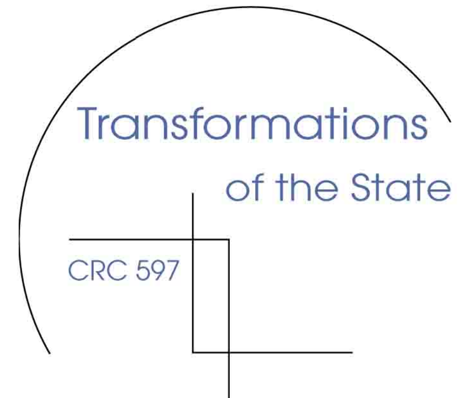

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Globalisation and the Welfare State: A Retrospective

Philipp Genschel

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Globalisation and the Welfare State: A Retrospective[*]

ABSTRACT

There are basically three stories about the globalisation-welfare state nexus. The first story argues that globalisation is the cause of the chronic crisis of the welfare state. As national economies open to the international market, governments are forced to adapt to the imperatives of global competition, and this means cutting cost-intensive welfare programs (globalisation theory). The second story argues that whatever the cause of the welfare state crisis, globalisation is not part of it. There is neither theoretical reason nor empirical evidence to believe that national policy autonomy has decreased due to increasing economic interdependencies (globalisation sceptics). The third story holds that globalisation, far from causing the welfare state's troubles, is a consequence of these troubles, and part of their solution (revisionism). The paper reviews each of these stories, and counterposes them to simple descriptive statistics on OECD countries.
(140 words)

Keywords: globalisation, macroeconomic policy, social policy, taxation, unemployment, welfare state.

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Globalisation and the Welfare State: A Retrospective

1. THE WORRIES OF THE NINETIES

Globalisation was the Western European crisis of the nineties. The red menace had disappeared with the implosion of the Soviet empire and public attention turned to the dangers connected with the final triumph of capitalism. The increasing internationalisation of the economy was seized on as a particular cause for concern. It appeared to endanger the balance of power between economy and polity. The state is, after all, a ‘local hero’. Wouldn’t its ability to control the market decline as the market expanded beyond its territorial boundaries? Of course, the government could continue its economic interventions: it could levy taxes as before, redistribute income, and regulate products and production processes. 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 spectre that haunted the decade. For only one thing is worse than being exploited by capital, and that is not being exploited by it.

The globalisation of markets seemed to leave governments with no choice but to pursue neo-liberal policies. “Good government” became synonymous with “market-friendly government” (Garrett 1998b: 2). Competitive party democracy stagnated 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 force wage restraint and discipline on (immobile) labour. The welfare state looked doomed. It appeared that only a “residual state” (Cerny 1995: 618) would survive, with no power to counter the “the economic horror” (Forrester 1999) of the global market.

The recession of the early nineties seemed to confirm all these fears. How much better it had been in the sixties and early seventies! “National economic boundaries were still effectively controlled” (Scharpf 2000: 24). Markets were limited nationally and could therefore be effectively influenced by domestic policy instruments. “State capacities” corresponded to “public demands and expectations” (Zürn 1998: 62)! In retrospect this was the golden age of the welfare state.

Of course, contemporary observers had not viewed these years as quite so golden. On the left there had been much hand wringing about supposed “contradictions of the modern welfare state” (Offe 1984: 147) and “crisis tendencies in advanced capitalism” (Habermas 1976: 33). Authors on the right bemoaned “anomic democracy” and “the overloading of government” (Crozier *et al.* 1975: 158,163). Although the ideological and terminological differences were substantial, the diagnosis was quite similar: a fatal gulf was opening up between social demands and the capacity of governments to meet

them. The “intervention and steering capacities of the state apparatus are in principle too limited to be able to process effectively the burden of … expectations” placed on the state by society (Offe 1984: 67).

According to this view, it was not the global market, by placing external limits on the welfare state’s ability to act, that was to blame for the discrepancy between social demands and welfare state performance; the welfare state itself was the problem. It systematically encouraged attitudes and expectations that it was not in a position to satisfy. The institutional guarantee that social needs would be taken care of worked as an incentive for people to invent new needs. The promise of insurance against macroeconomic shocks and individual life risks encouraged “civic irresponsibility” and moral hazard (Crozier *et al.* 1975: 16). “The agencies of the welfare state therefore produce, through paradoxical and latent functions, the very problems they are manifestly concerned with removing” (Offe 1984: 75). This could not but end in fiscal calamity (O'Connor 1973) and a “legitimation crisis” (Habermas 1976).

In contrast to the issue of globalisation, the idea of a systemic crisis of the welfare state never captured the imagination of the broader public (Kaase and Newton 1995: 72). In the early seventies there simply was no evidence of such a crisis. The economy was growing, unemployment was low and the generosity of the welfare system was increasing without obvious repercussions for state finances. In fact, the main problem, according to public perception, was not that the welfare state was expanding too quickly, but that it was not expanding quickly enough. Hopes for the future were running high and made existing social arrangements look dated. The welfare state was believed to be the agency to modernize them. People were impatient that it should do so more rapidly.

Even when serious difficulties loomed in the wake of the first oil price shock in the mid-seventies, this did not undermine public support for the welfare state (Kaase and Newton 1995: 69). The cause of the problems was perceived not as internal, but as emanating from the international environment. The search for sources of danger was directed outwards and this prepared the ground for the vision of globalisation-induced welfare state mayhem that dominated public perception during the nineties.

2. THREE TAKES ON GLOBALISATION

Of course, globalisation was an issue not only in public discourse, but also for political science. Since the early nineties, political scientists have been engaged in intense debate over the implications of economic globalisation for the welfare state. Their contributions can roughly be sorted into three schools. The first school to emerge, the *globalist*, school, maintains that the internationalisation of the economy indeed means “a fundamental transformation of the capitalist economy” (Scharpf 1994: 161)

that threatens the welfare state. According to this school, the welfare state steps in where the market fails, but can do so only if it is not exposed to market forces itself. Globalisation, however, subjects the welfare state to the market pressures of international competition and thus inevitably undermines its viability and effectiveness. The predicted result is a rollback of the welfare state and an international convergence around minimalist "competition state" structures (Cerny 1995: 620).

As a rationalization of diffuse public fears, the globalist school was extremely popular, especially during the early years of the debate. However, in the mid-nineties, it began to attract criticism from a second school, the globalisation *sceptics*. The members of this school deny that globalisation has any significant impact on the welfare state. They see neither theoretical reason nor empirical evidence to believe that an increase in international economic interdependence restricts national policy autonomy: the welfare state has not shrunk in size, cross-national differences survive, and "there remains a leftist alternative to free market capitalism in the era of global markets based on classic 'big government' and corporatist principles" (Garrett 1998b: 4). The public's fears, so the sceptics argue, are ill-founded and overblown.

