

## Have Governments Gone Too Far?<sup>1</sup>

*Nita Rudra*

Assistant Professor  
GSPIA  
University of Pittsburgh  
[rudra@pitt.edu](mailto:rudra@pitt.edu)

*Irfan Nooruddin*

Assistant Professor  
Department of Political Science  
The Ohio State University  
[nooruddin.3@osu.edu](mailto:nooruddin.3@osu.edu)

### Abstract

Why are governments of less developed countries prioritizing market-oriented policies over social objectives? Existing research finds that developing-country governments are reducing the share of budgets allocated to social programs in response to global economic pressures (i.e., ‘racing to the bottom’). The problem is that scholars treat the domestic politics supporting government reduction in welfare commitment rather abstractly. The implicit assumption behind such ‘tough love’ policy prescriptions is that entrepreneurs are lobbying governments to reduce spending, thereby lowering their labor costs and overall tax burden, so that they can better compete in global markets. Yet this alleged relationship between reduced social spending and market expansion has neither been sufficiently theorized nor been subject to an empirical test. We investigate this relationship through a cross-national time-series dataset of 40 developing countries. Our results challenge the existing logic of the race-to-the-bottom hypothesis and reveal that welfare retrenchment has no impact on international market prospects. To explain why governments are reducing social spending as markets expand regardless, we argue that both political leaders and businesses are using globalization as an excuse to demand long-desired reforms and, eventually, labor folds in the ‘war of attrition’.

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Recent scholarship supports the popular conjecture that government welfare spending in less developed countries (LDCs) is being sacrificed at the altar of globalization.<sup>2</sup> This research agenda is motivated by a chorus of scholars and policy-makers who have long argued that globalization leads to a race to the bottom (RTB). As nation-states attempt to promote exports and make their markets more attractive to mobile capital, governments might reduce use of a policy tool such as generous welfare benefits that can dampen rates of returns.<sup>3</sup> Neighboring markets will then enact similar reforms in order to maintain competitive parity. The problem is that the models that most scholars employ to represent this interstate competition face a significant shortcoming: we still do not know *why* LDC governments would comply with such reforms. For the RTB argument to hold, proponents assume that owners of mobile factors and export producers have acquired political dominance and are uniformly demanding such reforms so that they can reap the economic benefits of lower welfare spending. Yet surprisingly, this conjecture has hitherto been untested and lacks theoretical and empirical justification. Are business representatives mobilizing because the expansion of welfare spending in less developed countries affects their integration into today's dynamic and highly competitive global markets?

This paper is the first to analyze the force of some of the most basic assumptions of the RTB hypothesis.<sup>4</sup> At bottom, in order to determine whether the proposed incentive for businesses to mobilize is true, we investigate whether LDC government welfare choices really affect firms' export capacities as well as investor decisions to move capital in (or out) of these countries.

Findings in this paper have very broad implications. One of three scenarios is possible. First, if

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<sup>2</sup> We draw from Lowi's (1986) definition of 'welfare' as policies designed to exercise government 'responsibility for the injury and dependency of its citizens'.

<sup>3</sup>In addition to welfare spending, the race to the bottom discussions have applied to a broad array of services and programs that affect production costs such as wages, labor rights, taxes and the environment. Our paper focuses only on the RTB with respect to welfare spending.

<sup>4</sup> Jensen (2006) investigates the RTB hypothesis with respect to FDI inflows only. He finds that welfare spending has no effect on FDI inflows.

welfare spending has no noticeable effects on international market prospects, the existing logic of RTB demands immediate re-evaluation. The question then is whether governments have gone too far<sup>5</sup>, and scholars must explain why globalizing LDCs are systematically retrenching their welfare budgets – as several studies have shown – when this type of spending does not have any pull on investors’ decisions or export markets over time. Alternatively, if the size of the welfare budget does negatively impact prospects for international market expansion, the overall logic of the RTB hypothesis is confirmed. This finding, however, raises other concerns: first, microfoundations supporting RTB have not yet been identified in the existing literature<sup>6</sup>; and second, previous research on the effects of globalization on the welfare state needs to be reassessed because of potential endogeneity problems. In other words, at any given point in time, the effects can go both ways (*i.e.*, welfare spending affects international market prospects and vice-versa), and this must be accounted for in current models to get an accurate assessment of the determinants of welfare policy changes. The third possibility is that increasing welfare spending might actually encourage market integration by improving productivity, the stock of human capital, or overall stability. If confirmed, here again the fundamental assumptions of the RTB hypothesis that enjoys worldwide popularity requires urgent reexamination, and it reveals that the extant literature has not addressed the endogeneity problem.

Our findings defy traditional expectations. The results show that different types of welfare spending have no short-term or long-term effects on international market expansion. We increase confidence in these findings by demonstrating their robustness to statistical techniques designed to account for potential reverse causation. To make sense of the statistical patterns uncovered, we

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<sup>5</sup> This question (and title) is a play on Rodrik’s (1997) book, *Has Globalization Gone Too Far?* Rodrik argues that globalization has gone too far when international economic pressures result in welfare retrenchment.

<sup>6</sup> We define microfoundations as the local or individual-level actors and processes that give rise to nationwide patterns of change.

combine insights from neoclassical political economy and the “second-image reversed’ approach in international political economy (IPE), and suggest that the RTB story is one of politics as well as economics. While LDC governments may be motivated to improve the economic plight of the nation, they must navigate delicate political terrain to do so. Our results suggest that politicians and businesses – both export-oriented and import-competing – are using the excuse of RTB to increase their bargaining power and impose long-desired domestic reforms in social policies that would otherwise create fierce opposition from vested interest groups. The potential advantage is that this strategy allows governments to hold off vested interest groups without necessarily alienating them, while gradually building a wider support base.

The broader purpose of this paper is to contribute theoretically and empirically to existing welfare-globalization research. We aim to disentangle the complex relationship between globalization and domestic fiscal policy decisions in LDCs, particularly those linked to higher (nonwage) labor costs. We thus empirically limit our investigation to the effects of traditionally-studied variables (social security spending) thought to be vulnerable according to the RTB hypothesis. Theoretically, existing research is still vague on the precise political processes that connect globalization and RTB. Our aim is to uncover the interplay of mechanisms in the causal pathway connecting market expansion with social policy decisions.

The article is organized as follows. The first section explores the literature on globalization and welfare spending and reveals that the causal mechanism linking the two in developing countries has not yet been explored. We then identify six hypotheses that test the causal logic of RTB. Section three constructs empirical tests of the hypotheses, examining whether welfare spending does in fact affect the extent of international market integration. The final two sections

present an interpretation of the statistical pattern identified in the previous section and then conclude.

### **Existing Literature**

In a world increasingly free of restrictions on trade and capital flows, recent scholarship in IPE is paying greater attention to the impact of openness on domestic policy and preferences, or the second image reversed.<sup>7</sup> The central concern has been whether global market forces are now the primary driver of policies, pushing aside the potential impacts of local policy preferences, interest group politics, and domestic (formal and informal) institutions. One of the ways IPE scholars have attempted to answer this question has been to assess whether economic openness is undermining existing welfare policies. Under growing pressure to compete globally in export and financial markets, government welfare spending has come to be viewed as unaffordable; it raises production costs and inhibits sound macroeconomic fundamentals (e.g., inflation, excessively high taxes) causing lower profit margins and capital flight. Globalization is hereby claimed to compel governments to engage in a ‘race to the bottom’ in welfare spending so that they can outdo competitor nations and capture world market shares. The underlying logic is that profit maximization is increasingly serving as the sole criterion for government intervention and hence the forces of economic globalization have trumped national political dynamics (Mishra 1999, Drunberg 1998, Stryker 1998, Strange 1997, Gray 1998, Greider 1998).

This line of reasoning is compelling, but it treats the domestic politics supporting government reduction in welfare commitment rather abstractly. Why would governments agree to reduce social spending when this type of policy change can have dire political consequences?

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<sup>7</sup> Research related to the “second image reversed” emerged in reaction to Kenneth Waltz’s (1959) ‘second image’, or analyzing the internal characteristics of states rather than their external environment. As Gourevitch (1978) argued, “In using domestic structure as a variable in explaining foreign policy, we must explore the extent to which that structure itself derives from the exigencies of the international system” (1978: 882).

Welfare retrenchment has significant distributional implications. Vested interest groups that benefit from the existing programs will have a strong interest in defending the status quo (see Pierson 1996, Weyland 1996, Mesa-Lago 1985). In democratic and nondemocratic countries alike, governments have distributed welfare benefits in exchange for political support from more privileged socioeconomic groups (e.g., Brazil in Vargas era, India post-1945<sup>8</sup>). The puzzling question is, then, why governments might ignore the political demands of powerful socioeconomic groups in the current era of globalization.

This puzzle is more pressing in LDCs than it is in Organization of Economic Cooperation and Development (OECD) countries. This is because in the latter, many researchers find that the RTB hypothesis does not hold. Rather, IPE scholars present convincing empirical evidence that more open economies in the developed world have either increased welfare spending or that international economic forces are not an important determinant of social policy changes (Ha 2008, Garrett 1998, Cameron 1978, Rodrik 1997, Iverson and Cusack 2000, Clayton and Pontusson 1998, Pierson 1996). The causal mechanism is that governments respond positively to social groups' rising demands for welfare protections; if at all international economic forces are a factor, governments react to public pressure stemming from income and employment risks associated with globalization. The key here is that OECD scholars fill the explanatory gap by unveiling important microfoundations behind the governments' accommodations of rising demands for welfare: well-organized and 'encompassing' labor organizations (Garrett 1998, Hicks 1999, Korpi 2006), leftist parties (Korpi and Palme 2003, Hicks 1999, Huber and Stephens 2001, Kwon and Pontusson 2007), long-time welfare beneficiaries such as the handicapped and the disabled

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<sup>8</sup> Here we are referring to the generous social benefits (e.g., job security, housing subsidies, pensions) received by civil servants in India.

