REDISTRIBUTION POLICIES IN A GLOBALIZED WORLD [†]

Carles Boix [††]

December 30, 2010

Does the process of economic globalization curtail the capacity of national governments to pursue autonomous economic policies at home? Does the growing cross-border mobility of factors (and its associated threat of capital flight) discipline governments and limit the level of taxes and of public spending? Is economic integration inimical to redistribution at home? If trade and financial liberalization lead to higher levels of within-country inequality (or, at least, the emergence of economic sectors that bear significant economic losses), can states develop economically sustainable policies to compensate those made worse off by trade reforms? In fact, are there any particular policies that can make economic globalization and fair social policies at home (designed to share the gains from trade) compatible?

To answer these questions, that is, to describe the redistributive effects of globalization and the plausible policy responses of governments, this chapter is organized in three (sequential) parts or steps that gradually relax some of the assumptions of the model introduced at the beginning of the chapter. The first part examines the distributive effects of globalization in a single economy. To do so, it starts by characterizing (in a stylized manner) the political and fiscal setting in which the policy-makers of any sovereign country make their decisions on the level of economic openness, the tax rate, and the structure of public spending. It then describes the two main direct economic effects of globalization: an asymmetrical change in the returns to factors (and therefore, depending on the distribution of gains and losses, more or less economic inequality at home); and higher levels of factor mobility, that is, a reduction in the costs of moving any factor across national borders. It finally shows the three main policy consequences of globalization: a shift in the extent of social demands for redistribution; a potential reduction, due to a higher level of factor mobility, of the feasible tax rate; a change in the internal structure of taxation and, arguably, in the allocation of public expenditure. Whereas the first part of the chapter takes the process of globalization as given, the second part turns to examine the extent to which policy-makers choose the level of openness as a result of the distributive effects it has – this includes an analysis of the potential mechanisms policy-makers may develop to compensate the losers of globalization (and buy off their support for openness). This discussion identifies three alternative policy scenarios: one where protectionism prevails (whenever there is no compensation package to offset the losses inflicted by trade openness

on the decisive voter); a second one where openness and compensation come hand in hand; and a third (and empirically less common) instance where free trade is implemented without compensatory policies (mostly because the decisive voter gains directly from opening the economy). The second part includes as well an extensive discussion of the empirical evidence on the relationship between openness and social compensation -- this issue has been relatively well researched by the academic literature. Finally, the third part of the chapter allows for the possibility that the institutional system in which policy decisions are taken (on the degree of economic integration and social compensation) may itself vary (as a function of the country's level of economic and political development). Endogenizing the type of political institutions (in the context of several economies competing in world markets) allows us to discuss the conditions under which economic openness and domestic redistribution are jointly feasible over the medium run. Contrary to the position of those that associate globalization with a "tax race to the bottom", part 3 shows that openness and welfare states are compatible with each other, provided that liberal political institutions spread hand in hand with economic development. From a political point of view, this result is relevant because the standard solution that many have suggested to avoid a potential tax race to the bottom and the erosion of welfare states, arguably the construction of some kind of global federation, is politically unfeasible at this point in time.

1. REDISTRIBUTIVE EFFECTS OF GLOBALIZATION

1. 1. Economic and Political Setting

To examine the redistributive effects of globalization, it is convenient to consider an economy in which individuals are distributed uniformly on a continuum from 0 to 1, as represented by the horizontal axis of Figure 1. Although all individuals have the same time L available to them, they vary among them in their productivity and income: some have some additional skills S (some education) that make them more productive than those that have none; a few own some capital K with returns that are, by assumption, higher than the returns to S. As a result, the economy, represented in Figure 1A, has three types of individuals: U (those with no skills and no capital), S and K. Their respective incomes are $y_u < y_s < y_k$. The vertical axis of Figure 1 represents their

corresponding income level. Although the distribution of types may certainly vary over time or across economies, the unskilled *U* are the majority in the example of Figure 1.

[Figure 1 here]

For the time being, assume that all policy decisions (both on the level of economic openness and on the size and nature of taxes and public spending) are taken by majority voting, that is, according to the preferences of the voter located at the midpoint *M* of the distribution.[1] To keep the discussion simple, assume that voters raise revenue through a proportional tax on everyone's income. The resulting public revenue is then allocated in two ways. First, some fraction of revenue is equally distributed among all individuals through some direct transfers. Second, the rest of public revenue is spent on the provision of public goods such as infrastructures, human capital formation, an effective judicial system that reduces corruption, enforces property rights, etc. Spending on public goods increases everyone's productivity (and therefore everyone's income) but, crucially for the political and economic discussion that follows, it does so with some temporal lag. For example, investing in more education at time *t* does not translate into higher income gains immediately. It does only, if at all, in the following period *t+1*. Depending on the kind of public good, that temporal lag could vary from a few years to a generation.

This tax-and-spending scheme has a clearly redistributive structure and therefore embodies, in a stylized manner, a key trait of contemporary welfare states. Although everybody receives some lump-sum transfers (and benefits equally from the provision of public goods), high-income individuals contribute more to fund the state than low-income individuals. To put it differently, the former are net payers while the latter are net gainers. In this set-up, the median or decisive voter (*U* in the example of Figure 1), who chooses the tax to maximize her income, has a clear incentive to redistribute income from the high-income voters to himself.[2] In fact, the larger the portion of total income in the hands of high-income individuals, the higher the tax rate proposed by the median

---

[1] The voter in *M* or median voter splits the population in two halves – with one half located on each side of *M*.
[2] The median voter is the decisive voter because she can carry any of the two halves (located at each side) to defeat any proposal made by any individual located in any place in the distribution. For example, suppose that an individual *K* proposes a tax equal to zero. All the voters to the left of *M* plus *M* will agree to defeat that proposal. The same result applies to any proposal made by anyone to the left of *M*. *K*, *S* and those *U* between 0.5 and 0.6 in Figure 1 will vote against it.

voter. In other words, the tax rate increases with the level of income inequality (i.e. the difference between the median voter's income and the economy's average income). Still, the choice of tax rate is always constrained by its distortionary effects on the economy: since higher taxes (and more redistribution) reduce the incentive to work or to deploy more capital and, as a result, lower pre-tax income, from which both transfers and public good formation are financed, the decisive voter increases the tax rate only to the point where the utility generated by the available amount of public spending (directly through transfers, indirectly due to more investment) starts to decline (due to a fall in total income).

In turn, the decisive voter distributes public expenditure between transfers and public goods according to the proportion that makes the marginal benefit she derives (through her income) from the last unit being spent on public goods equal to the net benefit she derives from transfers. Public spending is therefore divided at the point where the combined increase in the decisive voter's income due to public investment and to the expansion of total output (which implies a larger pool available for redistribution) equals the increase derived from the last unit received in transfers. Since the positive effect of public good formation only happens in the next period after voters have incurred the investment cost, the amount spent on those goods is affected by the discount rate of voters. The more (less) voters care about the future, the more (less) they will be willing to sacrifice part of their current transfers for some increase in future income generated through more public goods formation.

1. 2. Economic Effects of Globalization

The economic integration in the world market of the closed economy just described will have two main economic effects. In the first place, it may result in a change in the returns to each domestic factor and a corresponding shift in the overall level of income inequality. In the second place, it may increase the mobility of economic factors. Those two effects will change, in turn, the structure of taxation and expenditure.

As shown by standard trade theory, the decision to liberalize the economy will affect the returns of individuals (the returns of factors in the context of a Stolper-Samuelson model) asymmetrically (as a function of each factor's comparative advantage in world markets) and

therefore the within-country distribution of income. Figures 2A and 2B offer two instances of the potential impact of economic openness on the level of income of each individual. In Figure 2A the returns (wages) to the unskilled rise while the returns to both skilled individuals and capital owners decline. As a result, there is a reduction in the overall level of inequality. (Figure 2 simply shows the gains or losses to each side – independently from their initial income. To denote the commonly accepted idea that free trade brings in overall net benefits, the size of each change is such that the sum of gains is larger than the sum of losses). As discussed by Williamson (1998), the formation of an integrated North Atlantic economy at the end of the 19th century accounted for much of the process of wage compression in Europe at that time. On the other hand, globalization may lead to higher levels of income inequality. This is the case displayed in Figure 2B, where the unskilled lose while skilled agents and capital owners gain from trade liberalization.[3] has been at Wood (1995) was one of the first authors to attributed a raising inequality in the advanced world in the last forty years to globalization and growing competition from developing economies, abundant in unskilled and semi-skilled workers. More recently, Spence and Hlatswayo (2011) and partly Autor (2010) have related the process of globalization to the growing polarization in employment and wage performance across economic sectors in North America and Europe.

[Figures 2A and 2B here]

Economic liberalization may also change the specificity of factors, that is, the extent to which the return of a given factor at home differs from the return the same factor obtains abroad. A factor is completely specific or immobile when its returns abroad are zero. By contrast, a factor is completely mobile or non-specific when its deployment yields the same returns both at home and abroad. By definition, economic liberalization, that is, the fall of cross-country economic barriers, increases factor mobility. Factor specificity, however, is also a function of, at least, two additional variables. In the first place, it depends on events that are mostly exogenous to policy decisions, such as transportation and communication costs. The continuous invention of new, faster means of communication in the last two hundred years (such as the telephone, the internet, etc.) has multiplied

---

[3] Figures 2A and 2B do not exhaust all the cases in which globalization affects returns to factors. They simply depict those cases based on the assumption that the effects of globalization are linearly correlated with income, either negatively or positively.

the mobility of factors dramatically. Likewise, the introduction of the steam engine or the container has resulted in a sharp decline of transportation costs and hence in the level of factor specificity (Frieden and Rogowski 1996). In the second place, factor mobility is a function of the policies and institutions in place abroad. As the quality of public institutions and outcomes (such as the judiciary, property rights enforcement, lack of corruption, etc.) and of public goods (such as education or infrastructures) abroad increase relative to the same institutions and goods at home, the returns of any factor at home and abroad converge and therefore factor mobility increases. The reverse istrue as well: as the quality of public goods and institutions rises at home (relative to the rest of the world), factor mobility effectively declines.

Any changes in both within-country inequality and factor specificity have important tax and spending consequences. When globalization leads to more income inequality, there will be more pressure for higher taxes and spending. In the instance represented in Figure 2B, the unskilled, who suffer an income loss and who constitute the majority of the electorate, will vote for some kind of compensation (in the form of higher spending in transfers or public goods) from the skilled and capital owners. By contrast, when, as in Figure 2A, globalization equalizes incomes, redistributive demands decline. Notice that globalization is here taken as given. However, in the context of a loss of income among the majority (the case depicted in Figure 2B), it can only take place if the winners compensate the losers to the point that they are better off than under the pre-globalization status quo. I explore this question in Part 2 of this chapter.

Although globalization may exacerbate the demands for more taxation and public spending (due to more income inequality), it may also curtail the capacity of states to meet those demands completely. Suppose that a higher level of financial and trade integration increases factor mobility to the point that net payers are better off leaving their home country in response to higher taxes. To avoid capital (or, more generally, factor) flight, policy-makers have to cap taxes and spending, even if that goes against the preferences of their citizens. Such a scenario of additional social demands unmet by national governments seems to capture much of the current discontent of certain social sectors across the world: rightly or wrongly, they perceive globalization as the imposition of

untrammeled markets that curtail the autonomy of national governments and that, therefore, restrict their ability to tax and spend as citizens wish.

