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REASSESSING THE RELATIONSHIP BETWEEN GLOBALIZATION AND WELFARE:

WELFARE SPENDING AND INTERNATIONAL COMPETITIVENESS IN LESS DEVELOPED COUNTRIES

by

Nita Rudra

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Requirements for the Degree
MASTER OF ARTS
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Master of Arts

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Abstract

This thesis challenges the conventional wisdom that government welfare spending in this contemporary era of globalization must be sacrificed for the sake of improving international competitiveness. Using the panel data for 44 less developed countries (LDCs) and the fixed-effects methods, it is revealed that LDC fiscal policy choices do *not* adversely affect their competitiveness. Rather, it is international market conditions and the indiscriminate behavior of international investors that are stronger determinants of LDC's national competitiveness and, subsequently, their level of economic globalization.

These findings provide sufficient justification for scholars and policymakers alike to reassess their claim that welfare state spending is inefficient and erodes a nation's competitiveness in global markets.

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I. Introduction

This analysis challenges the conventional wisdom that government welfare spending in this contemporary era of globalization must be sacrificed for the sake of improving international competitiveness. Research indicates that the incentives to prioritize market-oriented policies over social objectives (i.e., social security and welfare) are particularly high for governments of less developed countries (LDCs).[1] Such economic policy choices are consistent with the chorus of scholars and policymakers who claim welfare state spending is inefficient and erodes a nation's competitiveness in global markets. Yet a growing number of researchers assert that LDC fiscal policy choices do *not* in fact adversely affect their competitiveness. Rather, it is international market conditions and the indiscriminate behavior of international investors that are stronger determinants of LDC's national competitiveness and, subsequently, their level of economic globalization.

Globalization is not (yet) an inexorable process and thus it is all the more important to investigate the dynamic relationship between economic globalization and welfare spending. If the conventional neoliberal agenda and the call for prudent fiscal

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[1] See, for example, Arrighi and Silver (1999), Heredia (1997), Morales (1998), and Pasha (1996).

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policies is effective, then lower social spending should positively affect competitiveness and thereby effect stronger links with international markets.[2] This study assesses the impact of welfare state spending on economic globalization across 44 LDCs from 1972-1995.[3] The results of this paper support the conventional view that reduced government welfare expenditures increase competitiveness with respect to trade, but do not affect the competition for financial or productive capital flows.

This study asks whether the impact of LDC social welfare policies on trade and capital flows differs, if at all. By analytically separating the different components of globalization—trade, productive and financial capital flows—the impact of national political factors on each globalization parameter can be explored. This analysis relies on the assumption that a nation that is becoming more competitive will exhibit increasing levels of economic globalization *ceteris paribus*. It posits that the competitiveness of a nation is affected by higher (or lower) welfare spending if it is experiencing a corresponding decrease (or increase) in export levels and/or net capital flows. The model for exports is drawn from the debate between the World Bank and the International Labor Organization, while the model for the latter is constructed on the basis of the international (push) verses domestic (pull) source of capital flows.

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[2] This analysis assumes that if a nation increases its national competitiveness, then the economy will become more globalized.

[3] These countries include large parts of Asia, Africa, Middle East, and Latin America, and cover the post-Bretton Woods era. See Appendix B for more details.

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Careful empirical work on the political economy of both trade and capital flows in LDCs has long been needed. Scholars and policymakers alike stand to benefit from research that explores the feedback effects of lower state welfare spending in this era of economic globalization. This analysis accomplishes three things. First, it serves as a more rigorous test of the logic of the conventional wisdom. Research suggests that LDCs are indeed lowering their welfare expenditures in order to mollify international investors and increase national competitiveness. However, in order for the conventional argument to be complete, LDCs should be experiencing increased globalization as a response to this lower level of welfare spending. Second, this type of investigation into the globalization-welfare nexus provides greater insights into the complexity of these two variables and their interrelationship. Economic globalization, after all, is not an inevitable process that is immune to political pressures, particularly since capital has acquired institutional representation in transnational institutions. Finally, by disaggregating the different aspects of economic globalization, into increasing trade, and productive and financial capital mobility, this study explores the differential impact of LDC domestic policy on each of these variables.

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II. Conceptual Context

Conventional wisdom asserts but does not demonstrate how government welfare expenditures affect international competitiveness. Instead, there seems to be an implicit agreement in the globalization literature that spending on welfare is by definition inefficient and, consequently, dampens the competitiveness of national goods and services as well as incentives for capital investments. For example, Scholte (1997: 448) evidently assumes welfare spending harms competitiveness:

> At a time when the financing of many social security systems were coming under strain..., the added pressure from global capital for reduced taxes and labor costs has driven many governments to cut back welfare programs. In the cause of bolstering global competitiveness, governments across the planet have since 1980 rolled back social democracy and dismantled state socialism. Such shrinkages have been the cornerstone of many 'adjustment' packages in the South...Governments have generally implemented the greatest cuts in respect of sunk costs such as unemployment benefits, old-age pensions, and untied official development assistance.

Effectively removing questions of 'how' and 'why' redistribution policies (i.e., welfare spending) affect globalization from the realm of investigation, Gill (1995:417) takes a similar approach:

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> Driven to raise operating finance on the more globalized financial markets, governments are pressured into providing a business climate judged attractive by global standards in order to win and retain foreign direct investment... Traditional forms of state intervention in the economy to promote redistribution have declined, and the socialization of risk for the majority of the population has been eroding.

The problem with this scholarship is that it refers to the relationship between welfare-type fiscal policies and competitiveness in global markets at too high a level of abstraction. As a result, the reality that there are two distinct (albeit related) forces at play, one in export markets and the other in financial markets, and that welfare spending may have differential effects upon both is often overlooked. Underlying debates on each of the two aspects of LDCs economic globalization must be addressed before the conventional "race to the bottom" thesis can be fully validated.[4] If the corresponding empirical tests fail to confirm conventional wisdom on both counts, then the idea that welfare spending negatively affects national competitiveness misguides both scholars and policymakers alike.

Welfare statism as defined by Pfaller et al. (1991) refers in the most general way to "the use of state power and responsibility towards the ends of protecting citizens against economic adversities and ensuring a certain standard of prosperity to all." The analysis in this paper focuses specifically upon formalized public programs

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[4] Conventional theorists advocate the race to the bottom thesis. They argue that governments compete with each other by continuously lowering their taxes and labor costs in an effort to increase capital and trade flows. See, for example, Strange (1997), Scholte (1997), Greider (1998) and Nader (1993).

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of income maintenance and welfare services which, according to Pfaller et al. (1991) are the most visible manifestations of welfare statism.[5] Note that these schemes are generally financed by employer, employee, and state contributions and are considered to be a component of non-wage labor costs (or social wage). Interestingly, data shows that, on average, contributions from all three sources have fallen since 1972 (see Chart 1).[6] This study focuses specifically on government spending on social welfare, since it is the government that is the ultimate guarantor of the size and extent of the LDC welfare state.

How, then, might fiscal policies in this vein affect trade and capital flows of developing countries? Does the empirical evidence confirm the tenets of conventional wisdom that claim welfare spending negatively affects national competitiveness? Put differently, has the rise in LDC trade and capital flows since 1972 occurred in part as a response to lower government spending on welfare?

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[5] These refer more specifically to income transfers such as pensions, unemployment benefits and family allowances. See Table 1 for further descriptions.

[6] Because of limited data, this pattern could only be confirmed in a limited number of LDCs. Data on government welfare expenditures and economic globalization has been collected for a total of 53 LDCs. Of these, due to a lack of cross-national data on employer and employee contributions, the above pattern could only be verified in 45% of the cases. Thus, the conclusion that employer, employee and government spending in LDCs are declining is based on limited data.

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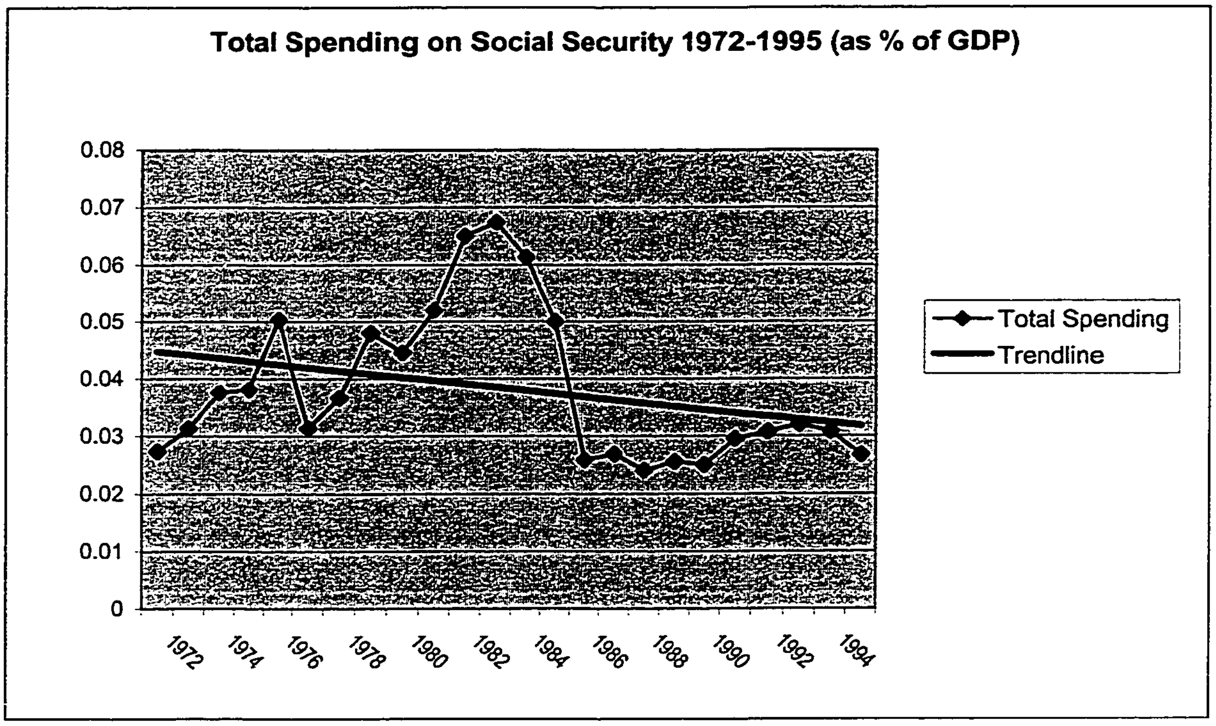
Chart 1: Total Social Security Contributions*



Source: *Government Finance Statistics* (IMF: various editions).

