

How does globalization affect european welfare states? assignment

[Sociology](#)



How does globalization affect European Welfare States? Introduction The effect that the process of globalization is having on the European welfare states has been the subject of much debate. The source of this debate lies in the fact that there has been a positive correlation between economic openness and the size of the welfare state in European countries. This directly contradicts liberal economic theory that increased economic openness will require the retrenchment of the welfare state in order for national economies to remain competitive in the international market.

There are some that argue that this relationship proves that increased trade and capital mobility have no meaningful effect on the viability of European welfare states, whilst there are those that attribute this relationship to the fact that globalization places greater social security demands on the state. It is my argument that the forces of globalization are posing a fundamental dilemma for European welfare states.

Free trade and capital mobility are altering the structure of European economies and posing greater risks for individuals, which are placing greater demands on the welfare state, whilst also simultaneously limiting the ability of the state to provide such assistance. In order for European economies to remain strong, and thus their welfare states to remain sustainable, there will have to be a change in policy that allows European countries to remain competitive in the global economy.

I will begin by outlining the liberal theory, before discussing the argument against the process of globalization affecting European welfare states. I will then go on to show how globalization does in fact affect European welfare

states, both through the increased demands and constraints its effects place upon them. Finally, I will analyse the implications for the future of European welfare states and how they will have to adapt in order to sustain strong economies and thus their own viability. Liberal Theory

According to liberal economic theory the welfare state is considered to be uncompetitive. "Income transfer programs distort labour markets and bias inter-temporal investment decisions" (Garrett & Mitchell 2001, p. 150). The higher levels of taxation required to fund the welfare state increase the relative cost of labour thus also increasing the cost of production. The process of globalization should therefore result in pressure to reduce the size of the welfare state in order for the national economy to remain competitive.

Increased trade liberalization means that domestic goods and services become subject to price competition, in which only the most efficient firms will survive. Firms that have high costs of production, such as those derived from higher wages and labour market regulation will be driven from the market. Similarly, increased capital mobility allows firms to move locations and invest in countries in which they will receive the highest rate of return.

High level of taxation and social contributions reduce the rate of return for firms and investors and thus make for a less attractive investment environment. Liberal theory holds that in order for countries to retain domestic capital and attract foreign capital, they will have to compete through tax competition, which necessitates the retrenchment of the welfare state. The cost of funding the welfare state through borrowing becomes higher as this increases the real interest rate, which depresses investment.

<https://assignbuster.com/how-does-globalization-affect-european-welfare-states-assignment/>

Furthermore, this will result in an appreciation of the exchange rate, which reduces the competitiveness of domestic producers in the world market (Garrett 2001, p. 6). Increased economic openness should therefore be related to a decrease in taxation and government consumption. However, what has actually occurred is the opposite. There has been a positive correlation between the levels of government consumption and social transfers as a share of GDP, and increased economic openness beginning in the 1950s (Iversen 2001, p. 45).

It is this fact that the empirical evidence doesn't seem to support the liberal theory that has given rise to the argument that globalization has no, or at the most, a negligible effect on the welfare state. The Case Against Globalization Critics of the ' globalization theory' argue that the effects of increased trade and capital mobility have been exaggerated and where they do exist, the empirical evidence does not support the liberal case. Despite the increased liberalization of both trade and capital, it is contended that national economies still remain largely isolated from one another.

Dani Rodrik raises an important point in relation to the liberal theory of capital movement, pointing out that different rates of return persist between countries and are not equalized by the flow of capital (Rodrik 1997, p. 22) Therefore, there must be other factors affecting the flow of capital. Similarly, in a model constructed by Garrett and Mitchell (2001), a significantly positive correlation was found between foreign direct investment and the level of welfare effort within an economy (Garrett & Mitchel, 2001, p. 47). Proponents of this view look towards domestic changes to explain the increase in the

size of the welfare state, rather than increased demands brought by globalization. Paul Krugman (1994) argues that the idea of globalization bringing with it heightened international competition is fundamentally flawed. Krugman argues that international trade is not a zero-sum game, the success of one economy, in principal, need not be at the expense of another.