In response to higher factor mobility, policy-makers may pursue two alternative strategies. On the one hand, they may respond to any possible differences in the level of specificity across factors to change the tax structure to rely more heavily on sectors or individuals that are less mobile. If, as it seems plausible to assume, capital owners are more mobile than skilled workers, we should expect the decisive voter (generally not a capital owner) to raise taxes on unskilled and skilled individuals and to lower them on capital to maintain the level of public spending while avoiding any kind of capital flight. Indeed, this is what emerges from the information presented in Table 1, which summarizes the evolution of the average tax burden of labor and capital in OECD economies since 1981. While personal income average tax rates and taxes on personal consumption have remained constant or even increased, tax rates on corporate income have declined rather sharply in the last thirty years.[4]

[Table 1 about here]

On the other hand, policy-makers may reassign public spending from pure transfers to public goods formation. (This second response is certainly compatible with the previous change in the underlying taxation structure). As already discussed above, financial and trade integration are a necessary but not sufficient condition to increase factor mobility. Factors only become more mobile (and therefore less taxable) only if there are other countries where their net return is equal to or higher than the one they earn at home. Since the underlying institutional quality of any foreign country and the nature of its public goods affect their productivity and hence the profitability of factors, policy-makers have an incentive to better their country's institutional infrastructure and to increase the supply of public goods in response to globalization and factor mobility – precisely to reduce the net mobility of factors and to meet any social demands for redistribution.[5]

---

[4] Still, corporate taxes as a share of total taxes have risen slightly over the last decades from 8 percent of total revenue in 1965 to about 10 percent in 2008.
[5] Burgoon (2001) finds empirical evidence showing that more trade openness is related to more expenditure on education and labor market training in OECD countries. Gemmell et al. (2008) conclude, however, that, in response to higher flows in FDI, OECD governments have cut on investment programs to maintain social

The success of such a public-goods strategy will depend on at least two factors. The first one is strictly economic -- the impact that each monetary unit spent on public goods has on the return of the mobile factor. To be feasible, the expenditure on public goods must increase the mobile factor's productivity by more than the cost of the tax raised to fund the investment (all in relative terms with respect to the foreign country). Otherwise, the mobile factor will still prefer the foreign option and the home country will be unable to pursue this investment strategy.

The second factor is political in nature. The median (or decisive) voter will only authorize any shift from transfers to public goods if that new allocation of resources makes her better off.[6] That allocation will depend, in turn, on two main things. On the one hand, it will depend on her economic profile: the less she benefits from public good investment (because her skills are too specific to a given occupation or because upgrading her skills is very costly), the more likely she will be to block any shift away from transfers. On the other hand, it will depend on the median voter's valuation of future income. Since the effects of investing in capital formation take place with a lag, if the median voter discounts the future quickly, most of the expenditure will be allocated to direct transfers. Otherwise, she will be more inclined to sacrifice some current income for a higher growth rate. What factors determine voters' discount rate? Without pretending to be exhaustive, two variables seem to be very prevalent in the advanced world: the age of voters and the quality of government. Workers closer to retirement will be less willing than young voters to sacrifice their pensions for human capital formation policies. Economies with relatively mature populations will tend to have a hard time reallocating resources from pure transfer schemes to more productive expenditure – as a result, they will either resist globalization or face important deadweight losses or inefficiencies (in the form of high unemployment, growing public employment, etc.) Shifting to public good formation will also be harder if voters have little trust in the effectiveness and fairness of

transfers. Both results are not necessarily at odds with each other given the conflicting effects of openness on income distribution and factor mobility I describe in the text.
[6] The incentive to invest in public goods is higher in an open economy than in a closed economy. If the existing level of transfers becomes unsustainable after globalization and therefore has to be adjusted downward, the median voter should accept more investment expenditure than before because it becomes the only means to equalize conditions (without forcing capital out) – even if that equalization stops short of what she obtained in a pre-globalized economy.

their state institutions: they will probably believe that a system of direct lump-sum payments will be less prone to corruption than investment projects implemented by public agencies.

In addition to taxing the least mobile factors and raising the formation of public goods, policy-makers may follow a third strategy altogether: rejecting globalization and closing the economy. I turn to examine this possibility next.

2. GLOBALIZATION AND COMPENSATION

2.1. The Promise of Compensation

Despite the net economic gains that, according to well-known results in trade theory, generally come from economic integration, trade (and financial) liberalization tends to be a rather contentious issue in domestic politics because, as shown in part 1, the gains and losses of globalization are all but uniformly distributed across society. Those sectors that, rightly or not, expect to bear the losses of globalization will oppose economic integration. If they are politically decisive (either because they are organizationally strong and can lobby policy-makers in an effective manner or simply because the control the majority of votes), the government will fail in its attempts to open the economy.

[Figure 3 here]

If the losers from economic integration can block it, the only solution to sustain globalization consists in establishing a compensatory mechanism to share the total gains of economic openness with the losing sectors to the point of neutralizing their losses. Figure 3 depicts this case graphically. After opening the economy, the unskilled individuals, who constitute the majority of the population, bear an individual loss -0.2. By contrast, the rest of the population increases its individual income by 0.5. With total gains (40% x 0.5) larger than total losses (60% x -0.2), winners can make enough transfers to losers to secure a majority in favor of globalization. Those transfers may be targeted to a segment of the losing sector to build a bare majority. This is the instance represented in Figure 3. Alternatively, it may take the form of a general transfer to all losers. The latter case, which would be more costly but equally feasible from a financial point of view, happens under two main instances: whenever government is unable to discriminate among losers (either for information or identity

reasons or due to the kind compensatory instruments it employs); second, whenever the losers to the left of the decisive voter M have extra (nonvoting) tools (such as strikes, violence, etc.) to exert pressure on policy-makers.

This strategy of globalization and public compensation must fulfill two conditions to take place: it must be feasible from an economic point of view; and it must be credible from a political or institutional point of view. According to standard trade theory, the total gains from openness generally exceed its total losses. This fact, which is already reflected in Figures 2 and 3, makes compensation (and therefore openness) possible by definition. Still, if globalization also leads to more factor mobility, those compensatory schemes may be impossible to finance (since the mobile factors would simply flee to other countries before paying more taxes). Anticipating that outcome, the potential losers of globalization would block the process of economic integration. In short, globalization looks as a sharp double-edged sword: it both pushes policy-makers to cut and expand the size of the state. Which effect prevails depends on the direction and size of the two economic effects of openness.

As partly discussed in part 1, in response to the challenges (and benefits) of globalization, policy-makers have a strong incentive to invest in more public goods (rather than in direct transfers) to reduce the incentives of factors to move abroad (by making all of them more productive) and to facilitate the possibility of a globalization-with-compensation compromise in the long run. Notice, however, that, because the effects of investment come with a temporal lag, that strategy is initially much more expensive than implementing a system of compensation strictly based on transfers. Immediately after opening borders, the winners have to compensate the losers through direct transfers while also spending some extra more on investment strategies that will only pay off in the following period (in the expectation that, if they do, they may allow them to cancel the compensatory transfers in that period). As a matter of fact, it may not be even feasible because mobile factors would have to pay for more taxes upfront (to fund the compensatory strategy) without receiving any benefit from a more productive or educated labor force until the following period. Two propositions follow from these dynamics. First, the political timing of reforms may be crucial to the success of liberalization policies. If economic openness threatens part of the tax base of an economy

and therefore the very possibility of opening the economy, the best policy response is to invest heavily in public good formation <u>before</u> opening the economy: this will increase support for liberalization and will minimize the threat of factor exit. Second, it may explain why economies rich in human capital and endowed with good governing institutions accept globalization more readily: they simply have the tools to reconcile their domestic demands with the benefits of free trade.

The strategy of globalization and public compensation must also be viable from an institutional or political point of view to succeed: this requires that the pro-globalization sector credibly commits to funding a compensation package over time. A simple promise of compensation (to make losers at least as well off under the new regime as they are under the status quo) is not enough because, once the reform is passed by the majority, free traders have an incentive not to approve the compensation plan. Anticipating this, the majority will continue to block the reform. Well-functioning elections (through which politicians become bound by their electoral promises and can be punished by voters if they do not carry those promises through) and strong parties (which tie politicians to promises made by previous leaders) are the type of institutions that should improve the capacity of liberal reformers to make credible compensatory promises.

The problem of credible commitment does not exist if pro-globalization policies can be easily reversed. The threat of some future political punishment (in the form of lost elections, a revolt or a coup) should be enough to discipline politicians. However, protectionist sectors are often endogenous to protectionist policies. Import-competing sectors may not be satisfied with a compensation package because it may not ensure their persistence -- and therefore their political capacity to receive governmental transfers – under an open economy. Consider, as an example, the case of European farmers. Hurt by the competition of developing nations, they have two solutions: they may oppose trade liberalization or they may support it in exchange for some transfer in the form of employment subsidies (a lump-sum compensation for the loss of market share) and job retraining that leaves them with the same or a higher income. Both solutions may not be identical from a political point of view. With tariff protection, farmers maintain both control over their share of the European market <u>and</u> their political cohesion and strength. By contrast, although the compensation solution may leave them indifferent in welfare terms, it may gradually erode their political power. As

more farmers abandon their farms to pursue other activities, their identity as farmers as well as the organizational networks they had wane, their capacity to hold government accountable for its initial promises declines, and it becomes easier for free traders to dismantle the compensation system. In short, at least for certain sectors with highly specific assets or skills, protection and tariffs are politically much more attractive.[7]

2. 2. Statistical Evidence on the Globalization-Compensation Nexus

In exploring the consequences that the international economy has on the domestic political arena, a growing literature has shown in the last two decades that higher levels of trade systematically lead to a larger public sector across both developed and developing nations. In this subsection I revise the current statistical evidence. Sections 2.3 and 2.4 describe, in a succinct manner, several historical episodes illustrating the joint development of openness and compensation. Section 2.5 then considers some empirical work on why those compensation packages were set in place, stressing the role of political strategy in the construction of political coalitions. The final subsection reviews the literature on the globalization-compensation hypothesis in developing countries.

In a path-breaking article, Cameron (1978) observed that the best predictor of an increase in the size of the public sector as a share of GDP in the period 1960-75 was the degree of economic openness (as the sum of exports and imports over GDP) in 1960 among OECD countries, with a correlation of 0.78. Employing a world sample, Rodrik (1998) then showed that greater openness increases domestic volatility and risk: a 10-percent increase in external risk, measured in the form of fluctuations in the terms of trade, increases income volatility, measured through fluctuations in real GDP, by 1.0-1.6 percent. That volatility, which results from the fact that small, open economies are less diversified than large economies, pushes the public sector, whose employment and income levels are uncorrelated with world-driven shocks, to smooth the risk born by households as a result of external shocks. For the world sample in the mid 1980s and late 1990s, an increase in trade

---

[7] A clear example of the underlying logic can be found in history: the medieval guilds resisted their destruction well into the 19th century because the very laws that defined them determined their capacity to extract rents.

openness (imports and exports of GDP) of 10 percent is associated with a 2-percent increase in government consumption in GDP. More recent econometric analysis has confirmed those findings. Garrett (1998) has shown that trade openness is associated with higher levels of government consumption and overall spending for world cross-sections in the mid 1980s and the mid 1990s. Mares (2005) finds that economic openness is related to the introduction of social insurance coverage. Employing survey data for several OECD countries, Hays et al. (2005) confirm the compensation-openness nexus at the individual level: workers in import-competing sectors have a lower probability of supporting protectionism if they enjoy a generous safety net.