The sceptic position, however, raises the question of why the welfare state has been under constant siege for the past twenty years. If globalisation is not to blame, then what is? Since the late nineties, an increasingly vocal *revisionist* school has claimed that the troubles of the welfare state are largely self-inflicted. Globalisation, far from causing these troubles, is one of their consequences and part of their solution. The disciplinary power of international markets helps governments to check the vicious dynamics of welfare policy and thus contributes towards saving the welfare state from itself. The "ostensible 'terror of economics' poses no problem whatsoever", but rather points "to the way out of a self-made cul-de-sac" (Rieger and Leibfried 2003: 29).

With the revisionist position, the globalisation debate has come full-circle. It goes back, even if largely unconsciously so, to the arguments of the crisis theories of the seventies. This paper takes stock of the insights that the globalisation debate has generated underway. It reviews the main arguments of the three schools and confronts them with simple descriptive statistics on 18 OECD countries.[1] The following section clarifies the key concepts: what do the participants in the debate mean when they refer to 'globalisation' or the 'welfare state' (section 3)? The next two sections discuss what the three schools have had to say about globalisation's impact on the two major fields of welfare state activity, namely macroeconomic control (section 4) and redistributive

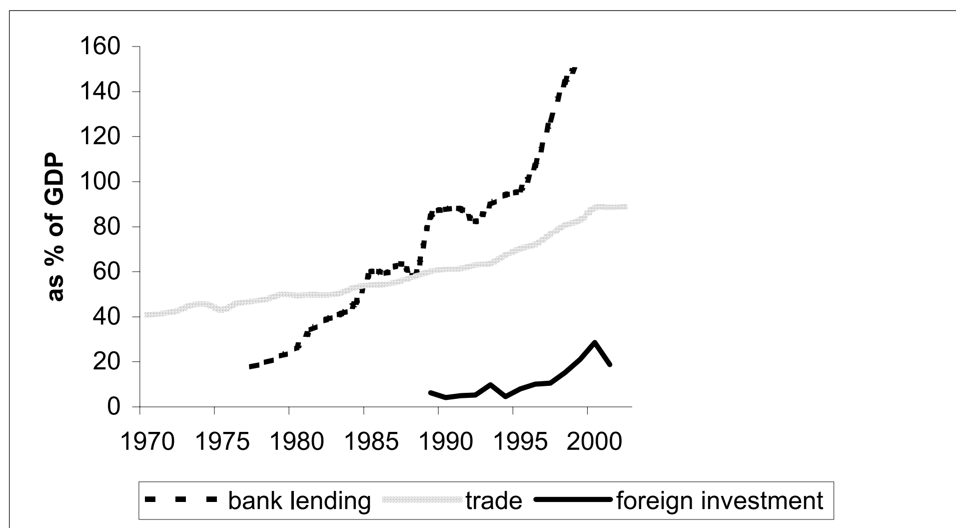
[1] Austria, Australia, Belgium, Canada, Denmark, France, Germany, Ireland, Italy, Japan, Netherlands, New Zealand, Sweden, Switzerland, United Kingdom, United States. Due to problems of data availability, not all 18 countries are included in all figures.

social policy (section 5). The final section summarizes the results of the globalisation debate (section 6).

3. CONCEPTS AND DEFINITIONS

It is important to note that the disagreements between the three globalisation schools are not purely definitional. The understanding of the two key terms – globalisation and welfare state – is almost uniform. There is agreement that ‘globalisation’ refers to the international integration of markets for goods, services and capital. There is also agreement that this integration is in fact taking place. To be sure, the globalists perceive the advances of globalisation as more dramatic and consequential (see e.g. Held *et al.* 1999) than the sceptics (e.g. Hirst and Thompson 1999). But even the sceptics do not deny that the volume of cross-border transactions has increased dramatically over the past decades. As Figure 1 demonstrates, international trade has more than doubled since the seventies in OECD countries. International bank lending has grown more than eightfold, and the volume of foreign direct and portfolio investment has quadrupled during the past decade alone (Figure 1).

***Figure 1**: International bank lending, international trade, and foreign investment in 14 OECD countries, 1970-2002.*



Notes: Data are unweighted averages from OECD Economic Outlook, OECD Main Economic Indicators, and BIS Quarterly Review. Foreign investment refers to inflows and outflows of foreign direct and portfolio investments. Trade is imports plus exports. Bank lending refers to the foreign assets and liabilities held by banks. Countries included are Austria, Belgium, Canada, Denmark, France, Germany, Ireland, Italy, Japan, Netherlands, Sweden, Switzerland, UK, and US.

The sceptics note, however, and many globalists concede, that the current state of economic integration is not without precedent. In the period up to the First World War,

international trade grew at similar rates and reached comparable levels to today's, while net capital movements were considerably higher (see Hirst and Thompson 1999: 19-61). The real difference between then and now is not globalisation but the welfare state (Rieger and Leibfried 2001: 19). Unlike its predecessor, the liberal, nightwatchman state of the early twentieth century, the welfare state of the century's end is deeply involved in the management of the economy. This involvement dates from the post Second World War period when governments all over Western Europe, North America and the Antipodes declared themselves ready, and were increasingly expected by the electorate

- to systematically control economic developments at the macro-level (macroeconomic control), and
- to guarantee, unconditionally, adequate living standards at the micro-level (redistributive social policy).

Macroeconomic control is usually associated with an active 'Keynesian' policy that ensures continuous growth and full employment through 'countercyclical' monetary and fiscal policy. Redistributive social policy implies the public provision of social insurance against individual risks such as poverty, sickness, and unemployment plus the redistribution of income and wealth from those doing well in the market to those at risk of falling by the economic wayside.

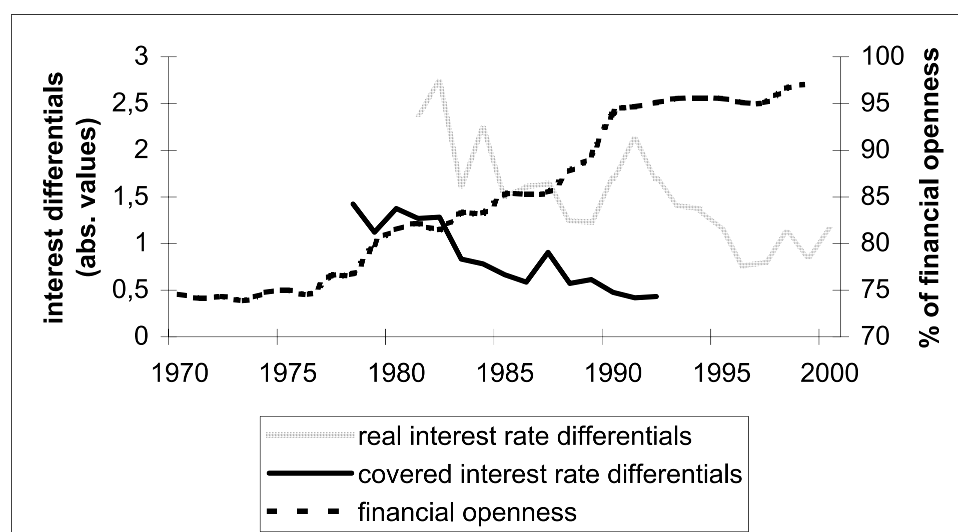
Being more involved in the management of the economy, the welfare state is also more likely to be affected by the economy's globalisation. The matter in contention among globalists, sceptics, and revisionists is whether this is for the better or the worse. Does globalisation undermine national macroeconomic control (section 4)? Does it pull the fiscal rug out from under redistributive social policy (section 5)? In short: Does it spell the end for the Keynesian welfare state as we know it?

