



Focus Paper

Globalisation and the Welfare State

Can the Welfare State Still Keep Up
with Globalisation?

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with Globalisation?

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Executive Summary

In the second half of the 20th century, globalisation and the welfare state expanded in tandem. This complementarity was an essential prerequisite for the social acceptance of globalisation. Unfortunately, the strength of the link between globalisation and the welfare state has weakened over time and in present days has almost vanished.

While trade enhances overall welfare, it can cause substantial disruption in the structure of an economy. As a consequence of the specialisation that trade brings about, production factors are shifted from the less competitive to the more competitive sectors. In practice, this process can be painful. It is here where a strong welfare state provides an important service in ensuring transition and mitigating negative effects for individuals. Also, it is known that trade increases inequality within countries. Both, structural change and rising inequality have – if unchecked – the potential to undermine social acceptance of trade.

As this paper will show, the correlation between trade and the welfare state has become weaker over time and is now almost flat. This suggests that the insurance function of the welfare state is no longer as important as it was in previous decades. While the research in this paper is merely prima facie evidence, it could indicate an important reason for current discontent with globalisation and free trade.

The Link between Globalisation and the Welfare State

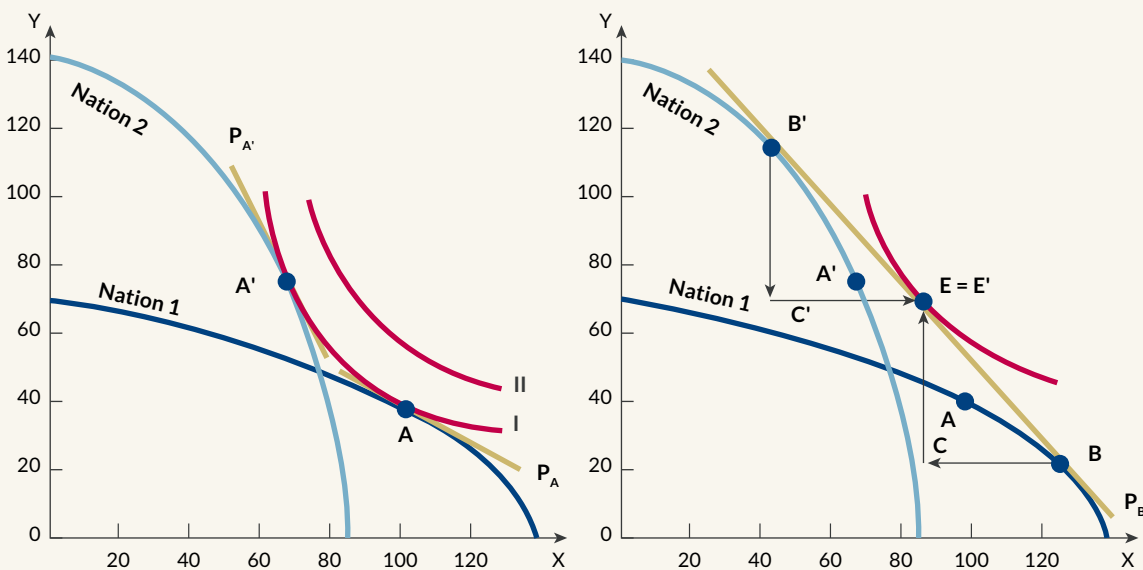
Many economists are puzzled by the rising discontent with globalisation. After all, the benefits of free trade are well known: Without it, the large welfare gains across the globe and lifting millions out of poverty would have been impossible.¹ Yet economists should also be aware that with a net welfare gain of trade come undesirable side-effects. If unchecked, trade leads to larger inequalities within countries and heightened fragility of the more vulnerable parts of society. These downsides to trade are generally thought of as acceptable, since they are corrected by modern welfare states. This acceptance requires a positive relationship between openness to trade and the scope of the welfare state. Such a strong positive relationship existed in the past. Unfortunately, this relationship has apparently first weakened and subsequently almost disappeared over recent decades.