(Pierson XXX), and institutional complementarities that reinforce comparative (institutional) advantages (Hall and Soskice 2001).

In the developing countries, however, the opposite holds true: existing scholarship not only presents empirical evidence that favors the RTB hypothesis, but the causal mechanisms linking global economic pressures with cutbacks in government spending are also vaguely specified. In direct contrast to the advanced industrialized countries, several scholars have consistently found that globalization is correlated with welfare retrenchment in LDCs (Garrett 2000; Kaufman and Segura 1998; Rudra 2002; Wibbels 2006; Wibbels and Arce 2003). Then by using the advanced capitalist countries as a foil, their analyses suggest that the domestic institutions that mediate the effects of international market forces on welfare policies in the OECD countries simply do not exist in developing nations. In effect, the latter are marked by ‘what isn’t’, such as decentralized and disorganized labor movements, vague party platforms, and weak democratic institutions that are ultimately incapable of mediating the economic pressures of international markets. The impacts of the relatively small but politically powerful distributional coalitions in LDCs that have a vested interest in vigorously defending their existing benefits are altogether ignored in this literature. In sum, the IPE literature leaves us with little knowledge of the actual conditions that *do* exist to effect changes in LDC domestic welfare policies as markets expand; instead, we only have information about forces and processes that *do not* exist to prevent welfare retrenchment.

The operating assumption in the literature thus is that capital has gained significant power over labor and governments in the globalizing environment, using its leverage to prevent welfare policies that ultimately require unwanted taxation and higher labor costs.<sup>9</sup> Kaufman and Segura-Ubiergo (2001: 571), for example, interpret their findings as evidence that “secular shifts in the

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<sup>9</sup> The conjecture that capital has gained bargaining power in the globalizing environment is a common theme in the IPE literature. See, for examples, Haggard and Maxfield, Goodman and Pauly, Keohane and Milner, Przeworski and Wallerstein 1988.

preferences and relative power of business sectors exposed to increases in international competition curb social spending over the long term.” Wibbels (2006) similarly infers from his results on globalizing LDCs that “under tight macroeconomic conditions ... tradables are likely to have a dominant interest in fiscal retrenchment at the expense of spending on human capital.”

The problem is that this aspect of the RTB argument continues to prevail without any supporting evidence. Empirically, no studies to date have investigated whether capital is in fact systematically lobbying LDC governments to reduce welfare expenditures so that they can better compete in the global economy. The theoretical basis for this assumption has also been recently challenged. Recent work on business and the welfare state casts serious doubt on the notion that capital will be uniformly against social welfare policies (Burgoon 2002; Swenson 2002; Mares 2003a, 2003b; Swank and Martin 2001). On the contrary, these studies suggest that under certain conditions (employer organizations, cross-class coalitions, coordinated market economy, competition for high-skilled labor, sectors facing high volatility) employers might actually support higher welfare spending despite globalization pressures.

The causal logic of the RTB hypothesis thus needs to be built on stronger theoretical and empirical foundations. Given the counter argument above, we need more convincing reasons to accept the RTB proposition that capitalists are actively engaging in the competitive underbidding on LDC welfare provisions in response to the globalizing environment. This hypothesis must be tested against alternative hypotheses to assess whether the causal mechanism supporting the RTB is valid. If the RTB proposition that capitalists have much to gain in international markets from LDC welfare retrenchment is true, we can surmise that their growing wealth and political influence with globalization are successfully outweighing the demands of the socioeconomic groups currently benefiting from the status quo. The next logical step, therefore, is to identify

testable hypotheses about why entrepreneurs may or may not demand LDC welfare reform in the current era of globalization.

### **Disentangling the causal logic of RTB: Identifying Hypotheses**

The RTB logic relies on the conjecture that capitalists, *i.e.*, export producers and international investors, have vested economic interests in lobbying the government for welfare reform *in the globalizing era*. We derive six testable hypotheses from the broader literature to examine the possible links between capitalists' interests in the level of government social spending and international market integration; two of these hypotheses are linked to the causal mechanism supporting RTB hypothesis, and the remaining four are alternative hypotheses that undermine the explanation for race-to-the-bottom policy actions.

We begin by disaggregating globalization and, thereby, first examining the possible motivations of export producers to lobby the government for welfare retrenchment as markets expand. The RTB hypothesis holds that expanding economic openness and greater public investment in social programs are a zero-sum game. In other words, there is a clear trade-off between welfare retrenchment and exports promotion: welfare spending reduces rates of return, and, consequently, hinders the competitiveness of producers of goods and services. For example, Scholte (1997: 448) states:

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 to sunk costs such as unemployment benefits, old-age pensions and untied official development assistance.

This zero-sum notion of welfare spending and market expansion as the underlying motivation for export-oriented firms to spend resources on lobbying governments is based on three supply-side

arguments. First, interventions tend to impose labor rigidities and drive up employment costs beyond equilibrium levels. Riveros (1992), for example, argues resulting non-wage costs of labor significantly affect the level of manufactured exports from LDCs. Second, welfare spending (e.g., social security) is often used by governments in exchange for rent-seeking activities (Banerji and Ghanem 1997; Pedersen 1997; Rudra 2005; Kaufman and Nelson 2004). Finally, interventions in the labor market can create moral hazards by stifling incentives to work, save, and invest (James 1999).

Marshall (1994:55) describes in the following way the alleged zero-sum trade-off between welfare spending and export competitiveness:

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.

If these conditions are true, it is reasonable to expect that export producers would be inclined to lobby governments for social spending cuts and the causal mechanism supporting the RTB hypothesis would thus be validated.

This position has had strong popular and institutional support. For example, although the World Bank has more recently come around to supporting the existence of some safety nets, they have been traditionally very cautious in their approach and have advised many governments to cut back on welfare programs. The World Bank has long argued that LDC governments need to discipline public spending, particularly on items as job security and mandated contributions to social funds, because it protects labor excessively and is distortionary. According to World Development Report 1990:

When governments intervene in the market for labor, they often exacerbate the anti-labor bias of protection Labor market policies- minimum wages, job security regulations, and social security- are usually intended to raise welfare or reduce exploitation. But they actually work to raise the cost of labor in the formal sector and reduce labor demand and thus depress labor incomes where most of the poor are found (World Bank, 1990: 63).

We thus label the first hypothesis in favor of the RTB logic, the World Bank hypothesis:

*(H1) Increased welfare spending leads to lower exports. H1 confirms World Bank hypothesis and causal logic of RTB.*

At the same time, however, existing scholarship in comparative political economy (CPE) presents good reasons to question the zero-sum relationship between international markets and spending, suggesting that export-producing firms have fewer incentives for demanding welfare retrenchment than projected by RTB theorists. This literature presents the view that the relationship between generous social provisions and export competitiveness in LDCs is simply not clear cut. Some researchers posit that labor policies can actually improve productivity by increasing loyalty to the firm, increasing worker motivation and workplace cooperation, and promoting overall social stability (Kenworthy 1999; Marshall 1994; Garrett 1998). More recently, scholars such as Swensen (2002) and Mares (2003) have presented rich empirical evidence challenging the conventional view that employers are uniformly against welfare policies. The ‘varieties of capitalism’ literature has also revealed that some institutional configurations are conducive to welfare expansion, making certain kinds of capitalism compatible with generous social policies (*i.e.*, a ‘coordinated market economy’). As Sengenberger (1993: 327) discusses the net benefits of social welfare programs, the likelihood of a positive-sum trade off with market expansion emerges:

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 labor] standards can thus act as an inducement to endogenous developments.

After all, high social-welfare countries such as Sweden, Germany and Finland do quite well in the current world economy. We label this the International Labor Organization (ILO) hypothesis since their institutional position is that social protections can enhance productivity (see Gillion 2000).

*(H2) increased welfare spending leads to higher exports; H2 confirms ILO perspective and the RTB logic needs to be reexamined.*

One other possibility, much less addressed by the IPE, CPE, or social policy literatures is that welfare spending has no effect on export competitiveness. Economists have found that other factors such as technology (product and process innovation), investment in research and development, and skill content play a more important role in determining export shares (Fagerberg et al 2007, Ionnidis and Schreyer 1997, Kravis and Lipsey 1992). Studies by Weyland (1996), Rudra (forthcoming) and Mesa-Lago (1984) suggest that this might hold particularly true in LDCs since it is generally a very small percentage of the larger workforce who benefit from social protections. Others such as Wade (2004) have suggested that the external environment, such as international demand for exports and geopolitics, can influence the level of exports in LDCs.