*For countries included, please see Appendix B.

Very little empirical work has been done on the political economy of trade and capital flows. As of yet, there are no studies that have addressed these questions and convincingly demonstrated that the logic behind conventional theories is empirically sound. Responses to these inquiries must be drawn from two different lines of debate: one emphasizes determinants of competitiveness in export markets, while the other

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discusses forces driving financial flows. In the first debate, economists from the World Bank and International Labor Organization deliberate the effects of welfare spending on international competition in export markets. They are particularly concerned with labor costs associated with greater welfare spending.[7] The second debate revolves around the primacy of global 'push' or domestic 'pull' factors of capital flows. If LDC welfare expenditures are indeed affecting the competition for financial flows, then the implication is that domestic determinants (or the "pull" factors) of capital inflows predominate over systemic ones (or the "push" factors)

Welfare Spending and International Competition in Export Markets

The debate between World Bank economists and economists from International Labor Organization (ILO) concerns the effects of welfare spending on export competitiveness.[8] Advocates of the World Bank perspective argue that contemporary LDC welfare spending, particularly on such items as job security and

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[7] There is an alternative argument in the globalization literature that welfare spending indirectly affects export competitiveness by causing an appreciation in the exchange rate. However, this effect is not generalizable since currency appreciation that occurs in response to increased government spending is contingent upon several variables, such as the source of government finance (borrowing instead of taxing or money creation) and on private sector reactions. This analysis is based on a general definition of performing competitiveness (see Pfaller et al. 1991). Therefore, the direct effect of welfare spending on performing competitiveness is the focus of this paper. Refer to section on "International Competitiveness" (page 22) for a more precise definition of performing competitiveness.

[8] The classification of World Bank vs. ILO are general ones, and mirror those used by Freeman 1993. Indeed, there are many outside these institutions who accept similar theoretical positions. At the same time, there are many within the respective institutions who do not accept the general views.

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mandated contributions to social funds, protect labor 'excessively' and are thereby distortionary.[9] Such interventions interfere with the efficient allocation of resources by driving up labor costs and encouraging rent-seeking activities. The idea is that a state committed to few of such labor market interventions can instead devote resources to promoting competitiveness and raising national output. Freeing private enterprise of such "onerous burdens" is extremely important for improving labor's performance.[10] In contrast, the ILO argues that welfare spending has a positive effect on competitiveness. By providing the necessary income security, the corresponding improvements in social well-being ultimately result in higher labor productivity. It is, then, the World Bank perspective that provides fodder for the conventional belief that there is an inverse relationship between welfare spending and competitiveness in international export markets.

The World Bank perspective focuses upon three supply-side arguments for why social welfare programs might adversely affect competitiveness. The first of the arguments is that interventions tend to impose labor rigidities and drive up labor costs beyond equilibrium levels. The setting of labor standards causes misallocation of

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[9] Because World Bank views traditional pay-as-you-go social security and welfare systems as inefficient, their policy recommendations call for privatization of such schemes. For examples, see Holzmann 1997, World Bank Policy Research Report 1994, Estelle 1992.

[10] Pfaller et al (1991) notes that the challenge of competitiveness can be met in several ways: currency devaluation, reducing welfare statism, reduction of other costs—most of all wages, and redistribution of costs of welfare statism away from enterprises to households. The analysis in this study focuses only on the reduction of welfare statism and tests the effectiveness of this **political choice** on international markets.

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resources and prevents markets from reaching optimality conditions (Freeman 1993). Riveros (1992) argues that the resulting level of the non-wage costs of labor significantly affects manufactured exports in LDCs. Unfettered labor markets, in contrast, set wages and levels of employment that are closer to being Pareto-efficient. Thus, reducing total labor costs would lead to increased economic openness, greater economic growth and, thereby, a higher standard of living for workers.

The second line of reasoning of the World Bank is that such welfare programs indirectly influence export competitiveness by encouraging rent-seeking activities. Social welfare policies prompt capitalists, workers and even governments in LDCs to devote resources towards rent- seeking instead of raising national output. Many social security experts have argued that governments, in exchange for political influence, often distribute benefits to labor (Midgeley 1984, Banerji and Ghanem 1997, Pedersen 1997). At the same time, Esping-Andersen (1996) implies that traditional elites have an interest in pressuring governments to maintain their traditional privileges (i.e., non-taxation of the rich in Latin America). Either way, whether welfare programs encourage rent-seeking in the form of income transfers from political decision makers to workers or capitalists, they require real resources that are withdrawn from productive activities.[11] The net effect is a loss in (domestic) efficiency in the Paretian

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[11] See Pedersen (1997) for the theoretical link between rent-seeking and Bhagwati's (1982) directly unproductive, profit-seeking activitis (DUP). Pedersen also presents an interesting argument on the political economy of distribution between capitalists, workers, and governments. He argues that political decision makers represent an interest group themselves and prefer income transfers that will serve their own interests.

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sense. Here, the link between welfare policies and export competitiveness is indirect in that there is a 'deadweight' loss of resources that could have been otherwise directed towards activities involving export production.

The third argument refers to issues of labor productivity. Simply put, interventions in the labor market create a moral hazard problem by stifling incentives to work, save and invest. Unemployment benefits and compensation schemes, for instance, are said to moderate the disciplinary effect of unemployment on work intensity (Marshall 1994). In another example, the *World Bank Research Report* (1994) argues that early retirement provisions reduce the supply of experienced workers and resulting in a labor force comprised mostly of relatively less experienced workers. Thus, workers subject to pure market forces perform more efficiently and raise national output. The idea is that in the contemporary era, the work force should become even more "disciplined and malleable" in order to keep up with global competition. Marshall (1994: 55) describes the alleged trade-off between welfare spending and export competitiveness faced by nations:

> A new emphasis has been placed on the alleged need for greater flexibility and less regulation of dismissal and contracts of employment. Whether expressing the more sophisticated or popular form, these views assume that for export competitiveness to improve, labor costs must go down, the workforce must become more disciplined and malleable, and individual efforts must increase. In the context of such views, labor protection and trade union intervention in the labor market and at the workplace are perceived simply as obstructions to the achievement of those aims.

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Figure 1 illustrates the World Bank view.

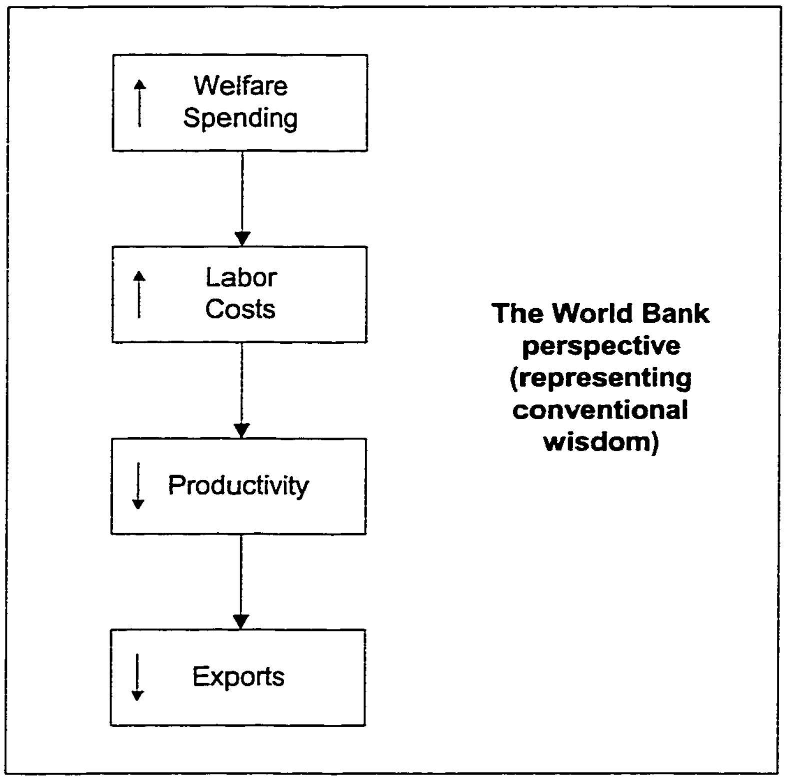

Figure 1: The World Bank Perspective.

ILO theories, on the other hand, argue that welfare programs are socially beneficial and thereby positively contribute to economic competitiveness and economic development. While this perspective is "more diffuse and less analytically grounded" than the World Bank's, it provides theories strong enough to present a case in favor of interventions (Freeman 1992). Theorists supporting the ILO view argue

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that it is all the more crucial to maintain labor standards in the era of globalization so that social stability can accompany greater market exposure and rapid economic growth.

ILO justifications for welfare policies are both economic and non-economic. Support for social programs is first and foremost based on moral imperatives. The risks and uncertainties that accompany market development require that the state provide a minimum level of economic security for its citizens. Citizens must be compensated for the negative externalities of the market, even if market integration may benefit society in the long run. Second, in contrast to the World Bank, the ILO argues that government mandated labor standards are actually Pareto improvements. Such benefits directly mitigate the principal-agent problem not considered in World Bank assessments of the costs and benefits of welfare programs. By heightening worker motivation and workplace cooperation, labor policies can increase workers' attachments to the firm (Kenworthy 1999, Marshall 1994). Therefore, the ILO stresses that higher labor benefits can actually increase the productivity of labor. The consequent reduction in per unit labor costs results in a net improvement in competitiveness.

Sengenberger (1993:327), in the *International Labour Review,* summarizes the net benefits of basic social welfare programs:

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> Once assured of minimum protection firms and other members of the community have an incentive to search for other, more constructive responses to competitive pressures, such as the introduction of better products and processes, a more rational utilization of their physical and human resources and an improved infrastructure. [Minimum labour] standards can thus act as an inducement to endogenous development.