Whereas previous work saw compensation as mechanically deriving from increased openness, Adserà and Boix (2002) develop a model in which openness only happens if free traders offer some compensatory package to losers. That offer is only made, however, if the latter are politically decisive. This means, broadly speaking, that in democratic settings openness only happens if there is some compensation policy in place. However, in authoritarian regimes, where the majority is arguably excluded from voting, the process of economic liberalization may sometimes take place without offering any side payment to losers. Employing a panel data of around sixty five developing and developed nations for the period 1950-1990, they show that the size of the public sector as a share of GDP is, first, correlated with trade openness and that, second, the relationship is strongly conditional on the political regime in place. For medium levels of economic development, for instance, public revenue is around 23 per cent of GDP in a closed economy (where exports and imports equal 10 per cent of GDP), independently of the political regimes. However, as trade openness goes up to 100 per cent of GDP, public revenue rises to about 28 per cent of GDP under an authoritarian regime and to about 33 per cent of GDP under a democratic system.[8] Recent articles by Rudra and Haggard (2005) and Hiscox and Kastner (2008) confirm these findings.

---

[8] The results are estimated for an economy with a per capita income of $4,000. Adserà and Boix (2002) also show that the level of compensation will vary with the distribution of factors in the economy. Assuming a Stolper-Samuelson set-up, in labor-abundant economies, the majority of the population will lean toward free trade without any need to receive compensatory deals. By contrast, in labor-scarce economies, where the majority loses from trade, compensation packages will tend to be substantial. This result is confirmed after running a model with the log of capital stock per worker (as reported in the Penn World Tables), alone, in combination with trade openness and in interaction with openness and democracy. As expected, the size of the public sector grows with capital abundance (that is, with scarce labor and then a more pressing need to compensate).

[Figure 4 here]

Figure 4 shows the association between level of trade openness (measured through the proportion of exports and imports over GDP) and the unexplained variation of public revenues over GDP (once one controls, in a panel data estimation, for the effect of development on trade openness): each dot represents one country-year in a world sample that spans from the mid 1960s until the mid 1990s. The association is positive and statistically significant.[9]

2. 3. From Laissez-Faire to Compensatory Policies in Democratizing Europe (1830-1950)

A historical analysis of the evolution of trade policy in Europe since the 19th century also shows that the compensation was crucial to the process of globalization (conditional on the type of political institutions in place).The introduction of a laissez-faire trade regime in the first half of the 19th century in Britain and its gradual extension to continental Europe in the following decades was achieved without any simultaneous expansion of domestic mechanisms of compensation. Free trade was introduced with the support of commercial and urban interests in Britain and the backing of working class associations, who constituted the great majority of the enfranchised British electorate and whose interests were aided by an electoral system that was extremely biased against the agrarian sector, which had borne most of the losses of the tariff reform of 1846, and the urban poor (Rogowski 1989; Schonhardt-Bailey 1991).

The stability of the Cobdenite regime was put into question, however, by two parallel developments at the turn of the century. After the electoral reform of 1884, which equalized the franchise conditions of the rural counties to those already in place for counties, the British electorate doubled to encompass between two thirds and four fifths of the adult male population. A fall in agricultural prices and, above all, the growth of German competition unnerved British public opinion. Several anti-free trade episodes, such as an early resolution of the National of Conservative Associations in 1887 in favor of 'fair trade', the 'Made in Germany' panic of 1896 and the reimposition of sugar dues, the coal export duty and the corn duty in the late 1890s and early 1900s

---

[9] Figure 4 is presented as indicative of a correlation between trade openness and domestic compensation. For a more systematic analysis of that relationship and its possible causal structure, see all the references cited in the text and, in particular, Adsera and Boix (2002) and Hiscox and Kastner (2008).

finally led to a program in favor of an imperial tariff in the Conservative party's electoral platform of 1906. Although the Liberal party won in the 1906 landslide election under the banner of free trade, the economic downturn of 1907-08 and stagnant real wages resulted in a marked popular shift to Tariff Reform candidates in several by-elections (Searle 1992).The Liberal government responded by creating an old-age pension program in 1908, raising land taxes through the 'People's Budget' and introducing labor exchanges and trade boards the following year, establishing national insurance for sickness, invalidity and unemployment in 1911 and passing the Miners' Minimum Wage Act of 1912. The combination of free trade and compensation embraced by the Liberal cabinet pushed Conservatives and moderate Liberals into the tariff reform camp. As the Duke of Northumberland, a former opponent of Tariff Reform, wrote to Stratchey in the autumn of 1909 in reaction to Lloyd George's fiscal plans, "protection cannot be worse than Socialism (...) And as (...) Tariff Reform or Socialism are the only possible alternatives at this moment, I am quite prepared to swallow the former".[10] The political debate that emerged at the turn of the 20th century continued to structure the agenda of the interwar period. The Conservative party led the battle for imperial protection in the 1923 elections and was able, with the growing support of manufacturers and the City, to impose its solution in 1931. By contrast, Labor, which had succeeded the Liberals as the progressive alternative, almost unanimously defended free trade.[11] The fiasco of the 1930s policies and the victory of Labour in 1945 eventually brought Britain to the camp of open borders and sizable public intervention.

A similar evolution, with a much earlier and radical commitment to the compensation strategy, took place in Scandinavia. In Denmark and partly in Sweden the basis of universalist compensatory policies were already put in place at the turn of the century (Baldwin 1990). As soon as the Liberal party, supported by the Danish farming community, secured a strong majority in parliament, all-inclusive, non-contributory, tax-financed pensions were established in the 1890s. The type and size of pensions directly responded to the tradeable nature of farming sector: first, they were "one of the more successful measures tried" to attract labor needed by the farmers to keep

---

[10] Quoted in Blewett (1972), p. 79.
[11] As late as 1931, 93 per cent of Labour candidates supported free trade in their manifestos. Howe (1997), p.285.

being competitive "just as competition and falling prices fettered their ability to improve conditions and stem migration" (Baldwin 1990: 75); second, due to the international-prices-taker nature of Danish farming producers, their costs (and benefits) were spread across the whole population. The strategy of openness and compensation deepened in the 1930s and intensified again in the 1960s and 1970s (Cameron 1978, Katzenstein 1985). In the early 1970s and among OECD nations, public spending in education averaged 5.4 percent of GDP in open economies (those were exports equal 40 percent or more of GDP) and 3.7 percent in closed countries; income maintenance programs were 12.9 percent of GDP and 8.6 percent of GDP respectively; public fixed capital formation was 4.5 percent and 3.7 percent of GDP; subsidies were 2.5 and 1.2 percent respectively; and labor market policies amounted (in 1985) to 1 and 0.5 percent in each set of countries (OECD, several years).

The formation of a free trade plus compensation regime in Northern Europe contrasts with the combination of protectionist schemes and a smaller welfare state adopted by both Australia and New Zealand (Castles 1985 and 1989; Mabbett 1995). In response to depressed economic conditions in the late 19th century and given the low competitiveness of Australian industry at the time, Australian Labor agreed to support tariff reform in exchange for the legal recognition of a minimum wage for unskilled labor. Legal wage regulation, which was systematically sustained through a national system of compulsory arbitration in industrial disputes enshrined in the Federal constitution, had the objective to secure, in the terms of the 1907 Harvester Judgment from the Court of Conciliation and Arbitration, a "fair and reasonable wage" to meet "the normal needs of an average employee regarded as a human being living in a civilized community."[12] Sustaining a wage threshold required uncoupling (parts of) the domestic economy from international markets. A restrictive immigration policy in favor of preserving a 'white Australia' to block the inflow of low-wage, non-white workers became the masthead of the Federal Labor platform in 1905. Similarly, both Australia and New Zealand erected a strong tariff system to sustain prices in the domestic manufacturing industry in the 1920s and 1930s with clear success. Whereas export prices fell by 40 percent between 1920 and 1935, real weekly wages of workers only decreased by 5 percent in the same period in

---

[12] Quoted in Castles 1989, 34-5. The introduction of a protectionist regime also required buying off the support of farmers through a system of subsidies.

New Zealand. The use of methods to shape the wage structure significantly lessened any social demands for a large welfare state. In 1949-50, Australia only spent 4.7 percent of its GDP on social security -- compared with an average of 8.0 percent in 14 advanced industrial democracies (Castles 1985). By 1975, tax revenue as a proportion of GDP was 7.5 percentage points below the OECD average in both Australia and New Zealand.

2. 4. Free Trade, Democracy and Taxes in Southern Europe (1930-1980)

Although happening in a different historical juncture, a similar story may be told about the process of economic liberalization and political democratization that took place in Southern Europe in the last third of the 20th century. The Great Depression and the establishment of authoritarian regimes triggered the introduction of strong autarkic economic policies in Southern Europe in the 1930s and 1940s. Italy only abandoned them following the military defeat of 1945. Portugal and Spain did in the late 1950s after almost two decades of economic stagnation. Following an economic stabilization plan in 1957-59, the Spanish government made the peseta convertible, dismantled import quotas and courted foreign capital aggressively. Economic liberalization was followed by a rapid growth of the tradeable sector. The sum of exports and imports as a percentage of GDP rose from about 10 percent in 1958 to 34 percent in 1974. The inflow of foreign private long-term capital went from 15 million of US dollar in 1958 to 435 million ten years later. The maintenance of an authoritarian regime until 1975 'freed' the Spanish state from actively responding to the rapid dislocation caused by the process of economic liberalization. Tax revenues as a proportion of GDP fluctuated around 17 per cent throughout the 1960s and then climbed slightly to about 23 per cent in 1974 -- a level equal to about half of the tax effort of any other mid-size European country. Expenditure on social policies was half the European level (Maravall 1995). Expenditure in education averaged less than 2 percent in the 1960s -- about a third of the German and French level. Very similar policies were pursued in Portugal. Even with higher levels of trade openness (the sum of exports and imports as a percent of GDP was around 55 percent in the 1960s), public revenues stood below 20 per cent of GDP under Salazar's authoritarian rule (Corkill 1999). Indeed,

authoritarianism operated in a very similar fashion in Latin America's Southern Cone in the 1970s and in East Asia: it combined trade and financial liberalization with anemic social policies.

