

# Globalisation and the State: Still Room to Move?

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In recent years, scholars and policy makers have questioned the extent to which the nation-state – specifically, the modern welfare state, marked by intervention and publicly-provided social protection – is compatible with economic globalisation. While transnational actors, including multinational corporations, institutional investors, banks and non-governmental organisations, undoubtedly influence contemporary national policy making, they have not brought about the demise of the nation-state. Nor have the pressures generated by such actors eliminated cross-national diversity in policy outcomes and political institutions. In the face of economic globalisation, governments retain ‘room to move’, particularly in the developed world but also in developing nations. This essay reviews the empirical and theoretical evidence in support of this claim, beginning with the general issue of economic globalisation and government policy making. I then turn to the relationship between global capital markets and government autonomy. In conclusion, I ask why the ‘race to the bottom’ (RTB) logic remains a feature of contemporary public debates and explore variation across countries and investors in the pressures emanating from global capital markets.

## **Economic globalisation and national government policies**

Many popular discussions of economic globalisation invoke the ‘race to the bottom’ hypothesis, which is grounded in the imperatives of cross-national competition and economic efficiency.<sup>1</sup> Nations benefit, in aggregate terms, from trade and financial openness, but openness forces them into competition with one another. Competition reduces governments’ abilities to provide goods and services to their citizens and renders governments more accountable to external economic agents than to citizens. This hypothesis implies not only a convergence of national policies, but also a convergence toward the lowest common denominator. It has become a favourite straw man of comparative and international political economists.

There are myriad reasons to be sceptical of the claim that the competitive pressures set off by economic openness will lead nations to pursue a similar, bare bones set of economic and social policies. First, domestic institutions play

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an important role in mediating pressures from the global economy, and these institutions often are resilient in the face of global economic pressures. For instance, there are different ways of organising production in capitalist economies.<sup>2</sup> Varying complexes of institutions can generate similar levels of overall economic performance, and these sets of business practices, training systems and worker organisation provide comparative advantages to particular countries and sectors. At the heart of this argument is a Tiebout-type model, in which specialisation is possible within globalisation. Assuming that citizens and firms have different preferences over public services, taxation and regulation, governments will offer different combinations of these goods, and firms and citizens will locate in the jurisdiction that best matches their preferences. As endogenous growth theory also predicts, some economic agents will favour government intervention – rather than market-oriented governance – in domestic economies.<sup>3</sup> Second, economic openness may increase, rather than decrease, citizens' demands for public sector intervention, as a means of compensating voters for externally-induced economic volatility. As globalisation heightens economic insecurity, demands for government intervention persist, or indeed increase.<sup>4</sup> While governments may pay an economic price (in the form of higher interest rates, for instance) for maintaining welfare state policies, this price is offset by the internal political benefits of compensatory policies.<sup>5</sup>

These theoretical doubts about the RTB logic imply that, despite increases in trade and financial openness, national economic and social policies will continue to display a good deal of diversity, reflecting differences in citizens' and firms' preferences, political institutions and traditional welfare state policies. How well does the evidence support this prediction? Among developed democracies, substantial cross-national diversity remains in areas such as government consumption spending, government transfer payments, public employment and public taxation; but growing cross-national similarity characterises aggregate monetary and fiscal policies.<sup>6</sup> Economic globalisation appears related to substantial convergence on overall fiscal (the size of public deficits) and monetary policy (the inflation rate) outcomes; nevertheless, domestic politics and institutions continue to be the most important determinants of the overall size of government, the distribution of government spending across programmatic areas and the structure of taxation.<sup>7</sup>

In the developing world, economic globalisation has created greater pressures and incentives for cross-national policy convergence, particularly in the direction of neoliberal economic reform. Again, however, some room for government autonomy and cross-national policy diversity remains. The 'compensation hypothesis' is borne out in studies that confirm, just as in developed nations, a positive association between trade openness and the size of the public sector.<sup>8</sup> This is particularly true in democracies, where the combination of trade openness and democracy pushes public spending upward, reflecting the incentives of governments to compensate citizens exposed to volatility (and the absence of these incentives in non-democratic polities). Developing nations – especially those with competitive export sectors – may be able to sustain a policy of high compensation (generous welfare state policies), especially if the public goods provided generate future improvements in competitiveness and economic growth.<sup>9</sup>