In Krugman's model, growth rates of standards of living equal the growth rates of domestic productivity, not relative productivity in the global economy (Krugman 1994, p. 34). As such, the greater demands placed upon European welfare states which have resulted in its increase in size are likely to be the result of domestic factors rather than globalization. De-industrialization The primary domestic factor that welfare state expansion within Europe has been attributed to is the process of de-industrialization.

The shift away from agriculture and manufacturing industries in the developed economies of Europe towards services, and the technological change occurring in these economies combine to create a situation where there is a greater demand from the labour force for the provision of welfare measures. The effect that the structural shift of the European economies has had on their respective welfare states is related to the transferability of skills of those members of the labour market that were previously employed in the declining industries (Iversen & Cusack 2000, p. 25). This section of the labour force either required re-training, remained unemployed or exited the labour market with the assistance of early pension schemes, all of which placed additional demands on the welfare state. The technological changes that have occurred in the advanced European economies have increased the skill

premium within these economies. The result of this increase in the skill premium has increased the demand for skilled workers in Europe, but decreased the demand for unskilled workers.

This is seen as a fundamental cause for the high levels of structural unemployment (Krugman 1994, p. 70). It is my argument that rather than being isolated from the process of globalization, de-industrialization is indeed very much linked to free trade and is one of the ways that globalization is placing greater demands on the welfare state. The various factors linked to globalization that place greater demand on the welfare state comprise what is known as the 'compensation hypothesis' (Garrett 2001, p. 6).

The 'compensation hypothesis' states the reason for the increase in the welfare state which has coincided with increased globalization is in response to both the effects that globalization has had on the European economies and the greater risk facing individuals (Ruggie 1994, p. 4) Globalization as a Cause of De-industrialization The impact of free trade and capital mobility is that the price of certain goods and services will rise while the price of others will fall. This relative change in prices will aid certain European industries whilst simultaneously hurting others (Tanzi 2000, p.). As we would expect with free trade, national economies will naturally direct resources towards those sectors in which they have a comparative advantage. For the European economies, this will result in the shift from labour intensive industry, where wages are the determining factor towards services and higher-value sectors where higher wages are less of a factor. It is this fact that is a major contributing factor in European de-industrialization, thus

resulting in all the demands on the welfare state that I have mentioned above.

Furthermore, as European economies are increasingly moving towards higher value services and industries which tend to require a higher level of education and training, it is likely that to remain competitive in these sectors, there will need to be an increase in social provisions for such investment in human capital. Besides from the demand that occupational transition places on the welfare state as I have already mentioned above, the transferability of social security is also a key issue. In many cases the private social security schemes that employees may be contributing to may be firm or industry specific. In these cases, when a particular firm or industry may be in decline because of the pressures of international competition the state may be forced to intervene in order to support those members of the labour force who have already invested in private social security schemes but are unable to utilise them due to the structural shifts in the economy (Iversen & Cusack 2000, p. 325). Labour Market Risks

The process of globalization has not only altered the structure of European economies it also exposes the labour markets of these nations to greater risks, thus increasing the demand for social security. “ An increase in openness makes domestic capital more responsive to changes in international prices and correspondingly magnifies the amplitude of fluctuations in real wages at home” (Rodrik 1997, p. 6). Due to the exposure to the increased level of risk, there is a detrimental effect on labour.

In order to combat this risk, and return the utility of workers to its reservation level, there is an increased demand on income transfers (Rodrik 1997, p. 6). It can be argued, that globalization actually reduces the exposure to risk of European economies. Consumption risk may be reduced as a result of labour market diversification into the global economy, facilitated by capital liberalization. Also, the higher the level of integration into the global economy, the less vulnerable the economy becomes to purely domestic shocks (Rodrik 1997, p. 2). However, this is unlikely to be the case in Europe. As I have already outlined, the affect of free trade is resulting in a move towards specialization in the service and high value sectors. In reality, this concentration of industry is likely to make a greater proportion of the labour market more vulnerable if there is a fall in demand for these goods and services. This places a greater demand on the welfare state to put in place insurance against such an economic downturn.