1 Bertelsmann Stiftung (2016)

Trade allows countries to specialise in those sectors in which they hold a comparative advantage, i.e. those sectors in which they can produce relatively more efficiently than their trading partner(s). In the Heckscher-Ohlin model,² a simple yet intuitive workhorse of trade economics, this leads to a more efficient employment of production factors with a net gain for all participating factors. When countries liberalise their trade regime, they move from a domestic equilibrium of allocation of resources between sectors to an international equilibrium. This implies that production factors previously used to produce goods in a sector in which a country does not hold a comparative advantage will move to a sector where a comparative advantage exists so as to be more effectively employed. This process is illustrated in Figure 1. In the graph on the left-hand side, two countries are displayed in autarky, the blue curves repre-

2 Ohlin (1967)

FIGURE 1: The Heckscher-Ohlin Model



Source: Ohlin (1967)

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senting their respective production functions. These functions represent all possible allocations of resources to produce the two goods in this example, X and Y. A and A' represent the respective production equilibria in autarky, i.e. the most utility enhancing trade-off between the production of X and Y. The graph on the right-hand side shows how these equilibria evolve under trade between the two countries. As Nation 1 is relatively better at producing X and Nation 2 is relatively better at producing Y, both countries specialise according to their comparative advantage. This alters the previous optimal trade-off for producing X and Y. For Nation 1, optimal production moves from point A to point B and for Nation 2 from A' to B'. Both countries are now producing more of the product in which they have a comparative advantage. The combined production of both products under trade is higher than under autarky. Thus, while the highest utility curve – the red convex curve – that can be reached under autarky is I, under free trade II can be obtained. That is why trade is on average welfare enhancing. But, of course, moving from the autarky equilibrium to the trade equilibrium means a reallocation of workers from the sector without comparative advantage to the other one with.

What in economic theory sounds like a smooth and quick process is, in the real world, often cumbersome and slow. In practice, shrinking the less competitive sector leads to unemployment as workers need to undergo retraining if they are able to work in the more competitive sectors. In that case, unemployment would be merely transitional. But retraining is not always possible. The result is permanent unemployment or work in lower-paid sectors. Another implication in economic theory is that remuneration in the less competitive factor decreases. This implies rising income inequalities because of specialisation and international trade. These negative side-effects of increased international trade – rising inequality and precariousness – have been known for some time.³

It is hardly novel then to correct these negative side-effects through a functioning welfare state. By addressing excessive and, in all likelihood, harmful inequalities and providing insurance against precariousness, the welfare state makes it possible to harness the beneficial effects of international trade by mitigating the potentially negative ones. Unsurprisingly, then, for most of the post-war era there was indeed a strong positive association between the openness ratio – exports plus imports over GDP – and the scope of the public sector. Before exploring the empirical rela-

tionship between openness and the size of the state sector, let me elaborate further on the complementarity between the two variables. A strong public sector enables a government to perform four important functions:

- **Insurance:** The more open an economy, the more it needs some sort of insurance against volatility in external demand. It is another empirical fact that output in more open economies is more volatile than in relatively closed economies. While on average output is higher, some sort of insurance against the negative effects of volatility is required. This can best be provided by a welfare state which insures against unemployment or prevents unemployment altogether.
- **Redistribution:** If inequalities become excessive, they can have a harmful effect on growth as well as political stability. Redistribution to prevent harmful inequalities is therefore an essential function of the welfare state.
- **Retraining:** For the adjustment process of moving from a more closed to a more open equilibrium to work as smoothly as possible, retraining of workers is essential. Hence, this is an important feature of modern welfare states which aim to provide retraining and reinsertion policies rather than mere unemployment insurance.
- **Business cycle smoothing:** A country with a larger public sector can engage in Keynesian business cycle smoothing more effectively than one where the public sector is comparatively small. This criterion has lost importance over time, especially since Keynesian policies work less effectively with rising openness. It remains, however, a function through which a government can mitigate external shocks.