The Spanish (and Portuguese) transition to democracy in the mid 1970s did away with the combination of economic liberalization and minimal compensatory policies. In the context of overwhelming popular support for integration in the European Union, Spanish public expenditure grew by over 1 percentage point of GDP per year in real terms after 1975, reaching 49.6 per cent of GDP in 1993. Although an important part of that growth was simply due to the explosion of political demands that followed the introduction of free elections, part of the expenditure was related to the new conditions imposed by the rapid internationalization of the Spanish economy. In response to adverse international conditions, the Spanish government first spent heavily on unemployment benefits and injected money into entire industrial sectors -- subsidies and capital transfers rose to 5.6 percent of GDP by 1982. In the mid and late 1980s, the public sector then shifted the content of public expenditure to support strong capital formation policies that could increase Spain's competitiveness. Whereas subsidies and capital transfers were cut substantially by almost 2 per cent of GDP between 1982 and 1989, public fixed capital formation rose by 2.1 points of GDP up to 5.2 per cent of GDP in 1991, general education expenditure went up to 4.7 percent of GDP in 1994, and active labor market policies reached over 1 percent of GDP. Part of these new programs were supported with European structural funds, themselves a result of an explicit deal in which the Spanish cabinet supported German and French plans to forge the European Union in exchange for substantial transfers to Spain's poorer regions (Boix 1998).

2.5. Protectionism versus Free Trade and Compensation

Even though, as stressed before, the policy bundle of trade and compensation is Pareto-optimal with respect to protectionism, the latter has been rather widespread in many nations. This is apparent in Figure 5, which reproduces the evolution of the median tariff in the world, in Europe and

in America and Australasia. [13] Tariffs declined over the nineteenth century and then during the first decades of the twentieth century, particularly in Europe. After the Great Depression, however, the median tariff shot up dramatically from 9.8 percent in 1929 to 22.3 percent in 1932 in Europe and from 19 percent to 24 percent in America and Australasia. After 1945, tariffs were progressively lowered across the globe. By 1970 the median tariff was 3 percent in Europe and less than 10 percent in America.

[Figure 5 here]

Part of that temporal and cross-national variation had to do with two types of international factors. First, it responded to the strategic interaction of governments. That would explain why trade regimes clustered at the continental level: at least before World War II, tariffs were low in Europe but high both across America and Australasia. It would also clarify why both the reduction of tariffs in the 1860s and 1870s and their abrupt reintroduction in the 1930s took place through a tipping model. Second, cross-national behavior was probably shaped by the presence of a hegemonic power committed to free trade. Before 1918, although only for Europe, tariffs tracked British commitment to free trade. During the interwar period, the absence of a pro-free trade international hegemon facilitated the tariff escalation of the 1930s. Finally, after World War II, tariffs fell under the aegis of American supremacy.

Domestic factors also explain the extent to which policy-makers prefer protectionism over free trade. As discussed above, the size and political leverage of winners and losers determines the likelihood with which free trade policies will be chosen.[14] More to the point, the free-trade-plus-compensation solution only prevails if policy-makers can develop the proper bureaucratic tools (such as a viable welfare state) and political institutions (such as parties and unions) that allow them to promise compensatory policies in a credible manner. Using a most-similar research design, Boix (2006) examines this question through the comparison of the two self-governing colonies of Victoria and New South Wales. Before the formation of the Australian Commonwealth in 1901, in New

---

[13] Data for the period from 1865 to 1950 encompasses 35 nations. Data for America and Australasia has been obtained directly from Jeff Williamson (Clemens and Williamson 2001). Data for Europe comes from Mitchell (1992). The data for the period from 1970 to 1999 comes from the World Bank Development Indicators.
[14] See Rogowski (1989). For a summary, see Adserà and Boix (2003).

South Wales the Free Trade party struck a compact with the Labor party to sustain low tariffs in exchange for progressive direct taxation, a battery of industrial regulations and stable and generous public expenditure. By contrast, Victoria's protectionist politicians used the strong relationship between their Liberal party and unions to create a 'new protection' regime in which workers supported high tariffs in exchange for an arbitrational and tax system that made sure that part of the gains of protection were directly passed unto workers through high wages. Those different policy outcomes cannot be attributed to any structural factors: both colonies were very similar in population size, living standards, endowments, economic structure and constitutional arrangements. The adoption of opposite trade and fiscal policies resulted from the decision of politicians to organize very different electoral coalitions in similar policy spaces.

2. 6. The Compensation-Liberalization Nexus in Developing Countries

Whereas most of the literature confirms a positive association between globalization and public compensation for OECD countries, several articles generally find that correlation to be either non-existent or negative in developing countries. [15] Examining a sample of 14 Latin American countries from 1973 to 1997, Kaufman and Segura-Ubiergo (2001) conclude that economic internationalization increases the relative power of business sectors exposed to international competition and reduces social expenditure. After confirming that result for a broader sample of non-OECD countries, Rudra (2002) and Rudra and Haggard (2002) attribute those effects in developing countries to the existence of weak unions. That negative correlation may be also related to the fact that globalization has income compression effects in economies abundant in unskilled and semi-skilled workers. Additionally, several authors have claimed that the welfare state disproportionately benefits economically and politically privileged labor groups in less developed countries such as higher-skilled blue-collar and salaried workers and that it does not serve its intended goals of poverty alleviation (Mesa-Lago 1994, Huber 1996).

---

[15] For exception to the positive relation, see Garrett (2001), who shows that, at least for the mid 1990s, the relationship breaks down for high spending countries and that higher levels of trade integration did not lead to larger public sectors in the 1990s, and Dreher, Sturn and Ursprung (2008), who conclude that globalization is not associated with higher levels of expenditure after looking at a sample of 60 countries from 1971 to 2000 and to the universe of ECF countries since 1990.

Most recent quantitative studies have found, however, that the non-compensatory effects of globalization are all but uniform. Rudra (2004) concludes that globalization raises the incentives of developing countries for more redistributive education spending as well as more political lobbying and clientelism on publicly sponsored health programs and social security and welfare spending. After pointing that governments in open economies in the less developed world resort to restrictive spending policies because they have much more limited access to capital markets in bad times and are more exposed to currency fluctuations, Wibbels (2006) finds that trade openness is associated to more human capital formation always. Avelino et al (2005) show that trade openness is correlated with more social security and education spending (but not with more aggregate spending) in a sample of 19 Latin American countries from 1980 to 1999. More recently, Noorudin and Simmons (2009) argue that the extent of compensatory policies in developing countries is conditional on regime type. Whereas democracies in relatively closed economies react to openness by increasing spending on welfare and education, non-democracies cut back spending on both categories. However, as openness increases, regime differences decline and finally disappear.

3. ARE WELFARE STATES SUSTAINABLE IN A GLOBALIZED WORLD?

According to a rather widespread view among both public opinion and academic researchers, globalization threatens the ability of national states to sustain their own economic policies and to fund their social programs. Welfare states become hard to fund due to increasing inter-state competition for capital. The overall threat of factor reallocation weakens any political incentives to approve and sustain meaningful financial, labor and environmental regulations. Economic integration at the world level ignites a "race to the bottom" that jeopardizes democratic institutions and the postwar settlement that combined the market economy with an extensive safety net.[16] In light of such a dire view of the effects of globalization, its critics then split into two political camps: the "protectionists" and the "federalists". The protectionists, whose electoral support has grown recently in many democracies, would rather stop or even undo the process of international integration.

---

[16] For a popular account, see Friedman (1999). For an academic's perspective, see, for example, Rodrik (2007), chapter 6.

Historically, this protectionist backlash already happened in the 1920s and 1930s (Williamson 1998). The federalists, by now mostly limited to parts of the academic world and some policy elites, defend the construction of global political institutions to unify national regulations (such as labor or environmental standards) in order to counter the effects of excessive capital mobility and inter-state competition. Such a solution would arguably allow everyone to gain from free trade and the benefits of specialization at the international level while protecting key social and regulatory provisions at the national level. It would simply extend at the world level the system of "embedded liberalism" that was put in place at the national level (and partly among all developed democracies) after World War Two.[17]

　　To determine whether that critical view of globalization is correct, however, we need to examine it as part of a dynamic process of economic and political development, that is, in a context in which there are several countries developing (or not) and choosing a set of political institutions and economic policies. To do so, let us think of a world with three sovereign countries, *A*, *B* and *C*. Assume that, through a random process, *A* grows first. Underlying *A*'s growth, there is a continuous process of capital accumulation. Capital formation takes place unabated until, due to some decreasing returns to capital, the marginal return to capital falls to a level below its returns in economy *B* (minus the extra cost of moving that capital across borders). In its search for profits, the extra capital moves from country *A* to neighboring country *B*, triggering a process of growth in the latter economy. Economy *B* converges to the level of development of country *A* – the point at which the marginal return to capital is equivalent in both economies. This generates, in turn, a new capital outflow to country *C*. Even if this overall process may be somewhat bumpy along the way (Krugman 1991, Adserà and Ray 1998), what we should observe is a process of diffusion of capital and,

---

[17] The solution of global federalism is hard to implement, however, for several reasons. First, the level of economic and political heterogeneity across countries makes it difficult to see how they can give up some of their sovereignty to common institutions. For example, the European Union, which includes a relatively similar population (at least with respect to the whole world population) with democratic institutions in all its member states, has probably reached a limit in its federalization process due to its growing internal heterogeneity (Boix 2004). Second, since many developing countries seem to believe that, at their developmental stage, unbridled globalization (with high factor mobility) benefits them most, their incentive to establish some federative structure at the world level is very low.

ultimately, of growth convergence, with all economies reaching the same steady state in terms of capital accumulation and growth (Lucas 1990).

As is well known, that process of inter-state convergence to the same level of development only takes place, however, if those economies have the same underlying production technology, saving rates and population growth (Solow 1956) as well as the same institutional structure (affecting tax rates, the provision of public goods and property rights) (North 1990). Otherwise, the rate of return to capital will vary across countries and, as a result, either capital will not flow from rich to poor countries or it will only partially. In other words, in a world where countries differ in their technological and institutional conditions, each economy will reach a different level of economic development.

Suppose that the process of development (which, again, is partly conditional on the presence of certain institutions, such as a judiciary guaranteeing property rights) results in the introduction of new political institutions, and, more specifically, in the introduction of political liberties and the institutionalization of democracy. That has, in turn, two effects. In the first place, democracy and the expansion of the franchise lead to or are, at least, associated with rising taxes and more public expenditure. That result follows directly from the model discussed in the first part of the chapter. The extension of democratic rights implies that more, generally poorer, voters vote; as the income of the decisive voter becomes lower, that is, as her income moves further away from the economy's average income, there should more demand for higher taxes and transfers.[18] In the second place, political liberalization and the growing protection of human rights (such as freedom of expression, association, and so on) strengthens labor and therefore its wage bargaining capacity. As shown by Rodrik (1999), the income share of labor experiences substantial increases after countries transit to a democratic regime yet drops following a democratic breakdown. Rodrik's data is reproduced in Table 2. Employing a larger database, Przeworski et al. (2000) confirm those results.

[Table 2 here]

---

[18] On empirical evidence about the effect of democracy on spending, see Boix (2003). For a different view that sees development and democratization as covarying factors that are associated with larger public sectors, see Mulligan et al. (2004).

With all these stylized facts (on the sources and consequences of growth) in mind, we can go back to examine the question of how globalization affects redistribution. For countries that are fully integrated in the world market, the process of political and institutional liberalization (that is, democratization, increased tax capacity and stronger labor movements) seems to pull both the growth rate and the extent of feasible redistribution downward. After political liberties are introduced, the net return to capital becomes lower: wages and labor's income share grow faster than in a regime where human rights are not protected; taxes become higher, with deleterious effects (unless the government invests in those public goods and infrastructures that may raise the returns to factors). As a result, capital or, for that matter, any mobile factor leaves the country at an earlier stage than in the model I sketched at the beginning (and where political institutions were taken as given).