Ultimately, according to the ILO, there is no trade-off between equity and efficiency (see Figure 2). By improving social well-being and increasing labor productivity, implementation of social welfare programs makes capitalism compatible with overriding social objectives (Pfaller et al. 1991).

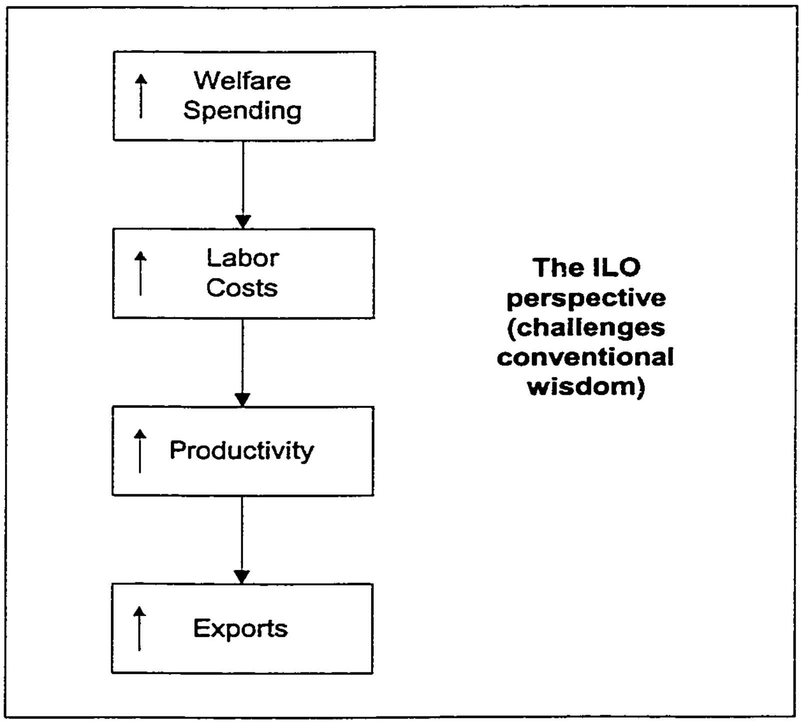

Figure 2: The ILO Perspective.

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Welfare Spending and the Competition for Capital Flows

Conventional theorists such as Grieder (1998), Nader et al. (1993), Strange (1997), Scholte (1997), Cerny (1995), Grunberg (1998) and Rodrik(1997b)[12] base their analyses on the assumption that fiscal policies, particularly concerning social welfare, are fundamental determinants of capital flows. These analysts adopt the domestic 'pull' interpretation of capital flows, or the conception that international capital flows are 'pulled' in by an attractive domestic investment climate. Hereby, lower welfare expenditures, by signaling strong fiscal discipline and a more 'friendly' tax environment, attract capital flows. This view, however, has been challenged by the recent works of theorists such as Maxfield (1998), Reisen (1996), Fernandez-Arias (1994) and Doodley et al. (1996). They question this method of emphasizing domestic conditions over systemic ones in attracting capital inflows. Capital flows to LDCs, they argue, are more a function of the business cycle in developed countries rather than domestic LDC conditions. Consequently, it is unfavorable conditions in developed countries, such as low interest rates, that 'push' capital flows towards LDCs. Much empirical work has been conducted on the merits of the push vs. pull hypothesis. Yet this is the first general cross-national study to model the particular

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[12] Rodrik (1997 and 1999) is not a conventional theorist as referred to in this paper. However, he is included here because he argues that although greater openness induces greater government spending, capital mobility mitigates this effect of trade.

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effects of government welfare spending on capital flows. It presents an alternative way to analyze the conventional wisdom while putting the contending (global push and domestic pull) hypotheses to an empirical test.

It is interesting to note that in the 'pull' story, capital inflows are subject to the full control of policymakers. In this perspective, if the goal is greater access to capital markets, governments are responsible for implementing the appropriate fiscal policies. Otherwise, bond markets, for example, will tend to punish government policies such as welfare that can result in high inflation and large budget deficits. These pressures are now particularly high since the form of capital flows to LDCs has changed. Since the mid 1980's, most foreign capital flows to LDCs have consisted of foreign direct investment, and portfolio equity flows (Griffith-Jones and Stallings 1995, Reisen 1996, Kuczynski 1994). This is in contrast to the predominance of commercial bank flows to LDCs in the 1970s. Thus, the current form of external capital flows matter because LDCs are increasingly subject to the judgement of international investors (Baer and Hargis 1997). More emphasis is being placed on LDC fiscal policies as investors can easily signal their displeasure with government policies with 'exit' or the threat of 'exit'.[13]

Conventional theories suggest that the link between welfare spending and capital inflows also occurs by way of the domestic tax structure. A more favorable tax

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[13] While the threat of exit is most applicable to portfolio investments, it also applies to foreign direct investments which can shift production to offshore factories with relatively low start up costs.

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environment is attractive to capital and thus serves as an important 'pull' factor. For example, lower social insurance payroll taxes reduce labor costs and provide a strong lure for direct investment, particularly in labor intensive industries. Grunberg (1998) then points out that this greater tax competition between nations is accompanied by fiscal degradation. Less taxes eventually means less social spending since the loss of fiscal revenue makes it even more difficult to increase and/or sustain welfare expenditures. Relatedly, the international market driven preference for lower taxes leads to lower government incentives for maintaining welfare states.

Figure 3 illustrates the domestic pull hypothesis:

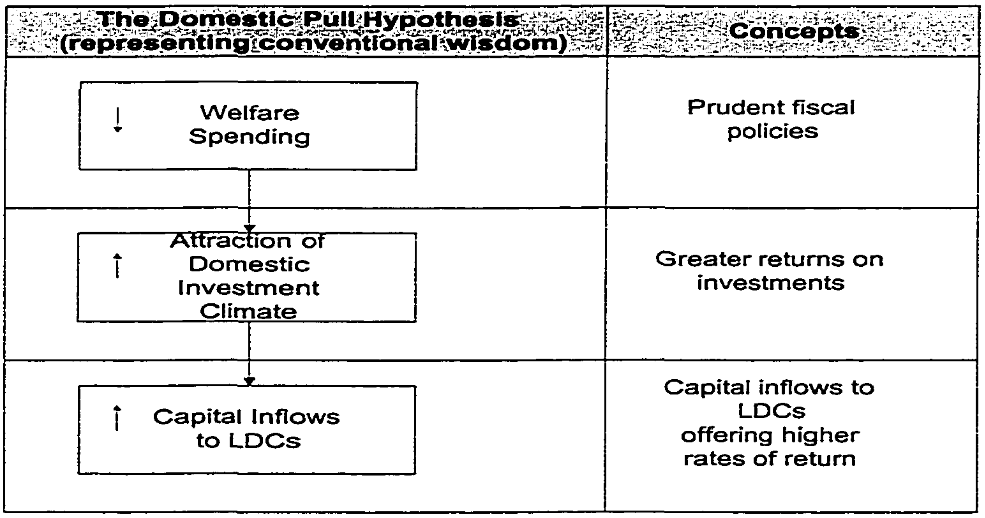

Figure 3: The Domestic Pull Hypothesis.

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In contrast, the 'push' theorists dismiss much of the conventional arguments by pointing out the theoretical and empirical weakness of their assumptions. They argue that capital inflows are to a large extent beyond the control of policymakers. Investors are presumed to be rational and have perfect information. Yet both Maxfield (1998) and Bertolini and Drazden (1997) argue that investors tend to become less discriminatory when world interest rates are low. As Maxfield (1998:1201) states, financial markets may, in fact, be irrational, and "psychology rather than economics drives capital flows." This tendency is intensified by the problem of information asymmetry, which is particularly acute in the globalizing world (Reisen 1996). Contagion effects, another systemic phenomenon, also demonstrate the problem of herd behavior among international investors. Panic caused by financial conditions in one country triggers capital flight in several LDCs, usually based on incomplete information about domestic conditions.

These scholars conclude that it is wrong to assume that international investors are making investment decisions according to the creditworthiness of LDCs. Thus, with some country exceptions, Fernandez-Arias (1996) and Doodley et al. (1996) find that international interest rates have been the dominant factor in explaining variations in annual private net capital flows to LDCs. Domestic policy, then, is not constrained by the inability to tax capital or implement social welfare policies. Rather, it is limited by high local interest rates and stable exchange rate expectations when global liquidity is tight (Maxfield 1998).

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Figure 4 represents the push hypothesis:

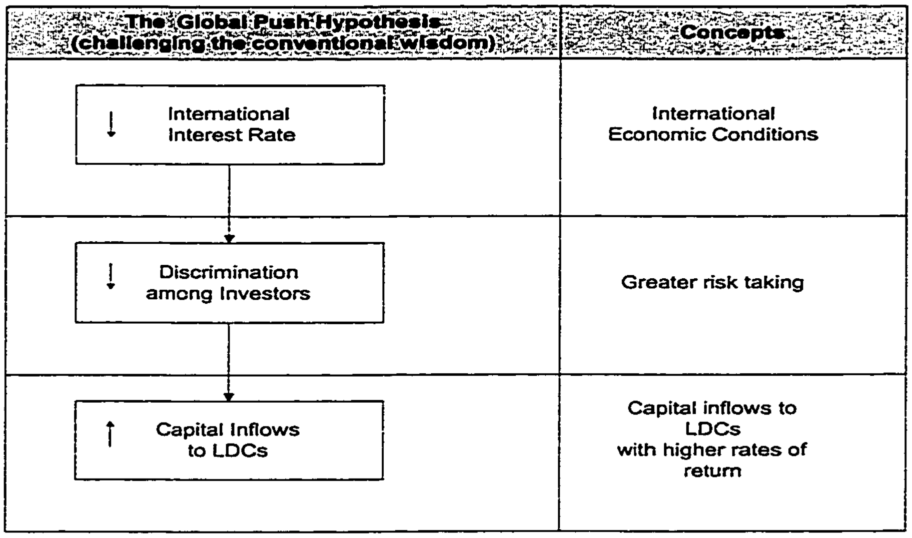

Figure 4: The Global Push Hypothesis.