4. GLOBALISATION AND MACROECONOMIC CONTROL

Globalists believe that globalisation undermines macroeconomic control. They see two reasons for this. The first is that the internationalisation of capital robs monetary policy of "its sovereignty over interest rates" (Scharpf 1991: 245). Interest rates are a central tool of macroeconomic policy. According to John Maynard 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" (Keynes cited in Helleiner 1994: 34). Capital control is a corollary to this. Governments can stabilize international interest rate differentials only if they are able to regulate cross-border capital flows. Globalisation, by lowering capital controls, undermines this ability. As a consequence, variations in national monetary policy no longer affect national interest rates, but only cross-border capital movements: loose money leads to

outflows, tight money to inflows. The interest rate ceases to be a strategic variable of national policy and turns into a global given. The evidence, of course, is less straight forward than the argument. Still Figure 2, by and large, confirms that cross-country interest rate differentials have declined as governments have loosened their capital controls. To be sure, there is still no perfect interest parity, but the room for national deviations has declined.

***Figure 2**: Financial openness and cross-country interest rate convergence in 14 OECD countries, 1970-2001.*



Notes: Data are unweighted averages. Real interest rate differentials refer to the standard deviation between national real long-term interest rates, OECD *Main Economic Indicators*. Covered interest rate differentials measure the international divergence between short-term interest rates, controlling for exchange rate risk (Shepherd 1994: 265-271). International financial openness is based on an index developed by Dennis Quinn (Quinn 1997) measuring the stringency of capital and current account restrictions. 100 % openness means no restrictions on cross-border transactions; 0 % means maximum restrictions. Countries included are Australia, Austria, Belgium, Canada, Denmark, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, UK and US.

The second reason why globalisation weakens macroeconomic control, according to globalist thinking, is the detrimental impact of capital mobility on fiscal policy autonomy. Capital mobility reduces the freedom to pursue an active fiscal policy in three ways:

- Capital mobility, by vitiating national sovereignty over the interest rate, forces governments to pay the going world rate to finance their fiscal deficits. If the going rate is high, as it was during the early eighties, this may well mean that an expansionary fiscal policy (*deficit-spending*) is prohibitively costly (Scharpf 1991: 245).

- Capital mobility increases the bargaining power of capital owners. Capital owners are often wary of public borrowing because they see in it a harbinger of increased inflation. As long as they are effectively locked up in national markets, there is little that they can do to sanction excessive public borrowing. However, as capital controls come down and cross-border capital mobility increases, the sanctioning potential of capital owners grows. They no longer have to buy the national debt. If the national government appears to be fiscally reckless, capital owners can switch to the debt of other countries. This may force governments with large deficits to pay extra risk premia over and above the global rate in order to sell their debt (Moses 1994: 139).
- Finally, to the extent that public debt attracts foreign capital in a world of unrestricted capital mobility, it may put upward pressure on the exchange rate. This in turn may have negative effects on export demand in the tradable goods sector, undermining the stimulating effects of a deficit-financed fiscal expansion (Moses 1994: 139).

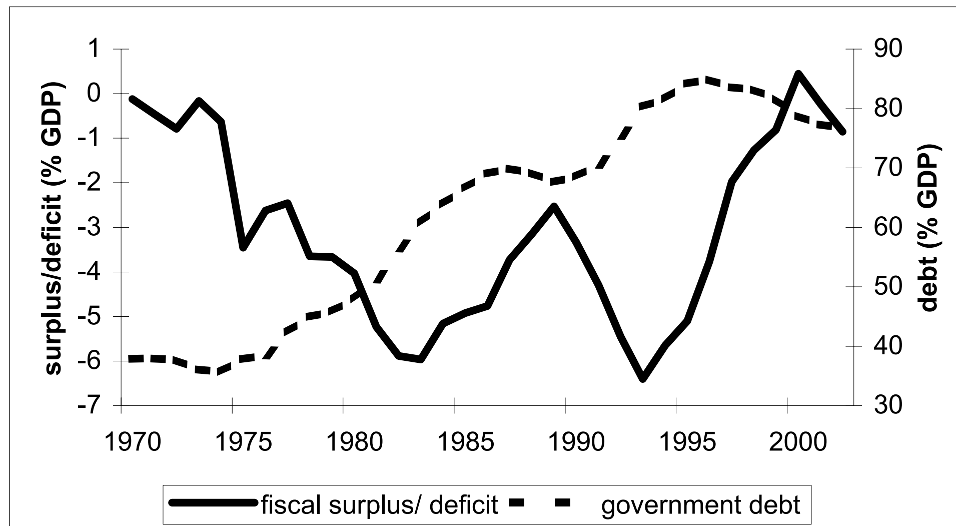
In all three ways, globalisation makes a counter-cyclical fiscal policy more costly and less effective.

Many globalists consider France’s economic policy about-turn in the early eighties a textbook example of how globalisation undermines national macroeconomic control. Assuming office with a Keynesian expansionary strategy in 1981, the new socialist government was “forced by the realities of the international capital market to capitulate by the summer of 1982” (Scharpf 1991: 245). Unable to defend national reflation against a restrictive international trend, it had to switch to a policy of tight money and austerity budgets. Apparently, even recalcitrant socialists are unable to resist global market forces.

The sceptics refuse to believe all this. They argue that, contrary to globalist assumptions, the internationalisation of capital makes deficit spending cheaper rather than more costly, because it gives governments access to a much larger pool of capital. The state can run larger deficits with less risk of driving up interest rates and crowding out private investment. Also, internationalisation intensifies the competition among capital owners, thus pushing down credit rates and risk premia. This explains why even small and relatively vulnerable countries like Belgium and Ireland were able to incur massive debts during the eighties without being penalized by the markets (Garrett 1998b: 43). It may also explain the general trend towards large fiscal deficits depicted in Figure 3. Since the seventies, governments across the OECD have habitually run deficits, even in the absence of transitory cyclical downturns. The public debt burden more than doubled between the mid-seventies and mid-nineties from, on average, less

than 40 percent of GDP to more than 80 percent. There were signs of improvement during the late nineties, when many OECD countries managed to balance their budgets for the first time since the early seventies. In recent years, however, deficits have come back with a vengeance.