These four points illustrate why the welfare state and economic openness are indeed complementary. The terms of state sector and welfare state have, admittedly, been used here with a lack of precision. This is because previous studies on the subject have relied on different functions and measures of the state sector in general or the welfare state more specifically. Cameron (1978) focusses on the public sector since he is examining the state's ability to employ Keynesian policies to alleviate external shocks. The next section briefly illustrates the empirical relationship between openness and the state sector.

3 Stolper und Samuelson (1941)

Globalisation and the Welfare State

Over Time

Two studies have so far investigated the relationship between openness and the role of the public sector in the economy. The first attempt was Cameron (1978), Lindbeck (1977) who investigated rather different hypotheses on drivers of public sector development. His main finding is that the strongest driver was the openness ratio – imports plus exports, in relation to GDP – which confirms an hypothesis proposed by (Lindbeck 1977). He correlated this openness ratio with general government revenues⁴ for a

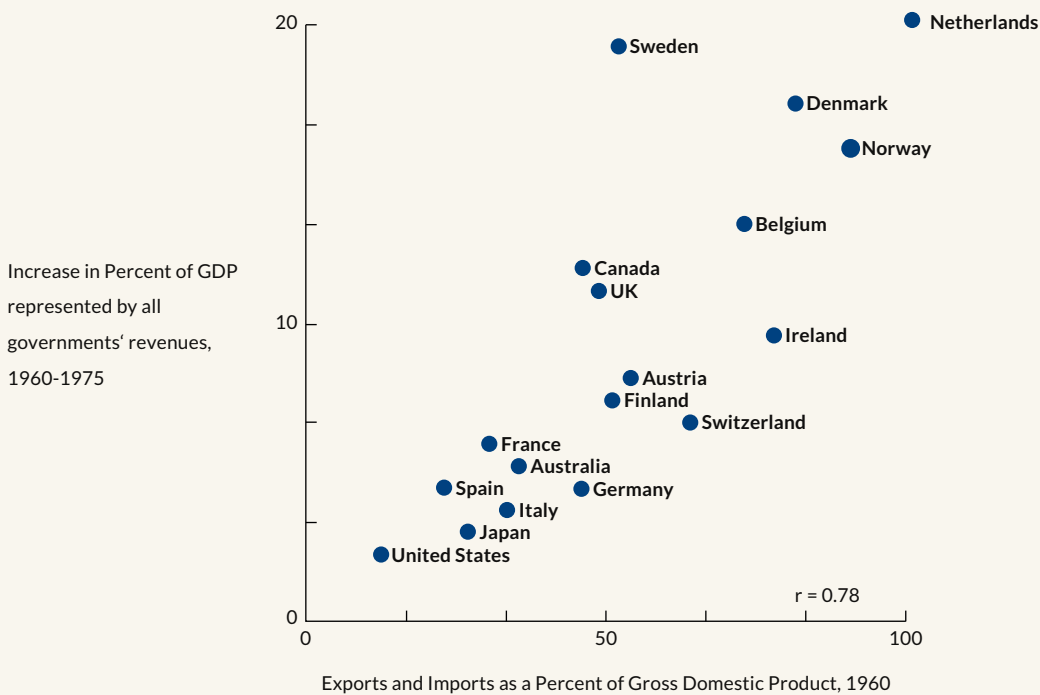
4 The choice of general government revenues as a proxy for the public sector or even the welfare state may seem exotic. Cameron justifies it by declaring: “Although imbalances occasionally occur between the aggregate totals of all government revenues and expenditures, the two have usually moved in tandem. Thus, the scope of the public economy can be compared as well by considering the revenues of

group of industrial economies and found the clear and positive relationship presented in Figure 1. Cameron’s main findings were re-examined by Rodrik (1998).