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III. The Empirical Model

Background

These models will be estimated by cross-section time series data. Panel data techniques and the fixed effects method have been chosen to assess the impact of welfare spending on globalization for three reasons. First, panel data sets increase efficiency by using a large number of data points, increasing the degrees of freedom and reducing the collinearity among explanatory variables. By following a given country over time as it changes status (e.g., from more welfare spending to less, or vice-versa), panels enable a proper recursive structure to study the before/after effects (Hsiao1986). Second, the fixed effects procedure allows one to control for the effects of missing or unobserved variables by utilizing information on the intertemporal dynamics as well as the individuality of entities. Such a procedure eliminates much of the omitted variable bias. For example, country effects capture land size, a variable that is highly correlated with trade.[14] In another example, fixed effects are particularly important for capturing the tendency towards high inflation (especially for some Latin

[14] In addition, for reasons of linear dependency, land size could not be used as an independent regressor. Instead, controlling for country effects 'swallows up' the effects of land size and is therefore included in the model.

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American countries) in the model for capital flows. Ultimately, fixed effects controls for such country-specific differences without having to model it explicitly.

The proposed model posits that LDCs do not satisfy the conditions of perfect competition. By lagging the necessary explanatory variables, this model takes into account the time lapse involved with political decision making, economic adjustments, and the allocation of resources. Moreover, one might argue that the causality is reversed and that private capital flows affect changes in gross domestic product (GDP), foreign exchange reserves and the level of International Monetary Fund (IMF) credits.[15] Yet it is not possible for *current* private inflows to affect these same variables in the previous period. Therefore, this estimation technique mitigates simultaneity problems by lagging some of the necessary variables such as welfare, GDP, IMF credits, and foreign exchange reserves. Both welfare spending and IMF credits were lagged up to 4 years. Four years was the limit chosen since some LDCs did not begin the process of liberalization until the early 90's. Lagging any more than four years would interfere with analysis of the recursive effects of lower welfare spending.

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[15] The democracy variable is not included here because it is not plausible that private inflows affect the level of democracy in the same period. To check this, the democracy variable was tested both ways-by lagging and not lagging. The lagged democracy variable was insignificant each time.

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The Models

The following equations model both the international and domestic determinants of exports and capital flows. See Table 1 for a summarized description of all the variables.

Model 1:

$$\text{Export} = b_1\text{export}_{i(t-1)} + b_2\text{welf}_{i(t-1)} + b_3\text{netfdi}_{i(t-1)} + b_j\Sigma b_j X_{it} + \Sigma b_k\text{country}_i + \Sigma b_l\text{year}_t + \mu_{it}$$

Model 2:

$$\text{Netk} = b_1\text{netk}_{i(t-1)} + b_2\ \text{welf}_{i(t-1)} + b_3\text{trade}_{i(t-1)} + b_4\text{intdiff}_{it} + b_j\Sigma b_j X_{it} + \Sigma b_k\text{country}_i + \Sigma b_l\text{year}_t + \mu_{it}$$

Model 3:

$$\text{Fdi} = b_1\text{fdi}_{i(t-1)} + b_2\ \text{welf}_{i(t-1)} + b_3\text{trade}_{i(t-1)} + b_j\Sigma b_j X_{it} + \Sigma b_k\text{country}_i + \Sigma b_l\text{year}_t + \mu_{it}$$

The b's are parameter estimates in this equation, while the subscripts i and t represent the country and year of the observations respectively; b_1 is the lagged rate of openness, incorporated to alleviate problems of serial correlation across error terms; μ

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is an error term. ΣX represents the vector of control variables, or GDP, democracy, pressures from international finance institutions and foreign reserves. The international level variables are lagged in order to take the period of 'adjustments' into account. Also, note that logarithms are taken of all the variables. This type of relationship is useful in that it displays the property of constant elasticities between the variables.

Models 1, 2, and 3 test the conventional wisdom that LDC governments are meeting the challenge of increasing competitiveness (1972-1995) by reducing government welfare expenditures. Model 1 assesses the conventional wisdom as it applies to competitiveness in export markets. If the World Bank is correct, then b_2 will be negative and the empirical evidence will support the conventional claims that lower welfare spending improves international competitiveness. However, if the ILO perspective is more accurate, then b_2 will be positive and welfare spending actually supports an increase in international competitiveness.

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Table 1: Concepts, Measurements and Definitions

Concepts	Measurements*	Definition
National Competitiveness	The amount of total exports [EXPORTS], net private capital flows [NETK] and net foreign direct investment [FDI] as a percentage of GDP- dependent variables.	Exports is the level of exports divided by GDP. Net capital flows consist of private debt and nondebt flows. Private debt flows include commercial bank lending, bonds and other private credits; nondebt private flows are foreign direct investment and portfolio equity investment (divided by GDP).
Government Welfare Expenditures	Social security and welfare as a percentage of GDP (+/-) [WELF]	'Social security' consists of income transfers, providing benefits in cash or in kind for old age, invalidity or death, survivors, sickness and maternity, work injury, unemployment, family allowance, and health care. 'Welfare affairs and services' are defined as assistance delivered to clients or groups of clients with specials needs, such as the young, the old, or the handicapped.
Economic Development	The Gross Domestic Product per capita (+) [GDP]	'GDP' is the total gross domestic product of a country divided by total population.
Political Regime	Indicator of democracy (+/-) [DEMOC]	Using scale 0-10; 10 =strong democracy. This indicator is derived from the codings on the competitiveness of political participation, the openness and competitiveness of executive recruitment, and constraints on the chief executive.
Pressure From International Financial Institutions	Use of Credits from the International Monetary Fund (+) [IMF]	Denotes repurchase obligations to the IMF for all uses of IMF resources. Includes enlarged access resources, trust fund loans, and operations under structural adjustment facilities.
Foreign Reserves	Foreign exchange reserves (+/-) [RESV]	Holdings of foreign exchange reserves minus gold as % of imports.
Interest Rates	The difference between international interest rates and domestic interest rates (-) [INTDIFF]	London Interbank Offer Rates represent the international interest rates. The interest rate for each developing country is represented by the 'average' annual interest rate.

*The signs in the parentheses under measurements represent the expected direction of the relationship. Multiple signs mean that there is an underlying debate regarding the expected direction of the relationship. For data sources, list of countries and years included, and more detailed definitions on some of the variables, see Appendix A.

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Models 2 and 3 assess the effects of specific LDCs' fiscal policies on capital inflows. Private net capital flows are the favored proxy because they represent gross inflows minus amortization. They therefore convey some estimation of how much 'capital' remains within the country.[16] Net foreign direct investment (FDI) flow, used to represent productive capital mobility, is the third dependent variable. While Model 2 analyzes the determinants of productive *and* financial capital flows, Model 3 isolates the effects of welfare spending on productive capital flows. If the logic of the conventional theorists is correct and prudent fiscal policies are domestic 'pull' factors that affect capital inflows, then b_2 will be negative.[17] If, instead, the global push factors, such as international interest rates, are the major determinants of capital flows to LDCs, then b_2 may be either positive or insignificant.

Credibility of the global push hypothesis will be tested in two ways. The significance level of the dummy variables that take year-specific effects into account will be the first indication. This series of year dummy variables capture the effects of common shocks experienced by all the developing countries in a given year. For instance, if the world interest rate was low and indeed driving capital flows towards LDCs, then without inclusion of the year dummies, the democracy and/or welfare

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[16] In contrast, gross capital flows is an estimate of the degree of capital mobility (see Montiel 1994), or the cross-border flows of capital. Therefore, capital mobility might be high, while the country's ability to attract capital relative to others might be low. It is thus an insufficient indicator of international competitiveness for capital.

[17] GDP, foreign reserves, democracy are also considered pull factors, but are not the focus of this paper or of the conventional theories on welfare.

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variable would likely be biased upward—showing high significance levels and a positive coefficient. The inclusion of the year dummies, however, might generate positive coefficients for those years and render the democracy and/or welfare variable as insignificant.

Thus, these coefficients will capture some of the variation in average annual global interest rates. If they are insignificant, then year effects do not exist and international conditions are less likely to be a determinant of LDCs capital flows. The second test of global push factors will be the interest rate differential between the London Interbank Offer Rates (LIBOR) and the domestic interest rate of developing countries.[18] If this coefficient is negative, or capital inflows are greater when LDC domestic interest rates are higher than LIBOR, then the push hypothesis will be confirmed.

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[18] LIBOR commonly represents the international interest rate.

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IV. The Variables

International Competitiveness: Dependent Variables [NETK, FDI, and EXPORT]

Based on Jeffry Hart's *Rival Capitalists* (1992:7), all three models operationalize national competitiveness by the level of exports and net (productive and financial) capital flows, relative to GDP.[19] Indeed, there is an underlying debate regarding the characterization of 'competitiveness'. Economists are quick to remind us that firms are competitive, not nations. Perry and Robertson (1998) convincingly argue, however, that nations do compete for the confidence of capital market investors.[20] By the same token, many scholars address the concept of competitiveness, as it is applied to trade performance, on an economy-wide basis. Alesina and Perotti (1997) monitor improvements in competitiveness by falls in the

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[19] Hart (1997) argues that for the economy as a whole, rising real GDP, relatively stable inflation rates, stable or rising export levels as a percent of GDP, trade surpluses, and rising labor productivity demonstrate increasing competitiveness. Note that Hart (1997) does not specifically suggest capital flows as a percentage of GDP as a measure for national competitiveness. This measures is adopted from Fernandez-Arias (1996) and Claessens and Naude (1993). See section on 'Data Limitations' for further explanation.

[20] Note that Perry and Robertson (1998) do not directly refer to states, but to political-economic systems.

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relative unit labor costs in manufacturing in one country relative to its competitors.[21] The actual chance of selling products in an internationally contested market is then called its performing competitiveness.[22] According to Pfaller et al. (1991:6), a country may be forced to reduce costly welfare expenditures in order to safeguard its performing competitiveness. Note that this concept of competitiveness operates under the assumption that governments are concerned with increasing aggregate economic performance.