Case-study evidence for Latin America, for example, reveals clearly the role of domestic politics. Marcus Kurtz's study of social policies in Chile and Mexico demonstrates that, despite the espousal of neoliberal reforms and the presence of external constraints in the 1980s and 1990s, there were important differences in their social welfare regimes. While the global economy and the dominant neoliberal ideology narrowed the policy space for the Chilean and Mexican governments, there remained substantial room for variation. This variation flowed from political alliances, the degree of organisation of the poor in society and the competitiveness of the political party system.<sup>10</sup> Along slightly different lines, Sarah Brooks reports that pressures from international financial markets have an effect on social security reforms in a wide sample of countries. But, at the same time, the type of political regime, as well as the distribution of political power and the structure of previous social security arrangements, also influences the reform process.<sup>11</sup> Tax policy in Latin America similarly reveals this mixed pattern. Higher levels of short-term capital flows and foreign direct investment (FDI) place downward pressure on capital's share of taxation. Dependence on international financial institutions also predicts that labour will bear a greater share of the tax burden. But left government and labour power are important and significant determinants of tax policy.<sup>12</sup> For developing nations, then, a more mixed picture has emerged: as in the advanced democracies, political institutions and domestic interests continue to play a role in the determination of social and economic policies. But, in some cases, the role of domestic factors is rivalled by the pressures emanating from economic globalisation.<sup>13</sup>

### **Global capital markets and government 'room to move'**

When we turn from the general impact of economic globalisation to the specific influence of international capital markets, the same mixed patterns emerge, in which international forces affect government policy making, but not to the exclusion of domestic factors, and developing nations are more constrained than developed ones. While capital market openness provides governments with greater access to capital, it also subjects them to external discipline; investors' capacity for exit provides them with political voice.<sup>14</sup> Governments must sell their policies not only to domestic voters, but also to international investors. Because investors can respond swiftly and severely to actual or expected policy outcomes, governments must consider financial market participants' preferences when selecting policies. As financial openness increases, then, the capacity to spend and tax, and the more general ability to pursue divergent policies, should diminish markedly.

Has this happened? As above, some cross-national convergence has occurred, leading to lower average rates of inflation and smaller fiscal deficits in both advanced and developing nations. But, when we move beyond these macro-policy indicators, we find less evidence for convergence, particularly in developed nations. For instance, Brian Burgoon's study of social policy in the Organisation for Economic Cooperation and Development (OECD) finds that openness to foreign direct and portfolio investment has a generally positive effect on spending for worker training and relocation, but a negative effect on total social

spending. He also reports smaller, negative relationships between financial openness and health care and family benefits. But the size and the statistical robustness of these relationships is modest. In the developing world, there appear to be greater pressures for policy convergence, and these pressures extend beyond macro-policies to more micro-policies such as the tax structure (the balance of the burden between labour and capital) and the provision of education, health and social security policies.<sup>15</sup>

What explains the difference in the financial market constraints faced by developed versus developing (or ‘emerging market’) nations? In my previous analysis of the influences of the government bond market on national policy making, I posit that, because of professional investors’ incentives and information needs, financial market pressures will vary across groups of countries.<sup>16</sup> In the advanced capitalist democracies, market participants consider key macroeconomic indicators, but not supply-side or micro-level policies. The result is a ‘strong but narrow’ financial market constraint. Governments that conform to capital market pressures in select macroeconomic areas, such as overall government budget deficits and rates of inflation, are relatively unconstrained in supply-side and microeconomic policy areas. For the most important developed nations, the constraint may not be very strong: the archetypal current case is the continued ability of the United States government to borrow at relatively low rates of interest, despite its large and growing budget deficits.