In Figure 2, the x-axis measures the openness ratio, while the y-axis represents the increase in government revenues. As can be easily seen, there is a clear and positive association between the two variables. While being a very relevant finding, it is possible to criticise Cameron’s methodology. First, one may consider a group of 18 economies too small a

governments rather than their expenditures - that is, by considering the extractive aspect of government. The public economy is defined in terms of the total of all revenues obtained by all levels of government in a nation.” Cameron (1978)

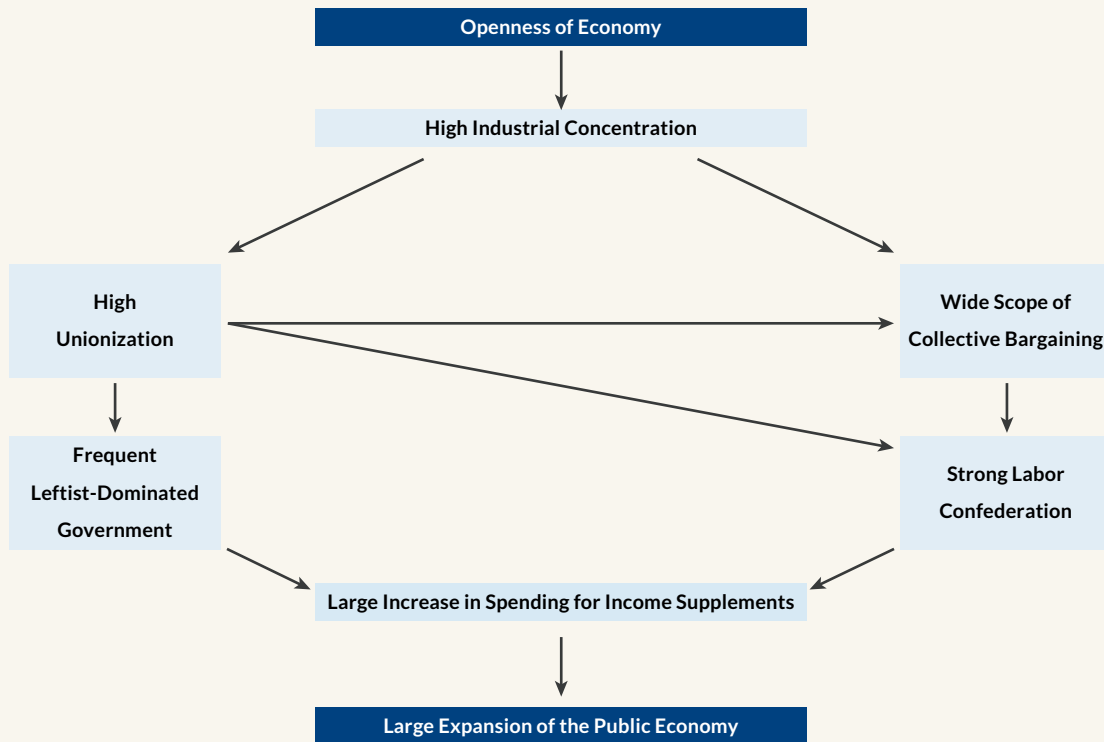
FIGURE 2: The Openness of the Economy and the Expansion of the Public Economy