Whether this process and globalization will lead to a 'race-to-the-bottom' or not will depend on the political effects of economic development. If the process of growth results in different political and fiscal arrangements across countries, leading to political and labor rights in *A* but not in *B* (or in *A* and *B* but not in *C*), that is, if there is no "political convergence", the process of globalization and the emergence of *B* as a competitive economy will erode the redistributive effort and labor's share of national income in *A*.

Otherwise, that is, if the process of economic development triggers a process of political liberalization and democratization, globalization will not jeopardize *A*'s welfare state. There will be the same cycle of economic growth and overall convergence predicted in at the beginning of this section with a model based on purely economic traits (i.e. devoid of any institutional traits). In this story, which now includes a political and institutional dimension, as *A* becomes wealthier, its government expands political rights, democratizes its institutions and establishes a safety net. At some point, that is, in response to those changes (and provided they do not increase the productivity of capital through higher political stability, more accountable administrative structures, a better and healthier labor force), capital may leave. Exogenously (due to the inflow of foreign investment) or endogenously, *B* takes off and catches up with economy *A*. But in due time its economic development sets off similar processes of political liberalization. The net returns to capital become

similar to the more mature economy *A*. Factor mobility stabilizes and all economies reach a similar economic and institutional steady-state. In short, even if some adjustments have to be made in *A*, political liberties and welfare states are not fundamentally threatened by globalization and the overall process of economic catch-up that is taking place across the world.

Which one of the two stories is right? Does development cause political development and democracy? The literature on the relationship between economic development and political liberalization is still the object of a heavily contested debate. Examining a world sample for the period from 1950 to 1990, Przeworski and Limongi (1997) concluded that higher levels of per capita income stabilize democratic institutions but do not raise the probability of democratization. Hence one could envision a world in which developing nations (not belonging to the old industrial core in the North Atlantic region broadly construed) do not necessarily liberalize, eventually threatening the redistributive structures of the first industrializers. Employing a larger temporal sample, several papers have shown, however, that development both triggers democratic transitions and deters democratic breakdowns (Boix and Stokes 2003, Epstein et al 2006, Kennedy 2010). Still, the positive effect of development on democratic stability seems to be stronger than on democratic transitions, at least for the period after 1950 (Houle 2009; Boix 2010). A plausible theoretical rationale for this result would look as follows. Once countries have developed, high levels of per capita income stabilize the position of the ruler for two complementary reasons: the authoritarian ruler can buy support among the population, and the latter may prefer the stability of authoritarian rule (without political rights) than democratic rule (and political rights) if there is some uncertainty (generating some loss of material welfare with some probability) attached to the transition process (Miller 2010).

How do these results affect our discussion on the redistributive effects of globalization? We need to distinguish here between two types of wealthy (and stable) authoritarian regimes. On the one hand, some countries are authoritarian because their rulers control a very profitable natural resource (such as oil) that allows them to deactivate any democratic demands either by spending lavishly on their populations or by repressing them mercilessly (or both) (Ross 2001). Those cases are of little

interest for our purposes: they are not competing directly with other globalized economies for the kinds of assets that jeopardize the welfare state.

On the other hand, there are a handful of countries where the authoritarian ruler or clique invests heavily on public goods and human capital formation while suppressing all demands for direct redistribution (through transfers or higher wages) as a way to compete with already developed democracies. It that strategy succeeds, that is, if the economy grows fast and per capita incomes converge to the levels of democratic regimes, the population may have little incentive to invest time and resources in toppling the ruler. In fact, this strategy of rapid growth may lead to a rather equal domestic distribution of skills and of incomes. Following the model in Part 1, redistributive demands remain low and therefore any popular pressures to establish a democratic system (that may only imply non-material improvements in terms of political liberties) are very mild. The strategy of authoritarian stability and competition through high public goods and low taxes then remains self-sustaining. In a fully integrated world economy, capital or any mobile factors continues to flow into those authoritarian economies, rich in human capital and other public goods, yet low in pure redistributive transfers. Now, if those authoritarian economies are sufficiently large, they would end up undercutting the system of embedded liberalism that prospered among advanced democracies before globalization kicked in.

How prevalent are these regimes? After the transition to democracy of several East Asian economies (Korea in 1988, Taiwan in 1996) and once we exclude resource-rich countries, there are few cases that are both authoritarian and wealthy[19]. Moreover, those that are turn out be small in size – i.e. Singapore (arguably Hong Kong). Why is that the case? It is likely that smallness provides authoritarian politicians with two important advantages. First, political control is easier to maintain. Second, smallness (jointly with the type of economic activities that take place in city-states, which are essentially entrepôt economies) makes the threat of exit of capital almost costless and therefore very credible. This mechanism disciplines the ruling authority and makes democracy superfluous as a tool to hold politicians accountable. Democratic institutions have a fundamental growth-enhancing effect: by holding politicians accountable, they deliver the kinds of institutions and practices (clean

---

[19] I consider wealthy a country with a 2009 per capita income over $10,000 in PPP terms.

government, strong property rights, low levels of rent-seeking) that sustain growth in the long run (Olson 2000). But if smallness is replacing democracy quite effectively as a system to sustain pro-growth institutions, then one of the main attractions of having a democratic constitution goes away. The opposite is probably true for large countries. Political authority is difficult to maintain without some kind of encompassing institutions. More important perhaps, the non-institutional mechanisms (the threat of factor mobility) that may sustain a "well-behaved" authoritarian system are much weaker. Without constitutional checks-and-balances, corruption is rampant, growth slows down, and eventually comes to a halt at a mid point in the development path. If proper legal and political institutions are needed to generate sustained growth, development will be likely to lead to a process of political liberalization. Democratization, in turn, should make those countries converge to some extent with standard European welfare states.

That development-democratization nexus may explain why, contrary to an unconditional "race-to-the-bottom" story, welfare states have been so resilient so far. Figure 6 shows the world average of public expenditure and the extent of economic integration in the last fifty years. Globalization has proceeded at a fast pace yet the size of public sectors has not changed much and, if anything, has grown over time.

[Figure 6 here]

Even if development, democratization and redistribution are correlated in the long-run, they may not be in the short run. There is certainly no magical income threshold above which countries become democratic automatically. Hence the timing of those economic and political transformations (and the responses from policy-makers in already redistributive settings) may be crucial to explain the evolution of both economic integration and domestic compensation across the world. At least until the 1970s or 1980s, the wedge between factor returns in OECD countries and the world was high. That gap probably allowed advanced democracies to sustain generous welfare states and a strong commitment to free trade at the same time. Of course, efficient governments and well-functioning, universal education systems were also central to generate the conditions that kept those economies attractive to investors. As several economies, mostly in East Asia, industrialized, some

27

economic sectors in the European and North American industrial core ceased to be profitable. This process may have intensified with the emergence of China as a new industrial power.

A substantial proportion of the old advanced world successfully adjusted to the new conditions – relying on a more educated labor force (partly through generational replacement) and on firms that kept upgrading their technological advantage. Among those sectors that have been unable to compete, the consequences of the globalization shock have differed across countries with the strength of the domestic compensatory system. In the United States and the United Kingdom, which have quite flexible labor markets that adjust readily to world prices, wages among unskilled workers have fallen or stagnated in real terms – this has resulted, so far, in lower levels of structural unemployment yet higher levels of income inequality. By contrast, long-term unemployment, sustained by labor regulations and unemployment benefits, has shot upwards in Europe, especially in those countries in its periphery (such as the Mediterranean basin), which combine weakly competitive industries and very generous welfare systems.[20]

As discussed above, although policy-makers have an incentive to respond to globalization by changing the transfer/public goods ratio within public spending, whether they eventually do will depend on the composition and interests of the electorate. In advanced democracies the shift toward more investment (and away from direct redistribution) seems to be jeopardized by two broad social developments. First, the gradual ageing of Western populations forces national governments to spend increasing resources on pensions and therefore limits their ability to sustain other kinds of public programs (unless they resort to more public debt). Second, in labor markets with highly protected workers (such as those prevalent in continental Europe), the latter are effectively insulated from global competition and have little interest in a straight public goods strategy.[21] This, again, makes policy-makers more reluctant to restructure public spending – and therefore may exacerbate protectionist tensions.

---

[20] The economics literature is still divided on the sources this growing unemployment-inequality trade-off between those that stress pure skilled-biased technological change and those that underline the effects of trade. For a review and discussion, see Feenstra and Hanson (2001).

[21] Additionally, the decline of encompassing unions and of centralized wage bargaining may have reduced the incentives of unionized workers to internalize the costs of their decisions and may have reduced their incentives to favor public-goods policy strategies (Olson 1981, Calmfors and Driffill 1988).

4. CONCLUSIONS

After describing the economic effects of globalization (a shift in the distribution of income and higher factor mobility), this chapter has examined the policy responses of policy-makers to economic integration in the world market. First, the process of globalization may imply the adoption of compensatory policies toward those economic sectors that lose from more economic openness. Although the final introduction of those mechanisms of public compensation is a function of the electoral weight of each economic sectors and of the institutional set-up (democratic or not, etc.) within which decisions are made, there is considerable statistical and historical evidence showing that compensation and openness do go hand in hand, at least in developed countries.

At the same time, however, since the process of globalization increases the mobility of factors, it may jeopardize the ability of states to meet social demands for compensation (or for any redistributive mechanism). A policy of social compensation, by reducing social conflict and guaranteeing some kind of social contract, may in itself reduce the incentives of certain factors (such as capital) to move abroad in response to higher taxation. However, globalization should also push states to shift public resources from pure redistribution spending to public good and human capital formation. Because investment policies only increase the returns to factors with a lag (if at all), the commitment of policy-makers to develop investment policies will be strongly affected by their electorates' factor endowment and discount rates. This tension between pure transfers and public goods (and human capital formation) seems to have risen in advanced countries due to changes in their demographic structure and to the power of labor market insiders.

In the medium and long run the possibility to maintain welfare states and a globalized economy depends on the interaction of the economic structure and political institutions of all countries. An influential part of the literature argues that globalization triggers a tax and spending race to the bottom. According to this position, the advanced world will end up adjusting its welfare state downward, forced by the competition of emerging economies. In turn, the industrializing world has little incentive to introduce any social and labor regulations that could derail it from catching up with wealthier economies. A different view on the effects of globalization on social policies is,

however, equally possible and empirically more compelling. In this account, tentatively sketched in the last part of this chapter, as soon as each economy reaches a certain level of prosperity, it expands political rights and democratizes. This, in turn, leads to the creation of a social insurance system and to a bigger share in labor income. Since factor returns converge across all economies, all countries develop along similar economic and institutional paths, reaching an analogous economic and institutional steady-state. In short, even though more mature economies may have to implement some policy adjustments in the short and medium run, political liberties and welfare states are compatible with globalization in the long run.