Globalization has created an asymmetry between employers and employees. Employers have a greater ability to move location than employees, which has given rise to an inequality in bargaining power between the two groups (Rodrik 1997, p. 29). Firms are now less reliant on domestic labour as they have the option of moving location and employing foreign labour. European firms are less likely to be inclined to incur the cost of providing social security schemes for their employees.

In such an environment it will become necessary for the state to maintain or even increase its provision of social security if the market fails to provide complementary private schemes. The distortive effects that the welfare state

has on the labour market are interacting with the effects of globalization to pose serious problems in terms of unemployment for European economies. Besides from the effects of taxation, the welfare state distorts the labour market by eroding incentives to work save and invest (Esping-Andersen 1996, p.). The presence of the welfare state introduces a higher 'reservation wage' into the European labour markets. Increasing the minimum wage level at which workers are willing to participate in the labour market has the effect of increasing unemployment. The effects of globalization exacerbate this fact. The process of globalization has had the effect of creating greater inequality within Europe between those employed in high-value industries and services, and those employed in low-value sectors.

An increase in inequality is likely to cause the wages of those employed in low-value sectors to fall relative to the average (Krugman 1994, p. 60). A greater number of workers are likely to find that available market wages are below their reservation wage, and as such exit the labour market (Krugman 1994, p. 61). The high levels of unemployment benefits provided by European welfare states, which raise the 'reservation rate', interacts with the effects of globalization to reduce the participation rate and increase the unemployment rate with European economies.

Welfare States and Unemployment Globalization has thus simultaneously altered the structure of the economy, whilst creating increased demands on the welfare state. It is here where the fundamental problem facing European welfare states arises. The emerging economies in Europe are going to be

dominated, but not solely comprised of services and high-value industries. However, “ the service economy tends to be dualistic, combining knowledge-intensive professional and technical jobs with low-end, low value-added, labour intensive service jobs” Esping-Andersen 2000, p. 16). Expansion and creation of lower-end service jobs is restricted by strong wage compression, and high levels of taxation, particularly mandatory contributions (Esping-Andersen 2000, p. 17). The problem facing European countries is that the relatively high levels of taxation required to fund the welfare state, and the increased level of wage compression brought about by increased transfer payments are restricting employment levels in the lower-end sectors and thus resulting in relatively higher unemployment rates.

Unemployment vary quite considerably between different European countries and also between other advanced industrial nations (see appendix 1. 1). In order to gain a more detailed understanding of how globalization is affecting the prospects of the European welfare states, it is important to understand how the differences in the welfare state models adopted by different countries have affected their economies. Every welfare state is different, however, by using Esping-Andersen’s (1990) distinction, we are able to analyse the effects of the fundamental principles of each. Table 1. 1

Government Sector 2004	Government Revenue % of GDP	Government Expenditure % of GDP
Australia	36. 6	36. 2
France	49. 8	53. 4
Germany	43. 2	46.
Sweden	58. 3	57. 3
UK	40. 8	43. 9
US	31. 9	36. 5

Source: OECD 2007 The first model of welfare state is known as the ‘ liberal’ model and is the general model followed by Australia, USA and increasingly the UK (Esping-Andersen 1990, p. 6). The general

attributes of this model is the promotion of welfare primarily through the market. Income-transfers and labour market regulation are kept at a minimal level, thus allowing the level of government spending and taxation to remain at a relatively low level (see table 1. 1). A second model, the 'corporatist' model, is the model that has been pursued in Germany and France. The foundation of this model lies in providing welfare through the family (Esping-Andersen 1990, p. 27).