***Figure 3**: Fiscal policy in 11 OECD countries, 1970-2002.*



Notes: Data are unweighted averages from OECD *Economic Outlook*. Countries included are Austria, Belgium, Canada, Germany, France, United Kingdom, Italy, Japan, Netherlands, Sweden and United States.

Globalisation sceptics also doubt that the globalisation of capital necessarily undermines monetary policy autonomy. They concede that it loosens national control over the interest rate but deny that this makes monetary policy ineffective. National monetary policy can still affect the domestic economy, they argue, it just works through the exchange rate rather than the interest rate (Oatley 1999). An increase in the money supply, instead of lowering the interest rate triggers an outflow of capital. This, in turn, puts pressure on the exchange rate and leads to a devaluation of the national currency. This depreciation then fuels exports, slows imports, and thus increases aggregate demand in the domestic market.

There is only one case in which the sceptics see reason to assume that market integration undermines national macroeconomic control: the case of monetary policy in a context of open borders *and* fixed exchange rates (Garrett 1998b: 41). As the Mundell-Fleming model – the standard model of the open economy – suggests, the three policy goals of monetary policy autonomy, international capital mobility, and stable exchange rates cannot be had simultaneously. Governments cannot have monetary policy autonomy in the presence of free capital movements and stable exchange rates. However, governments can liberalize capital controls *and* retain monetary policy autonomy, as long as they are willing to give up stable exchange rates.

By this reading, the real problem of the French socialists was that they were not prepared to make this sacrifice. They could have continued with their Keynesian strategy if they had left the European monetary system (Hall 1990: 177). Their decision, in the end, to stay in the European monetary system and give up on Keynesianism can hardly be blamed on globalisation.

In the eyes of the sceptics, globalists are wrong "to believe that governments must pursue fixed exchange rates when capital mobility is high" (Garrett 1998b: 42). Indeed, many globalists subscribe to this belief (see e.g. Moses 1994: 133; Scharpf 1991: 248; Webb 1991: 318), and while it may appear unfounded in light of the Mundell-Fleming model, it clearly reflects a pervasive empirical trend in Europe. Since the eighties, practically all European governments have pursued a policy of simultaneous capital liberalisation and exchange rate fixing. The Single Market and Monetary Union are the most visible examples of this. Why did governments pursue this policy? Were they ignorant of the Mundell-Fleming model?

The revisionists maintain that governments knew exactly what they were doing; they pursued capital liberalisation and exchange rate stability in parallel precisely because they wanted to restrict their own freedom to pursue Keynesian macroeconomic policies. In a sense, their loss of national autonomy was their own autonomous choice (Notermans 1993). The revisionist argument rests on the assumption that Keynesian macroeconomic policies are ultimately self-defeating. Fiscal or monetary expansions can stimulate economic activity only if they come as a surprise. If market participants expect an expansion, they will raise prices and wages in anticipation and thus weaken the stimulus. The problem is that a Keynesian government can hardly prevent such anticipatory reactions because everyone knows of its commitment to an active macroeconomic policy. Governmental attempts to surprise the market are thus expected. While the government may, for some time, try to outdo public expectations by printing and spending even more money, the price in terms of inflation and budget deficits eventually becomes unbearable and forces the government to give up the Keynesian policy posture that caused the pathology of expectations in the first place (Offe 1984: 200-201).

The revisionists believe that this dilemma lies at the root of the French policy about-turn in the early eighties. The Socialist government realized that the perverse side-effects of its Keynesian strategy 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 interventionism. In order to escape this trap, the government voluntarily surrendered the monetary policy autonomy that is the precondition for the Keynesian strategy (Levy 2000: 323-324). Thus it remained in the European monetary system and shortly afterwards agreed to liberalize French capital controls. In short,

Keynesianism in France was not brought down by the impossibility of isolating the French economy from a restrictive world, but by the government's inability to stabilize the economy in the absence of the constraints of a restrictive world (see Notermans 1993: 152).

Revisionists are convinced that this argument also explains the policy choices of other soft currency countries such as Italy, Sweden or Norway. They maintain that these countries also pegged their currencies to the European monetary system and abandoned their capital controls in order to import from without the monetary discipline that they were unable to generate from within (Ferrera and Gualmini 2000; Notermans 1993). However, this argument cannot explain the behaviour of Germany and other hard currency countries such as Belgium, Denmark or the Netherlands. Germany had no trouble controlling domestic inflationary tendencies. It did not need the 'nominal anchor' of the European monetary system; rather, it provided the nominal anchor for that system. Why did it do so? What was the German interest in European monetary integration?

A second revisionist argument answers this question by emphasizing the real – as opposed to the monetary – effects of economic openness and exchange rate stability (Frieden 2002). The base assumption is that governments treat trade liberalisation, capital deregulation, and monetary integration as macroeconomic policy tools in their own right. Like Keynesian monetary and fiscal policy, these measures spur growth and employment, but at a lower cost in terms of inflation and public debt. Therefore, as disillusionment with Keynesianism spread during the late seventies and early eighties, governments increasingly turned to these policy tools, as is evidenced most dramatically by the EU's drive towards the single market and monetary union.

While it is common economic wisdom that trade and capital openness facilitate economic integration and spur efficiency and growth, the same is not true for fixed exchange rates. Most globalisation sceptics, in line with the economic mainstream, deny that fixed exchange rates have any major effect on economic integration. They believe that capital market integration (capital mobility) and exchange rate stability are independent policy variables, as the Mundell-Fleming model suggests. Some concede that both variables may be interrelated, but suggest that the relationship is negative rather than positive. Observing that the most disruptive currency crises of recent years, such as the Argentina crisis, concerned commitments to fixed exchange rates rather than floating ones, they conclude that rigid exchange rate arrangements lead to lower rather than higher capital mobility and economic integration (Garrett 1998b: 43). The revisionists, in contrast, believe that fixed exchange rates are needed to reach high levels of integration. In the absence of stable exchange relations, integration remains low because currency volatility makes otherwise profitable cross-border transactions

excessively risky. Exchange rate stability, by reducing the currency risk, increases integration (Frieden 2002: 839). Therefore, contrary to the Mundell-Fleming model, high capital mobility cannot be had in the absence of stable exchange rate arrangements.

5. GLOBALISATION AND REDISTRIBUTIVE SOCIAL POLICY

The less control the welfare state has over market developments *ex ante* at the macro-level, the more important becomes its ability to correct market outcomes *ex post* at the micro-level. The globalists fear that globalisation undermines this ability. The integration of markets makes it easier to move human, real, and financial capital across national borders and, consequently, more difficult to subject them to national taxation. Capital owners can avoid high taxes by shifting their assets to low-tax countries: *exit* becomes a viable option and a credible implicit threat. Governments can no longer adjust the 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. This lures governments into a competition for lower tax rates and pushes the effective burden on capital down to ever lower levels (Dehejia and Genschel 1999: 403).