For developing nations, however, the scope of the financial market influence often extends to both macro- and micro-policy areas. Market participants, concerned with default risk, consider many dimensions of government policy. Domestic policy making in these nations will tend more toward the convergence view, as the financial market constraint is both strong and broad. As a result of their concerns with default risk, financial market participants treat emerging markets differently from – and more stringently than – developed ones.<sup>17</sup> The consequences of strong and broad financial market influence for developing country governments *could* be rather severe. Because the interest rates charged to governments are related directly to a wide range of economic policies, social policies and institutional features, governments that want to please international market participants may find themselves highly constrained. Investors can easily punish governments, and their grounds for punishment include both macro-level and supply-side policies, as well as political outcomes. Those societies most in need of egalitarian redistribution may have, in terms of external pressures, the most difficulty achieving it. Yet, even in developing nations, many governments seem to have some room for policy autonomy. Argentina’s recent decision to offer a ‘take it or leave it’ deal on its defaulted sovereign debts is an extreme case; to the surprise of many market observers, approximately 90 per cent of bond-holders agreed to accept only 30 cents on the dollar (rather than the more standard 50 to 60 cents) from the Argentine government.

To understand less extreme instances of developing nations resisting financial market pressures, it is important to note that financial market influence varies over time, as well as across groups of countries. Often, the global market environment is normal and country-specific factors dominate; governments’ costs of borrowing depend on their policies, as well as on their country category.

But, in other periods, external factors dominate and the global market environment is characterised by a mania (risk acceptance) or a panic (risk aversion). In these environments, developing countries find their access to capital either very easy (mania) or very difficult (panic). In the former, even nations with poor policies can access capital at low rates and constraints are meagre; in the latter, even those with good policies have difficulty in attracting investment. Therefore, we also should observe variation in policy that is correlated with variation in global market sentiment. For instance, when global liquidity is high, we should observe more cross-national diversity among developing-nation policies.

### **The persistence of the ‘race to the bottom’**

Despite the accumulation of empirical evidence against the RTB logic, this argument continues to characterise popular debates. Pundits claim that the global economy has placed governments, particularly in the developing world, in a ‘golden straightjacket’: they must compete in order to survive, and the only means of competing is reducing government intervention, lowering taxes and steadfastly pruning environmental, health and safety and labour regulations. Developed nations also are not immune. US firms and employees must worry not only about the flight of multinational production to developing nations, but also about the outsourcing of jobs to low-wage locales. What explains this apparent disconnect between social science research on the subject and the claims of politicians and pundits? To begin, the developing world shows us that, while a full RTB process is not occurring, there are stronger pressures on some governments than on others.

But two additional elements are important. The first is ideological. For many, the RTB, and the possibility of constraints on government autonomy, is favourable. Economists, as well as political scientists in the public choice tradition, usually assume that the market is a more legitimate arbiter of value – and of values. If there are constraints on governments that result from financial globalisation, they are welcome ones: they will pull governments back from the precipice of distorting policies. On the other hand, many political scientists worry about the failures of markets to provide public goods and improve overall welfare. For them, constraints on governments are unwelcome ones, as they inhibit the ability of governments to protect their citizens from the vagaries and volatilities of markets. Of course, this is an old debate, underscored by important normative questions and reflected in debates regarding the value of pre-First World War *laissez-faire* capitalism vs. post-Second World War ‘embedded liberalism’.<sup>18</sup>

The RTB claim, then, can be used to justify the delegation of decision making away from governments, toward the private sector. If a policy maker’s claim is not only that governments *should not* intervene in the domestic economy, but that they also *cannot* do so, s/he may be better able to convince voters of the necessity of making certain policy changes. The global economy, then, becomes a useful scapegoat for leaders who would like, for domestic reasons, to reduce government spending, lower the rate of inflation or enact tax and social security reform.<sup>19</sup> This may assume that voters lack sophistication: that they do not

realise that the pressures being invoked are more imagined than real with the result that policy makers consequently are able to fool them.

Policy makers who scapegoat international capital markets do so not necessarily out of ideological bias. Sometimes, the global economy is a convenient cover for the negative consequences of past policy mistakes. Reform is necessary, leaders might argue, not because of past governments' mismanagement of the public economy, but because domestic firms are falling behind and threatening to exit. Leaders also may attempt to provoke a shift in ideas regarding the appropriate relationship between state and market; in at least some instances, this promotion reflects strategic behaviour rather than learning or ideational change.<sup>20</sup> For instance, in the face of steeply rising rates on government borrowing, Sweden underwent a significant amount of welfare state retrenchment in the 1990s. For some, this was evidence that the Swedish welfare state model was incompatible with globalisation. But the real roots of Sweden's problems appear to have been domestic: once Sweden confronted its domestic fiscal crisis, which included a deficit/gross domestic product (GDP) ratio of 16 per cent in 1993, it experienced an economic recovery. At the end of the 1990s and the beginning of this decade, Sweden addressed pressures on its welfare state by trimming and modifying existing programmes, rather than by making fundamental changes to its universalistic welfare state principles.<sup>21</sup> And it was once again able to pursue many of the social policies that have been its hallmark.