Hypothesis three is thus:

*(H3) increased welfare spending has no effect on exports; H3 suggests that the RTB logic needs to be reexamined.*

Next, what are the possible motivations of international investors to lobby the government for welfare retrenchment in the current era of globalization? The following hypotheses set out to determine whether fiscal policies (related to redistribution) of LDCs are fundamental determinants of capital flows. The RTB proponents assume that owners of mobile assets are 'pulled' in by an attractive domestic investment climate. Lower government expenditures on welfare protections are

considered desirable to help to attract foreign capital to the extent that it signals strong fiscal discipline and a friendlier tax environment. As a result, hypothesis four, or the pull hypothesis, is based on the logic of RTB and can be articulated as follows:

*(H4) Increased welfare spending leads to fewer capital inflows; H4 confirms the (welfare) pull hypothesis and supports the causal logic of RTB*

Yet another angle of the pull hypothesis exists. It is feasible that owners of mobile assets might actually desire greater social spending for the same reasons as claimed by supporters of the ILO hypothesis – it increases productivity and social stability, certain institutional complementarities, etc. (see, for example, Garrett 1998). If this is true, then advocates of the RTB hypothesis must revisit the theoretical foundations of their argument and re-interpret the existing empirical findings. Hypothesis five is thus:

*(H5) increased welfare spending leads to greater capital inflows; H5 confirms pull hypothesis and challenges the logic of RTB.*

However, the pull view has been challenged by Maxfield (1998), Reisen (1996), and Fernandez-Arias (1996). These scholars question the emphasis given to domestic conditions relative to international ones in attracting capital. Capital flows are more a function of business cycle in the developed countries than conditions prevailing in the LDCs. Put another way, unfavorable conditions within the developed countries such as low interest rates push capital to the developing world. Maxfield and Bertolini and Drazden argue that investors become less discriminatory when interest rates are low. As Maxfield (1998: 1201) suggests, financial markets may be irrational and ‘psychology rather than economics drives capital flows.’ After examining the empirical evidence, Fernandes-Arias (1996) found that international rates have been the

dominant factor in explaining variations in annual private capital flows in LDCs, not domestic conditions.

In sum, the ‘push hypothesis’ suggests that domestic policy is not constrained by the inability to tax capital or implement social welfare policies. It is limited by economic factors such as high local interest rates and expectations to maintain stable exchange rates when global liquidity is tight (Maxfield 1998). If the push hypothesis (*i.e.*, H6) is true, then this suggests that the welfare budget of a potential host government is not on the list of investor priorities, and representatives of mobile capital have less incentive to actively lobby the government for welfare retrenchment.

*(H6) capital flows are more responsive to external factors rather than domestic ones such as the level of welfare spending; H6 confirms the push hypothesis and challenges the causal mechanisms of RTB.*

### **Empirical Analysis**

The task ahead is to assess whether the purported connection between globalization and lower welfare spending in LDCs is valid, *i.e.*, the causal mechanism that capitalists are demanding retrenchment to reduce its negative effects on their international market prospects. Rejection of this link undermines existing RTB explanations for variations in LDC welfare spending. In this section, we test the six proposed hypotheses to determine whether the World Bank (H1) and Pull hypotheses (H4) that support the RTB logic hold up against alternative hypotheses. Ideally, the RTB logic is best evaluated using systematic data on the preferences of (and expression of preferences by) those in the tradable sector and owners of mobile capital. Since this data is nonexistent, we can infer some degree of corporate interests by assessing what is driving exports

and capital flows and if government welfare spending is one of these factors.<sup>10</sup> Our rationale is if the data indicate levels of welfare spending impact export competitiveness and are a factor in attracting international capital, then we have some empirical support for the RTB logic that international market pressures (*i.e.*, the profit incentive) are motivating businesses to express their preferences, either formally or informally (or both) for retrenchment.

To test the six hypotheses, we use a panel data model to test the effects of social security and welfare spending on paths to openness—a country’s level of exports, and its ability to attract foreign direct and portfolio investment (all measured as a share of gross domestic product).<sup>11</sup> Based on econometric techniques advocated by Beck and Katz (1995), we correct for both panel heteroskedasticity and spatial contemporaneous autocorrelation. In addition, problems of potential serial autocorrelation within each panel are addressed by estimating and adjusting for a panel-specific AR(1) process. This model follows Achen’s (2000) recommendation against applying the standard practice of simply using a lagged dependent to correct for serial autocorrelation. These results provide Prais-Winsten coefficients with Panel Corrected Standard Errors (PSCE).<sup>12</sup>

The models estimated are

$$\begin{aligned}
 [1] \text{ Exports}_t &= \beta_0 + \beta_1 \text{Welfare}_{t-2} + \beta_2 \text{FDI}_{t-1} + \beta_3 \text{GDPGrowth}_t + \beta_4 \text{GDP}_{t-1} \\
 &+ \beta_5 \text{GDPpercap}_t + \beta_6 \text{Democracy}_t + \beta_7 \text{INTDIFF}_{t-1} + \mathbf{D}_i' \boldsymbol{\gamma} + \mathbf{T}_t' \boldsymbol{\zeta} + \varepsilon, \\
 [2] \text{ FDI}_t &= \beta_0 + \beta_1 \text{Welfare}_{t-2} + \beta_2 \text{Trade}_{t-1} + \beta_3 \text{GDPGrowth}_t + \beta_4 \text{GDP}_{t-1} \\
 &+ \beta_5 \text{GDPpercap}_t + \beta_6 \text{Democracy}_t + \mathbf{D}_i' \boldsymbol{\gamma} + \mathbf{T}_t' \boldsymbol{\zeta} + \varepsilon
 \end{aligned}$$

<sup>10</sup> We did consult the World Bank’s Business Enterprise surveys but these do not ask about preferences for specific types of government spending.

<sup>11</sup> Data are drawn from the 2006 World Development Indicators CD-Rom, 2006 Government Finance Statistics CD-Rom, and 2006 International Finance Statistics CD-Rom, except for the Polity index which comes from the Polity 4 dataset (World Bank 2006; International Monetary Fund 2006; Marshall and Gurr 2004). The resulting unbalanced panel dataset covers 59 developing countries between 1972 and 2005. We do not include the post-Soviet states or the oil-exporting Gulf countries in the analysis. A list of the countries included in the dataset is provided in the appendix, as are summary statistics for all variables utilized in the models.

<sup>12</sup> Note that we reestimated the model using a lagged dependent variable as a second check on the results. Any discrepancies are noted in the text.

$$[3] \text{ PORTFOLIO}_t = \beta_0 + \beta_1 \text{Welfare}_{t-2} + \beta_2 \text{GDPGrowth}_t + \beta_3 \text{GDP}_{t-1} \\ + \beta_4 \text{GDPpercap}_t + \beta_5 \text{Democracy}_t + \beta_6 \text{INTDIFF}_{t-1} + \mathbf{D}_i' \boldsymbol{\gamma} + \mathbf{T}_t' \boldsymbol{\zeta} + \varepsilon$$

where  $\alpha$ ,  $\gamma$ , and  $\zeta$  are vectors of coefficients to be estimated;  $\mathbf{D}$  is a set of country fixed effects, and  $\mathbf{T}$  is a set of decade fixed effects.<sup>13</sup> We also re-estimate the models using year fixed effects as a check on our results (not reported here). The sample includes 59 developing countries for which data on social security and welfare spending are available (listed in the data appendix).

Table 1 summarizes our main expectations. If the assumptions behind ‘race to the bottom’ policy actions are correct, then the coefficients on welfare spending in all three models will be negative and significant, confirming the World Bank and pull hypotheses. This would suggest that business representatives indeed have some profit-motivated incentives to lobby the government for lower welfare budgets. A positive and significant coefficient for welfare spending in the export model, on the other hand, would undermine existing RTB explanations of retrenchment and lend some credibility to the ILO hypothesis. A null finding would also call into doubt the claim that this type of spending has any affect on states’ export sectors. For the investment models, a positive and significant coefficient for welfare spending would reject the RTB logic (*i.e.*, investments would flow to states with more generous welfare benefits), while supporting a version of the pull hypothesis (‘welfare pull’). Whereas if the coefficient on welfare spending is statistically insignificant in the FDI and portfolio models *and* the international factors and temporal fixed effects are significant, then the data would overwhelmingly support the push hypothesis.

**Table 1. Summary of Expectations for Welfare Spending**

Export Model	Hypotheses	Expectations for $\beta_1$ (welfare spending)	Implications
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<sup>13</sup> We experiment with lagging the spending variables up to four years, but the results do not change. Therefore, to maximize the number of usable observations we report the two-year lag model. The other covariates are entered as one-year lags, except for democracy, which enters contemporaneously. In results not reported here, we also estimate the models as cross-sections and five-year panels. The results reported below do not change.

	<i>World Bank</i>	<i>- and significant</i>	<i>Supports logic of RTB</i>
	ILO	+ and significant	Rejects logic of RTB
	Null	Insignificant coeff	Rejects logic of RTB
<b>Portfolio and Foreign Direct Investment Models</b>	<i>(Welfare) Pull</i>	<i>- and significant</i>	<i>Supports logic of RTB</i>
	Pull	+ and significant	Rejects logic of RTB
	Push	Insignificant, but significant coefficients on int'l variables	Rejects logic of RTB

DEPENDENT VARIABLE:

Our dependent variable is estimated using three different indicators of the extent of a country’s engagement in the international economy: the size of its export sector, net inflows of foreign direct investment, and net portfolio investments flows (all measured as a share of overall Gross Domestic Product). These three indicators provide the clearest test of the race-to-the-bottom hypothesis by focusing on the most common paths towards international market expansion utilized by developing countries (Ahlquist 2006; Haggard 1990; Jensen 2006). Conventional policy wisdom also suggests that increasing exports, and attracting FDI and portfolio capital, are important for economic development more generally, which is why the race-to-the-bottom argument that generous welfare benefits hurts country’s performance in these three areas is especially pertinent (World Bank 1999/2000).