REFERENCES

Adserà, Alícia and Carles Boix. 2002. "Trade, Democracy and the Size of the Public Sector,"
	International Organization 56 (Spring): 229-62.
Adserà, Alícia and Carles Boix. 2003. "The Political Economy of Trade and Economic Integration:
	A Review Essay." In Robert Devlin and Antoni Estevadeordal, eds. *Bridges for
	Development: Policies and Institutions for Trade and Integration*. Inter-American
	Development Bank. Washington, DC.
Adserà, Alicia & Ray, Debraj. 1998. "History and Coordination Failure," *Journal of Economic
	Growth* 3(3): 267-276.
Autor, David. 2010. "The Polarization of Job Opportunities in the U.S. Labor Market. Implications
	for Employment and Earnings." The Center for American Progress and The Hamilton
	Project.
Avelino, G., D.S. Brown and W. Hunter. 2005. "The Effects of Capital Mobility, Trade Openness,
	and Democracy on Social Spending in Latin America, 1980–1999," *American Journal of
	Political Science* 49 (3): 625-641.
Baldwin, Peter. 1990. *The Politics of Social Solidarity: Class Basis of European Welfare State,
	1875-1975*. New York: Cambridge University Press.
Blewett, Neal. 1972. *The Peers, the Parties and the People : the British General Elections of 1910.*
	Toronto : University of Toronto Press.
Boix, Carles. 1998. *Political Parties, Growth, and Equality. Conservative and Social Democratic
	Strategies in the World Economy*. 1998. New York: Cambridge University Press.
Boix, Carles. 2003. *Democracy and Redistribution*. New York: Cambridge University Press.
Boix, Carles. 2004. "The Institutional Accommodation of an Enlarged Europe." Friedrich-Ebert-
	Stiftung. Berlin.
Boix, Carles. 2006. "Between Protectionsim and Compensation: The Political Economy of Trade."
	In Pranab Bardhan, Samuel Bowles and Michael Wallerstein, eds. *Globalization and
	Egalitarian Redistribution*. Princeton University and Russell Sage Foundation. Chapter 8.
Boix, Carles. 2010. "Development and Democratization." Princeton University. Unpublished
	manuscript.
Boix, Carles and S. Stokes. 2003. "Endogenous Democratization." *World Politics* 55 (July): 517-49.
Burgoon, Brian. 2001. "Globalization and Welfare Compensation: Disentangling the Ties That
	Bind," International Organization 55 (Summer): 509-551.
Calmfors, Lars and John Driffill. 1988. "Bargaining Structure, Corporatism and Macroeconomic
	Performance," *Economic Policy* 3(April):13-61.
Cameron, David R. 1978. The Expansion of the Public Economy: A Comparative Analysis.
	American Political Science Review 72:1243-61.
Castles, Francis G. 1985. *The Working Class and Welfare: Reflections on the Political Development
	of the Welfare State in Australia and New Zealand, 1890-1980.* London: Allen & Unwin.
Castles, Francis G. 1989. Social Protection by Other Means: Australia's Strategy of Coping with
	External Vulnerability. In *The Comparative History of Public Policy*, edited by Francis G.
	Castles, chapter 2. New York: Oxford University Press.
Clemens, A. Michael and Jeffrey G. Williamson. 2002. "Why the Tariff-Growth Correlation
	Changed After 1950?" Harvard University. Unpublished Manuscript.
Corkill, David. 1999. *The Development of the Portuguese Economy: a Case of Europeanization*.
	New York : Routledge.
Donges, J. B. 1971. From an Autarchic Towards a Cautiously Outward-Looking Industrialization
	Policy: The Case of Spain. *Weltwirtschaftliches Archiv* 107: 33-72. Reprinted in *The
	Economic Development of Spain since 1870*, edited by Pablo Martín-Aceña and James
	Simpson, 350-89. Aldershot, UK.
Dreher, Axel, Jan-Egbert Sturm and Heinrich W. Ursprung. 2008. "The impact of globalization on
	the composition of government expenditures: Evidence from panel data," *Public Choice* 134:
	263–292.

Epstein, David L. Robert Bates, Jack Goldstone, Ida Kristensen and Sharyn O'Halloran. 2006. "Democratic Transitions," *American Journal of Political* Science 50 (July):551-569.

Feenstra, Robert C., and Gordon H. Hanson. 2001. "Global Production Sharing and Rising Inequality: A Survey of Trade and Wages," *NBER Working Paper* No. 8372.

Friedman, Thomas. 1999. *The Lexus and the Olive Tree*. New York: Farrar.

Frieden, Jeffry A. and Ronald Rogowski. 1996. The Impact of the International Economy on National Policies: An Analytical Overview. In *Internationalization and Domestic Politics*, edited by Robert O. Keohane and Helen V. Milner, chapter 2. New York: Cambridge University Press.

Garrett, Geoffrey. 1998. *Partisan Politics in the Global Economy*. New York: Cambridge University Press.

Garrett, Geoffrey. 2001. "The Distributive Consequences of Globalization." Unpublished manuscript. Yale University.

Gemmell, Norman, Richard Kneller and Ismael Sanz. 2008. "Foreign investment, international trade and the size and structure of public expenditures," *European Journal of Political Economy* 24: 151–171.

Hays, Jude C., Sean D. Ehrlich and Clint Peinhardt. 2005. "Government Spending and Public Support for Trade in the OECD: An Empirical Test of the Embedded Liberalism Thesis," *International Organization* 59 (Spring): 473-494.

Hiscox, Michael J. and Scott Kastner. 2008. Trade Policy Openness, Government Spending, and Democratic Consolidation. In *Global Democracy and Its Difficulties*, Anthony Langlois (ed.). New York: Routledge.

Houle, Christian. 2009. "Inequality and Democracy: Why Inequality Harms Consolidation but Does Not Affect Democratization," *World Politics,* 61 (August): 589-622 .

Huber, E. 1996 "Options for Social Policy in Latin America: Neoliberal versus Social Democratic Models."In *Welfare States in Transition: National Adaptations in Global Economies*, edited by G.Esping-Andersen, pp. 141–191. London: Sage Publications.

Katzenstein, Peter. 1985. *Small States in World Markets: Industrial Policy in Europe*. Ithaca: Cornell University Press.

Kaufman, Robert and Alex Segura-Ubiergo. 2001. "Globalization, Domestic Politics, and Social Spending in Latin America: A Time-Series Cross-Section Analysis, 1973-97," *World Politics* 53 (July): 553-587.

Kennedy, Ryan. 2010. "The Contradiction of Modernization: A Conditional Model of Endogenous Democratization," *Journal of Politics* 72(July): 785-798.

Krugman, P. 1991. "History Versus Expectations," *Quarterly Journal of Economics* 106, 651-667.

Lipset, Seymour M. 1959. Some Social Requisites of Democracy: Economic Development and Political Legitimacy. *American Political Science Review* 53: 69-105.

Lucas, Robert E. 1990. "Why Doesn't Capital Flow from Rich to Poor Countries?," *American Economic Review* 80 (May): 92-96.

Mabbett, Deborah. 1995. *Trade, Employment, and Welfare : a Comparative Study of Trade and Labour Market Policies in Sweden and New Zealand, 1880-1980.* Oxford, England : Clarendon Press.

Maravall, José María. 1995. *Los resultados de la democracia*. Madrid: Alianza Editorial.

Mares, Isabela. 2005. "Social Protection Around the World External Insecurity, State Capacity, and Domestic Political Cleavages," *Comparative Political Studies* 38 (August): 623-651.

Mesa-Lago, C. 1994. *Changing Social Security in Latin America*. London: Lynne Rienner Publishers.

Miller, Michael. 2010. "Economic Development, Violent Leader Removal, and Democratization." Princeton University. Unpublished manuscript.

Mitchell, Brian R. 1992. *International Historical Statistics, Europe, 1750-1988*. New York: Stockton Press.

Mulligan, Casey B.; Gil, Ricard; Sala-i-Martin, Xavier. 2004. "Do Democracies Have Different Public Policies than Nondemocracies?," *The Journal of Economic Perspectives* 18 (Winter): 51-74.

Nooruddin, Irfan and Joel W. Simmons. 2009. "Openness, Uncertainty, and Social Spending: Implications for the Globalization— Welfare State Debate, *International Studies Quarterly* 53 (September): 841–866,

North, Douglass. 1990. *Institutions, Institutional Change and Economic Performance*. Cambridge: Cambridge University Press.

Olson, Mancur. 1981. *The Rise and Decline of Nations*. New Haven, Conn.: Yale University Press.

Olson, Mancur. 2000. *Power and Prosperity*. New York: Basic Books.

Przeworski, Adam and Fernando Limongi. 1997. "Modernization: Theories and Facts," *World Politics* 49 (January).

Przeworski Adam, José Cheibub and Fernando Limongi. 2000. *Democracy and Development*. New York: Cambridge University Press.

Rodrik, Dani. 1998. "Why Do Open Economies Have Bigger Governments?" *Journal of Political Economy* 106: 997-1032.

Rodrik, Dani. 1999. "Democracies Pay Higher Wages," *Quarterly Journal of Economics* 114 (August): 707-738.

Rodrik, Dani. 2007. *One economics, many recipes: globalization, institutions, and economic growth.*

Rogowski, Ronald. 1989. *Commerce and Coalitions: How Trade Affects Domestic Political Alignments*. Princeton, New Jersey: Princeton University Press.

Ross, Michael. 2001. "Does Oil Hinder Democracy?", *World Politics* 53 (April): 325-361.

Rudra, Nita. 2002. "Globalization and the Decline of the Welfare State in Less-Developed Countries," *International Organization* 56 (April): 411-445.

Rudra, Nita. 2004. "Openness, Welfare Spending, and Inequality in the Developing World," *International Studies Quarterly* 48 (September): 683–709.

Rudra, Nita and Stephan Haggard. 2005. "Globalization, Democracy, and Effective Welfare Spending in the Developing World," *Comparative Political Studies* 38 (November): 1015-1049.

Schonhardt-Bailey, Cheryl. 1991. Lessons in Lobbying for Free Trade in 19th-Century Britain: To Concentrate or Not. *American Political Science Review*, 85 (March): 37-58.

Solow, Robert M. 1956. "A Contribution to the Theory of Economic Growth," *Quarterly Journal of Economics* 70 (February): 65-94.

Spence, Michael and Sandile Hlatshwayo. 2011. "The Evolving Structure of the American Economy and the Employment Challenge." Working Paper. Center on Foreign Relations.

Wibbels, Erik. 2006. "Dependency Revisited: International Markets, Business Cycles, and Social Spending in the Developing World," *International Organization* 60 (April): 433-468.

Williamson, Jeffrey G. 1998. "Globalization and the labor market: using history to inform policy." In Philippe Aghion and Jeffrey G. Williamson. *Growth, Inequality and Globalization*. New York: Cambridge University Press. Pages 105-200.

Wood, Adrian. 1995. *North-South Trade, Employment and Inequality: Changing Fortunes in a Skill-Driven World*. New York: Oxford University Press.

TABLE 1. Evolution of Tax Rates on Capital and Labor, 1981-2010

A. Tax Rate on Corporate Income, 1981-2010

	1981	1990	2000	2010	Absolute Change
Australia	46.0	39.0	34.0	30.0	-16.0
Canada	50.9	41.45	42.6	29.5	-21.4
France	50.0	42.0	37.8	34.4	-15.6
Germany	60.0	54.5	52.0	30.2	-29.8
Italy	36.3	46.4	37.0	27.5	-8.7
Japan	n.a.	50.0	40.9	39.5	-10.4
United Kingdom	52.0	34.0	30.0	28.0	-24.0
United States	49.7	38.6	39.34	39.2	-10.5
All OECD Economies (Unweighted Average)	47.7	41.3	34.6	27.3	-18.7

-18.7

Source: OECD Statistics.