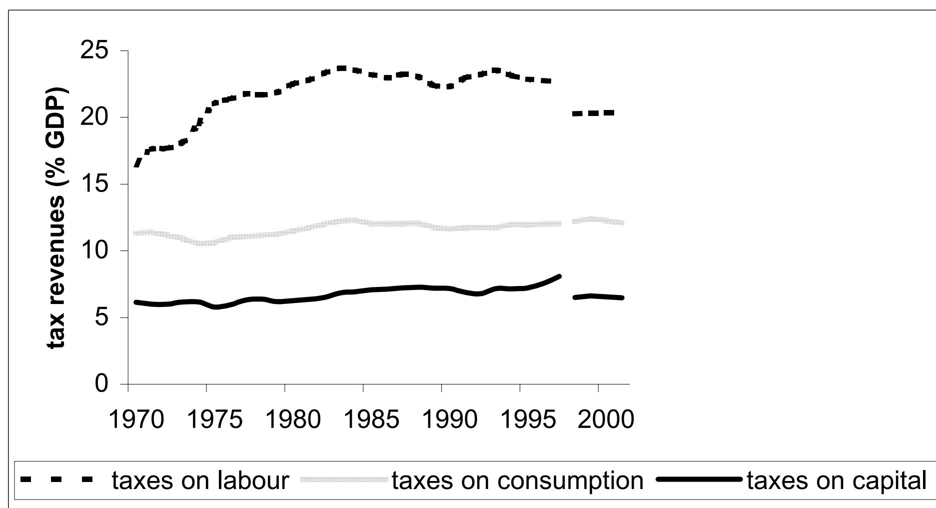
The tax competition for mobile capital has two consequences for the welfare state. First, the revenue basis shrinks. Since governments can no longer turn a fiscal profit on capital, they find it increasingly difficult to fund a given level of social policy spending. Second, the ability to use the tax system itself as a redistributive instrument also declines. Since the rich usually have more capital income than the poor, tax progressivity almost inevitably declines when tax competition reduces the tax burden on capital. Redistribution is then effectively limited to transfers between immobile factors; that is, between high and low labour income. At best this means “socialism in one class” (Scharpf 1991: 269), and at worst the complete “erosion of the welfare state” (CEPR 1993: 94). The different ‘worlds of welfare’ converge around a highly problematic model of minimal redistribution and social protection (convergence thesis[2]).

The sceptics consider the convergence thesis exaggerated. Capital taxation has never played a large role in funding the welfare state. The main burden has always been borne by labour. As Figure 4 shows, over the past thirty years taxes on capital – physical capital, intangibles, financial investments, savings, profits – have raised revenues only in the order of magnitude of 5 to 7 percent of GDP in EU member states. By contrast, taxes on labour income – wages – have raised revenues of up to 23 percent of GDP. Therefore, even if revenues from capital taxation should decrease as a consequence of

[2] In the literature, the convergence thesis also goes under the slightly misleading name of ‘efficiency thesis’ (e.g. /Garrett and Mitchell 2001).

globalisation, the impact on the fiscal viability of the welfare state would remain modest (Rhodes 2001: 96). What is more, there is no evidence of such a decline. On the contrary, as Figure 4 also shows, while revenues from labour taxation have decreased slightly, revenues from capital taxation have increased slightly since the mid-eighties. Econometric studies even suggest that the relationship between economic openness and capital taxation may be positive rather than negative: countries that are strongly integrated in the international economy systematically tax capital higher than less strongly integrated countries (Quinn 1997; Swank 2002: 255). The sceptics conclude that even in a global economy, the welfare state retains considerable taxing power. Governments "wishing to expand the public economy for political reasons may do so (including increasing taxes on capital to pay for new spending)" (Garrett 1998a: 823).

Figure 4: *Tax revenues according to macroeconomic tax base in 9 EU member states, 1970-2002.*

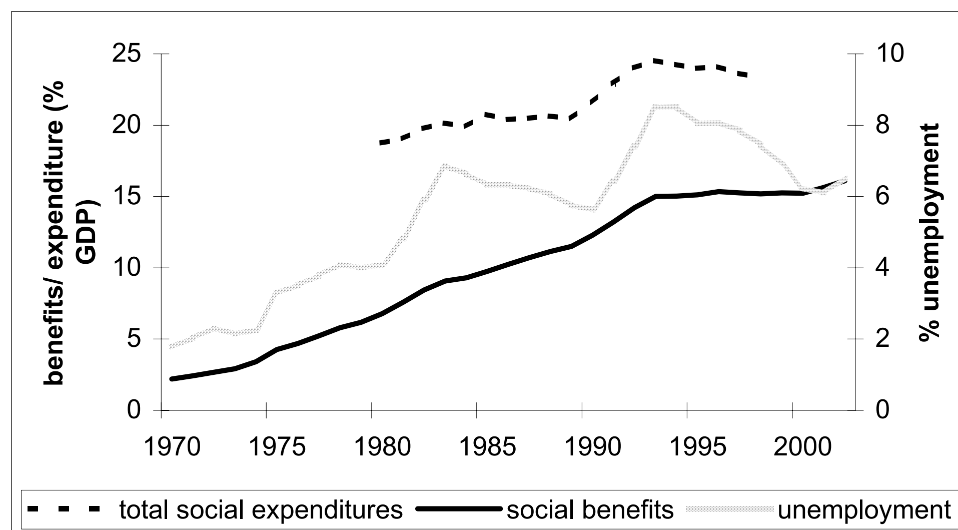


Notes: Data are unweighted averages from Eurostat *Structures of the Taxation Systems in the European Union* 2001 and 2003. Countries included are Belgium, Denmark, Germany, France, Ireland, Italy, Luxembourg, Netherlands and United Kingdom. ***Note***: Data for periods 1970-1997 and 1998-2002 are based on different national account systems (ESA 79 and ESA 95) and not fully comparable.

The globalists remain unconvinced. They concede that there has not yet been a tax meltdown. They argue, however, that this is not because tax competition is powerless, but because during much of the eighties and nineties the pressure it exerted on total tax levels and capital tax revenues was checked by two countervailing pressures: mass unemployment and high social spending. As Figure 5 shows, unemployment rose from below 2 percent on average in OECD countries in 1970 to more than 8 percent in the mid-nineties, while the social benefits paid by governments grew from only 2 percent of GDP to more than 15 percent, pushing up total social expenditures to close to 25 percent of GDP. The rise in mass unemployment pressured governments to reduce non-

wage labour costs, and thus prevented a shift of the tax burden from capital to labour. The escalation of spending requirements in social policy forced governments to defend high levels of revenue, and thus stood in the way of a downward adjustment of the total tax burden (Ganghof 2000: 638; Genschel 2002: 246; Swank and Steinmo 2002: 646). Caught between these opposing pressures, most European welfare states suffered from a sense of permanent fiscal failure. Fundamental reform seemed urgent but elusive. The pace of reform was high, but tended to shift problems from one end of the tax system to another rather than solve them.