Significantly, although the proposed models analyze capital and trade flows independently, it cannot be denied that the two economic forces are interrelated. Net capital flows, for instance, are expected to have a negative effect on trade. Large capital inflows are often accompanied by inflationary pressures, real appreciation of the exchange rate, and deterioration in current accounts (Calvo et al. 1994). Simply put, high capital inflows might adversely affect trade ratios through their direct effect on the exchange rate. It is thus expected that domestic export sectors have incentives to pressure governments for increased capital controls.

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[21] Sanyal (1993) argues that a country's short-term competitiveness depends on the ability to produce at a lower cost. Long-term competitiveness, on the other hand, depends on improvements in productivity. The analysis in this paper focuses on short-term competitiveness.

[22] Underlying competitiveness is the ability to provide qualitative excellence, while performing competitiveness refers to ability to sell on the world market. See Pfaller et al. (1991) for further details on the distinction between underlying competitiveness and performing competitiveness.

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In contrast, it is plausible that high levels of trade have a positive effect on both productive and financial capital flows.[23] A liberal trade and payments regime is often used as country creditworthiness indicators by international investors (Lensink and White 1998). Additionally, the fact that inputs can be procured from the cheapest source and dividends can be repatriated boosts investor confidence (*Asian Development Bank* 1995). Higher trade flows should then attract greater capital flows. Therefore, for both trade and capital flows, the lagged variables of the other are used as regressors. Capital flows are lagged in Model 1 to avoid simultaneity problems, while trade flows are lagged in Models 2 and 3 since risk ratings are made on the basis of historical data.[24]

Social Security and Welfare [WELF]

LDCs' government welfare spending is the primary variable of interest. Welfare spending, as it is measured in this analysis, provides an indication of both the prudent fiscal policy and the social wage. The social wage variable is of direct relevance to the ILO-World Bank debate because it focuses on benefits available to the working population and is therefore a component of total labor costs. Government welfare expenditures in Model 2 also contributes to the push-pull debate

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[23] Here, 'trade' refers to the level of imports and exports as percentage of GDP.

[24] Interestingly, multicollinearity was not a problem here. Correlation between capital flows and trade was moderate (0.28).

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of capital inflows. Reductions in welfare spending represents (potentially) lower inflation, less deficit spending and a more favorable tax environment for the pull theorists. Therefore, if the pull hypothesis is valid, lower levels of spending represent prudent fiscal policy (consistent with the neoliberal agenda) and should therefore attract more capital flows.

Here it is important to emphasize that it is *government* spending on social security and welfare that is of interest. Data illustrates that total contributions to social security have been falling since 1972 (refer to Chart 1).[25] Notice that government, employer and employee contributions follow similar trendlines (see Charts 2, 3, and 4). Importantly, only government and employer contributions can affect labor costs.[26] Governments hold the option of using general revenues to compensate for a fall in employer contributions to labor. Yet the data shows strong indications that governments are following the same expenditure patterns as employers. It is not feasible to use data on employer contributions to assess the level of non-wage costs because such cross country data is unavailable and, when it does exist, there is a very low number of observations. Thus, for this analysis, government contributions to social security and welfare are used as a proxy for the level of social

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[25] Note that government contributions apply to social security and welfare. Employer contributions exclude welfare.

[26] It is interesting that employee contributions have also been falling. Recall that it is the government that determines the size and extent of the welfare state. If governments opt to reduce the welfare state, then it is expected that contribution from all three sources will fall.

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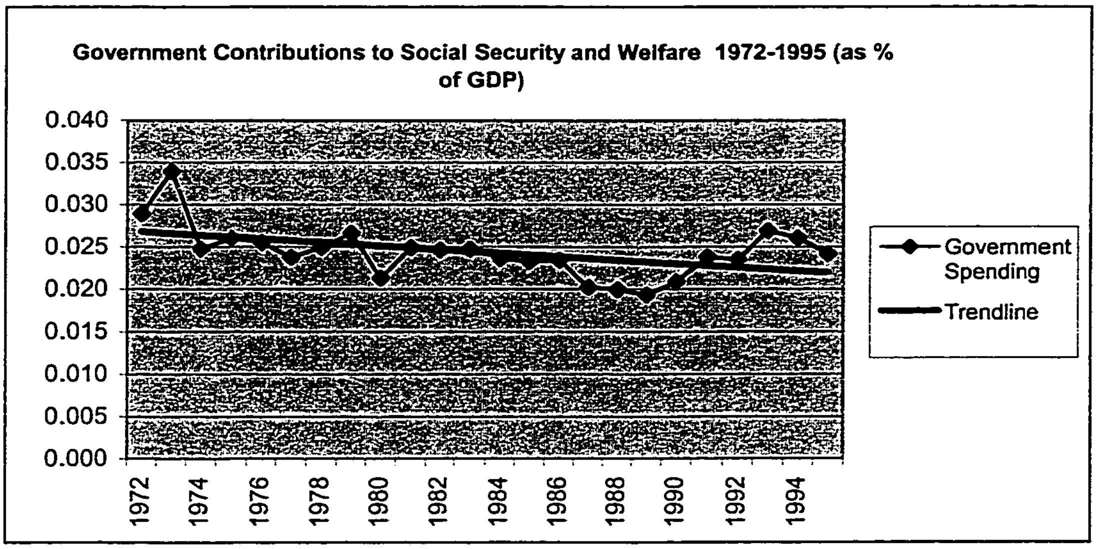
wages instead of employer contributions in LDCs (see, for example, Kenworthy 1999).[27]

Chart 2: Government Contributions to Social Welfare*



Source: *Government Finance Statistics* (IMF: Various editions).
* Please see Appendix B for the included countries.

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[27] Kenworthy (1999) disaggregates government transfers and social wage. However, his definition of social wage parallels the concept of social security and welfare applied in this paper.

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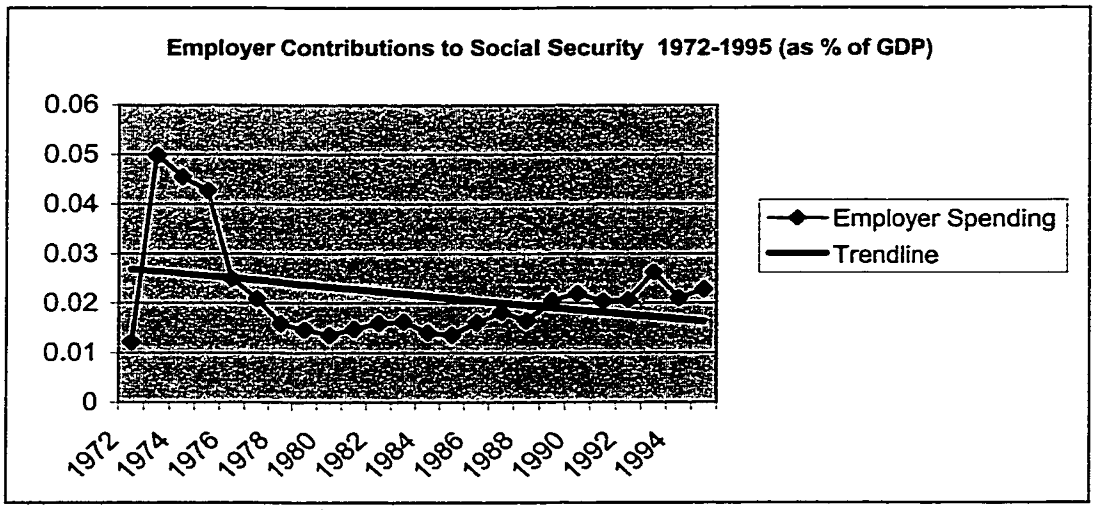
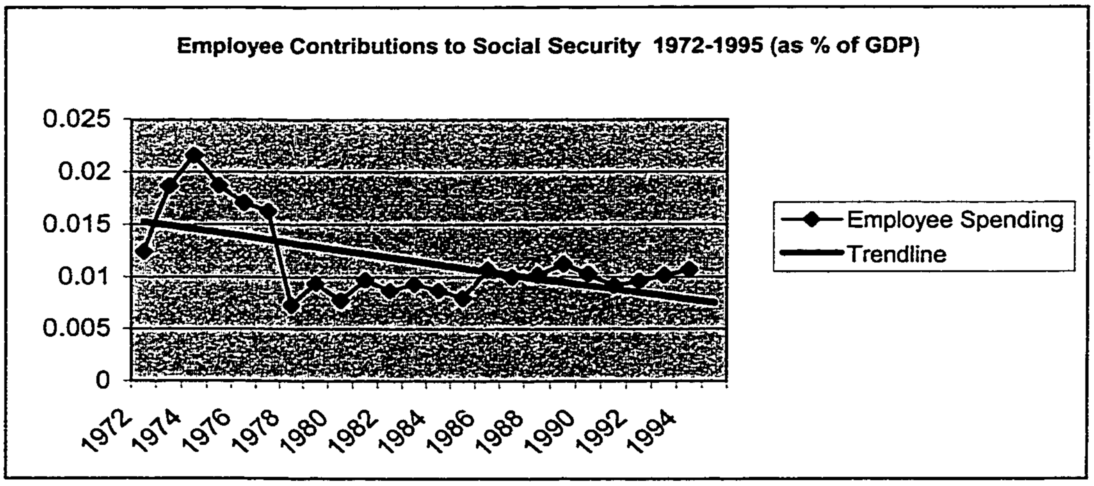
Chart 3: Total Employer Contributions to Social Security*



Source: *Government Finance Statistics* (IMF: Various editions)
* Please see Appendix B for the included countries.

Chart 4: Total Employee Contributions to Social Security*



Source: *Government Finance Statistics* (IMF: Various editions).
* Please see Appendix B for the included countries.

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Interest Rates [INTDIFF]

The interest rate differential between developed and developing countries is, according to the push hypothesis, the fundamental determinant of capital inflows to LDCs. If this differential is high, then capital inflows to LDCs should be greater. Recall that conventional theorists do not place any emphasis on the push factors. Therefore, if the latter are correct, then INTDIFF, or b_4, will be insignificant.

The push hypothesis, however, will be verified if $b_4 < 0$. LIBOR is commonly used to represent the international interest rate.[28] Three different measures of the domestic interest rate are applied alternatively to ensure the robustness of the results : average interest rate, official interest rate and private interest rate.[29] INTDIFF is estimated as follows:

$$b_4 = \text{LIBOR} - \text{domestic interest rate}$$

Thus, if the domestic interest rate is higher than LIBOR, then b_4 will be negative as capital flows toward LDCs. Conversely, if LIBOR is higher than the domestic interest rate, then capital will flow towards the developed countries and away from LDCs (b_4.