As such, there is a heavy emphasis on employment protection and maintaining high wages for the primary 'breadwinner' of the family (Esping-Andersen 2000, p. 5). Social security tends to be focused around employment, and both taxation and government interference in the market are higher than in the 'liberal' model. The final model is the 'social democratic' model, of which the best example of country operating such a system is Sweden. The 'social democratic' model is based upon the principles of universal equality, and the de-commodification of welfare needs (Esping-Andersen 1990, p. 27).

Whilst both the levels of income transfers and government expenditure are higher than in the 'corporatist' models, the focus of the welfare state is directed towards activating employment rather than protecting it (Esping-Andersen 2000, p. 4). Table 1. 2 | Unemployment (Total Unemployment as a Percentage of the Labour Force) | | | 2005 | | Australia | 5. | | France | 9. 9 | | Germany | 11. 3 | | Sweden | 7. 8 | | United Kingdom | 4. | | United States | 5. 1 | Source: OECD 2007 As we would expect unemployment levels are lowest in the 'liberal' countries (see table 1. 2). Low levels of government

expenditure keep labour market distortions to a minimum, whilst lower levels of taxation and regulation facilitate the growth of low-end employment. However, the data reveals that levels of government expenditure and taxation are not the sole determining factors of unemployment.

Despite the fact that levels of both taxation and government expenditure are higher in Sweden than in the 'corporatist' models of France and Germany, unemployment remains at a lower rate. It is this fact that gives a clear indication of the implications the forces of globalization will have on the European welfare states. Whilst, the presence of the welfare state is always going to have at least some negative impact on employment levels in low-end sectors of the economy, the use of particular policies of the welfare state can either exacerbate or cushion this negative impact.

The effect of the welfare state on the economy is to a large extent dependant on the effect it has on labour market flexibility. The high levels of unemployment in the 'corporatist' models exemplified by the statistics for France and Germany show that the welfare policies centred around employment protection have resulted in problems with dealing with the effects of globalization. The higher levels of taxation required to fund the relatively high levels of government expenditure have meant that low-end employment has stagnated.

Also, focusing on employment protection for current industries has meant these countries have had problems maintaining employment levels in the face of globalization induced structural shifts in the economy. The Swedish welfare state, even with high levels of taxation, which we would expect to

<https://assignbuster.com/how-does-globalization-affect-european-welfare-states-assignment/>

suppress employment in the low-end sectors to a greater extent than in Germany and France, has maintained lower levels of unemployment. This can be attributed to the policies investing in education and retraining, which has allowed the Swedish labour force to adapt to structural shifts in the economy (Huber & Stephens 2002, p. 4). Globalization has not only affected the European welfare states by placing a greater demand on their social provisions, it has also placed significant constraints upon their expansion and subsequent ability to meet these heightened demands Welfare States Constraints European welfare states have been constrained indirectly, as a result of capital liberalization. The increased mobility of capital in the global economy does not directly dictate constrain the ability of government's to provide social security, however, it does raise the cost of undertaking certain policies.

Increased capital mobility translates into greater opportunity for investors to constantly move capital in search of the greatest returns. Productive investment in the economy will decline if taxation levels and labour market regulations reduce relative post-tax profits in comparison to a different location. Furthermore, as firms have a greater choice in production locations, European countries will face job losses if taxes and regulations increase the relative costs of domestic production (Scharpf 2000, p. 4).

The result of this is that, in situations where cost is the determining factor in investment decisions, the tax burden will have to be fully borne by immobile factors such as labour. According to 'liberal theory' and the constraints that globalization has placed upon the welfare states, we would expect to find

that European countries would be engaged in a 'race to the bottom' in the reduction of taxation levels. However, as the FIGURES show, this has not been the case. Critics of the 'globalization thesis' argue that this proves that globalization doesn't necessitate that governments enter into tax competition with one another.

However, this view does not take into account other factors, which have affected national governments' ability to reduce taxation levels.

