these economies and they may therefore "rely on a broader set of instrumentalities to achieve risk reduction" [1996, 14].
14. See, for example, Bruno and Sachs [1985] and McCallum [1986].

15. See Green et al. [1994] for further discussion of the relationship between corporatism and the welfare state.
16. Hirst and Thompson [1992, 393] take the view that "globalization has not taken place and is unlikely to do so" although others argue, less strongly, that regionalization is the more important of the two forces.
17. For discussion, see for example, Rhodes [1992].
18. Using home-country data for FDI, Lipsey et al [1995, 45] find that "the share of internationalized, or affiliate production has risen from about 4 ½ per cent to between 6 and 7 ½ per cent of world output since 1970." Using host country data, two calculations were made. Both resulted in a lower figure for internationalized production although in one case the increase was rapid in the late 1980s (in the other case there was no discernible trend).
19. For evidence on firm location decisions see, for example, Friedman et al. [1992].
20. This report contains data through 1981.
21. The countries for which we have full data are Australia, Austria, Canada, Denmark, Germany, Norway, United Kingdom, and United States. In addition we have spending figures on education and social security and welfare for Japan and Sweden. Missing data for at least some years precludes the inclusion of more OECD countries.
22. As Esping-Andersen notes, "In Britain, total social expenditure has grown during the Thatcher period, yet this is almost exclusively a function of very high unemployment. Low expenditure on some programs may signify a welfare state more seriously committed to full employment" [1990, 20].
23. This interpretation assumes that globalization is a 1980s phenomenon.
24. We call this a strong version of the hypothesis since it requires changes in the composition of welfare state spending unadjusted for demographic change. In fact, all of the countries in our sample experienced a rise in the ratio of the population over the age of 64 to that under the age of 25. This may be expected to affect education and health expenditures. The small number of data points precluded our adjusting welfare state spending in these categories for demographic changes which might have also permitted testing a weaker version of the 'competitor states' hypothesis.
25. A full set of Tables providing details of all of the results discussed in this paper is available from the authors upon request.
26. The Crouch corporatism index ranges from 0. 0 to 4. 0, with countries scoring one point for each of the following criteria met: work councils, centralized union movement, low shop floor autonomy, and coordination among employers. We designate as corporatist countries with a Crouch score greater than 2. See Appendix Table A1 for country scores. Of course, this a static notion of corporatism and ignores the important changes in corporatist institutions which have taken place in the past 25 years. The index which we have adopted is used simply because it permits empirical testing.
27. Disaggregating by regional affiliation yields no discernible trends, although our ability to test for regional convergence blocs was severely limited by the countries in our sample.
28. We are grateful to Dr. Javid Taheri for providing us with internationally comparable unemployment rates.

TABLE A1
Business Cycle Peak Years, Data Sources, and Crouch Index

	Business Cycle Peak Years			
	Period 1: Early 1970s	Period 2: Late 1970s to Early 1980s	Period 3: Late 1980s	Crouch index of corporatism
Australia	1973	1978	1989	0.0
Austria	1974	1980	1991	4.0
Canada	1974	1979	1988	0.0
Denmark	1973	1979	1986	3.0
Germany	1973	1979	1991	4.0
Japan	1973	1979	1991	1.5
Norway	1976	1980	1986	4.0
Sweden	1970	1979	1989	4.0
United Kingdom	1973	1979	1989	0.0
United States	1973	1978	1989	0.0

Sources: For periods 1 and 2, OECD [1985]. For period 3, IMF [1995]. For Crouch index, Crouch [1983].

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