A second element contributing to the persistence of RTB is methodological. It is quite easy to find instances of governments cutting social programmes or lowering taxes, or to find cases in which workers in developing nations are treated poorly. In some instances, especially in the developing world, governments have enacted policy changes in an effort to attract investment or promote export industries. Portraying the plight of a textile worker in Vietnam, or of a firm that has moved from the US to Mexico, and again from Mexico to China, may make for appealing journalism. But such anecdotal evidence may not be representative of broader empirical patterns. There may not be a real connection between alleged causes (economic globalisation) and apparent effects (a lack of labour rights in poor nations). Rather, while globalisation and labour rights may trend in the same direction, the ultimate determinants of workers' rights – or, to take another example, of anti-inflation policies – may well be internal. This second element reveals not only a failing of journalists and policy makers to absorb the findings of academic research, but also of academic researchers to study systematically some of the key – but empirically difficult – questions regarding the effects of economic openness on societies.

### **Varieties of constraints and varieties of capitalists?**

In addition to resisting the temptation to rely on anecdotal evidence, analyses of globalisation's impact on policy making must draw specific causal linkages. Economic globalisation is a multifaceted concept. Some nations have high levels of trade openness, but lower levels of capital market openness; high trade openness may present governments with one set of pressures, while high capital market openness may expose them to a different – and perhaps contradictory – set of

demands. For instance, as Dani Rodrik and others have suggested, increased trade openness may enhance public demands for compensation, while increased reliance on short-term capital flows may reduce governments' capacity to accumulate large debts and run substantial budget deficits.<sup>22</sup>

Similarly, some nations attract mostly long-term investment (FDI), while others are more reliant on shorter-term portfolio flows. This difference – this 'variety of capitalists' – generates different vulnerabilities and opportunities for governments. Along these lines, a recent study demonstrates that different types of capital – commercial bank loans, FDI and portfolio investment – have different effects on governments' preferences over exchange rate regimes.<sup>23</sup> And, even within FDI, there is likely to be variation across sectors (such as between labour-intensive textile production and capital-intensive pharmaceutical industries) in terms of investors' preferences and pressures on national policies.<sup>24</sup>

As Wibbels and Arce have noted, 'the manner in which a nation is plugged in has implications for the constraints domestic policymakers will encounter'.<sup>25</sup> Tying this to the point above about the temptation to rely on anecdotal evidence, when we hear assertions about the impact of globalisation on the nation-state, the questions that we must ask are 'what type of globalisation?', 'what kind of state?' or, more specifically, 'under what conditions does economic openness leave governments with reduced room to move, and under what conditions does state autonomy persist?' Only by specifying how varying dimensions of globalisation matter for government policy choices can we begin to gauge the overall – and often contending – effects of economic openness on policy making. The existing evidence suggests that these overall effects are likely to be diverse, with some sorts of openness associated with a growth in public sector intervention and other types associated with a decline in public sector intervention. Finally, in order to understand fully the linkages between economic globalisation and national governments, we need to connect events in global markets with changes in government policy, and we must consider how various domestic institutions and ideologies mediate these changes. In other words, under what conditions do governments accede to, resist or attempt to insulate themselves from financial market influence?