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[28] This analysis uses the one-year rates, which differ very little from one-month, three-month and even six-month rates.

[29] Since using the different measures did not show much difference in the estimations, the results in this paper reflect only the average interest rate.

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of course, will still be negative). Indeed, the INTDIFF variable is a very important indicator of the push hypothesis.

Control Variables: Democracy [DEMOC], GDP Per Capita [GDP], IMF Credits [IMF], Foreign Exchange Reserves [RESV]

The vector ΣX_{it} represents the range of political and economic control variables. According to existing studies, the level of democracy, pressure from international institutions, the level of economic development, and foreign exchange reserves influence the levels of capital and trade flows. It is expected that all these control variables will be positively correlated with the dependent variables. Certainly, there are ongoing debates on the relationship between some of these control variables and the dependent variable (democracy and trade, for example). This study is useful in that, while its main concern is to analyze the effects of welfare spending on international competitiveness, the findings also contribute to some of the accompanying debates. However, in order to sustain the focus of this study, the parallel debates will be discussed only briefly.

Most of the variables and their expected signs are self-explanatory. IMF credits [IMF] should be positively related to trade and capital flows, while GDP [GDP] is likely to be negative since richer countries are less dependent upon both types of flows. Foreign reserves [RESV], however, are included only in Model 2 as they are

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directly relevant to capital flows.[30] The impact of reserves on capital flows is not as straightforward as one might expect. Certainly, the traditional wisdom is that RESV is positively related to capital flows. Countries with high foreign reserves are supposedly better able to adjust to the destabilizing effects of capital inflows because these stocks can be used as 'shock absorbers'. Under such conditions, governments are less likely to restrict capital inflows and outflows. When foreign exchange is low, however, speculative attacks on its currency will lead governments to impose capital controls and create a dampening effect on inflows (Leblang 1997).[31] Haggard and Maxfield (1996), however, challenge this economic interpretation. They argue that balance of payments crisis lends greater bargaining power to international-oriented sectors and thus leads to liberalization of capital accounts. Therefore, in this analysis, if capital inflows are positively associated with low foreign reserves (an indicator of crisis), then the Haggard and Maxfield hypothesis will be confirmed.[32]

The democracy variable [DEMOC] deserves a little more explanation. Building on the literature in political science, scholars debate whether democratic countries will be more competitive in the global economy than less democratic ones.

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[30] Note that multicollinearity problems with foreign reserves and IMF credits were suspected, tested and confirmed. Thus, Model 2 excludes IMF credits.

[31] This incentive is particularly strong in fixed exchange rate regimes.

[32] Note that Model 2 assumes that low foreign reserves are one way of measuring crisis in LDCs. If foreign reserves are high enough to stabilize the effects of balance of payments shocks, then a crisis will not occur.

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Pro-democracy advocates (those who believe that democratic countries trade more) argue that the plurality of votes in a democracy is a check on the power of narrower interest groups. For example, Banerji and Ghanem (1997) state that democratic countries trade more because they are less likely to pass inefficient labor legislation benefiting 'insiders'.[33] On the other hand, democracy skeptics (those who argue that democratic countries trade less) claim that such political freedoms have a negative effect on trade (Verdier 1998, Perry and Robertson 1998, Destler 1995). They argue that because democracies encourage a greater role for interest groups (i.e. from the non-tradable sector) in the legislative process, democracies have deleterious consequences for trade. Thus, since there is no consensus on the issue, more empirical evidence is needed on the issue to help solve the debate.

There is a similar lack of consensus regarding the relationship between democracy and capital flows. One might expect that democracies suggest political stability and, thereby, encourage private capital. The improved transparency and availability of information linked to democracies should be a further incentive for investment. Yet Maxfield (1998) points out the possibility that soft authoritarian regimes might be preferable to democracies because of the greater ease in privileging capital's policy demands over local constituents. As the editors of the *Columbia Journal of World Business* (1994:6) put it, any "deviation from the 'Washington

[33] An example would be workers in privileged industries, or the urban labor elite.

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doctrine' [will] have a chilling affect [sic] capable of casting a pall over international investor enthusiasm." It is thus easy to imagine why international investors might shy away from the political uncertainty still prevalent in the developing democracies of today, given the priorities placed on the neoliberal agenda. Here again, the findings of this study will contribute to the substance of this debate.

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V. Data Limitations and Notes on Methodology

The aim here is not to resolve the debate on what constitutes the competitiveness of a country or what is the best measure. Instead, it is to assess the impact of social welfare spending on a country's ability to export more goods in international markets and to attract greater capital inflows. The ILO-World Bank debate, as well as the pull or push controversy, present the appropriate frameworks in which to address this underlying agenda.

Some obvious difficulties exist in measuring national competitiveness. Indeed, as Krugman (1994) has stressed, the success of one country in the world market does not have to be at the expense of another country.[34] Both exports as a percentage of GDP and the magnitude of the trade balance are popular proxies of a country's general economic strength and competitiveness (Haque et al 1995, Ezeala-Harrison 1999, Hart 1992). Yet although they both have their drawbacks, export intensity is a better proxy of competitiveness (over time) than trade balances. It is important to emphasize that the latter can be affected by factors other than competitiveness. For instance, South Korea is well known as a successful exporter. However, it ran a substantial trade

[34] Krugman (1994) argues that national competitiveness is difficult to assess since higher exports can also mean higher imports, and also because a country may be competitive in one area and not in others.

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deficit for many years because of its high imports of capital goods and technology needed for its heavy investments (Haque et al 1995). Using exports as a measure of competitiveness, on the other hand, can also be problematic because temporary currency devaluations can cause a rise in exports. The upshot is that unlike trade balances, applying a fairly long time series analysis can mitigate this shortcoming of using exports/GDP.

Even more limiting is the use of net capital flows as percentage of GDP to assess a country's ability to attract foreign capital flows. First, wealthier countries (i.e., the United States) might show a low capital flow ratio because of the large size of their GDP. However, the data set used in this analysis is confined to developing countries and, thus, can avoid the problem of extremely high GDP's skewing this ratio. Both Claessens and Naude (1993) and Fernandez-Arias (1996) are good examples of works that have successfully applied the net capital flows/GDP measure in developing countries to assess 'competitiveness' as it is applied in this analysis.[35] A second argument against the use of this measure might be that countries with high savings rate might 'need' less capital inflows. However, data indicates that high savings countries, such as South Korea and Singapore, have been experiencing increasing trends in capital flows.

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[35] This means that Fernandez-Arias (1996) also uses the measure of net flows/GDP to address the push-pull debate. Claessens and Naude (1993), however, focus more on capital flight (or capital outflows) instead of net capital flows. Their intent is not to address the push-pull debate. However, the measurement concepts are relatively the same.

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Finally, issues of data quality and comparability are likely to be problematic in cross-section, time-series data. The severity of this problem is mitigated by using mostly IMF and World Bank data. It is then reasonable to assume that data was systematically gathered for all 44 developing countries used in this data set. However, this approach does not completely eliminate problems of comparability (Harrison 1994). Data definitions and coverage are subject to change even within the same country over time.

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VI. Discussion of Results

Overview

The following results are conditioned upon international and domestic determinants of trade and capital flows. Altogether, there is weak support for the conventional wisdom that greater welfare spending has an adverse effect on LDCs' international competitiveness. Even though the results from Model 1 favor the World Bank perspective over the ILO, the magnitude of the welfare variable's impact is quite small. According to the data, it takes at least a four year cycle before there are any efficiency effects from reduced welfare expenditures (or lower social wage). On the other hand, welfare spending has no effect on a nation's competition for capital flows, either productive or financial. Instead, the results from Model 2 and 3 give very strong support to the push hypothesis, or the argument that international factors are the primary determinants of capital inflows to LDCs. In sum, welfare spending has differential effects on trade and capital flows, affecting the former more than the latter.

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Model 1 : The World Bank Versus ILO

The effects of welfare spending on the level of imports and exports relative to GDP are reported in Table 2. These findings support the conventional wisdom, albeit weakly. Several combinations of the explanatory variables were tested. The welfare variable was significant only after a four year lag was introduced. Even then, the value of the welfare coefficient was relatively low. A 10 percent increase in welfare spending leads to only a 0.1 percent decrease in trade flows. Otherwise, any trace of the efficiency effects of lower welfare spending do not appear for three years. The fact that these results do not provide strong support for either the World Bank or the ILO's perspective leaves much room for conjecture. How valid are government policies that reduce welfare spending if there is a minimum four year time lapse before the effects on competitiveness are realized? Are there better and more immediate ways to increase efficiency and improve international competitiveness? If so, then why was reducing welfare spending the political choice of LDC governments?

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Table 2: Model 1—Dependent Variable: Exports

Independent Variable	Parameter Estimate	Standard Error
exports (lagged)	0.545**	0.029
lgwelf (lagged 4 years)	-0.017***	0.009
netfdi (lagged 1 year)	0.018***	0.009
gdp per capita (lagged 1 year)	-0.134*	0.021
democ	0.001	0.031
imf(lagged 3 years)	-0.0002	0.001
Country Effects	Yes#	
Year Effects	***YES***#	
R^2	.997	
N	1008	
F Value	10.06	

Fixed effects regression estimates. ***p<0.01; **.01<p<0.05; *0.05<p<0.10. #
F test for fixed effects. # p<0.01

The fixed effects test revealed that country specific differences and year effects account for most of the growth in trade flows (significant at the 99% confidence level). This suggests that both historical and international conditions are the most important determinants of LDCs' international competitiveness in export markets. It

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is likely that past economic policy choices, such as import-substitution industrialization or export oriented industrialization, are important historical elements affecting the current level of openness. The year dummies suggest that major fluctuations of the international business cycle have an impact on trade flows. For example, the negative coefficients on the years covering the late seventies and the early eighties (not reported here) indicate that global recession affected the level of trade in LDCs. Trade flows in LDCs began to pick up again in the late eighties when conditions in the world economy had significantly improved.