Source: Cameron 1978

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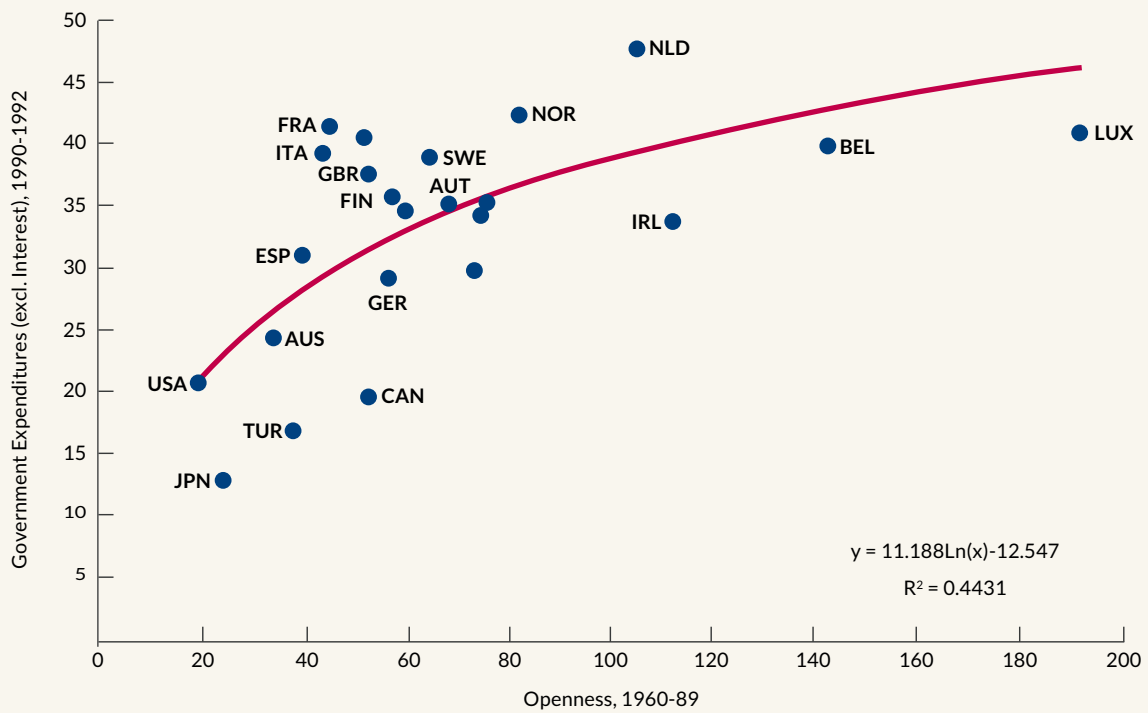
FIGURE 3:



Source: Cameron 1978

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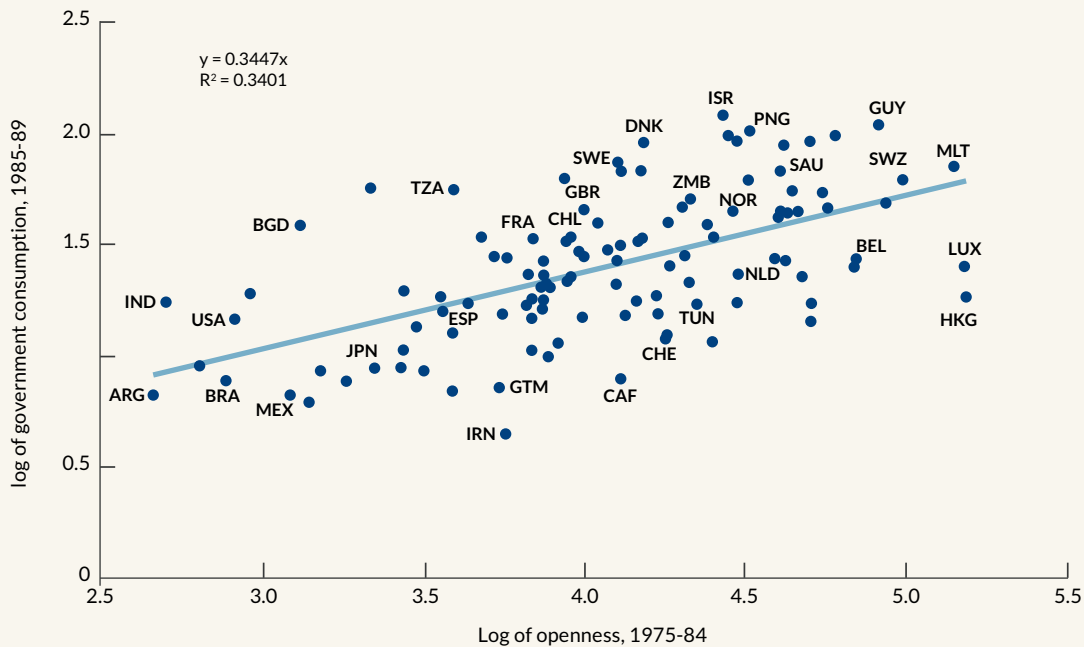
FIGURE 4: Relationship between Openness and Public Expenditures



Source: Rodrik 1998

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FIGURE 5: Partial Relation Between Openness and Government Consumption
(controlling for per-capita income, urbanization, dependency ratio, area and region)



Source: Rodrik 1998

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sample from which to derive general conclusions. Second, while he does undertake a regression analysis, he does not choose a set of independent control variables to correct for any omitted variable biases.