B. Average personal income tax and social security contribution rates on gross labour income (Taxes estimated on average wage), 2000-2009

	2000	2009	Absolute Change
Australia	26.11	22.00	-4.11
Canada	25.39	22.80	-2.59
France	28.79	27.70	-1.09
Germany	44.52	41.30	-3.22
Italy	28.16	29.30	1.14
Japan	17.00	20.10	3.10
United Kingdom	25.38	25.30	-0.08
United States	24.91	22.40	-2.51
All OECD Economies (Unweighted Average)	29.1	26.8	-2.3

Average wage: average annual gross wage earnings of adult, fulll-time manual and non manual workers in the industry (ISIC C to K)
Tax Rate: Combined central and sub-central government income tax plus employee social security contribution, as a percentage of gross wage earnings.
Source: OECD Statistics.

C. VAT/GST rates in OECD member countries

	First Year of Implementation	Tax Rate in 1976 or First Implementation Year	Tax Rate in 2010	Absolute Change
Australia	2000	10.0	10.0	0.0
Canada	1991	7.0	5.0	-2.0
France	1968	20.0	19.6	-0.4
Germany	1968	11.0	19.0	8.0
Italy	1973	12.0	20.0	8.0
Japan	1989	3.0	5.0	2.0
United Kingdom	1973	8.0	17.5	9.5
All OECD Economies (Unweighted Average)				+3.3

Source: OECD Statistics.

TABLE 2. Political Regimes and Factor Share of Labor.

		Factor share of labor (manufacturing)	
Year	Country	Pretransition	Posttransition
A. Transitions from democracy to autocracy			
1973	Chile	0.24	0.13
1980	Turkey	0.38	0.25
1976	Argentina	0.31	0.19
1964	Brazil	0.26	0.19
	Mean	0.30	0.19
B. Transitions from autocracy to democracy			
1974	Greece	0.33	0.40
1974	Portugal	0.40	0.58
1975	Spain	0.51	0.58
1989	Chile	0.15	0.17
1989	Hungary	0.35	0.42
1983	Turkey	0.27	0.20
1983	Argentina	0.19	0.20
1985	Brazil	0.22	0.20
	Mean	0.30	0.34

Note. The factor share of labor refers to the ratio of average wages and salaries to MVA per worker, or the wage bill divided by value added in manufacturing. Pre- and postvalues are calculated using up to three observations prior to and following the year of transition indicated.

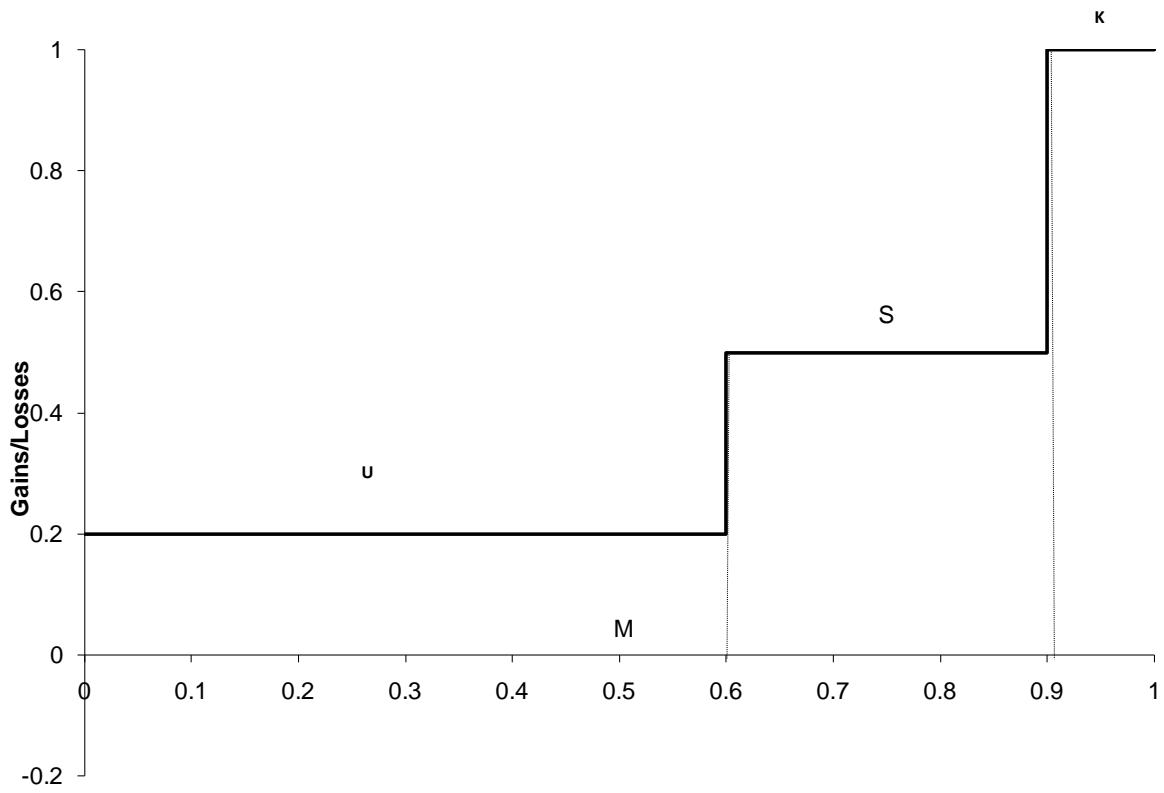Source: Rodrik (1999), Table 6.

Figure 1. Stylized Economy

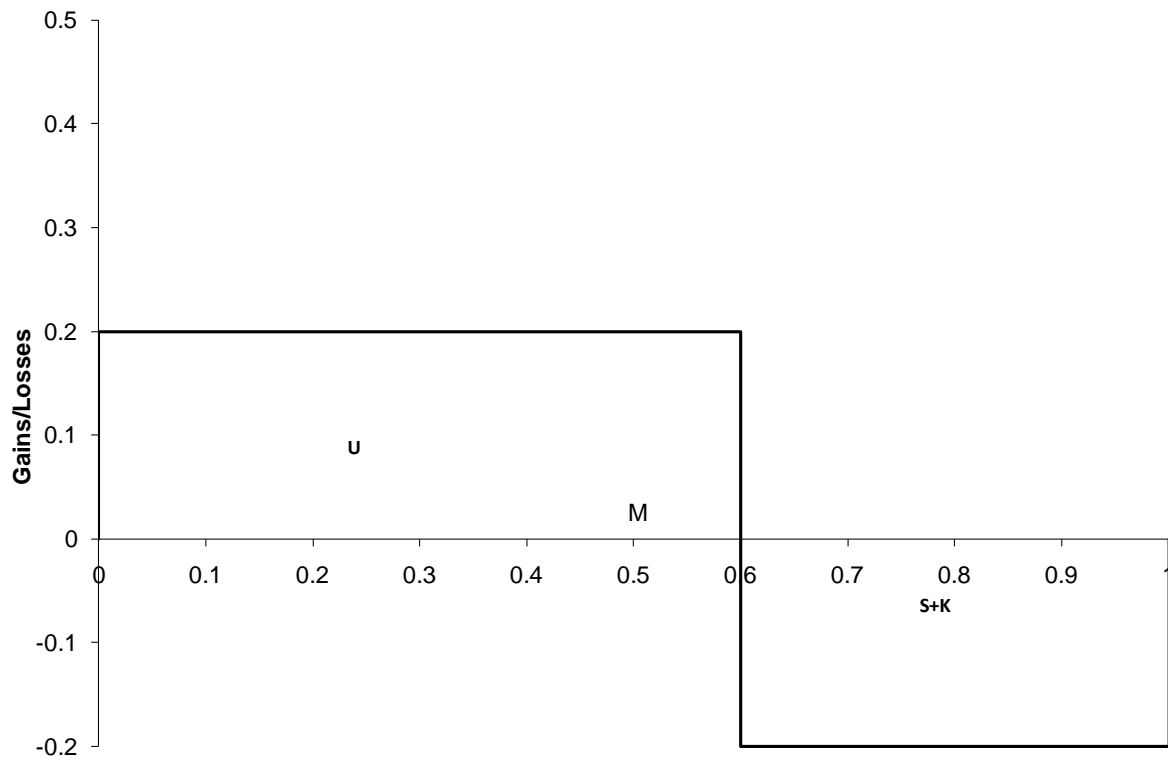**Figure 2.A. Economic Integration and Growing Equality**

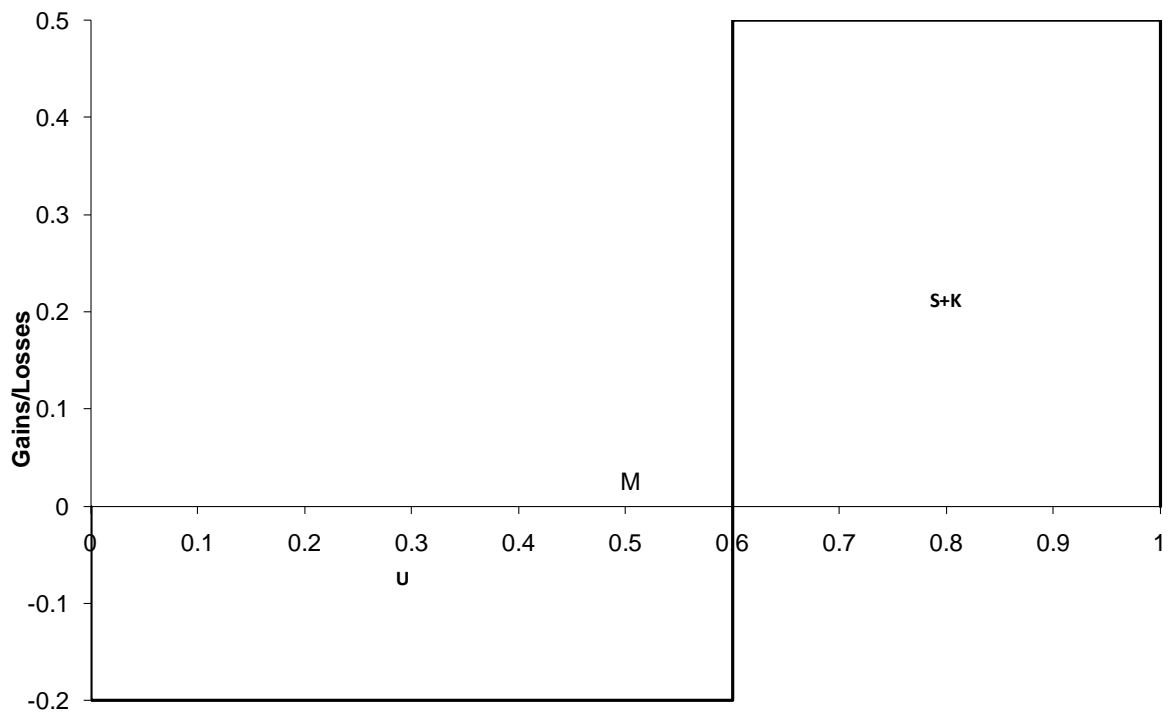## Figure 2.B. Economic Integration and Growing Inequality