The other significant determinants of trade were net foreign direct investment (FDI) and GDP. Both the negative coefficient on GDP and the positive effect of FDI were interesting findings. Assuming that countries with large GDPs have larger domestic markets, it is no surprise that richer countries export less in this era of globalization. The positive effect of foreign direct investment confirms the proposition that such ventures increase export levels in a nation (Amirahmadi and Wu 1992). Yet again, the magnitude of this relationship should be kept in proper perspective, since the coefficient suggests that a 5% increase in FDI (which is quite large) effects only a .1% increase in trade.

The insignificant coefficients on the IMF credits and democracy were unexpected. Even with lags up to four years, there was no effect of IMF credit on trade flows. This directly challenges the arguments of theorists such as Bullard and Malhotra (1998) who target international finance institutions and their "neoliberal

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crusades" for having a strong impact on the liberalization policies of developing countries. The insignificant results on the democracy variable were particularly surprising at first, given the ongoing debates linking democracy and trade. Yet it is important to realize that the tenets of these theories were formulated on the basis of well-developed democracies and the existence of interest group politics.[36] Results in Table 2 suggest that the effects of low GDP and the high demand for capital flows in LDCs crowd out the effects of democracy. The implication is that poorer countries of the world economy are more susceptible to the pressures of globalization and are thus liberalizing their trade regimes, regardless of regime type.

The greatest lesson to be drawn from these results is that it is the passage of time that is most relevant to the link between lower welfare spending and international competitiveness. This 'gap' leaves much room for other alternatives to be explored in the name of improving efficiency and labor productivity. What stands out most is the seemingly negligible role for "politics" in the political economy of trade (as witnessed by the insignificance of the democracy variable and the low coefficient on welfare). Yet this would be a hasty conclusion to make for two reasons. First, it is highly possible that the strong significance of the country dummies encompasses some of the country specific political differences not necessarily captured by the democracy

[36] Banerji and Ghanem(1997) are an exception to this in that they find a positive correlation between democracies and trade in LDCs. However, there are problems with their estimations in that they do not take differences over time into account, nor do they control for significant country specific differences (such as land size).

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variable (such as the organizational strength of privileged domestic industries and/or labor unions). Second, recall that reducing welfare spending is a political choice made by LDC governments in response to the pressures of globalization. Seen in this way, governments could just as well have opted to reduce other costs such as subsidies to inefficient industries, or chosen a different strategy altogether, such as currency devaluation (see Pfaller et al. 1991). Regardless, these findings indicate that it is incorrect to associate welfare spending with a precipitous decline in export competitiveness. Welfare spending is therefore not a primary factor affecting international competitiveness and need not be discouraged in the current era of globalization.

Model 2: Domestic Pull Versus Global Push

The results in Tables 3, 4, and 5 provide strong evidence against the pull hypothesis and thus the conventional wisdom. This model was first estimated without the interest rate variable in order to disentangle the effects of the year dummies.[37] Inclusion of the interest rate variable in Table 4 provides further and even stronger verification of the push hypothesis. Finally, Table 5 demonstrates that welfare spending is also not correlated with productive capital flows. These regression results

[37] In other words, it is necessary to test if the year dummies 'swallow up' the effects of the interest rate differential between developed and developing countries.

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taken together demonstrate that the effects of welfare spending on productive *and* financial capital flows are clearly inconsequential. The welfare variable failed to emerge as significant even after lagging it up to four years, and with several different combinations of explanatory variables.

Table 3: Model 2—Dependent Variable: Net Capital Flows (Excluding Interest Rate Variable)

Independent Variable	Parameter Estimate	Standard Error
netk (lagged)	0.266***	0.039
welf (lagged 3 years)	-0.019	0.047
trade (lagged)	0.182	0.168
gdp per capita (lagged)	0.080	0.150
democ	-0.037**	0.016
resv (lagged 2 years)	-0.099*	0.062
Country effects	Yes#	
Year effects	Yes#	
R^2	.446	
N	1008	
F value	2.65	

Fixed effects regression estimates. ***$p<0.01$; **$.01<p<0.05$; *$0.05<p<0.10$.
F test for fixed effects. #$p<0.01$.

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It was only after lagging welfare by three years and the effects of the level of foreign reserves by two years, that any significant results were yielded. Put simply, government spending on welfare does *not* yield a barrage of capital flight as charged by the conventional wisdom. In fact, it has no effect on capital flows. On the contrary, the significance of the year effects (at the 99% confidence level) suggests that international factors (or the push variable) influence the rate of capital flows. The year effects suggests that year-to-year changes in international interest rates are more important that the domestic level variables. Annual changes in global interest rates are reliable proxies since they do not differ much from monthly or bi-yearly changes. This was cross-checked with the annual LIBOR rates reported in the IMF's *International Finance Statistics* which tended to vary only slightly (less than 1 percent) from the weekly and six month interest rates. Thus, although year effects do not directly capture the impact of short-term changes in the interest rate, they do indicate how annual changes might affect the direction of capital flows (see Chart 5).

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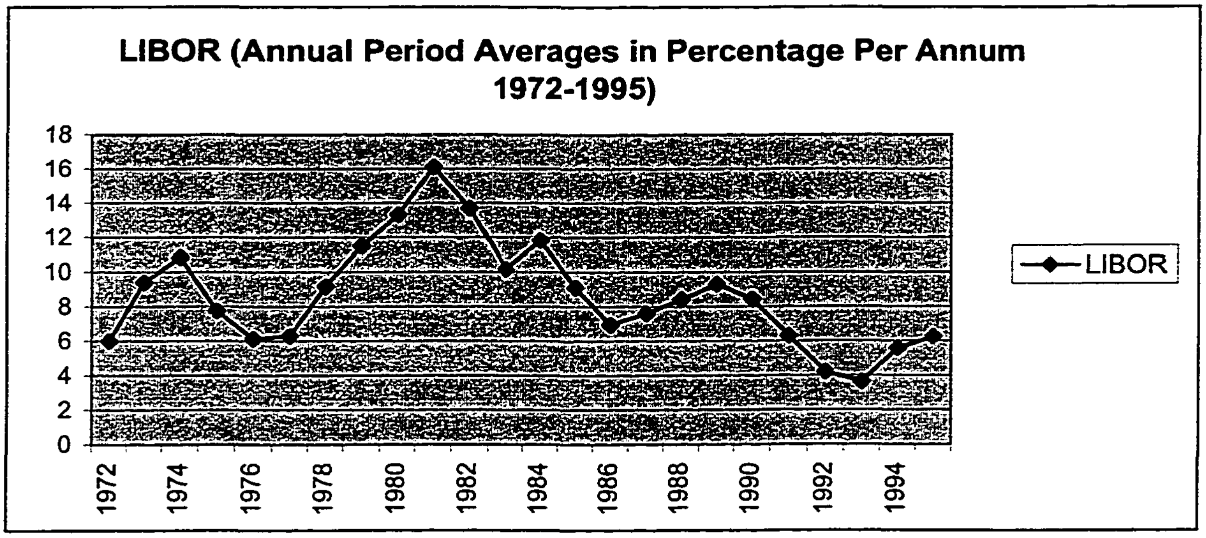
Chart 5: Trends in LIBOR From 1972-1995



Source: *Global Development Finance* (IMF: Cd-Rom: 1999)

Regression results indicate that capital inflows to LDCs clearly went up during most years that international interest rates were low. In the mid 1970's, for example, the positive sign on the year effects (1974 and 1975) illustrates that capital inflows to LDCs increased in those years (not reported here). The year coefficients were negative in the mid to late eighties when international conditions were improving and LIBOR was relatively high. Finally, when interest rates in the developed world went down again in the early nineties, year coefficients turned up positive.

Yet despite the similar pattern between the direction of the year dummies and LIBOR, this relationship must be viewed with caution. After all, even though the impact of interest rate differentials might be a strong component of the year effects,

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these dummies capture other conditions in the world economy that might also be affecting capital flows (i.e. recession, crisis).[38] Therefore, another set of regressions were run in order to capture the impact of the interest rate differential more directly. This time, however, the regressions were applied both ways, by including and excluding year effects, in order to avoid any multicollinearity problems. Year effects remained significant even when the interest rate variable was included, suggesting that there are other things going on the world economy (aside from interest rates) that affect capital inflows(i.e. crisis and global recessions).

[38] Also, there are some inconsistencies between the year effects and LIBOR. For example, in 1982 and 1983 when LIBOR was highest, year effects in LDCs were negative.

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Table 4: Model 2—Dependent Variable: Net Capital Flows (Year and Interest Rate Variables)

Independent Variable	Parameter Estimate	Standard Error
netk (lagged)	0.244***	0.038
welf (lagged 3 years)	-0.006	0.047
trade (lagged)	0.225	0.166
gdp per capita (lagged)	-0.095	0.148
democ	-0.039**	0.016
resv (lagged 2 years)	-0.115*	0.061
intdiff	-0.605***	0.136
Country effects	Yes#	
Year effects	Yes#	
R^2	.949	
N	1008	
F value	2.79	

Fixed effects regression estimates. ***$p<0.01$; **$.01<p<0.05$; *$0.05<p<0.10$.
F test for fixed effects. #$p<0.01$.

In this table, the overall fit is very impressive. Notice that the interest rate variable is negative and significant at the 99 percent confidence level. Moreover, the magnitude of the impact of the push factor is quite large relative to the other variables.

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Interest rates in LDCs that are higher than developed countries interest rate by say 2%, will increase capital flows to LDCs by 3.3%! These results are consistent with the works of Maxfield (1998) Reisen (1996), Fernandez-Arias(1994) and Doodley et al. (1996). The significance level on all of the other variables, particularly welfare spending, remained unaffected. It is important to observe that other important pull variables such as trade and GDP also had a negligible effect on capital flows. These are the two most common country risk factors assessed by investors and, therefore, important variables for the pull hypothesis (Lensink and White 1998).