PRIMARY INDEPENDENT VARIABLE:

Our primary independent variable is the size of the government’s budget for social security and welfare, which we measure as a share of GDP.<sup>14</sup> We focus on social security spending because it is most subject to the logic of the race-to-the-bottom argument since it has a direct effect on labor costs. If employers are lobbying governments to reduce their spending so that their firms can compete more effectively in global markets, we would expect that demand to focus most keenly

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<sup>14</sup> The results are robust to measuring welfare spending as a share of total government spending or on a *per capita* basis. Available upon request.

on this welfare sector. As such, most existing research on the effects of globalization on government spending finds that education and health spending are not vulnerable to increased trade openness (Kaufman and Segura-Ubiergo 2001; Rudra forthcoming).<sup>15</sup>

#### CONTROL VARIABLES:

For all three models, we include as controls: *GDP growth*, *GDP per capita*, *total GDP*, *democracy*, and *skilled population*.<sup>16</sup> *GDP growth* should positively affect the level of exports, FDI, and portfolio flows because firms in countries experiencing robust growth should be better able to generate more exports, and be more attractive to foreign investors. We also expect that the size of the economy (operationalized by *GDP total*) impacts the level of exports because larger economies have larger markets and thus have more resources to marshal towards the export sector. By this same logic, larger economies can offer foreign capital more opportunities for productive investment (Ahlquist 2006; Jensen 2006). We also control for the level of development (*GDPpercap*) and expect it to have a positive coefficient in all the models given consistent findings that richer countries export more effectively and provide better host environments for prospective investors (Ahlquist 2006).

We include a measure of the *size of the skilled labor force as a share of the working age population* in all three models to get a sense of worker productivity. We expect that a larger skilled labor force will improve a country's export performance, but either be unrelated or negatively related to foreign direct investment inflows. More skilled labor allows domestic firms to compete internationally by producing products more efficiently and of higher quality. But since much FDI

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<sup>15</sup> We control for education and health care spending in other versions of the model. Neither is ever statistically significant, and they do not affect our findings regarding the effects of welfare spending. Available upon request.

<sup>16</sup> In separate analyses, we use Vreeland's IMF Program participation data (2003) to control for the effects of structural adjustment programs. Including this variable does not affect the results reported below, so we exclude it from the final model reported since we do not have the space here to discuss fully non-random selection into IMF programs. Our results do indicate that the unconditional effect of IMF programs is to increase FDI but decrease portfolio flows. IMF programs have no effect on exports in our data. Available upon request.

to LDCs is seeking cheaper labor costs (Noorbakhsh, Paloni, and Youssef 2001), investors might prefer low-skill labor countries and hence the coefficient will be negative and significant. By the same token, however, skilled labor may have no effect on FDI since investors are heterogeneous, and the importance of skilled labor varies across sectors. Since our measure of FDI inflows is aggregated across sectors, on average, it is plausible that the size of the skilled labor force might have no effect on FDI inflows (Makino, Lau, and Yeh 2002). The impact of skilled labor in the portfolio model is somewhat less controversial; skilled labor can serve as an important pull factor since capital should flow to countries where firms are more productive and offer higher rates of return

We include *democracy* in the export model and FDI model because some scholars assert this regime type trades more and offers better tax incentive policies to foreign investors. This is primarily because democratic governments are accountable to the general public, which rewards better economic performance and job creation (Ahlquist 2006). Jensen (2006) further argues that democracies should benefit investment by providing a stable and relatively transparent policy environment for investors. However, other scholars suggest that democracy should have an adverse effect on investment and exports (Li and Resnick 2003). The ability of interest groups to influence policy development in democracies creates the possibility that those displaced by FDI inflows (e.g., local and immobile factors of production in the same sector) and export growth<sup>17</sup> can lobby for inefficient protectionism while hurting the larger but less organized public. Also, “soft authoritarian” governments may be better able to ignore public opinion in favor of pro-

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<sup>17</sup> Export growth can have negative consequences on domestic-oriented firms that rely on imports for their inputs by diverting production and investment away from domestic markets, and by increasing inflation. Export growth can lead to currency appreciation, which not only makes imports more expensive, but also could lead to an increase in inflation and discourage consumer spending. Pereira and Xu 2000 further argue that export growth in LDCs can adversely impact domestic production and investment because it “typically suggests a shift of domestic production towards more labor-intensive commodities with comparative advantages in the world market. As a result, the growth of domestic investment in these countries can decrease as exports increase”.

business policymaking (e.g., anti-protectionist policies, lower labor standards and environmental regulations), while still enjoying a modicum of political stability relative to harsher authoritarian or totalitarian governments (Haggard 1990).

Our theoretical expectations for democracy in the export and FDI models are thus ambiguous. However, in our portfolio model, we expect democracy to have a clearer, positive effect and serve as an important *pull* factor. This is primarily because democracies are considered to be more credit-worthy (Ahlquist 2006; Schultz and Weingast 2003). Democracy in this analysis is operationalized using the combined Polity index, which ranges from 0 (pure non-democracy) to 20 (pure democracy).

We control for *FDI* in the export model only since theory suggests that foreign investment can have a positive effect on trade (Caves 1996; UNCTAD 2002). The logic is that FDI encourages exports primarily by fostering productivity gains, international technology spillovers and access to new specialized intermediate inputs.

By a similar logic, in the FDI model, we control for the overall levels of *trade openness* (the sum of imports and exports as a share of GDP). The expectation is that higher trade openness should be positively related to investment flows. Lower barriers to trade make it easier for foreign investors to obtain inputs from around the world as well as to access international markets with their goods. Additionally, a liberal trade regime is seen as an indicator of a country's creditworthiness (Lensink and White 1998).

To test the push hypothesis effectively, the portfolio model includes a measure of *interest rate spread* from the WDI 2004, which is the difference between the domestic deposit rate and the London Interbank Offer Rate (LIBOR). We expect a positive and statistically significant relationship between interest rate spread and globalization if the push hypothesis that international

conditions (such as low rates in OECD countries) affect capital movements more than domestic ones is correct. In other words, when an LDC's domestic deposit rate is higher than international interest rate represented by LIBOR (*i.e.*, the difference is positive), the return to investing money in the LDC is higher than on the international market and so capital should flow into the country. When the spread is negative, returns are lower than elsewhere, and so capital should flow out.

## RESULTS:

To preview our findings, our statistical analysis provides *no support* for the proposition that increased social spending hurts the ability of firms in a country to compete internationally, and hence provides direct profit incentives for firms to mobilize against welfare spending. If anything, there is some support for the ILO perspective that increased welfare spending might enhance investment attractiveness. Further, our results indicate that exports and investments are more influenced by the states' general policy orientation towards international markets, the performance and size of its domestic economy, country-specific effects, and common international factors.

Table 2 reports the effects of welfare spending on the size of the export sector, of foreign direct investment inflows, and of portfolio investment flows, each measured as a share of national income.

**Table 2: LSDV Results**

	<b>Exports (% of GDP)</b>	<b>Net FDI (% of GDP)</b>	<b>Portfolio Inv. (% of GDP)</b>
Welfare Spending <sub>t-1</sub>	-0.023 (0.013)	0.283 (0.074)***	0.032 (0.044)
Trade Openness <sub>t-1</sub>		0.979 (0.202)***	
Net FDI <sub>t-1</sub>	0.013 (0.006)**		
Growth <sub>t-1</sub>	-0.135 (0.148)	1.251 (0.716)*	2.318 (0.977)
GDP Total <sub>t-1</sub>	0.451 (0.133)*	-0.362 (0.691)	-0.131 (0.671)
GDP per capita (Log) <sub>t-1</sub>	-0.071	1.611	1.243

	(1.77)	(0.791)*	(0.742)*
Democracy	0.051	0.026	0.201
	(0.021)	(0.084)	(0.095)**
Skilled Working Population	-0.026	-0.259	0.414
	(0.019)	(0.093)***	(0.159)***
Interest Rate Spread			0.063
			(0.046)
Seventies	-9.051	-0.342	-5.636
	(2.200)***	(0.276)	(12.053)
Eighties	-9.155	-0.247	-5.757
	(2.216)***	(0.169)	(12.162)
Nineties	-9.161	n/a	-5.261
	(2.232)***		(12.317)
Time Fixed Effects	Yes***	Yes***	Yes***
Country Fixed Effects	Yes***	Yes***	Yes***
No. of Observations	663	668	453
No. of Countries	40	40	35

Notes: \*\*\*, \*\*, and \* indicate significance at the 1%, 5%, and 10%, levels respectively. Entries in parentheses are standard errors corrected for clustering by country. Unit and time fixed effects coefficients are suppressed to preserve space; joint tests of these effects indicate significance at  $p < 0.01$  for all models. Models estimated using STATA 9.2. Summary statistics provided in appendix.

As Table 2 indicates, we find no evidence in favor of the RTB logic (*i.e.*, World Bank and (welfare) pull hypotheses) as higher welfare spending exhibits minimal impacts on exporters or the flows of portfolio investment according to our data; the estimated coefficients in these models are essentially zero. The only model in which welfare spending is a statistically significant predictor is for net foreign direct investments. Its effect is positive and thereby appears to lend some support to the ILO hypothesis that domestic welfare spending can matter for investor decisions, but in the opposite direction from what the RTB logic would suggest. Rather than be frightened away by the burden of higher welfare spending, this result implies that investors are attracted by the possibility of a more secure labor force (c.f. Garrett 1988).<sup>18</sup> However, it should be emphasized that this finding did not hold up to robustness checks; in subsequent analyses

<sup>18</sup> Existing research has shown a negative relationship between total government consumption and budget deficits and FDI and portfolio flows (Ahlquist 2006; Jensen 2006). But welfare spending forms a very small portion of overall government expenditures in LDCs. Our result speaks to the relationship between welfare spending and FDI flows only, but is agnostic as to whether higher overall spending is good or bad for attracting investment.

reported in the next section we find that such spending has, on average, a null effect on investment.<sup>19</sup>

In all models, rather, other economic and political variables are relevant for explaining improved performance in international markets. In terms of export performance, FDI, market size (GDPtotal) and democracy have positive effects. Findings on the first two economic variables are consonant with UNCTAD's findings (2002). The positive results for the political variable- democracy - are in line with previous research by Lindenberg and Devarajan (1993). In the FDI model, trade, growth, and level of development (GDPpercap) encourage this type of investment, while higher skilled workforce discourages it. The negative coefficient on the skill variable supports the proposition that labor-abundant LDCs are attracting greater levels of FDI.