Furthermore, I contend that tax competition still exists as a result of the pressures of globalization, even though it may not be apparent in the limited, tax revenue figures. The fact that the general revenue from taxation has not decreased within European countries does not disprove the pressures of globalization on national tax levels.

When we consider the other determining factors on taxation levels, it becomes clear that globalization can result in pressure towards the reduction in tax levels, even if general tax revenue does not decline. Political demands, a shift in the demographic of European countries, high levels of pre-committed government spending all placed demands on maintaining or even increasing the level of social transfer payments of European welfare states. This combined with the increasing public debt, meant despite the pressure to engage in tax competition, general tax revenues remained fairly consistent (Genschel 2002, p. 46) Although, general levels of tax revenue have not decreased as one might expect according to 'globalization theory', when the structure of the tax system is examined closer, the effects of globalization become apparent. Within the leading industrial nations, the period since the

early 1980s, has witnessed a tendency to decrease tax on capital whilst taxation levels on labour have generally increased (Rodrik 1997, p. 26). This reflects the need to provide greater levels of social security, from the risks and changes brought by globalization, and the constraints upon taxing mobile capital (Rodrik 1997, p. 7). The liberalization of capital mobility has presented new opportunities for tax avoidance, and allowed countries to structure their tax systems in such a way as to attract mobile capital. An example of such measure is that the rate of tax on interest incomes of non-residents is often reduced to zero (Swank 2000, p. 8). Implications for European Welfare States Globalization has placed greater demands on the European welfare states, whilst constraining their ability to meet these demands.

The dual forces of free trade and capital mobility thus have major implications on the future of the European welfare states. Firstly, as the comparison between the unemployment figures of the 'corporatist' states of France and Germany, and Sweden which follows the 'social democratic' model highlight, European welfare states will have to move towards policies that increase labour market flexibility. Policies such as employment protection should be replaced with investment in education and retraining which would allow European countries to adapt to structural changes in the economy and minimise the unemployment effects of such shifts. Investment in human capital would also enhance employment in the long-term as the labour force would be better equipped to work in the high value industry and service sectors towards which the European economies are gravitating towards (Ferrera & Rhodes 2000, p. 259). The constraints that globalization

<https://assignbuster.com/how-does-globalization-affect-european-welfare-states-assignment/>

has placed on the sources of welfare state funding pose a more difficult challenge to European welfare states.

The shift in taxation burden from mobile factors such as capital towards immobile factors such as labour will inevitably increase the costs of production, which as I have already outlined, has a negative effect on employment levels, particularly in the low-end sectors of the economy. There appears to be a fundamental trade-off between equality and employment. This is characterized by the by the comparison between the US and Europe. The US has been able to maintain lower levels of unemployment than those in Europe, but the cost has manifested itself through greater levels of inequality (Krugman 1994, p. 3). Conclusion In conclusion, the process of globalization has had a considerable impact on European welfare states, both in terms of increased demands and the ability to meet those respective demands. Increased trade liberalization has resulted in structural shifts in the European economies which in turn places greater demands on welfare provision through education and re-training requirements or social assistance, be it in the form of unemployment benefits or pension provision.

Globalization has also necessitated that the state increase its role in the provision of social security as a result of the differing effects it has had on firms and the labour market. Increased exposure of the labour market to the pressures of the global economy coupled with the shift in the power relationship between employers and employees have demanded state intervention, as the pressure on firms to provide social security has lessened. The distortive effects of the welfare state on the labour market, combined

with the effects on tax policy have resulted in negative effects in low-end employment.

Fundamentally, the effects of globalization necessitate that in order for the European economies to remain strong, and their respective welfare states remain viable, they will have to adapt. The key to welfare state survival is that it utilises policies that increase labour market flexibility, be it through de-regulation or investment in human capital. However, globalization has posed a crucial dilemma for European welfare states. European states will have to make a decision between achieving greater equality, or lower unemployment. The forces of globalization appear to make the two incompatible.