The remaining domestic level variables such as democracy and foreign reserves, however, did have an effect on capital flows. Does this finding challenge the push hypothesis that domestic level variables matter less in the competition for capital? The most obvious answer is that while push factors might be the primary determinant of capital flows to LDCs in the aggregate, certain domestic level differences (e.g., regime type and foreign reserves) do matter for the distribution of those flows to individual countries. Thus, these results challenge Maxfield's conclusion in World Politics (1998) by suggesting that governments of soft authoritarian regimes are less likely to implement capital controls and attract greater capital flows.[39]

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[39] Perry and Robertson (1998) also provide empirical evidence that there is a trade-off between democracy and capital market efficiency. However, they focus their analysis on the developed economies.

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A few words on the negative coefficient of the foreign reserves variable is in order. The negative sign on foreign reserves provides strong empirical support for the work of Haggard and Maxfield (1996) on "The Political Economy of Financial Internationalization." By taking political evidence into account, they convincingly challenge standard economic interpretations by arguing that a balance of payments crisis eventually leads to financial liberalization and thus greater capital inflows to LDCs. [40] It is during a crisis that political conditions are most fertile for the removal of capital controls, since the need to reassure creditors and investors is greater under such circumstances. Haggard and Maxfield contend the bargaining power of liberalization advocates both within the government and the private sector are consequently strengthened during crises. Thus, the inverse relationship between foreign reserves and capital inflows shown in Tables 3 and 4 lends strong empirical confirmation to the Haggard and Maxfield hypothesis.

Yet what happens when productive capital flows [FDI] are disaggregated from net capital flows? Does lower welfare spending then become an important pull factor for foreign direct investors? After all, as Schwartz (1998) points out, productive and financial capital have quite distinct effects and differing degrees of mobility. Logically, it would seem that both the social wage *and* domestic tax structure (a pull factor) would affect the investment decisions of productive capital. The driving force

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[40] Recall that this model assumes that balance of payments crisis and low foreign reserves must occur concurrently.

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behind productive capital investment then represents a bridge between the ILO-World Bank and the push-pull debate. Yet Table 5 shows that welfare spending still does not adversely effect a country's ability to attract capital flows.

Table 5: Model 3—Dependent Variable: Net Productive Capital Flows

Independent Variable	**Parameter Estimate**	*Standard Error*
fdi (lagged)	0.399***	0.041
welf (lagged 2 years)	-0.014	0.049
trade (lagged)	0.398***	0.133
gdp per capita (lagged)	-0.184	0.141
democ	0.033**	0.015
imf (lagged 3 years)	0.119***	0.004
Country Effects	*YES*#	
Year Effects	Yes#	
R^2	.705	
N	1008	
F value	2.94	

Fixed effects regression estimates. ***$p<0.01$; **$.01<p<0.05$; *$0.05<p<0.10$.
F test for fixed effects. #$p<0.01$.

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These results are interesting in that they show the pattern of signs for trade, IMF credits[41], and democracy were contrary to those found for net capital inflows. More relevant for the purposes of this paper, however, is that there is no relationship between welfare spending and productive capital flows.[42] The estimated coefficients suggest other pull factors besides reduced social spending influenced the level of productive capital flows to LDCs.

Summary

To summarize, the magnitude of the effect of welfare spending is minimal on LDCs international competitiveness. The evidence in the previous four tables suggest three basic things about the political economy of trade and capital flows. First, the logic of the conventional wisdom, as it was represented by the World Bank perspective and the pull hypothesis, overall has very little empirical support. Cross-national historical differences and year-to-year variations in international economic conditions matter more for trade and net capital flows to LDCs (although productive capital did react more to the domestic level control variables). Second, to the extent that welfare spending did exert an influence on trade flows after four years, the effects

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[41] This model assumed that IMF credits were a more appropriate determinant of productive capital flows than foreign reserves.

[42] As in the other regressions, welfare spending was tried in different combinations, lagging it up to four years.

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were only marginally consistent with the conventional view. The four year gap between welfare spending and its effects on export competitiveness leaves little room for the defense of economizing on social policies. Finally, these results call into question the dichotomous nature of the pull vs. push debate. It is true that the findings suggest international investors are not 'rational' as is commonly assumed, particularly when international interest rates are low. However, while push factors are the primary determinant of capital flows to LDCs as a whole, country specific differences can 'pull' in more capital flows relative to other LDCs. Either way, this paper has firmly established that government welfare spending is not a significant pull factor in the competition for either productive or financial capital flows.

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VII. Implications

The evidence presented in this paper strongly indicates that globalization variables in LDCs are not responsive to changes in domestic welfare spending. There is a marked disjuncture between those who think welfare spending is good and/or necessary for globalization and those who think it discourages it. Reassessment of the globalization-welfare nexus casts much doubt on the conventional wisdom that greater government spending on social programs creates production inefficiencies and encourages capital flight. Simply put, causality between globalization and welfare is not unidirectional. A fundamental flaw in the logic of the conventional wisdom is revealed when cause and effect are investigated separately. Thus, the dynamic nature of the globalization-welfare relationship must be understood so that firm conclusions can be drawn. Results from the intertemporal models used in this paper emphasize the fact that LDC governments can make the political choice to increase social spending without affecting international competitiveness in the current era of globalization.

This analysis accomplishes three things. First, it reveals that conventional theories on globalization and welfare do not withstand more rigorous tests. Although LDCs may be lowering their welfare spending in the era of globalization, they are not subsequently becoming more competitive in global markets. Second, this investigation uncovers some of the complexities behind the globalization-welfare

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nexus. It is ultimately *not* economic necessity but the political choice of governments that has affected the outcome of the globalization-welfare relationship in LDCs. This is perhaps because capital generally has more institutional representation in LDCs (through international financial institutions, for instance) than does labor and other marginalized groups. Finally, this study exposes the different magnitudes of impact of domestic policy on trade, productive and financial capital flows. It is trade flows that are most affected by government spending on welfare, while capital flows are more highly correlated with international factors.

So what are these 'pressures' of globalization to which LDC governments are reacting? Why have LDC governments reduced spending on social programs in response to increased levels of globalization when LDC welfare states, in fact, do not severely affect international competitiveness? One interpretation of the empirical evidence in this paper could be that it is the reinvigorated political faith in the efficacy of markets combined with the underdevelopment of political institutions for labor that has created a de-emphasis on social spending. Put differently, the discourse of neoliberalism has gained momentum in LDCs. Rodrik (1997) is on target when he argued that "competitiveness" is too often used as an excuse for domestic reform. The analysis in this paper suggests that this is particularly true for LDCs. Rodrik (1997:80) states:

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> Too often [...] the need to resolve fiscal or productivity problems is presented to the electorate as the consequence of global competitive pressures. This not only makes the required policies a harder sell—why should we adjust just for the sake of becoming better competitors against the Koreans or the Mexicans?—it also erodes the domestic support for international trade—if we have to do all these painful things because of trade, maybe trade isn't such a wonderful thing anyhow!

In sum, this paper reveals that the relationship between the pressures of globalization and consequent social policy choices is by no means deterministic. These findings provide sufficient justification for scholars and policymakers alike to reassess their claim that welfare state spending is inefficient and erodes a nation's competitiveness in global markets. A better balance between greater exposure to international markets and addressing domestic social needs in LDCs should be set. Scholarly research has shown that greater social spending protects citizens from the risks and uncertainties of globalization. Consequently, there needs to be a growing realization amongst LDC governments (and international finance institutions) that something more needs to be done with respect to their social programs. It is hoped that the findings in this paper will help to convince LDC governments that they can afford to implement greater social spending in the current global era. In the end, international economic integration has not made national politics and policies in LDCs irrelevant.

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Appendixes

Appendix A: Data Sources

Appendix B: Countries Included

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Appendix A: Data Sources

WELF:	IMF, *Government Finance Statistics* and *International Finance Statistics*.
NETK:	World Bank, *World Development Indicators* Cd-Rom.
TRADE:	World Bank, *World Development Indicators* Cd-Rom.
FDI:	World Bank, *World Development Indicators* Cd-Rom.
INTDIFF:	IMF, *Government Development Finance* Cd-Rom.
GDP:	World Bank, *World Development Indicators* Cd-Rom.
DEMOC:	Ted Robert Gurr's and Keith Jaggar's *Polity III* (1994).
RESV:	IMF: *International Finance Statistics* Cd-Rom.
IMF:	World Bank, *World Development Indicators* Cd-Rom.

Less Developed Countries:

Argentina, Bangladesh, Bolivia, Brazil, Cameroon, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, Egypt Arab Rep., El Salvador, Fiji, Ghana, Guatemala, Guyana, Honduras, India, Indonesia, Jordan, Kenya, Lesotho, Liberia, Malawi, Malaysia, Mali, Mauritius, Mexico, Morocco, Nepal, Nicaragua, Pakistan, Panama, Paraguay, Philippines, Singapore, Sri Lanka, Tanzania, Thailand, Trinidad and Tobago, Tunisia, Turkey, Uruguay, Venezuela, Zimbabwe.

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Appendix B: Countries Included

Total Contributions to Social Security [Chart 1]:

Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cyprus, Dominican Republic, Egypt, Ghana, Honduras, Indonesia, Israel, Korea, Malaysia, Mexico, Nicaragua, Panama, Paraguay, Thailand, Trinidad and Tobago, Uruguay, Venezuela.

Government Contributions to Social Security and Welfare [Chart 2]:

Argentina, Bangladesh, Bolivia, Brazil, Cameroon, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, Egypt Arab Rep., El Salvador, Fiji, Ghana, Guatemala, Guyana, Honduras, India, Indonesia, Jordan, Kenya, Lesotho, Liberia, Malawi, Malaysia, Mali, Mauritius, Mexico, Morocco, Nepal, Nicaragua, Pakistan, Panama, Paraguay, Philippines, Singapore, Sri Lanka, Tanzania, Thailand, Trinidad and Tobago, Tunisia, Turkey, Uruguay, Venezuela, Zimbabwe.

Employer Contributions to Social Security [Chart 3]:

Argentina, Brazil, Colombia, Costa Rica, Cyprus, Egypt, Honduras, Israel, Korea Rep., Malaysia, Thailand, Trinidad and Tobago, Uruguay, Venezuela.

Employee Contributions to Social Security [Chart 4]:

Argentina, Brazil, Colombia, Costa Rica, Cyprus, Egypt, Honduras, Israel, Korea Rep., Thailand, Uruguay, Venezuela.

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