Finally, our results for the portfolio model demonstrate some support for the push hypothesis, that international conditions are strong determinants of portfolio flows. The interest rate spread variable does not show significance at the 90% confidence level here but when tested with annual fixed effects, the variable is positive and significant at the 95% level. This presents some support for Maxfield's (1998) proposition that capital flows are more a function of the business cycle in developed countries. The joint significance of the decade effects further supports the 'push' hypothesis that common international forces drive the flow of capital towards developing countries in particular years. The coefficients of the decade dummies for the exports model (suppressed for space) confirms the intuition that the late 1970s and early 1980s with its recessions in the West due to the oil shocks and debt crises were bad for developing countries, while the 1990s were better. Decade coefficients are negative in the 1980s and are consistently positive in the 1990s.

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<sup>19</sup> Jensen (2006: Table 4.2) finds no relationship between social security spending and FDI inflows.

Investors do not ignore domestic features, however. Indeed, portfolio flows are affected by economic growth (Ahlquist 2006); a more democratic environment (Schultz and Weingast 2003); and interestingly, the costs of labor. We find that countries with more highly-skilled labor forces attract less direct investment but more portfolio investment (see Noorbakhsh, Paloni, and Youssef 2001).

To summarize our empirical findings thus far, there is little consistent support for the claim that higher government social spending either hurts or helps countries expand their export sectors or attract more investment. Alternative political, historical and domestic and international economic conditions continue to explain most of the variance in exports and international investment. We thus have little reason to expect that capitalists would pressure governments for lower welfare spending just so that they can maintain higher profits in the globalizing environment. If the various robustness checks in the next section confirm this finding, then the existing logic of RTB arguments in studies that confirm an empirical correlation between economic globalization and its effect on welfare spending demand immediate reevaluation.

### **Robustness Checks: Potential Endogeneity**

Our empirical analysis thus far has revealed no support for the RTB hypothesis that welfare spending hurts states' exports or ability to attract capital. A potential criticism of these results is that they do not account for possible endogeneity between welfare spending and exports and investments. Indeed, the principal motivation for this research is the large body of literature asserting that globalization affects public welfare spending. This is because trade openness in particular has been found to be the primary cause of reductions in welfare spending thereby giving rise to the 'race-to-the-bottom' hypothesis (Rodrik 1997, Rudra 2002, Kaufman and Segura 2001,

Wibbels 2006, Jensen 2006).<sup>20</sup> Since we take the findings of this previous research seriously, we reestimate the models to account for the possibility that exports, FDI, and portfolio investment might be affecting the level of welfare spending and biasing our results.

Two separate econometric techniques were used to assess the robustness of our results to possible endogeneity.<sup>21</sup> First, we estimated a panel-vector-autoregression (P-VAR) model in which exports, FDI, portfolio investment, and welfare spending were allowed to affect each other.<sup>22</sup> Each variable was regressed against its own past values, as well as past values of the other variables (see Table A2 in the statistical appendix for more detailed discussion of findings). Thus, the potential endogeneity is directly accounted for, and the results are encouraging: past values of welfare spending are not statistically significant predictors of current values of exports, FDI, and portfolio investment, which supports the results reported in Table 2.<sup>23</sup> Second, because such models are biased towards Type II errors in the presence of highly-trended data, we estimated an instrumental variables regression as well. We instrument welfare spending with the level of spending on health care since we have both theoretical and empirical reasons to believe that government health spending will be correlated with social security spending but not international economic variables.<sup>24</sup> Estimating the IV model in a single-stage or in two-stages where the

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<sup>20</sup> Note that the results on the effects of capital account liberalization on spending are decidedly mixed. Jensen (2006) finds that foreign direct investment has no effect on spending on social security and welfare. Wibbels (2006),

<sup>21</sup> To preserve space, we report the results of these robustness checks in the statistical appendix.

<sup>22</sup> We thank Inessa Love for sharing the statistical code required to estimate the model. See Holtz-Eakin et al 1988 for a technical discussion of this model, and Franzese (2002), Love and Zicchino 2006, and Tang 2008 for recent applications. In a related spirit, we also estimated a Generalized Method of Moments (system-GMM) model developed by Manuel Arellano and Stephen Bond (Arellano and Bond 1991; Arellano and Bover 1995; Bond 2002; Bond et al 2001). Like the panel-VAR model, the system-GMM model uses lagged values of the independent variables as instruments for their present values. Our findings hold. See Table A2 in the appendix.

<sup>23</sup> And, as expected, exports, FDI, and portfolio flows do not affect welfare spending either. However, such models are biased towards Type II errors in the presence of highly-trended data, which is why we also estimate GMM and instrumental variable regressions in addition. See below.

<sup>24</sup> Theoretically, health spending in developing countries is mostly determined by domestic-oriented variables such as levels of income and economic growth (Okunade 2005). Developing countries traditionally spend very little of their national incomes on health care (Bajpai and Goyal 2005; Whyne 1995) and to the extent that they do the spending tends to be curative rather than preventive health care (Lindert 2004; World Bank 2003). This means that public

standard errors are bootstrapped to correct for the generated regressor yield the same results: welfare spending does not affect export performance, FDI or portfolio flows.

Our finding thus survives multiple robustness checks to ensure the results are not spuriously generated by endogeneity, which bolsters our claim that welfare spending does not affect exports, FDI, or portfolio investment.<sup>25</sup> The implications are important: governments have been retrenching their expenditures on welfare in the globalizing environment as previous research indicates, but our evidence thus far suggests it must be for some reason other than bolstering the international ‘competitiveness’ of its export-oriented firms or attracting foreign capital.

### **Robustness Check: Alternative Explanations for RTB Policy Actions**

Given increasing evidence that welfare spending does not reduce exports or foreign investment, two alternative implications of the race-to-the-bottom hypothesis deserve some attention. Critics of our argument might persuasively counter that, while welfare spending does not affect exports, FDI, or portfolio investment, the race-to-the-bottom logic would still hold if cutbacks in welfare spending are occurring because governments feel reducing the welfare budget is important for economic growth in a global economy or because they are being lobbied by import-competing sectors that wish to lower their labor costs. Is this the case?

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spending on health in developing countries tends to benefit the poor more than the middle class or rich who exit to the private health sector for their care. Therefore, globalization has no systematic effect on health spending because there are no coalitions to demand it: the poor do not mobilize for healthcare as the market expands because they have other immediate concerns (e.g., food and education) and because the quality of health care they traditionally received scarcely inspired much loyalty (Bajpai and Goyal 2004; Das Gupta and Rani 2004; Peters et al 2002). And the better-off are not likely to mobilize because they prefer private health care (Lindert 2004; World Bank 2004). This argument is borne out by empirical findings that increased trade openness does not affect health spending (Kaufman and Segura-Ubiergo 2001; Avelino, Hunter and Brown 2005). To the extent that trade could possibly affect health spending it would only be through mediating variables such as regime type (see for example Rudra and Haggard 2005), which is already controlled for in our models.

<sup>25</sup> We are not surprised by these results since studies which disaggregate trade suggest it is increasing import competition, rather than export growth, that causes governments to reduce welfare spending (Nooruddin and Simmons 2007). At the same time, reports on the effects of financial openness on social spending are decidedly mixed. Rudra (forthcoming), and Avelino, Hunter and Brown (2006), for example, find inconsistent results for the effects of financial openness

To get at these alternative causal explanations, we estimated two additional models.<sup>26</sup> In the first, we use growth in GDP per capita as the dependent variable, while the second model estimates the size of the import sector as a function of welfare spending, the same set of control variables as used above, and time and country fixed effects. If the alternative causal mechanisms are valid, then welfare spending should have a negative effect in the first model and a positive effect in the second; higher spending is expected to discourage growth, and, by hurting the competitiveness of domestic firms, should lead to a growth in imports. But, once again, welfare spending was statistically insignificant in both models. Rather both growth and the size of a country's imports are mainly explained by their past levels; structural factors captured by the fixed effects; common international forces captured by the period effects; the level of exposure to the international economy more generally; and the country's level of economic development, with richer countries growing more slowly and importing less overall (See Table A4 in the statistical appendix).

### **Interpretation of Results**

We have demonstrated that welfare spending has no effect on various indicators of country's economic globalization and performance, and that this non-result is robust to the use of several alternative statistical techniques. Why, then, as previous studies have shown, are LDC governments reducing spending on social programs in response to international market expansion when, as we find, this type of spending neither serves to improve export competitiveness nor attracts mobile capital? Our results essentially question the basic logic of RTB that pure economic criteria (*i.e.*, profit maximization) is the primary motive guiding public policies in a globalizing

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<sup>26</sup> In the growth model, we control for its lagged level, trade openness, foreign direct investment inflows, initial GDP per capita, and size of skilled labor force as a proxy for human capital. In the import model, we control for the lagged level, level of exports, net FDI, growth rate of the economy, and level of economic development. Both models include a full set of country and temporal fixed effects. Standard errors are corrected for clustering by country. The results are robust to the use of alternative estimation techniques.

economy. The findings do not, however, rule out the possibility that business and governments may have other (political) motivations to embrace welfare reform. Combining insights from the second-image reversed literature and neoclassical political economy presents a *plausible* explanation for what these alternative incentives might be and sheds some light on this statistical pattern. Of course, additional data and detailed case studies is required to confirm our interpretation. We argue that governments and business (domestic and international) are using globalization as an excuse for domestic reform so that they can ultimately reduce the influence of existing distributional coalitions, or rent seekers who have long profited from welfare subsidies and labor regulations.<sup>27</sup> At the heart of the issue, privileged labor groups – key members of these distributional coalitions – have been uncompromising with groups pushing for reform even before economic liberalization policies were adopted. But in more recent times, by applying the threat of global competition, politicians and business representatives are gaining the necessary leverage to implement long-desired reforms which, in turn, increase their negotiating power vis-à-vis labor in both the workplace and formal political arena. In time, labor comes to accept reform in an effort to avoid more radical redistribution policies. Mobile capital, however, is less likely to be directly involved in these negotiations since our findings show that welfare spending does not directly factor into investment decisions.