## Notes

1. For a review of the race to the bottom argument, see Daniel W. Drezner, 'Globalization and Policy Convergence', *International Studies Review*, Vol. 3, No. 1 (2001), pp. 53–78.
2. Peter Hall & David Soskice (eds), *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford University Press, 2001).
3. Isabela Mares, 'The Sources of Business Interest in Social Insurance: Sectoral versus National Differences', *World Politics*, Vol. 55, No. 2 (2003), pp. 229–58; and Salvatore Pitruzzello, 'Trade Globalization, Economic Performance, and Social Protection: Nineteenth-Century British Laissez-Faire and Post-World War II U.S.-Embedded Liberalism', *International Organization*, Vol. 58, No. 4 (2004), pp. 705–44.
4. Dani Rodrik, *Has Globalization Gone Too Far?* (Institute for International Economics, 1997); and Kenneth Scheve & Matthew J. Slaughter, 'Economic Insecurity and the Globalization of Production', *American Journal of Political Science*, Vol. 48, No. 4 (2004), pp. 662–74.
5. For example, Aliciá Adserá & Carles Boix, 'Trade, Democracy and the Size of the Public Sector: The Political Underpinnings of Openness', *International Organization*, Vol. 56, No. 2 (2002), pp. 229–62; and Brian Burgoon, 'Globalization and Welfare Compensation: Disentangling the Ties that Bind', *International Organization*, Vol. 55, No. 3 (2001), pp. 509–51.

6. Evelyne Huber & John D. Stephens, *Development and Crisis of the Welfare State: Parties and Policies in Global Markets* (University of Chicago Press, 2001). Allan and Scruggs use different measurements of welfare state output, leading to different conclusions: see James P. Allan & Lyle Scruggs, 'Political Partisanship and Welfare State Reform in Advanced Industrial Societies', *American Journal of Political Science*, Vol. 48, No. 3 (2004), pp. 493–512.
7. For example, Jude Hays, 'Globalization and Capital Taxation in Consensus and Majoritarian Democracies', *World Politics*, Vol. 56, No. 1 (2003), pp. 79–113.
8. Dani Rodrik, 'Why Do More Open Economies Have Bigger Governments?', *Journal of Political Economy*, Vol. 106, No. 5 (1998), pp. 997–1033.
9. Adserá & Boix, 'Trade, Democracy and the Size of the Public Sector'.
10. Marcus J. Kurtz, 'Understanding the Third World Welfare State after Neoliberalism: The Politics of Social Provision in Chile and Mexico', *Comparative Politics*, Vol. 34, No. 3 (2002), pp. 293–313.
11. Sarah Brooks, 'Social Protection and Economic Integration: The Politics of Pension Reform in an Era of Capital Mobility', *Comparative Political Studies*, Vol. 35, No. 5 (2002), pp. 491–525.
12. Eric Wibbels & Moisés Arce, 'Globalization, Taxation and Burden-Shifting in Latin America', *International Organization*, Vol. 57, No. 1 (2003), pp. 111–36. Rudra offers a more pessimistic analysis of the capacity of workers in the developing world to prevent reductions in social welfare policies: see Nita Rudra, 'Globalization and the Decline of the Welfare State in Less Developed Countries', *International Organization*, Vol. 56, No. 2 (2002), pp. 411–45.
13. For instance, Robert Kaufman & Alex Segura-Ubiergo, 'Globalization, Domestic Politics, and Welfare Spending in Latin America: A Time-Series Cross-Section Analysis, 1973–1997', *World Politics*, Vol. 53, No. 4 (2001), pp. 551–85.
14. Albert O. Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States* (MIT Press, 1970).
15. Burgoon, 'Globalization and Welfare Compensation'.
16. Layna Mosley, *Global Capital and National Governments* (Cambridge University Press, 2003).
17. Empirical support for these arguments comes from interviews and surveys of professional investors, as well as quantitative analyses.
18. Pitruzzello, 'Trade Globalization', discusses the historical roots of this debate.
19. See, for instance, James R. Vreeland, *The IMF and Economic Growth* (Cambridge University Press, 2003).
20. Mark Blyth, *Great Transformations: Economic Ideas and Political Change in the Twentieth Century* (Cambridge University Press, 2002).
21. Mosley, *Global Capital and National Governments*.
22. Rodrik, *Has Globalization Gone Too Far?*
23. George Shambaugh, 'The Power of Money: Global Capital and Policy Choices in Developing Countries', *American Journal of Political Science*, Vol. 48, No. 2 (2004), pp. 281–95.
24. See Layna Mosley & Saika Uno, 'Racing to the Bottom or Climbing to the Top? Economic Globalization and Collective Labor Rights', unpublished manuscript, University of North Carolina, 2005.
25. Wibbels & Arce, 'Globalization, Taxation and Burden Shifting', p. 130.