Cameron also develops a causal mechanism for explaining how openness leads to increased government spending: openness leads for him to a specialisation in industrial production which leads to a high degree of unionisation and collective bargaining (cf. Figure 3). This strong role of labour unions then follow more income supplements – what has above been described as the insurance content of the welfare state – which drives public expenditure.

Rodrik (1998) repeated Cameron’s investigations about twenty years later – and essentially confirmed his findings. But he analyses a much larger group of countries and undertakes a regression analysis that corrects for the potential effects of per capita income, the degree of urbanisation, the dependency ratio as well as area and regional effects. The period he considered is 1975–84 for openness and 1985–89 for government consumption. The partial correlation he finds – presented in Figure 5 – still shows a clear positive trend, although the coefficient of .34 is less steep than in Cameron’s sample. What’s more, the model’s

fit is a little less accurate. These differences might, however, be driven by the different composition of the sample and a comparison of logs, rather than levels. Hence, we have also included Figure 4, which is more comparable to Cameron’s analysis since it provides only a correlation of levels.

Rodrik undertakes further investigations that demonstrate that the association between total government expenditure and openness is indeed driven by the degree of exposure to external risk. He concludes that “societies seem to demand (and receive) a larger government sector as the price for accepting larger doses of external risk.” He goes on to make a prophetic prediction: “International trade has expanded considerably during the post-war period. Despite some reversals since the 1980s, so has the scope of government activity in most countries of the world. The findings in this paper suggest that this was perhaps no coincidence. And, looking forward, they suggest that scaling governments down – which is the trend of the 1990s – may actually harm the prospects of maintaining free trade on a global scale. Globalisation may require big, not small, government.”⁵

5 Both quotations Rodrik (1998), p. 26

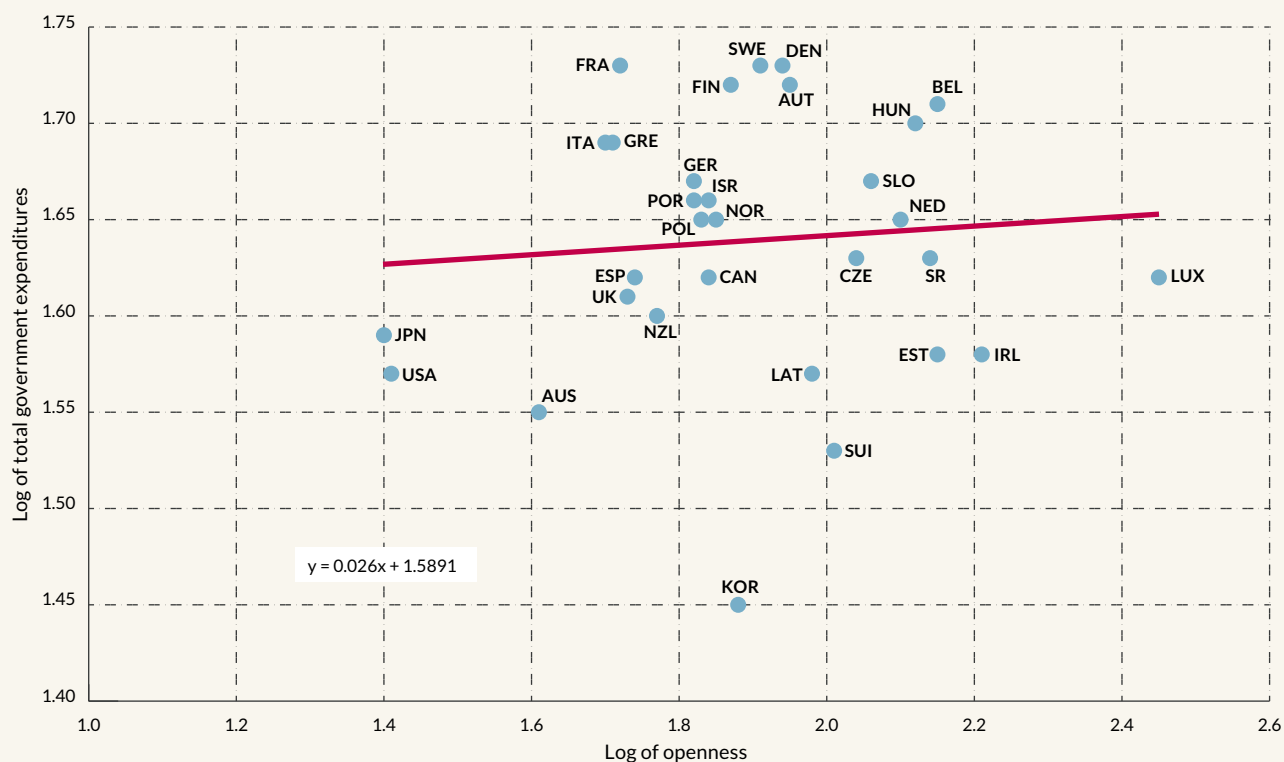
Globalisation and the Welfare State Today