This analysis is rooted in rational choice scholarship, or more specifically, the “rational choice” variant of the second-image reversed literature and one of the cornerstones in rational choice theory, neoclassical political economy (NPE).<sup>28</sup> We thus apply a focus upon individual actors and their involvement in political competition for the fruits of power, as well as identify

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<sup>27</sup> The bottom line is that in most developing countries, pension benefits and similar income transfers are not collective goods. Rather, they help ensure political survival and build loyalties that may prove lucrative even after they are no longer in office.

<sup>28</sup> See Green and Shapiro’s (1994) discussion of Mancur Olson’s *Logic of Collective Action*, a pillar of the neoclassical political economy literature.

propositions about the microfoundations of their behavior towards welfare reform. One additional assumption we employ here is that businesses have some active knowledge that, as the results in this paper show, nonwage labor costs have a minimal effect on their international market prospects. This is plausible for several reasons. First, many export-oriented firms, particularly those located in export processing zones, are often exempt from certain tax requirements and domestic labor regulations. Second, even when this is not the case, we expect that the statistical pattern that emerged in this study is revealed in annual profitability analyses of a large number of export-oriented and import-competing firms.

From NPE, we view the state as endogenous and the policies reflect vested interests in society (Colander XXXX). In a great many developing countries, the adoption of the more closed industrial substitution industrialization (ISI) development strategy led both industry and government to “buy” the cooperation of urban labor groups in key sectors (Schmitter 1974, Malloy 1979). Political leaders thus supported pro-labor policies and benefits in exchange for their workplace cooperation and political support. Accordingly, as Olson’s (1971) theory of collective action would predict, these privileged labor groups eventually formed distributional coalitions to insist that this type of state intervention continues. Generous pension benefits and job security are examples of common labor benefits that have persisted in developing countries way past the ISI period. As these costly benefits and regulations continue to be reproduced by the efforts of these distributional coalitions, labor’s hold in the workplace and privileged access to politicians are maintained.

Hereby, business representatives have a clear incentive to lobby for welfare retrenchment in developing nations irrespective of whether there will be immediate improvements in international market performance. Retrenchment is an important advance towards loosening the

political hold of urban labor groups since labor benefits have been one of the key instruments used by governments to maintain labor's cooperation and support. Capital would ostensibly gain more 'room to move' on a broad range of policy objectives.<sup>29</sup> Consequently, welfare reforms would place both domestically-oriented and internationally-oriented firms at an advantageous bargaining position in the workplace as well as the broader political arena.

The big question is 'why now', since reforms have long been on the agenda of a broad range of developing countries (Social policy report, World Bank 1990, Holzman and Hinz 2005). Here the international system plays a pivotal role in encouraging reform (*i.e.*, the second-image reversed), but not in the ways conventionally assumed by the popular RTB hypothesis.

Emphasizing the competitive pressures of globalization provides necessary fodder for capital to convince both government and labor that the need for welfare reform is now urgent. Recent polls suggest that the public in developing countries is seeing the benefits of competing in the rapidly expanding global economy (Pew Global Attitudes Project 2007:

<http://pewglobal.org/reports/pdf/258.pdf>). Interestingly, at the same time, strong support for social safety nets in developing countries has fallen (Ibid.). It is thus no surprise that 'competitiveness' has become a powerful buzzword in ongoing political debates and business representatives liberally apply the term to build momentum for labor reforms. As Indonesia's trade minister Rini Soewandi recently argued:

Where Indonesian industry does not possess a comparative advantage in raw materials, we are forced to try to keep labor costs at a minimum in order to compete globally. At the

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<sup>29</sup> In other words, capital aims for more power in the workplace to hire and fire labor, and in the political arena, greater bargaining power can lead to the implementation of policies in their favor such as reducing the overall tax burden, lower restrictions on exports (such as export taxes), stable exchange rates, etc. Take for instance the relatively recent labor reforms adopted by former Argentine President De la Rúa. Senior aides to De la Rúa predicted that the passage of the labor code in the Senate would give the administration momentum to further reduce business costs by deregulating the health care system ("Injecting Change Into Argentina; New President Tries to Keep Industry From Leaving the Country." *New York Times*. March 8, 2000).

same time, the lowering of tariffs is unleashing competition on the domestic market. As a result, Indonesian industry is under intense competitive pressure. ("Indonesia and Globalization" *The Globalist*, May 31, 2004).

Similarly, Argentina's Economy Minister Jose Luis Machinea stated:

Our eyes are focused on growth and whether we will be competitive or not...How do you reduce business costs? You reduce the country-risk ratings and interest rates, then you lower labor expenses (*New York Times*, March 8, 2000).

It is still curious, however, why governments might agree to support reforms since policymakers themselves are part of the distributional coalitions that have been earning rents from the selective allocation of benefits to labor (Weyland 1996, Kaufman and Nelson 2004, Rudra 2004). The pivotal factor is that many governments of developing countries are being confronted with the same problem: they initially supported generous pension systems for urban elite labor groups, and are now facing the problem of how to fund them in the future. Most public pension plans are defined-benefit plans financed on a pay-as-you-go basis. The most privileged groups typically enjoy lax eligibility criteria. For example, they contribute much less (sometimes nothing) than they get back, can receive a full pension after only a limited number of years in the workforce, and can retire and collect pensions at a relatively early age. As a result, pension deficits loom large and are on the verge of crisis for many. The longer-run impacts of fueling this deficit are now well-known: high interest rates, low domestic investment, fewer resources available for other socioeconomic groups, and worsening instability. Put simply, as time passes, the political costs to the state for maintaining status quo in welfare services will rise.

These circumstances threaten the government's ability to sustain rents through welfare benefits; they are harder pressed to use benefits in exchange for bribes and admiration from their traditional supporters. The consequence is that utility-maximizing politicians may be growing less secure about the future of their relationship with existing distributional coalitions and thereby have

an incentive to either shift allegiances or attempt to build broader coalitions. The latter is particularly appealing given expanding democratization in these countries. As such, governments are more likely to embrace neoliberal justifications for welfare reform, and with globalization comes newfound opportunity to convince labor that they must agree to do so.

But why would labor agree to be the group to bear the disproportionate share of the burden, even if these groups are convinced that stabilization more generally is necessary in the current global era? As Alesina and Drazen (1991) explain, under such conditions, a ‘war of attrition’ is likely to occur. Labor groups attempt to wait it out and see whether the burden of stabilization can be shifted elsewhere. During this process, however, labor is very often central to the debates on competitiveness and with these discussions has come increased public scrutiny.<sup>30</sup> It is commonplace for high-profile policymakers to underscore publicly the importance of ‘competitiveness’ and how and why labor reforms, in particular, are increasingly unavoidable. Take for instance recent comments by Singapore’s Deputy Prime Minister Trade Minister Lee Hsien Loong:

We must enhance the competitiveness of our economy... We undertook a fundamental review of the Central Provident Fund (CPF) Scheme, which is our social security and pension fund scheme. We refocused the CPF on its core objective of providing for the basic needs of the majority of Singaporeans, in terms of retirement needs, healthcare expenses and home ownership. We are tightening the use of CPF for buying properties, so as to leave more for retirement needs. We are reducing the coverage for high-income Singaporeans, who should be able to plan and provide for their own retirement. ... ***These measures will make our labour market more flexible, and contribute to our economy's overall resilience and competitiveness*** (emphasis ours; “Economic restructuring: philosophy and initiatives,” *The Business Times Singapore*, October 24, 2002)

In a similar vein, India’s former Prime Minister Atal Vajpayee at the inauguration of the 37th Indian Labour Conference stated:

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<sup>30</sup> We draw on Alesina and Drazen’s (1991) notion that credibility reflects political support.

In course of time... our economic policies and laws developed rigidities. They failed to respond to the changing needs and opportunities, both nationally and internationally. Our private sector was shackled by many unnecessary restrictions... Businesses are being forced to reorient themselves to face tough competition, both within the country and globally. There is simply no alternative to raising the efficiency of our production units, reducing costs, and improving the quality of our goods and services. Needless to add, *such re-orientation is impossible without the ability to restructure labour within individual businesses...* I urge all of you to view the proposed amendments to the labour laws in the broader perspective of how we can make our economy grow faster ... To term these labour reforms as anti-labour, as some people are doing, is misleading... They seek to protect Indian industries and businesses by enabling them to become more competitive, more profitable, grow faster, and, hence, employ more people both directly and indirectly (emphasis ours).

Consequently, as public awareness and support for reform rises, the cost for labor of remaining in the fight also increases, risking the loss of even more benefits in the long run than what is currently being negotiated (*i.e.*, more radical redistribution proposals).<sup>31</sup> As Alesina and Drazen (1991: 1183) put it, “in the war of attrition, passage of time and the accumulation of costs lead one group to give in and make a previously rejected program economically and politically feasible.” Accordingly, governments and business can effectively use the language of globalization to convince labor to accept at least some level of incremental reforms.