***Figure 5**: Unemployment, social benefits paid by the government and total social expenditure of the government in 13 OECD countries, 1970-2002.*



Notes: Data are unweighted averages from OECD *Economic outlook*. Countries included are Australia, Austria, Belgium, Germany, Finland, France, Italy, Japan, Netherlands, Norway, New Zealand, Sweden, and US.

Some observers argue that the rises in mass unemployment and social spending are themselves a part of the globalisation syndrome. High levels of spending follow from high levels of unemployment and income inequality, and these, in turn, follow from high levels of market integration. Three causal mechanisms are invoked:

- First, market integration increases labour market volatility. It allows business firms and final consumers to substitute foreign labour for domestic labour. If the price of domestic labour is too high, they invest abroad and/or buy imported goods from abroad. As a consequence, changes in prevailing wages – at home as well as abroad – lead to greater swings in the demand for domestic labour. The stability of employment relations decreases (Rodrik 1997: 19).
- Secondly, increased competition from low-wage countries in Eastern Europe and the Third World, but also from other advanced industrial countries, encourages labour-saving technological change in the tradable goods sector. Export

industries and import competing firms are continuously forced to improve their productivity or else go out of business. As a consequence, the demand for low-skill production workers goes down. Industrial employment decreases even in successful export nations like Germany. The centre of gravity in the labour market moves to the service sector (Scharpf 2000: 72).

- Thirdly, increased competition in the international capital market homogenizes the rate of return across countries and sectors. Investments in service industries have to earn the same return on capital as the most profitable alternative investment at home or abroad. Given the low potential of many services for productivity improvements (retailing, personal an domestic services, tourism, restaurant work), this benchmark can often be met only at the price of low wages. The result is either increased wage dispersion, as in Britain or the US where more people are forced to take up 'working poor' jobs in the service sector, or more unemployment, as in Germany and France where solidaristic union wages and government minimum-wage legislation keep the reservation wage of job seekers artificially high (Scharpf 2000: 73).

The short of these arguments is that globalisation increases the demands on the welfare state: more economic integration means more external risk, which in turn means a larger number of market losers who need to be compensated through redistributive social policy (compensation thesis).

The compensation thesis and the globalist convergence thesis are often considered competitors: one predicts an increase of welfare state size as a consequence of globalisation, the other a decrease. Much empirical research has gone into testing and evaluating these competing claims (see e.g. Rodrik 1997; Rodrik 1998; Bernauer 2000; Garrett and Mitchell 2001; Swank 2002). The results, so far, are inconclusive, but this may be no accident, because the two theses are potentially much more complementary than the empirical testing exercise allows for. To be sure, they invoke causal mechanisms that affect welfare effort in opposite directions. But that does not mean that these mechanisms cannot be triggered at the same time. In fact, it appears most likely that a globalisation induced increase in the permeability of national borders will give rise simultaneously to more tax competition and greater demands for social compensation for external economic risk. The net effect of both mechanisms is indeterminate because their individual effects tend to cancel out. As a consequence, there is little change in the aggregate indicators of welfare effort. It does not follow, however, that globalisation leaves the welfare state unaffected. To the contrary, globalisation puts the welfare state in a squeeze between higher demands and lower means that, ultimately, it may not be strong enough to resist. In conclusion, therefore,

the compensation thesis is much closer to the globalist view of globalisation induced welfare state stress than even the proponents of this thesis often care to admit.

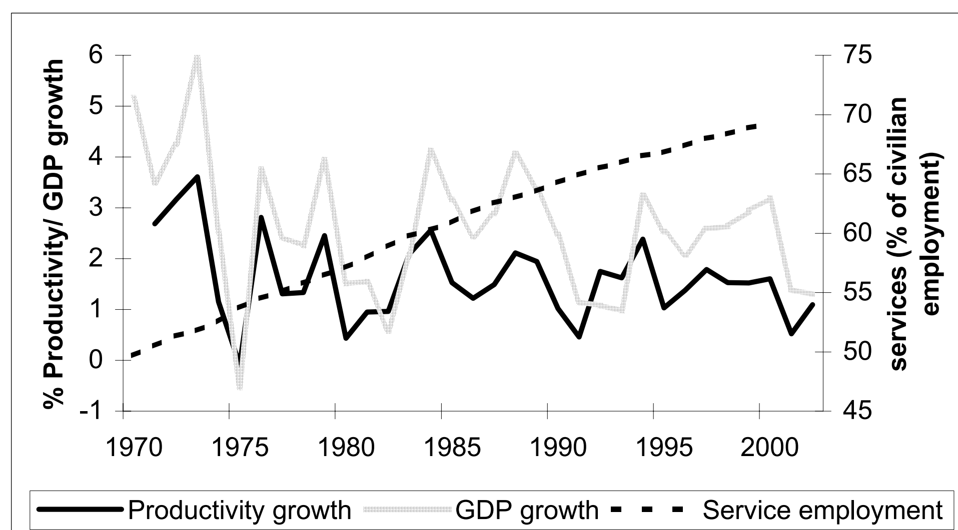
The sceptics, at least, distrust the compensation thesis as much as they distrust the convergence thesis. They doubt that globalisation increases external risk. Of course, international trade concentrates risks to the extent that it leads to specialization. However, it also diversifies risks to the extent that it occurs across several national markets. Which effect will dominate, the (risk intensifying) industrial concentration or the (risk lowering) diversification of markets, is impossible to determine theoretically (Manow 1999: 206). There is empirical evidence to suggest that more integrated countries do not suffer greater economic fluctuations than less integrated countries. According to some measures, fluctuations may even decrease with increased integration (Manow and Plümper 1999: 592; Iversen and Cusack 2000: 320).

The sceptics also deny that the decline of the (exposed) manufacturing sector and the rise of the (sheltered) service sector have much to do with globalisation. In their view, domestic factors have been more important, especially the widening gap between a high rate of productivity improvements in industrial manufacturing and an increasingly saturated demand for manufactured goods. Technological innovation and changing consumption patterns rather than international market integration drive the transformation process (Iversen and Wren 1998). The reason why so many people mistakenly attribute authorship to globalisation is just globalisation’s high visibility. Increases in cross-border economic activity are easier to observe than obscure changes in technology and social consumption. This lends prima facie plausibility to the globalist claim that the correlation in timing between economic liberalisation and the mounting problems of the welfare state reveals causation. However, the correlation is spurious – say the sceptics. In their view, the central culprit is the secular decline in productivity growth caused by the “massive shift in employment from relatively dynamic manufacturing activities to generally less dynamic service provision” (Pierson 1998: 540). Low productivity growth translates into slow GDP growth, and this, in turn, leads “to increases in unemployment or declines in wages, [and] to fiscal stringency as revenue (or at least revenue growth) declines and some unemployment-related expenditures actually grow” (McKeown 1999: 33).