Roughly twenty years later, we are again witnessing the rise of an anti-free trade movement. What could be more pertinent than to repeat Cameron's and Rodrik's exercise to verify whether the relation between big government and openness still holds. To this end, I analyse data on OECD economies between 1995 and 2014. What I present here should be considered simply as prima facie evidence, since I only show correlations, not regressions. In Figure 6, I present the correlation between total government expenditure and openness in logs, thus adopting the same measures and variables as Rodrik. The coefficient of 0.026 of the trend line is hardly positive; for the most part, the relation

between expenditures and openness seems to be flat. It certainly is much smaller than Rodrik's 0.34.

One might argue that, given that Keynesian business cycle management is no longer a widely used remedy against external demand fluctuations, looking at total government is no longer quite as relevant. Instead, more classic welfare state functions, such as insurance and redistribution, become more important. Hence, I have also correlated social expenditure with openness. The picture – presented in Figure 6 – remains, however, pretty similar: There is a very weak positive relation, far removed from the strong

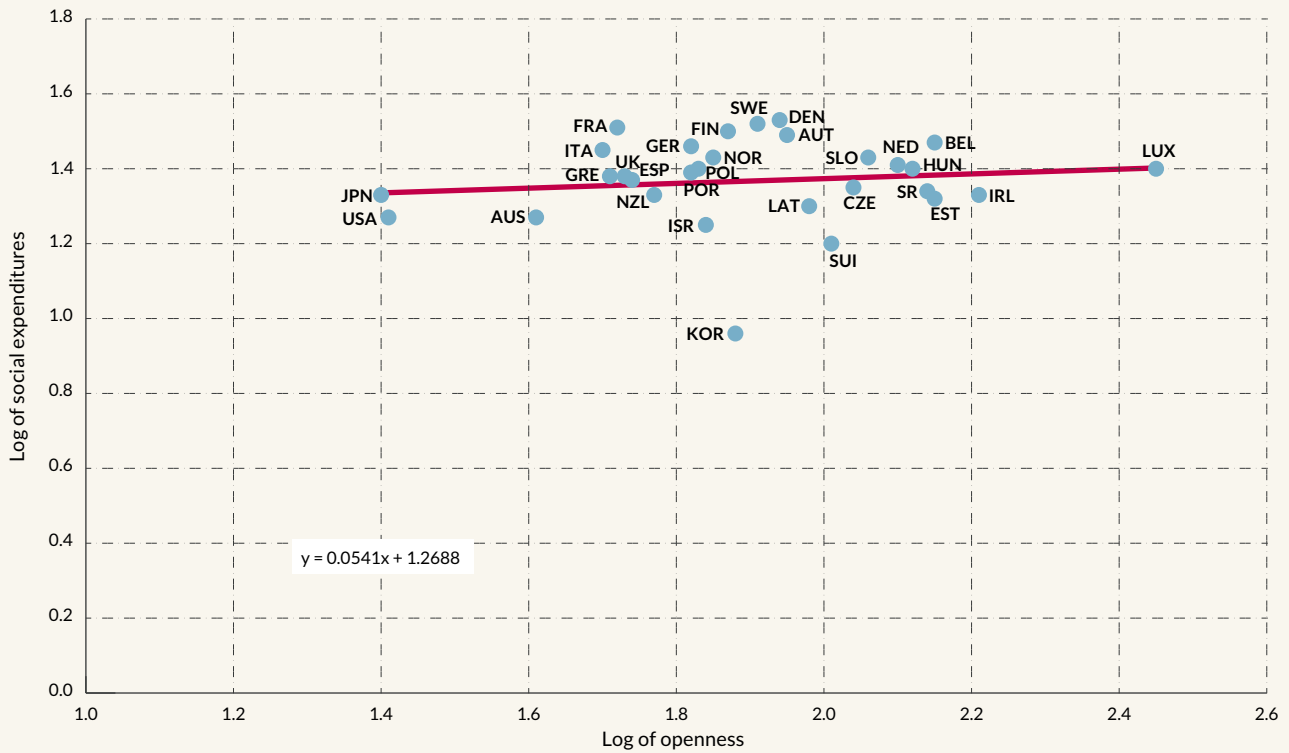
FIGURE 6: Correlation of Total Government Expenditures and Openness (1995-2014)



Source: own calculations based on OECD data

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FIGURE 7: Correlation of Social Expenditures and Openness (1995-2014)



Source: own calculations based on OECD data

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positive correlation found by Cameron and Rodrik. Whether one looks at the general scope of government or the welfare state, it seems clear that it has been outgrown by openness.

Rodrik argued that insurance against the downsides of international trade is essential if one is to reap its benefits. Over the last two decades, trade has grown faster than ever before – but the welfare state has failed to keep up with it. While the prima facie evidence presented here should not be overstated, this might be one of the reasons behind the current discontent with globalisation and the fear of continuously widening inequalities.