This interpretation of the statistical results has significant implications for the broader IPE literature. The common assumption in IPE is that globalization has already put capital in a superior position and public policies follow almost automatically in their favor – that capital has triumphed over labor. Our argument is quite distinct: we suggest that welfare retrenchment in the current global era is one means by which capital and eventually LDC governments are trying to weaken the political strength of distributional coalitions involving privileged labor groups. In the end, we are emphasizing a contrast between welfare retrenchment serving as a means to a particular end (*i.e.*, reducing the political clout of privileged labor) in ongoing domestic political

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<sup>31</sup> See Rudra (forthcoming) for more detailed discussions on how welfare reforms in developing countries tend to be incremental.

battles rather than welfare retrenchment as an end in itself. Of course, we advance only a plausible explanation of the statistical pattern here and further investigation is required to confirm why this pattern exists.

### **Implications and Future Directions**

Have governments gone too far? According to previous research, the answer is ‘no; globalization is linked to lower welfare spending in developing countries precisely because governments prioritize market-oriented policies so that entrepreneurs can better compete in the global economy. However, after subjecting this causal logic to an empirical test, our analysis suggests that the answer is ‘yes’. The evidence indicates that exports and capital flows are unaffected by changes in government welfare spending. It then does seem as if governments have gone too far in cutting back expenditures when such actions are not improving international market prospects. Our reassessment of the globalization-welfare nexus casts much doubt on the conventional RTB wisdom that internationally-oriented business has gained political power and is demanding that government lower spending *because it affects export competitiveness and their incentives to invest*. Simply put, causality between globalization and welfare is unidirectional; international market expansion is correlated with welfare retrenchment but this policy change in turn is not improving the international economic standing of LDCs. Results from the models used in this analysis thus signal that LDC governments are making the political choice to reduce social spending following market liberalization for reasons other than widespread pressure from capital to improve competitiveness in international markets.

We draw on IPE and NPE literatures to make sense of the statistical pattern that emerged in this analysis and suggest that politicians are exploiting globalizing conditions to help convince privileged urban labor groups that retrenchment of longstanding welfare programs is now

inevitable- even when it is not. We are not the first to propose that policymakers (and capitalists) are using globalization as an excuse for domestic welfare reform. Dani Rodrik, for example, posits that “too often the need to resolve fiscal or productivity problems is presented to the electorate as the consequence of global competitive pressures” and politicians do not make the case for reform on its own strengths (Rodrik 1997: 79). But unlike Rodrik, we do not find it surprising that at least *in some cases* LDC governments would resort to tactics of blaming globalization. Rather, our results imply that this may be one way in which governments can begin breaking up existing distributional coalitions which have had a long hold on social programs. It is certainly feasible that governments are searching for new and broader coalitions in this era of increasing market integration and expanding democratization. These incentives are even more pertinent in developing countries where welfare spending has been largely regressive, and so unlikely to be valued highly by the mass population. We have attempted to highlight the rational political motivations and subsequent maneuverings that take place in order for politicians to accomplish this goal. Consequently, while governments may have gone too far in cutting back welfare expenditures despite the fact that they have no impact on openness, we suggest they are doing so with (political) purpose.

This analysis thus opens up several new lines of investigation, particularly ones that would help assess the veracity of our proposed explanation for ongoing LDC welfare reductions in the current era of globalization. A next step would be to collect more data and engage in detailed case studies to assess how and why governments and business representatives apply neoliberal ideas to further their own political interests. In the war of attrition, why exactly did labor agree to reform and what are their expectations for the future? Even more interesting and meaningful for citizens of developing countries, is it possible that, by strategically using the enabling conditions of

globalization, governments are breaking the stranglehold of privileged groups over social programs and opening up the way towards pro-poor reform and more comprehensive welfare states? Indeed, could it in fact be the case that the 'race to the bottom' actually benefits the poor?

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## DATA APPENDIX

### *List of Countries in Sample*

Argentina, Bangladesh, Bolivia, Botswana, Brazil, Cameroon, Chile, China, Colombia, Costa Rica, Cyprus, Dominican Republic, Ecuador, Egypt, El Salvador, Fiji, Ghana, Greece, Guatemala, Guyana, Honduras, India, Indonesia, Iran, Israel, Jordan, Kenya, Republic of Korea, Kuwait, Lesotho, Liberia, Malawi, Malaysia, Mali, Mauritius, Mexico, Morocco, Mozambique, Nepal, Nicaragua, Nigeria, Pakistan, Panama, Paraguay, Peru, Philippines, Singapore, South Africa, Sri Lanka, Syria, Tanzania, Thailand, Trinidad & Tobago, Tunisia, Turkey, Uruguay, Venezuela, Zambia, Zimbabwe

### *Summary Statistics*

Variable	N	Mean	Std. Dev.	Min	Max
<i>Dependent Variables</i>					
Exports (% GDP)	1807	3.22	0.62	0.93	4.85
Net FDI inflows (% GDP)	1611	-0.13	1.68	-11.49	4.28
Portfolio Inv (% GDP)	1645	0.24	0.96	-5.17	8.73
<i>Welfare Spending</i>					

As % GDP	1341	0.03	0.04	0.0002	0.38
As % Total Spending	1348	0.11	0.12	0.002	0.67
As per capita	1390	146.64	316.84	0.01	2296.56
<i>Control Variables</i>					
GDP	1870	23.47	1.74	18.62	28.17
GDP Growth	1859	1.74	5.80	-50.49	89.83
Polity Score	1316	2.01	0.92	0	2.99
Interest Rate Spread	1281	-4.65	0.29	-6.79	0.60
Skilled Labor Force (% Working Age Pop)	1531	0.70	1.33	0	10.42

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## STATISTICAL APPENDIX

To assess the core question of whether domestic welfare spending affects exports and/or investment flows, while accounting for potential endogeneity, we utilize several different techniques. Principally, we use a vector-autoregression model (VAR) adjusted for panel data. The results of this analysis bolster confidence in our results and reveal little reverse causation between exports, FDI, and portfolio investment and welfare spending. Additionally, we analyze the model using Generalized Methods of Moments and instrumental variable regression estimators. These also allay concerns that our results are the result of unaccounted-for endogeneity.

### *P-VAR Analysis*

The VAR methodology assesses temporal priority among a set of possibly endogenous variables by regressing each variable on its own lags as well as the lags of the other variables in the system.<sup>32</sup> We specify a third-order VAR model as follows:<sup>33</sup>

$$z_{it} = \Gamma_0 + \Gamma_1 z_{it-1} + \Gamma_2 z_{it-2} + \Gamma_3 z_{it-3} + f_i + d_t + e_t$$

where,  $z_t$  is a four-variable vector that includes all the variables considered to be potentially endogenous: Exports, FDI, portfolio investment, and Social Security and Welfare Expenditures; the  $\Gamma$ s are vectors of coefficients to be estimated,  $f_i$  is a vector of country fixed effects,  $d_t$  is a vector of time fixed effects, and  $e_t$  is a white-noise error term.<sup>34</sup> The results and corresponding

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<sup>32</sup> The methodological discussion in this section borrows heavily from Holtz-Eakin et al (1988); Franzese (2002); Love and Zicchino (2006); and Tang (2008). We thank Inessa Love for sharing the STATA code required to estimate the panel-VAR model.

<sup>33</sup> Our results are robust to changing the number of lags used in the VAR system.

<sup>34</sup> Applying VAR to this system requires a few additional steps because of the panel structure of our data. First, we use forward mean-differencing via the ‘Helmert procedure’, which removes the forward mean for each variable for each country-year. The Helmert-transformed variables are thus not correlated with the lagged regressors allowing the latter to serve as instruments and for the coefficients to be estimated via system GMM. We also include time effects ( $d_t$ ) to capture aggregate shocks that affect all countries in a given year similarly. These time fixed effects are removed by ‘time-demeaning’ all the variables in the system, *i.e.*, subtracting from each variable their means calculated for each year (Arellano and Bover 1995; Love and Zicchino 2006).

variance decompositions are reported in Tables A2a and A2b, and the impulse response functions are shown in Figure 1.<sup>35</sup>

**Table A2a. Exports and Investment measured as Share of Country GDP**

Response to ↓	Response of...			
	Exports <sub>t</sub>	FDI <sub>t</sub>	Portfolio <sub>t</sub>	Welfare <sub>t</sub>
Exports <sub>t-1</sub>	0.94 (0.06)	0.61 (0.29)	-0.39 (0.31)	-0.002 (0.004)
FDI <sub>t-1</sub>	0.002 (0.01)	0.44 (0.06)	-0.01 (0.03)	0.001 (0.001)
Portfolio <sub>t-1</sub>	-0.01 (0.01)	-0.002 (0.04)	0.17 (0.07)	0.0003 (0.001)
Welfare <sub>t-1</sub>	0.75 (1.09)	-15.97 (6.27)	-4.51 (10.65)	0.75 (0.17)
N	579			

*Notes:* Cell entries show the coefficients of regressing the column variables on first-order lags of the row variables. Heteroskedasticity-adjusted standard errors reported in parentheses. Four variable VAR model is estimated by GMM; time and fixed effects are removed prior to estimation. Estimation conducted in STATA 9.2 using Inessa Love's `pvar` ado-routine.