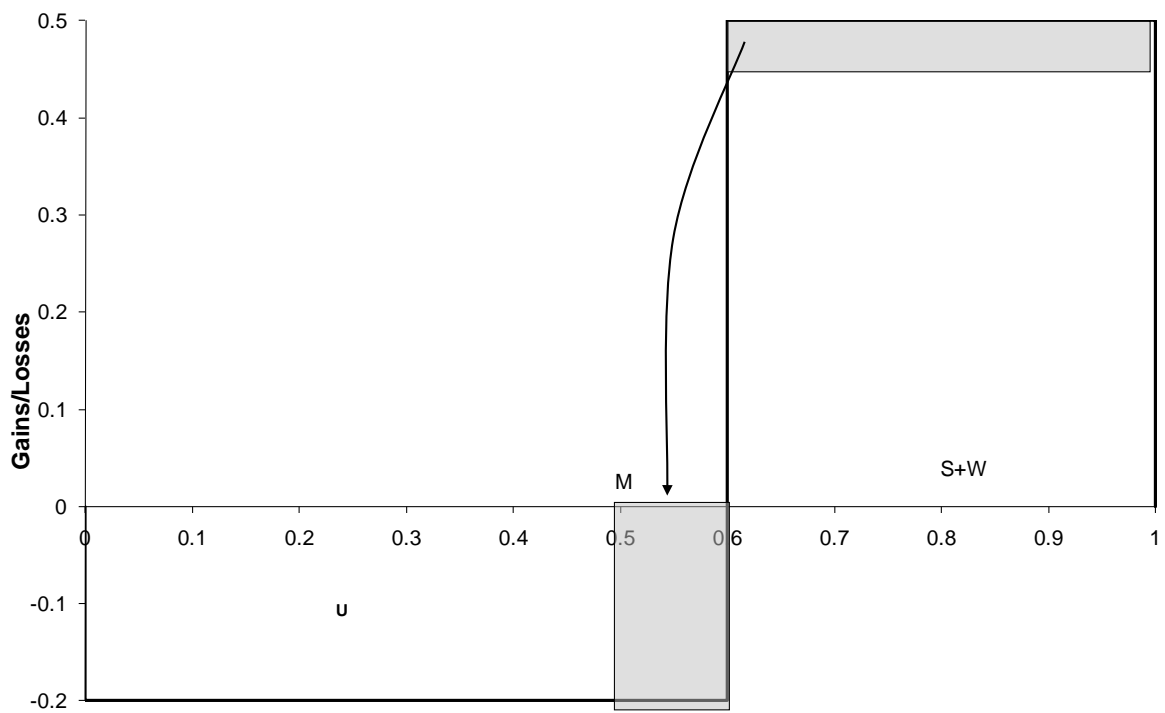## Figure 3. Compensation and Free Trade.

FIGURE 4. TRADE OPENNESS AND THE SIZE OF GOVERNMENT, 1950-1995

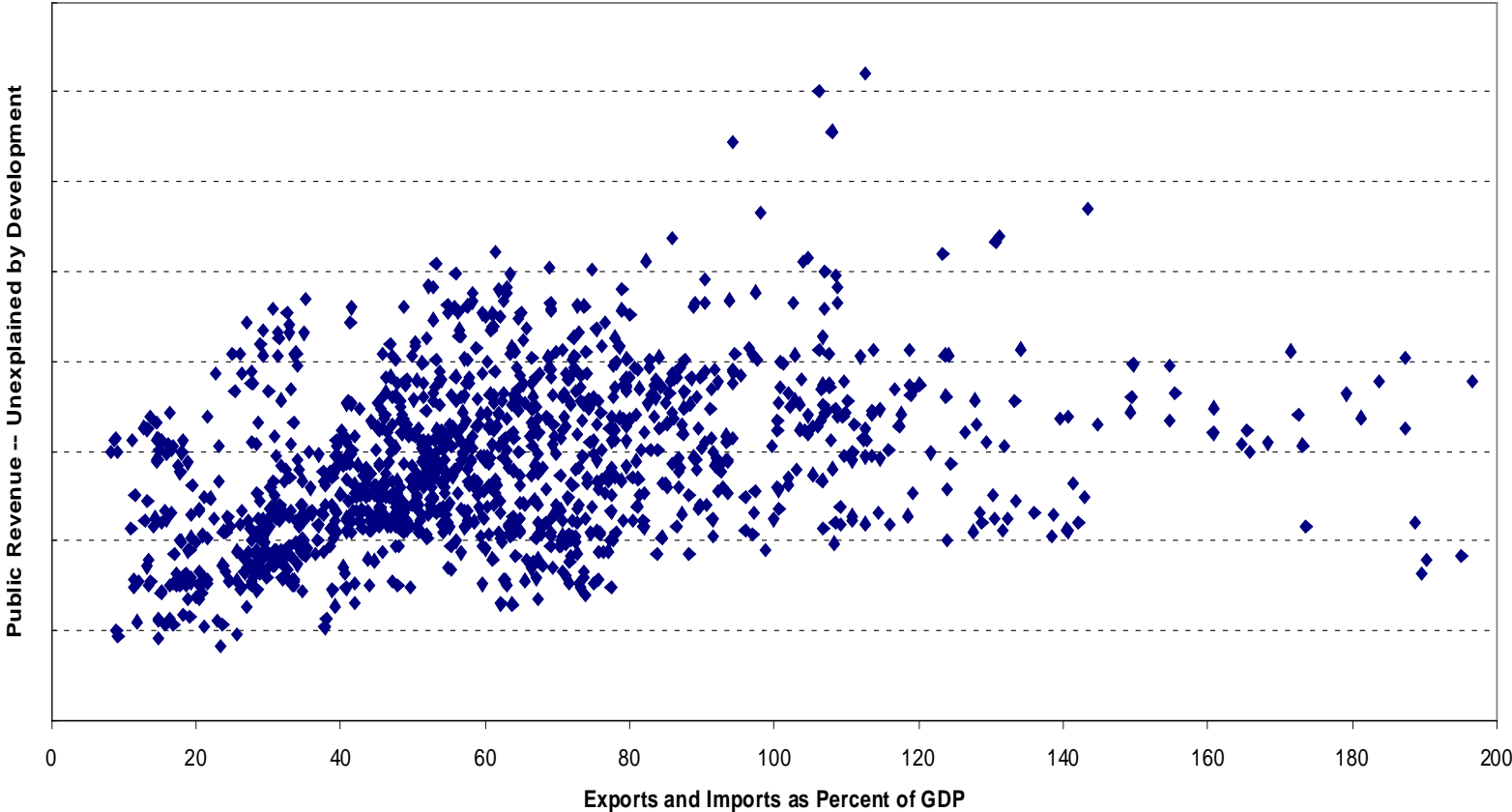Trade Openness and the Size of Government (Controlling for Development)
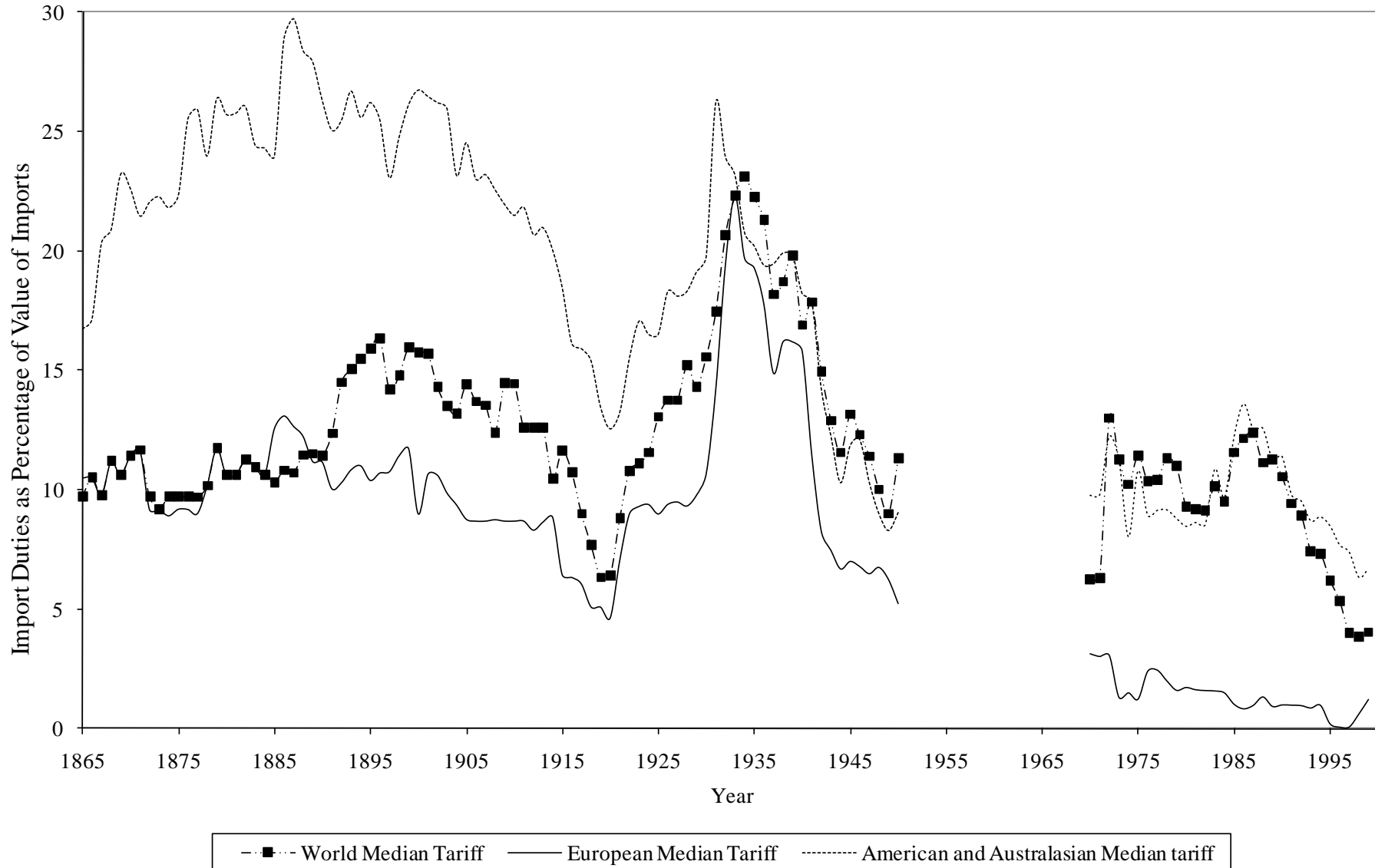
Figure 5. The Evolution of Tariffs 1865-1999

Legend: -■- World Median Tariff ── European Median Tariff ┄┄ American and Australasian Median tariff

X-axis: Year (1865–1995)

Y-axis: Import Duties as Percentage of Value of Imports (0–30)

Figure 6
The Evolution of Public Revenue and Trade, 1950-2005

Public Revenue over GDP in OECD Nations — — — Public Revenue over GDP in Non OECD Nations

Volume of Exports and Imports over World GDP