One should be aware of a few caveats associated with this analysis. It would be tempting to attribute these effects to a potential welfare state retrenchment in the aftermath of the financial crisis. If however, one splits the sample in pre- and post-financial crisis, the pictures are roughly the same. While the linear trend remains mostly horizontal, its sign actually drops from just positive to just negative after the financial crisis. The financial crisis may have aggravated an existing problem, not created it. Another criticism might concern the nature of the variables considered. While the openness ratio can grow almost infinitely – Luxembourg's, for example, is well over 400 percent of GDP – it is simply

impossible for government expenditure or social expenditure to grow to the same extent. If spending growth is more constrained than that of the openness ratio, it is hardly surprising that the correlation flattens over time. This issue has been addressed by choosing to look at the logs, rather than levels, of the variables studied. What's more, the lack of control variables implies that the correlations presented in the last section may well be driven by some unobserved variable bias. It would be an interesting task to undertake further research featuring a proper regression analysis which would produce more reliable results.

Conclusion

Despite the prima facie nature of this research, it suggests that trade has undoubtedly outgrown the public sector and the welfare state. This is potentially problematic because social acceptance of international trade requires the negative side-effects of trade to be addressed by a strong and effective welfare state. The increasing discontent with trade and globalisation may have to do with the inadequate manner in which welfare states are performing their redistributive and insurance roles.

Economists should not be puzzled by the discontent with which trade and globalisation is being met. Trade's undesirable side-effects have been known to economists for almost as long as the positive net gains. It is important to develop effective tools to keep the negative side-effects in check so as to ensure acceptance of the welfare-enhancing liberal world order. If the benefits of trade are too unevenly spread, it will prove impossible to sustain the system that generates them.

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