**Table A2b. Variance Decompositions from VAR Analysis**

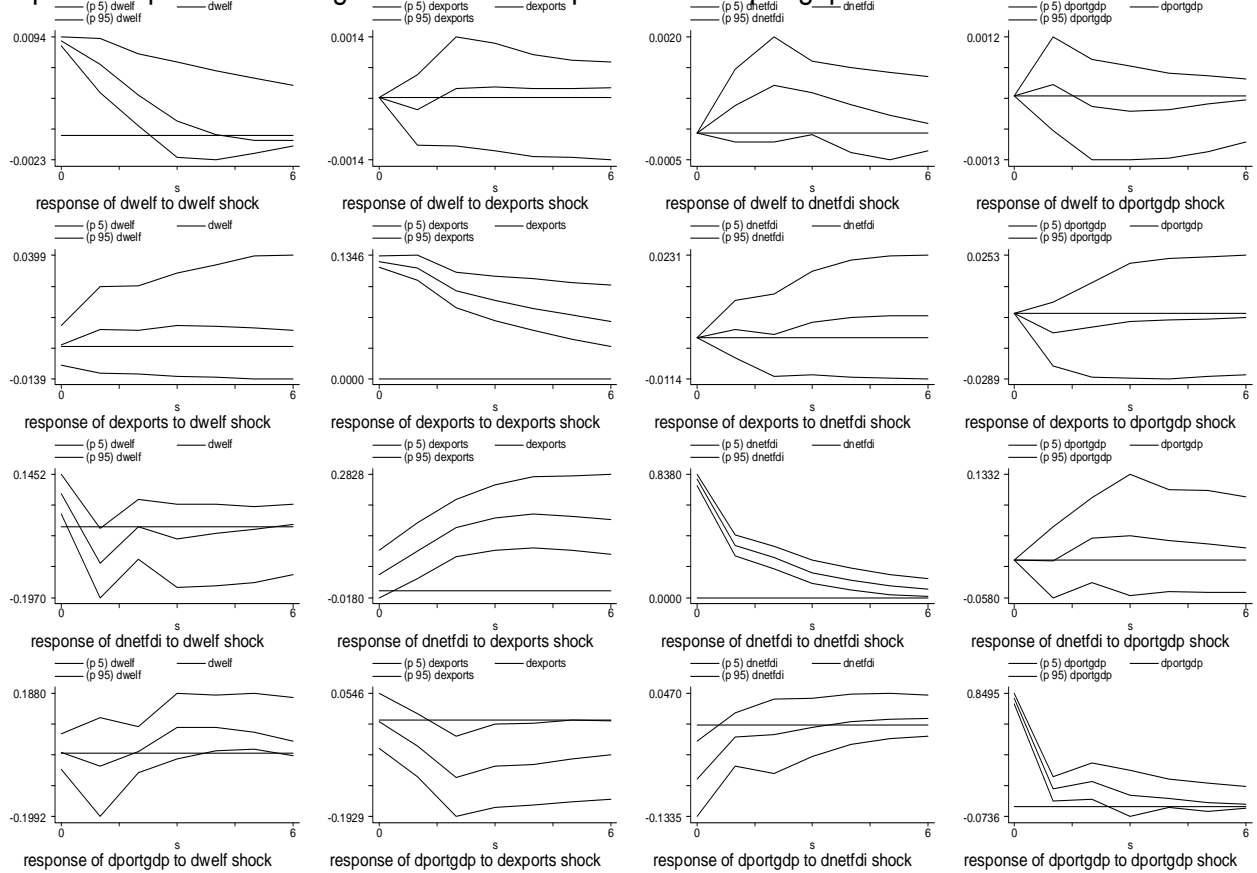
	Exports	FDI	Portfolio	Welfare
<b>Exports</b>	0.99	0.003	0.003	0.01
<b>FDI</b>	0.19	0.78	0.004	0.02
<b>Portfolio</b>	0.06	0.01	0.90	0.03
<b>Welfare</b>	0.003	0.02	0.002	0.98

*Notes:* Cell entries are percent of variation in the row variable (10 years ahead) explained by the column variable.

<sup>35</sup> Variance decomposition provides another way to assess these relationships by estimating the share of variation in one variable explicable by a shock to another variable, accumulated over time. We report the total effect of a shock to a variable on each of the others accumulated over a ten-year period. Impulse-response functions provide the response of each variable in the system to shocks in each of the other variables holding all other shocks to zero. We utilize routines developed by Love and Zicchino (2006) to calculate impulse-response functions (IRFs) with confidence intervals generated by Monte Carlo simulation (1000 repetitions per model).

**Figure A1. Impulse Response Functions from Table A2 above.**

Impulse-responses for 3 lag VAR of dwelf dexports dneftdi dportgdp



Errors are 5% on each side generated by Monte-Carlo with 1000 reps

In the impulse response functions since these are easiest to interpret. Specifically, we examine the predicted effect over time of increases in welfare spending on country's exports, FDI and portfolio inflows. The results suggest caution in accepting either the ILO or World Bank positions without reservation. The 95% confidence intervals for the response of exports to welfare spending (first column second row) encompass zero for the entire period investigated. With regard to FDI, as in the previous section, the effect of welfare spending on FDI (first column second row) is positive in the first time period, negative in the second, but has no effect on FDI beyond that. And while welfare spending has a statistically insignificant effect on portfolio flows initially, the VAR analysis (first column fourth row) suggests that the effect turns positive in the long run. To us, this

suggests a need first to investigate the robustness of the relationships uncovered here further, but also to revisit our conventional understanding of the race-to-the-bottom.

Just how large are these relationships? The main factors explaining the level of exports and FDI are their own past levels (see the variance decompositions in Table A2b). Shocks to exports, as seen in the LSDV analysis above, do affect future levels of FDI, and explain ~20% of future variation in FDI. Similarly, positive economic growth can explain about 7% of future variation in a country's share of total world exports and 5% of future variation in its share of total FDI inflows. Welfare spending, which appears to have a positive initial effect on FDI, accounts for just about 2% of future variation in that variable. Welfare spending explains 3% of future variation in portfolio investment, which corresponds to the longer-term positive effect revealed by the impulse response function.

On balance, then, the variance decomposition results coupled with the IRFs? suggest that exports do not respond to domestic spending, but that FDI and portfolio investment have weak positive relationships with welfare spending. Significantly, this finding has implications for the existing IPE literature. These tests reveal that existing models of globalization-welfare relationship do *not* suffer from endogeneity problems.

How confident should one be in these results? This question is especially pertinent since VAR is prone to making Type II errors (*i.e.*, to rejecting the alternative hypothesis when it's true), especially if highly-trended data result in the right-hand-side variables (the lags) being highly correlated with each other. In that case, the impulse-response functions tend to have wide confidence intervals (Franzese 2002: 117, *fn*61; Freeman et al 1998). To increase confidence in our finding that welfare spending has either a very weak or no effect on exports and investment,

therefore, we turn to several alternative econometric methodologies to estimate the effect of welfare spending on exports, FDI, and portfolio investment.

### *GMM and Instrumental Variables Analysis*

Table A3 below reports the estimated coefficient on our welfare spending variable using three different alternative estimation techniques to account for potential endogeneity. The first column reports the results of using a Generalized Method of Moments estimator, while the second and third columns report results from separate instrumental variable models.<sup>36</sup> We instrument welfare spending with the level of spending on health care since we have both theoretical and empirical reasons to believe that government health spending will be correlated with social security spending but not international economic variables .

**Table A3. GMM and Instrumental Variable Analyses**

<b>Estimator</b>	<b>Dependent Variable (all % of GDP)</b>		
	<i>Exports</i>	<i>FDI</i>	<i>Portfolio Investment</i>
GMM*	0.02 (0.03) <sup>49</sup>	-0.27 (0.48) <sup>58</sup>	0.19 (0.39) <sup>61</sup>
Instrumental Variable**	-0.003 (0.01) <sup>75</sup>	0.01 (0.05) <sup>82</sup>	0.05 (0.04) <sup>20</sup>
Instrumental Variable***	0.08 (0.09) <sup>42</sup>	-0.01 (0.28) <sup>98</sup>	0.02 (0.28) <sup>95</sup>

*Notes:*

1) \* Estimated using `xtabond2` command; \*\* estimated using `xtivreg` command; \*\*\* estimated using `xtreg` command with bootstrapped standard errors to account for generated regressor problem; all estimations conducted using Stata 9.2.

2) Cell entries are coefficients on welfare spending variable from separate models, each controlling for independent variables listed in Table 2 above as well as fixed effects. Standard errors corrected for clustering by country are listed in parentheses with p-values <sup>superscripted</sup>.

Regardless of estimation technique or of the globalization outcome used, the welfare spending variable is never statistically significant, which leaves us to conclude that our finding that welfare spending does not hurt a country's ability to participate in international markets or

<sup>36</sup> For reasons of space, we do not discuss the technical issues involved with these methods but refer interested readers to Arellano and Bond (1991), Arellano and Bover (1995), Bond (2002), Bond et al (2001), Heckman (1997), and Winship and Morgan (1999).

compete for international capital is robust, and not a spurious result generated through endogeneity.

**Table A4. Alternative Causal Mechanisms**

	<b>Economic Growth</b>	<b>Imports (% of GDP)</b>
Growth <sub>t-1</sub>	0.17 (0.06)***	
Imports (% GDP) <sub>t-1</sub>		-0.08 (0.05)*
Welfare Spending <sub>t-1</sub>	0.22 (0.26)	-0.11 (0.83)
Trade Openness <sub>t-1</sub>	2.15 (1.00)***	
Exports (% GDP) <sub>t-1</sub>		6.79 (2.61)***
Net FDI <sub>t-1</sub>	0.02 (0.15)	-0.32 (0.35)
Initial GDP per capita	-1.89 (0.42)***	
Growth in GDP per capita		1.47 (0.25)***
GDP per capita (Log) <sub>t-1</sub>		-5.21 (2.24)**
Time Fixed Effects	Yes***	Yes***
Country Fixed Effects	Yes***	Yes***
No. of Observations	891	967
No. of Countries	53	52

*Notes:* \*\*\*, \*\*, and \* indicate significance at the 1%, 5%, and 10%, levels respectively. Entries in parentheses are standard errors corrected for clustering by country. Unit and time fixed effects coefficients are suppressed to preserve space; joint tests of these effects indicate significance at  $p < 0.01$  for all models. Models estimated using STATA 9.2. Summary statistics provided in appendix