The empirical evidence is ambiguous. Figure 6 shows on the one hand, that the increase in service employment has indeed paralleled a general decrease in productivity and GDP growth. While service employment has grown in OECD countries from on average 53 percent of the civilian labour force during the seventies to almost 67 percent of the civilian labour force during the nineties, the average annual productivity growth rate has dropped from 2 percent (seventies) to 1.4 percent (nineties), and the average annual GDP growth has fallen from 3.3 percent (seventies) to 2.2 percent (nineties). On

the other hand, the curves for productivity and GDP growth exhibit large swings around the downward trend. It is, therefore, unclear whether this downward trend really is a downward trend. Also, the correlation between service employment and productivity growth/GDP growth is weak (-0.25/ -0.27 respectively). Therefore, even if a general slowdown of productivity and GDP growth should be responsible for the troubles of the welfare state, it is unclear whether this slowdown can be blamed on service sector growth alone. The service sector is a broad one. It includes sophisticated services in accounting, finance, logistics, and health care with substantial potential for productivity increases. Also, recent evidence from the United States suggests that some service sectors that are often assumed to be resistant to productivity improvement, such as retail, have in fact made large productivity strides during the late nineties in the wake of the introduction of new information and communication technology. We can not take it as axiomatic, therefore, that productivity growth in services will always be low (Hall 2001: 72).

Figure 6: *Service employment, productivity growth and GDP growth in 12 OECD countries, 1970-2002.*



Notes: Data are unweighted averages from OECD *Economic Outlook*, and OECD *Quarterly Labour Force Statistics*. Countries included are Australia, Austria, Canada, France, Germany, Italy, Japan, New Zealand, Sweden, Switzerland, United Kingdom and United States.

Revisionist authors believe that the problems of the welfare state are primarily self-inflicted. First, the welfare state throttles the economy on which it depends for its own funding. High taxes and deductions drain the private sector of resources that it could use more efficiently than the public sector. Social rules and regulations distort wage formation in the labour market and slow the pace of economic growth. The ‘creative destruction’ that is the main engine of capitalist development is blocked (Rieger and

Leibfried 1998: 790). Then, the welfare state drives up its own funding requirements by operating redistributive social policy programs which create the very insecurities and inequalities that they are designed to address. The most glaring examples are unemployment and demographic ageing.

- The welfare state contributes to the rise in unemployment through labour regulations which restrict labour supply, especially at the low-wage end of the labour market, and through taxes and deductions, which impose non-wage labour costs and thus reduce the demand for labour. The corporatist welfare states of Continental Europe run a particularly high risk of falling into a “welfare without work” trap (Esping-Andersen 1995), where high wage-related social security contributions lead to high unemployment, and high unemployment-related social spending requirements, in turn, lead to even higher contribution rates.
- The welfare state contributes to demographic ageing because of its strong focus on providing income and health care for the elderly. In the EU, health care provision and old age pensions alone account for four-fifths of total social protection outlays (Pierson 1998: 545). As a consequence, people live longer but have less incentive to have the children who would pay for their pensions and health care: ‘welfare without offspring’.

Does globalisation help to solve these problems? Some observers are sceptical. They fear that globalisation’s main effect will be to alert the “claimant” and “provider classes” of the welfare state to the precariousness of their positions and thereby harden political resistance to welfare reform. As a consequence, “the more open a country’s economy is, the more difficult it becomes to touch the status quo of the welfare state” (Rieger and Leibfried 1998: 365, 379).

Most revisionists view the matter differently. They believe that globalisation helps governments to increase the sustainability of the welfare state. First, it intensifies the feeling of crisis. Whether or not globalisation truly contributes to the problems of the welfare state is less important than the general perception that it does so. Globalisation symbolizes the inevitability of change. It forces policy makers and voters to re-evaluate existing arrangements, weakens status quo coalitions, and strengthens the position of the proponents of change. This is why the Left governments in power during Europe’s “social democratic moment” of the nineties (Hemerijck 2002: 177) did not waste much political capital on a rearguard defence of the old welfare state, but focused instead on building a new welfare state that would be a source of, rather than a drain on, economic efficiency. The vision was to create a social policy that accommodated the market rather than overruling it and guaranteed equality not by compensating market losers *ex post* but by providing equal opportunity for market success *ex ante*: “workfare” not welfare

(Jessop 2002: 152). Typical reform aims included replacing passive labour market measures such as early retirement or disability pensions by activating measures such as wage subsidies or 'in-work' benefits, trimming public pensions, refocusing social assistance on the truly needy, and directing more money towards women, children and families (Levy 1999; Rhodes 2001).

A second reason why some revisionists believe that globalisation helps welfare reform has to do with its effect on the international division of labour. As market integration deepens, the functional differentiation of the global economy grows. Countries specialize on sectors in which they have comparative advantage and give up on sectors in which they have a relative disadvantage. As a result, economic structures increasingly diverge – rather than converge – across countries, but become more homogenous within countries. Not only domestic industry but also

> *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.* (Streeck 2000: 255)

This "externalisation of heterogeneity" (Streeck 2000: 256) facilitates political agreement on reforms that tailor the welfare state, as a productive asset, to the specific needs of the national economy. Small countries, of course, find this strategy of national specialisation much easier to pursue than large countries. The greater internal heterogeneity of large countries makes it more difficult for them to devise welfare reforms that meet both the political requirements of national identity and solidarity and the economic requirements of specific firms and lead sectors. Small, relatively homogenous states can afford a "coordinated market economy" because they have little to coordinate. Large internally diverse states often cannot. They are left stranded with the unattractive choice to either abandon coordination and move towards a "liberal market economy" or face economic and fiscal decay.[3] This may explain why the small EU members have done so much better in recent years than their larger peers. As Table 1 shows, they grew faster, had less unemployment, were closer to fiscal balance, achieved greater equality in income distribution, and were better at combating poverty. The correlation between these indicators of welfare state performance and country size measured in terms of population is remarkably high. This may also explain why the small EU members are often so keen on market integration and so cool on political integration.

[3] For the concepts of 'coordinated market economy' and 'liberal market economy' see (Hall and Soskice 2001).

Table 1: *Performance of European Welfare States, 1997 – 2002*

		Population[a]	Growth[b]	Unemploy-ment[c]	Fiscal balance[d]	Inequality[e]	Poverty[f]
Small states	Luxembourg	0,4	6,0	2,9	4,2	3,7	12,0
	Finland	5,1	3,8	10,5	2,4	3,3	9,3
	Denmark	5,2	2,3	5,1	1,8	3,1	10,7
	Austria	8,0	2,3	5,2	-1,3	3,6	12,7
	Sweden	8,8	2,7	5,6	1,9	3,2	9,3
	Belgium	10,2	2,6	8,1	-0,6	4,1	13,7
	Netherlands	15,5	3,1	3,4	0,4	3,6	10,3
Large states	Italy	57,3	1,9	11,0	-1,7	5,1	18,3
	France	57,8	2,6	10,4	-2,0	4,3	15,0
	UK	58,6	2,6	5,7	0,4	5,0	18,7
	Germany	81,7	1,6	8,3	-1,7	3,6	11,3
Average small		7,6	3,2	5,8	1,2	3,5	11,1
Average large		63,9	2,2	8,9	-1,3	4,5	15,8
Correlation			-0,54	0,49	-0,68	0,62	0,58

Notes: Data are averages from OECD *Economic Outlook*, and Eurostat *General Statistics*.

[a] in million, 1995.

[b] Average annual percentage change of real GDP, 1997-2002.

[c] Average unemployment as a % of total employment, 1997-2002.

[d] Average fiscal surplus (+) or deficit (-) as a % of GDP, 1997-2002.

[e] Average S80/S20 quintile ratio, 1997-1999. S80/S20 is the ratio of total income received by the 20% of the population with the highest income (top quintile) and that received by the 20% of the population with the lowest income (lowest quintile). Higher values denote larger inequality.

[f] At risk of poverty rate, 1997-1999. The poverty rate gives the share of persons with an equivalised disposable income – *after* social transfers – below the risk-of-poverty threshold, which is at 60% of the national median equivalised disposable income.

Size seems to matter in a global economy, but in a very different way than the globalist account suggests. ‘Small scale’ is apparently an advantage rather than a disadvantage for the welfare state. Of the ten richest countries in the world, in terms of GDP per capita, only one has a population of above 7 million (the United States) while six have a population of below 1 million (Alesina and Spolaore 2003: 81). Small states have more to gain from globalisation because they are less likely to be economically self-sufficient and, hence, less likely to prosper in a context of closed borders. At the same time, they

are better placed to deal with the political repercussions of globalisation. Their high degree of internal homogeneity makes it easier for them to devise a collective response to globalisation that leaves no powerful domestic group aggrieved.

6. FROM OUTSIDE-IN TO INSIDE-OUT

Each of the three schools holds strong convictions regarding the causal nature of the globalisation-welfare state nexus. Globalists believe that globalisation imposes a detrimental constraint on welfare policy. By forcing the welfare state to compete internationally, globalisation undermines its power to domesticate competition nationally. Revisionists agree that globalisation is a constraint, but argue that this constraint is a beneficial one. It helps governments cope with weakness of will problems that are endemic to welfare states and tend to destroy them from within. The sceptics, finally, contend that globalisation places no constraints on national welfare policy whatsoever. In their view, the international integration of markets and national welfare politics constitute largely unrelated spheres with little causal interaction.

Which school is right? A lot of qualitative and quantitative research has been spent on this question. The results, however, have remained inconclusive. Carefully crafted case studies cannot ultimately establish whether a policy decision, such as the French policy about-turn of the early eighties, was, in the last instance, caused by globalisation (Goodman and Pauly 1993), deliberate choice (Hall 1990), or the internal contradictions of welfare capitalism (Levy 2000). Likewise, sophisticated statistical analyses fail to pin down with certainty the effects of globalisation on the welfare state. Does it lower the level of public spending (Garrett and Mitchell 2001), raise it (Rodrik 1998), or have no discernable effect on it (Kittel and Winner 2002)? Does it constrain capital taxation (Rodrik 1997) or not (Quinn 1997)? Does it eliminate policy differences between left and right governments (Kittel and Obinger 2003) or strengthen them (Garrett 1998b)? The answer to all these and similar questions differs depending on the sample of countries, time period, operationalisation of the variables, model specification, and controls.

The data speak, but with a forked tongue. After years of empirical research, it seems unlikely that this just reflects methodological imperfections which will, in due time, be cured by more cases, better data, and advances in analytical techniques. While technical problems and problems of data availability persist and are widely acknowledged, most participants in the globalisation debate have lost faith that the removal of these problems alone will lead to clear-cut results. There is a growing sentiment that the ambiguity of the data may be caused, at least in part, by the ambiguity of the object of study itself. Perhaps the effects of globalisation do not follow a single, time- and space-invariant logic across all welfare states. The sweeping claims and confrontational

language that dominated the early stages of the globalisation debate have given way to much more cautious and nuanced statements that allow for the possibility that there may be some truth in each of the three perspectives on globalisation. Take an important new contribution to the debate, such as Scharpf's (2000), and you will still recognize the affiliation with a particular school, in Scharpf's case the globalist one. What is striking, however, is the extent to which the arguments of this school have been enriched and in part overlaid and replaced with arguments from the other schools.

As claims to exclusive truth are waived, the globalisation debate is entering a new, post-heroic phase. Globalisation as a phenomenological and causal whole is being deconstructed. The hope of finding in it a meta-variable that accounts in simple, law-like fashion for all the problems and changes of advanced welfare states over the past thirty years has been abandoned. Globalisation is no longer conceived as a 'single exit situation' that forces governments to react in a particular way but as a 'multiple exit situation' offering a menu of choice. This is not to say that globalisation is irrelevant. It just means that political reactions to globalisation are not entirely pre-programmed by globalisation itself but also depend on domestic structures. The contribution of the three globalisation schools was to clarify the menu of choice available to governments: surrender to, disregard for, and encouragement of globalisation. By clarifying the range of choices, however, the three schools also highlighted their inability to individually or collectively account for the choice process itself.

Why do some governments sometimes react globalist style, while the strategies of other governments at other times are more in line with sceptical or revisionist accounts?

The importance of this question is now widely acknowledged. As a consequence the centre of the globalisation debate has shifted from its initial 'outside-in' focus – how does globalisation shape the welfare state? – towards an 'inside-out' perspective – how do the internal features of the welfare state shape national reactions to globalisation? A plethora of domestic factors have been discussed from this perspective: the type of welfare regime (Scharpf 2000; Hemerijck 2002), the structure of political institutions (Swank 2002), the political power of the left (Garrett 1998b), the production regime (Hall and Soskice 2001), religious legacies (Block 2003). This discussion cannot be summarized here – although it clearly is worth summarising. Suffice it to note that it corrects the bias of the early heroic phase of the globalisation debate towards overestimating globalisation's unifying force: Just because the global market reaches everywhere does not mean that welfare arrangements will converge everywhere. However, it is important to avoid the opposite bias as well: Just because cross-national differences persist does not mean that globalisation is inconsequential. It may not force welfare states to become alike. But it induces them to match others' macroeconomic

performance measured along a range of standardized performance indicators. In this sense at least, globalisation does indeed push towards ‘one world of welfare’.

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